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Selective Distribution of Luxury Goods in the Age of e-commerce

An Economic Report for CHANEL

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EXECUTIVE SUMMARY

1. We have been asked by Salans, counsel for CHANEL, to provide an economic opinion on the justification for restrictions on internet distribution by luxury goods manufacturers operating selective distribution networks.
2. The current competition policy regime for vertical restraints in Europe¹ (“the Guidelines”) recognises that it is legitimate for luxury goods manufacturers to establish and maintain selective distribution networks for the commercialisation of their products. These rules recognise that the manufacturer has a legitimate interest in maintaining a “brand image” and ensuring a high-quality “shopping experience”, because these are an essential part of the goods the customer demands. Furthermore, there is wide agreement that sales-point service and advice is an important value-enhancing activity in this industry. The current policy thus recognises that there are legitimate concerns about lower-quality “bricks-and-mortar” stores undermining the “image” investment of the manufacturers, and the possibility that such outlets might free-ride on the sales and advice service provided by higher-quality outlets. Unless manufacturers have contractual instruments that can generate the right incentives for retailers to invest in brand image and provide sales-point services, image will decline and services that are valued by consumers will not be provided.
3. The policy question that the Commission is examining is whether the same types of arguments can justify restrictions on a new distribution channel, namely internet retailing. In the run-up to the next version of the Guidelines (to be issued in 2010), the Commission has to decide whether manufacturer restrictions on internet retailing should be disallowed in the face of the perceived benefits provided by the internet distribution channel. *Inter alia*, the Commission is considering whether allowing luxury goods manufacturers to impose restrictions on the internet sales of their products is anticompetitive, and ultimately undermines the realisation of the benefits of internet retailing for consumers.
4. The latter view has been promoted by the auction site eBay in a recent paper.² The paper argues that restrictions on internet sales are no more than attempts by “entrenched manufacturers” to increase profits through market segmentation. It further claims that consumers are deprived of the benefits of the internet as a sales channel as a result. In this paper we show that the claims in eBay’s document are misleading and ill-founded in the light of the state of economic research.
5. Theoretical research on vertical restraints strongly supports the conclusion that restrictions such as those associated with selective distribution are efficiency enhancing as they typically address an incentive problem in the vertical chain: left to their own devices, retailers would choose levels of advertising, investment in store image and sales advice, width of product

¹ Commission Notice – Guidelines on Vertical Restraints (2000/C 291/01) published in the OJEC of 13/10/2000.

² “Empowering Consumers by Promoting Access to the 21st Century Market – A Call for Action” (2008).

range and levels of stock that are inefficiently low. In addition, the existing empirical research on vertical restraints (including selective distribution) has shown that restraints that result from private contracting between manufacturers and retailers typically generate efficiency gains in the form of output expansion. There is therefore wide consensus among economists that vertical restraints are typically motivated by the desire to eliminate inefficiencies that would otherwise arise.

6. Economic analysis also shows that intervention against vertical restraints such as selective distribution is only justified in the very limited set of circumstances where the restraints can have exclusionary effects (essentially, foreclosure of other manufacturers), and these do not appear relevant to the case of the luxury goods industry.
7. Having set out the general framework, we examine closely in this paper why the incentive effects mentioned above arise powerfully in the luxury goods industry. Consumers value the luxury “feel” of their experience with the product, and typically buy it to enhance their own image. The “image” of a brand is an integral part of the product, and determines the willingness to pay of consumers. It is therefore important for the manufacturer to ensure that the product is not sold in outlets whose “image” is inconsistent with the one the brand wants to project. For the product to be perceived as “high quality”, the “presentation” has to be consistent across outlets and sales advice has to “match” consumers with the best choice of product for them. Free riding on the image created or the sales effort expended by other stores will lead to an underprovision of the sales “presentation” and sales effort that are critical for a luxury good. As a result, a set of vertical restraints is necessary to enhance the efficiency of distribution. We show how the existing contractual restrictions in distribution contracts, such as those of CHANEL, reflect precisely these concerns.
8. Turning to the internet as a distribution channel, we then explain that the well-understood efficiency properties of vertical restraints also apply in the case of internet distribution. Indeed the incentive problems that these restrictions are meant to address may arise even more powerfully with the internet as a distribution channel. First, the internet as a medium may severely constrain the projection of the image that a manufacturer strives to create. Indeed, some of the most efficient ways of organising internet offerings appear to conflict directly with the projection of a “luxury” image. At this point in time, there is still great uncertainty as to whether an internet offering critically undermines the luxury image that is central to many products in the luxury goods industry. Secondly, an internet retailer cannot provide the same type of services (e.g. sales advice) as a bricks-and-mortar store and therefore its costs are lower. Internet retailing can therefore generate strong incentives for customers to obtain services like product sampling and sales advice in a bricks-and-mortar store, only to make the purchase from an internet-only store at a lower price. In this sense, the internet distribution channel generates the same incentive problem as a bricks-and-mortar retailer who does not exert sales effort.
9. Thus the analysis of the efficiency properties of selective distribution agreements holds independently of the retail channel. Indeed, the specific technology of internet retailing may even aggravate the issues and make appropriate vertical restraints more important. The restrictions that are currently in place for internet distribution in the contracts of CHANEL

appear well motivated by an effort to address these incentive problems. While alternative approaches could be conceived (e.g. charging internet retailers a *higher* wholesale price relative to authorised bricks-and-mortar retailers), these have been held back in practice by a perception that they could be seen by the competition authorities as a form of price discrimination.

10. We also explain that the benefits of internet distribution are not foregone as a result of restrictions on internet-only stores. Much of the advantages of internet distribution can be achieved even with such restrictions in place.
11. We finally discuss the possibility – strongly advocated by eBay in its recent paper – that the primary purpose of restrictions on internet distribution is price discrimination, i.e. maintaining price differences across geographic markets because this allows for greater rent extraction for manufacturers. Without restrictions on internet retailing, claims eBay, consumers would be able to arbitrage between different prices in different regions, and this would lead to lower and more uniform prices. We explain that:
 - first, the incentive problem in the manufacturer-retailer relationship is more severe in the case of internet retailing for exactly the same reasons that price differences may be reduced – namely that the internet allows for virtually costless arbitrage between price in bricks-and-mortar stores and on internet sites. The case for vertical restraints is therefore strengthened, not weakened;
 - secondly, it is incorrect to assume (as eBay does) that it is generally in the interest of a manufacturer to limit competition between retailers of his own product: the manufacturer actively wants the retailers to compete, and not earn too high a margin, unless there are significant incentive problems in the manufacturer-retailer relationship. The existence of selective distribution is therefore a clear indication that the incentive problems discussed in the economic literature do matter;
 - thirdly, even assuming that eliminating all restrictions on internet retailing could help reduce price differences across borders (which is not at all clear), it is incorrect to assume that this would have a systematic pro-competitive effect. Price convergence typically means prices rise for certain consumers, while they decline for others. The average prices may be higher overall. It is indeed well established that in many circumstances prohibiting price discrimination has an anti-competitive effect and leads to higher price levels – either directly, or indirectly through the elimination of certain retail offerings from the market. Some price discrimination may also directly enhance efficiency, by increasing retail effort where there is the greatest demand for it. To the extent that restrictions on internet distribution play any role in maintaining price differences across countries, there is therefore no economic basis for concluding that these are generally anticompetitive, or harm consumer welfare.
12. The existing body of economic analysis therefore has some important policy implications. The economic literature on vertical restraints strongly suggests a general presumption that vertical restraints are efficiency enhancing. Only in exceptional cases, in which clear conditions are

met for anticompetitive effects, can intervention be justified. In all of those cases the burden of proof of the anticompetitive effects should be placed on the antitrust authority.³ This logic powerfully applies to the case of selective distribution of luxury goods. However, e-Bay's paper pushes for change in the EU directive that would generally place the burden of proof of the efficiency effects of any restraints of internet retailing on the manufacturers (regardless of the market share of the manufacturer). Such a policy approach is not justifiable on the basis of the existing body of economic research. It is especially wrong-headed for a new distribution channel like the internet, where firms themselves have to experiment with contractual arrangements to find out about costs and benefits of different retailing models.

13. The insights of the economic literature fully apply to the internet as a distribution channel, just as to any other channel. The mere fact that a new sales technology like the internet is available does not imply that standard economic analysis does not apply. Economic analysis strongly suggests that manufacturers will efficiently choose between different sales technologies unless some very special circumstances apply. Further, there is no reason to assume that a new sales technology constitutes an efficient distribution channel for every industry – even if it is identified with the “new economy” or the “21st Century economy” as in the e-Bay paper.
14. Any limitation on the choice and contractual structuring of distribution channels through antitrust law has the potential to restrict the ability of manufacturers to find the most efficient channel for their purposes. Intervention is only justified in circumstances where the potential anticompetitive effects are significant, and these are no more likely for restraints on internet distribution than they are in the case of any other distribution channel. Distribution over the internet should therefore not be treated differently as to the legality of vertical restraints when the Vertical Guidelines are updated.

³ These conclusions hold even for the more controversial restraints, such as resale price maintenance (RPM). The current state of economic research has been explicitly recognised by the U.S. Supreme Court in the *Leegin* judgment (“*Leegin*”), which recently overturned the *per se* prohibition of RPM in the US. US Supreme Court, *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, June 2007 (Docket No. 06-480).

1. INTRODUCTION AND STRUCTURE OF THE PAPER

15. We have been asked by Salans, counsel for CHANEL, to provide an economic opinion on the justification for restrictions on internet distribution by luxury goods manufacturers operating selective distribution networks.
16. Our analysis below is based on a review of the existing economic literature on the theory and practice of vertical restraints. In addition, we have reviewed CHANEL's contracts with authorised retailers, including, specifically, clauses relating to internet retailing, and we have been provided by CHANEL with information on the structure of its prices to retailers for its "Fragrance and Beauty" product lines.
17. This report is structured as follows. **Section 2** summarises the insights of the theoretical and empirical economic literature on vertical restraints. **Section 3** discusses the specific circumstances of the luxury goods industry and how they motivate the adoption of selective distribution arrangements. We discuss the features of CHANEL's distribution agreements and show how they address the underlying incentive problems inherent in the distribution of luxury goods. **Section 4** explains that the internet is not fundamentally different as a distribution channel. We show that the same incentive problems arise as for traditional retailing and discuss possible contracting solutions. **Section 5** explains why eBay's claims that restrictions on internet sales are anticompetitive are based on incorrect reasoning. **Section 6** concludes with some policy recommendations, based on the lessons of economic analysis.

2. VERTICAL RESTRAINTS: ECONOMIC RATIONALE AND EMPIRICAL EVIDENCE

18. Vertical restraints have traditionally raised concerns in antitrust enforcement because they tend to limit the degree of competition between retailers distributing products of the same manufacturer (so-called "intra-brand" competition). However, from an economic point of view it is puzzling that a manufacturer would ever restrict competition between retailers: any such restriction of competition would increase the retailers' (downstream) margins at the expense of the manufacturer's own (upstream) margin. Everything else equal, manufacturers would like very intense competition between their retailers in order to extract maximal profits from their products. This basic insight has not only undermined the traditional view of vertical restraints, but also posed a challenge to economic theory. Why would manufacturers impose competition-reducing constraints (such as exclusive dealing, territorial exclusivity, selective distribution, etc.) on retailers if these increase the profits of retailers at the expense of manufacturers?

The economic literature has studied this question extensively, and identified several efficiency reasons why manufacturers may want to guarantee downstream margins in order to induce retailer behaviour that increases demand overall. In this section we discuss the many facets of this efficiency argument, and contrast it with anticompetitive theories of vertical restraints. We conclude that it is much more likely that a manufacturer would reduce competition between its retailers when it is motivated by efficiency concerns. The available empirical

research confirms that vertical restraints reduce intra-brand competition but at the same time also tend to increase sales. The empirical literature thus largely supports the efficiency explanations of vertical restraints.

2.1 THE EFFICIENCY RATIONALE FOR VERTICAL RESTRAINTS

19. In the relationship between a manufacturer and a retailer, the retailer will normally take actions aimed at maximising its own profits. However, on any unit sold by the retailer the manufacturer will typically make some margin. The actions of the retailer will therefore have some impact on the upstream manufacturer's profits by affecting the quantity sold. But normally a retailer will not take this effect on the manufacturer's profits into account. For this reason, the retailer generally takes decisions that do not maximise the joint profits of the vertical structure (manufacturer and retailers). Decision making in the vertical structure will then be inefficient.⁴
20. The impact of retailers' actions on the manufacturer's profits is called a "vertical externality" in the economic literature on vertical relationships. In most of this literature, vertical restraints are explained as contractual agreements that help align the incentives of the retailers with those of the manufacturer, thus eliminating the vertical externality. In other words, vertical restraints help replicate the incentives a manufacturer would face if it were vertically integrated into retailing. Vertical restraints can therefore be viewed as contractual restrictions that allow the replication of vertical integration without the manufacturer taking ownership.^{5 6}
21. Any deviation of behaviour from that of an integrated structure arises because the margin of an independent retailer is lower than the margin of an integrated structure. This can come about either because the marginal wholesale price exceeds the marginal cost of manufacturing, or because competition between retailers reduces the margin for any wholesale price.
22. The first problem arises because, typically, the manufacturer needs to raise the (marginal) wholesale price above the marginal cost of manufacturing in order optimally to extract profits from his sales. This creates an "upstream margin". The marginal cost faced by the retailer is then the marginal retailing cost plus the wholesale price, which is higher than the total

⁴ There are some very limited assumptions under which two-part pricing can fully resolve the problem. However, these are almost never relevant in real industries. The difference between the retailer margin and the industry margin is a property of almost all vertical structures.

⁵ There are some exceptions to this general rule, which we discuss in section 2.2.

⁶ There are in fact a number of reasons why vertical restraints can be more efficient than outright vertical integration. A leading issue is that for many products there are large economies of scope in retailing that prevent vertical integration for most manufacturers. Another reason is that vertical integration will typically induce a separation of ownership and control for the downstream retailers, which can lead to important agency problems that might be even more severe than those that arise under simple contracting. (See R.D. Blair and F. Lafontaine: "The Economics of Franchising", Cambridge University Press, Cambridge 2005.)

marginal cost of a vertically integrated entity. Hence, the downstream margin is lower for the independent retailer than for a vertically integrated unit at any retail price.⁷

23. The second effect is present when there is downstream competition. Suppose that competition is perfect at the downstream level, and as a result the downstream price-cost margin is zero. If there are demand-enhancing activities (e.g. sales effort) that the retailer can undertake, then there is no return on such activities and the retailer would not undertake them. But since the marginal wholesale price exceeds the marginal manufacturing costs this is inefficient: there *would* be a return to demand-enhancing activities from the point of view of a vertically integrated structure.
24. Both effects therefore lead retailers to make decisions based on a price-cost margin that is “too low” from the industry perspective. This leads to a number of well-known inefficiencies in the absence of vertical restraints:

The “double marginalisation” problem

25. An independent retailer will set the final price based on the wholesale price he faces from the manufacturer, which includes a margin on the manufacturing cost. Because it includes this margin, the “marginal cost” which the independent retailer faces is higher than the marginal cost that an integrated manufacturer/retailer would face. As a result the final price is too high relative to the one that would maximise the joint profits of the vertical chain. Both the firms and the consumers would benefit from elimination of this “double marginalisation”.⁸
26. Note that the double marginalisation problem arises because the retailer generally has some market power. If retailers were perfectly competitive, they would not be able to extract a margin, and the manufacturer could set his wholesale price (and effectively the final goods price) just at the level that maximises joint profits. This means that in the absence of demand-enhancing activities by the retailer, the manufacturer would like to induce as much competition among his retailers as possible. However, this conclusion is altered when the manufacturer has to give the retailer incentives for demand-enhancing activities (besides the setting of the retail price). This creates a conflict between the extraction of rents – for which competition between retailers helps – and giving incentives for demand enhancing activities – which requires a retailer margin.

Sub-optimal retailer advertising

⁷ This is a general problem in markets where producers of complementary products set prices independently. This was first observed by Cournot in his book *Recherches sur les principes mathématiques de la théorie des richesses* (*Researches into the Mathematical Principles of the Theory of Wealth*), 1838 (1897, Engl. trans. by N.T. Bacon).

⁸ See for a standard theoretical treatment G.F. Mathewson and R.A. Winter, “An Economic Theory of Vertical Restraints”, *Rand Journal of Economics* (1984). A summary of the policy issues can be found in G.F. Mathewson and R.A. Winter, “Competition Policy and Vertical Exchange”, Royal Commission on Canada’s Economic Prospects (1984); and Mathewson, Frank and Ralph Winter, “The Law and Economics of Resale Price Maintenance”, *Review of Industrial Organization* 13 (nos. 1-2), (1998): 57-84. See also “Brief of Amici Curiae Economists in support of Petitioner Leegin in the Supreme Court of the US (*Leegin*)” (“Economic Brief”).

27. Retailer advertising (either persuasive or informative) will increase the number of buyers who purchase the product of the manufacturer. Since the margin of the retailer is smaller than that of an integrated firm, advertising will be too low compared to an integrated firm. To the extent that advertising increases the number of buyers who know about the availability of the product, there is again the possibility of a Pareto improvement when advertising is increased.⁹ Note that in contrast to the double marginalisation problem this vertical externality cannot be resolved through more competition at the retail level. Competition at the retail level erodes downstream margins, thus reducing the incentive to provide retailer advertising. Efficient solutions will therefore necessarily require restricting competition between retailers. This is the case for *all* of the efficiency issues that we discuss below.

Sub-optimal provision of sales advice

28. Retailer effort might not consist of advertising as we normally know it but might instead amount to giving advice to the customer as to the product they should choose. Buyers may not be completely informed about all characteristics of a product and value an improved “match” with the most suitable product. The retailer will achieve a better match between buyer and product, and therefore achieve higher value for the buyer, the greater the retailer effort. Again, a retailer will not capture the full value of increasing the likelihood of a sale, leading to too little effort in matching the customer with the right product. Achieving a better match can improve both the joint profits of manufacturers and retailers as well as increasing consumer benefits from a purchase.¹⁰

Conflicting incentives to carry a product

29. Conflicts between upstream and downstream incentives can also arise concerning the decision to carry a specific product. Typically, there is some fixed retailing cost associated with carrying a product. This may consist of the shadow value of the shelf or retailing space dedicated to the product at the retail outlet. A product with low market share will tend to “sit” on the shelf for longer, and the retailer may need to be guaranteed a larger margin to carry it. In such a case, competition between retailers may make it much more difficult to resolve such conflicts. As an example, consider a retailer with a large amount of retailing space and a retailer with little retailing space. In order to convince the smaller retailer to carry the product the manufacturer has to guarantee the smaller retailer a larger margin than the larger retailer. This will often only be possible if competition between retailers is limited because the wholesale price cannot be reduced sufficiently for the product to be carried. However, it may be better for the manufacturer (and for consumers) if more retailers carry the product – despite the difference in relative retailing costs. This is an especially important consideration for manufacturers who are market entrants.

⁹ See also Mathewson and Winter, *op. cit.*, as well as earlier literature – e.g. Telser, Lester, “Why should suppliers want fair trade”, *Journal of Law and Economics* 3 (1960): 86-195.

¹⁰ A related idea is discussed in Marvel and McCafferty (1984), who emphasise the role of quality certification of products by reputable retailers. Marvel, Howard and Stephen McCafferty, “Resale Price Maintenance and Quality Certification”, *Rand Journal of Economics*, 15 (1984): 346-359.

Conflicting incentives to hold inventory

30. A variant of the idea that there are conflicting incentives to carry a product is that there may be conflicting incentives to hold inventory of a product when demand is uncertain. Since the retailer's margin is smaller than the industry margin, the retailer has a smaller loss than the integrated unit would have should a stock-out occur. The retailer will therefore hold too small an inventory in the absence of vertical restraints. This means that overall sales will be lower when no vertical restraints are available.¹¹

Conflicts arising from carrying products of competing manufacturers

31. A retailer may have less of an incentive to carry a product of the manufacturer or make a strong effort to win sales for the manufacturer through retailing effort because the retailer also carries the competing products of other manufacturers. Additional effort to sell the product of one manufacturer partly redistributes some of the sales from one manufacturer to the other, which is of no great advantage to the retailer. This effect may reduce overall sales effort below what manufacturers would choose were they to sell directly. Similarly, these incentives may limit the range of products that a manufacturer supplies. Economic theory predicts that a retailer has an incentive to carry a narrower product line than the upstream manufacturer would like it to. Both effects can limit competition between manufacturers, as they reduce the ability to provide a greater variety of choice to customers. Without vertical restrictions to offset this incentive, the retailer would have inefficiently low variety in its brand portfolio.
32. **To summarise:** in all of these cases the conflict between upstream manufacturer and downstream retailer arises because the downstream retailer does not take into account that the upstream manufacturer benefits from demand-enhancing activities. As a result of this "vertical externality" everybody in the industry may be harmed. Manufacturers and retailers make lower profits and customers face higher prices and/or lower quality, services, and variety than in an environment with appropriate vertical restraints. For this reason vertical restraints are generally seen as efficiency enhancing.

2.2 POTENTIAL ANTICOMPETITIVE EFFECTS OF DISTRIBUTION CHANNEL RESTRICTIONS

33. Although theoretical research has generated a host of explanations for efficiency-enhancing vertical restraints, the economic literature has also identified some circumstances in which restraints may be anticompetitive. All of these theories look at the possibility that vertical restraints can reduce *inter-brand* competition between manufacturers. We show that these theories are of relevance only in very restrictive circumstances.

¹¹ See for instance Krishnan, Harish and Ralph A. Winter, "Vertical Control of Price and Inventory", *American Economic Review*, 96 (2007): 1840-1857.

Commitments to be a less aggressive competitor

34. There is a large economic literature that considers the impact of making “precommitments” that reduce the aggressiveness of subsequent price competition (see Bulow, Geanakoplos, and Klemperer (1985), Fudenberg and Tirole (1984))¹². An early application of this idea to vertically related markets can be found in Bonanno and Vickers (1988).¹³ The essential idea is that an upstream manufacturer can use the double marginalisation problem to commit his retailer to set a high price. When a retailer selling a rival manufacturer’s product observes a high wholesale price, the rival retailer will anticipate a higher price, and set a higher price itself. Rey and Stiglitz (1995)¹⁴ apply this idea to vertical restraints. They observe that many vertical restraints (like exclusive territories) can be used to reduce intra-brand competition between the retailers of the manufacturer. A commitment to such constraints therefore leads a retailer of a rival manufacturer to anticipate less aggressive pricing and thus induces higher prices in response. The idea is thus to use precisely the difference in margins faced by the vertically integrated firm and the independent retailer to “commit” to less aggressive behaviour in the market.
35. There are two problems with the application of this literature to competition policy. First, the actual effects on the price level tend to be of a small order of magnitude. The effect is always much smaller than reducing the number of upstream competitors by 1. The second problem is that commitments to less aggressive pricing are only credible if the commitment can be observed. While it is the case that the existence of vertical restraints like territorial exclusivity can be observed, it is important for the analysis of Rey and Stiglitz (1995) that the wholesale price schedule is observable as well. If it is not, then the results are either overturned or the order of magnitude of the effects becomes even smaller. Indeed, little attention is paid to these theories in policy advice because there is no empirical evidence that indicates that this effect is of any practical importance.

Facilitating collusion

36. Another concern expressed in the literature is that a vertical restraint can facilitate collusion in a market. This has been argued in a paper by Jullien and Rey (2007) for the case of Resale Price Maintenance.¹⁵ The idea is that RPM increases market transparency among manufacturers. Since wholesale price cuts are difficult to observe, it is hard for manufacturers to detect whether a retail price cut is a result of retailer costs (and behaviour) or induced by a

¹² Bulow, Jeremy I., John D. Geanakoplos, and Paul D. Klemperer, "Multimarket Oligopoly: Strategic Substitutes and Complements", *Journal of Political Economy*, 93 (1985): 488-511, and Fudenberg, Drew and Jean Tirole, "The Fat-Cat Effect, the Puppy-Dog Ploy, and the Lean and Hungry Look", *American Economic Review*, 74 (1984): 361-366.

¹³ Bonanno, G. and J. Vickers, "Vertical separation", *Journal of Industrial Economics*, 36 (1988): 257-265.

¹⁴ Rey, P. and J. Stiglitz, "The role of exclusive territories in producer's competition", *Rand Journal of Economics*, 26 (1995): 431-451.

¹⁵ Jullien, B. and P. Rey, "Resale Price Maintenance and Collusion", *Rand Journal of Economics*, 38 (2007): 983-1001.

deviation from a collusive wholesale price. By determining the retail price directly through RPM it becomes visible whether the manufacturer has deviated or not. The issue of market transparency is very specific to RPM, and does not extend to other restraints like selective distribution.

Of course this does not mean that it is impossible to construct models in which vertical restraints may facilitate collusion through a different channel. For example Nocke and White (2007)¹⁶ show that vertical integration can facilitate collusion by reducing the incentives of a rival to deviate from collusion. Essentially vertical integration denies a deviator one potential retail outlet. We believe this result can be replicated in a model in which exclusive dealing arrangements restrict the retailer to carry only the manufacturer's product. However, selective distribution systems are very different because they deny potential retailers the opportunity to carry the product. Such vertical restraints then *increase* the profits a rival can make in a deviation. These theories are therefore not applicable to selective distribution systems.

We also note that overall this is a very recent branch of the literature, and the plausibility of these theories is still being discussed. Moreover, if antitrust enforcement against collusion is rigorous it seems inappropriate to prohibit vertical restraints on this basis. Because vertical restraints have great potential for efficiency enhancement, it appears unreasonable to prohibit them in the absence of clear evidence of collusion. But if such evidence exists, enforcement against collusion should be sufficient to prevent collusive conduct. Furthermore, there is no evidence that points to the empirical relevance of these effects.

Vertical restraints and foreclosure

37. The economic literature is much more concerned with vertical restraints, especially exclusive dealing arrangements of all kinds, if they can lead to the *foreclosure* of another firm from a market. While other commitment effects have a marginal impact on price level, the elimination of a competitor could have a large effect – at least in a highly concentrated market.
38. Essentially, this concern would come down to a plausible possibility of one manufacturer denying access for another manufacturer to sufficient retail outlets. This concern appears implausible in industries where the retail function is relatively fragmented, so that a manufacturer could not realistically deprive a competitor of customers, by foreclosing access to retail outlets. For this to be an issue at all, very strong market power and very exceptional circumstances would have to be in place. In the absence of such exceptional features, there can be no realistic exclusionary concern.
39. Such concerns are particularly out of place for the selective distribution networks in the luxury goods industry. Selective distribution does not establish an outlet as an exclusive retailer for a manufacturer. Indeed, it simply limits the number of retailing outlets that a manufacturer sells

¹⁶ Nocke, Volker and Lucy White, "Do Vertical Mergers Facilitate Upstream Collusion?", *American Economic Review*, 97 (2007): 1321-1339.

to. This means that selective distribution networks cannot possibly have exclusionary effects on other manufacturers.

40. **In summary**, there is no basis in economic analysis for a presumption that vertical restraints have anticompetitive effects. The economic literature shows that concerns about a relaxation of inter-brand competition by vertical restraints must be limited to very specific circumstances. In particular, selective distribution cannot induce foreclosure concerns. But absent concerns about inter-brand competition, a manufacturer only has an interest to limit intra-brand competition if this is necessary to give incentives for efficiency-enhancing activities by the retailer. Anticompetitive effects are therefore highly unlikely.

2.3 EMPIRICAL EVIDENCE ON VERTICAL RESTRAINTS

41. While theory suggests that some anti-competitive effects are likely to be small and others cannot arise from selective distribution systems, it does not exclude the *possibility* of anticompetitive effects in some circumstances. It is therefore reasonable to look at the results of the empirical evidence, to help form a view about the presumptions that should be adopted by policy.
42. The empirical economic literature contains relatively limited systematic evidence on the effects of vertical restraints. Nonetheless, the available evidence supports the efficiency-enhancing interpretations of vertical restraints that are advanced by the theoretical literature and is inconsistent with the theories of anticompetitive effects.
43. A recent survey by Lafontaine and Slade (2008)¹⁷ finds that privately-agreed vertical restraints tend to increase the price of a product – confirming that intra-brand competition is reduced as a result of the restraints. But this does not mean that consumers are worse off. Indeed, all the studies reported in the survey that have sought to measure the *quantity* effects of voluntary vertical restraints have found that such restraints have led to greater sales (which indicates increased welfare). For instance Sass (2004) and Sass and Saurman (1993, 1996) find this result for exclusivity restrictions (i.e. exclusive dealing and exclusive territories) for the distribution of beer.¹⁸ Similar results are found by Hanssen (2000) for block booking in movie distribution, and Ippolito and Overstreet (1996) for RPM in glassware.¹⁹ Asker

¹⁷ Lafontaine and Slade, "Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy", *Handbook of Antitrust Economics*, MIT Press 2008.

¹⁸ Sass, T.R., "The Competitive Effects of Exclusive Dealing: Evidence from the US Beer Industry", *International Journal of Industrial Organization*, 23 (2005): 203-25. Sass, T.R. and D.S. Saurman, "Mandated Exclusive Territories and Economic Efficiency: An Empirical Analysis of the Malt-Beverage Industry", *Journal of Law and Economics*, 36 (1993): 153-77; and "Efficiency Effects of Exclusive Territories: Evidence from the Indiana Beer Market", *Economic Inquiry*, 34 (1996): 597-615.

¹⁹ Hanssen, A., "The Block-Booking of Films Re-Examined", *Journal of Law and Economics*, 43 (2000): 395-426. Ippolito, P.M. and T.R. Overstreet Jr., "Resale Price Maintenance: An Economic Assessment of the Federal Trade Commission's Case against Corning Glass Works", *Journal of Law and Economics*, 39 (1996): 285-328.

- (2004)²⁰ is the only study that has looked at the effects of voluntary vertical restraints on costs, and finds that costs were reduced as a result of exclusive dealing in beer distribution.
44. These results are consistent with a number of earlier case studies. Hourihan and Markham (1974)²¹ conduct a number of case studies showing that the abolition of vertical restraints (RPM in this case) as a result of regulatory intervention in the US led to a collapse of inventory holdings for those retailers where the price constraint was previously binding, as predicted by the theoretical work of Krishnan and Winter (2007)²².
45. The existing empirical research also provides evidence that protection of the retail margin by the upstream supplier (either through RPM or the use of selective distribution) may be important in preserving the incentives to carry the product. Andrews and Friday (1960) describe a number of industries in which intervention against vertical restraints led to a significant reduction in the number of retail outlets.²³ For example, the number of outlets for Schick shavers was documented to have fallen by 80% as a result of the policy intervention. Similar empirical evidence for the efficiency-enhancing role of vertical restraints in more recent times is presented in Marvel, Deneckere, and Peck (1996, 1997)²⁴.
46. Lafontaine and Slade (2008) note that there is a dramatic difference between privately agreed (voluntary) vertical restraints and government-imposed restrictions. They find that the latter almost always lead to worse outcomes on all measured dimensions: “higher prices, higher costs, shorter hours of operation, lower consumption, and lower upstream profits”. This suggests that – at least in the set of studies they review – restraints tend to be efficiency enhancing when they are chosen voluntarily but typically decrease efficiency otherwise.
47. Consistent with our assessment of the relevance of different theoretical approaches, these results provide very little empirical support for intervention against vertical restraints. While it cannot be excluded that some theories of harm could be relevant for some markets, these will be very special cases that require strong evidence. The available data simply do not justify a presumption that vertical restraints generally lead to anticompetitive effects.

3. EFFICIENCY BENEFITS OF SELECTIVE DISTRIBUTION RESTRICTIONS IN THE SALE OF LUXURY GOODS

20 Asker, J., “Measuring Cost Advantages from Exclusive Dealing: An Empirical Study of Beer Distribution”, Stern School of Business, New York University, mimeo (2004).

21 Hourihan, A.P. and J.W. Markham, “The Effects of Fair Trade Repeal: The Case of Rhode Island”, Cambridge, MA: Marketing Science Institute and Center for Economic Studies (1974).

22 *Op. cit.*

23 Andrews, P.W.S. and F.A. Friday, *Fair Trade: Resale Price Maintenance Re-examined*, 1960, Macmillan.

24 Howard Marvel, Raymond Deneckere and James Peck, “Demand Uncertainty, Inventories, and Resale Price Maintenance,” *Quarterly Journal of Economics*, Vol. 111, No. 3 (1996): 885-913; and “Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition,” *American Economic Review*, Vol. 87, No. 4 (1997): 619–641.

48. The incentive effects described in section 2.1 arise powerfully in the luxury goods industry. As a result, a set of vertical restraints appears to be necessary to enhance the efficiency of distribution. This has long been recognised by competition authorities.²⁵ In this section we briefly discuss the specific vertical externalities that play a central role in this industry, and then highlight how the existing contractual restrictions in distribution contracts reflect precisely these concerns.

3.1 PRODUCT IMAGE, SHOPPING EXPERIENCE AND “MATCHING” AS KEY CUSTOMER REQUIREMENTS

49. “Luxury” products appeal to large sections of consumers because of their lifestyle associations. Market research (and the marketing literature) consistently find that consumers value the luxury “feel” of their experience with the product (from packaging to texture to colour to scent) and buy luxury goods with the intent of enhancing their image – both in their self perception, and in their desire to present an appealing image to others. This is a common feature of fashion-related products. This means the value of a specific purchase will often be related to how *others* view the product, and a deterioration of image even in the assessment of people who are not consumers of the product can reduce the value of the product to the customer.
50. The “image” of a brand is therefore an integral part of the product, and determines the willingness to pay of consumers. Manufacturers of luxury goods invest heavily in preserving

²⁵ For instance in the YSL perfume case in 1991 (16th December, 1991, IV/33.242 - Yves Saint Laurent Parfums), the Commission recognised:

"Since the maintenance of a prestige brand image is, on the luxury cosmetic products market, an essential factor in competition, no producer can maintain its position on the market without constant promotion activities. Clearly, such promotion activities would be thwarted if, at the retail stage, Yves Saint Laurent products were marketed in a manner that was liable to affect the way consumers perceived them. Thus, the criteria governing the location and aesthetic and functional qualities of the retail outlet constitute legitimate requirements by the producer, since they are aimed at providing the consumer with a setting that is in line with the luxurious and exclusive nature of the products and a presentation which reflects the Yves Saint Laurent brand image. In addition, the criterion relating to the shop-name is designed to ensure that the name of the perfumery or shop or area within the perfumery counter or perfumery is situated is compatible with the principles governing the distribution of the products in question and thus to exclude any name whose image would be associated with an absence of or restriction in customer service and in standing and with a lack of attention to decoration. It should be stressed in this respect that the down-market nature of a retail outlet or of its name cannot be deduced from the retailer's habitual policy on prices."

And further, in analysing YSL's so-called "closed network" clause:

"..... the requirement incumbent on Yves Saint Laurent Parfums or, where appropriate, its exclusive agents to market the products bearing the Yves Saint Laurent brand name only in retail outlets that meet the conditions specified in the selective distribution contract is complementary to the specialization requirement imposed on authorized retailers and makes it possible to ensure uniform conditions of competition between resellers of the brand. Otherwise, competition would be distorted if Yves Saint Laurent Parfums supplied traders which, not being subject to the same obligations, had to bear financial charges that were appreciably smaller than those borne by the members of the selective distribution network. In such a situation, it would no longer be possible to require authorized Yves Saint Laurent retailers to continue to carry out their own obligations, with the result that the selective distribution system could no longer be maintained."

the image of the brand through advertising, promotions and endorsements, and in making sure each product reflects and supports the brand image. They do so because customers positively *value* the image that is associated with the brand and the product, for they perceive that image in part attaches to them when they choose and wear (or otherwise use) the product.

51. Consumers also attach value to the *experience* of buying the good because it affects their assessment of brand image. It is important that the presentation and the environment in which the good can be bought reflects the type of luxury experience that consumers aim to obtain through the purchase of the good.
52. Finally, the choice of a specific product is highly personal, as it reflects an image that a buyer has of herself, as well as the image the buyer wants to project to others. It is therefore important to provide the buyer with an opportunity to find the most suitable *match* between the whole range of products on offer and her own specific needs. In particular, the assessment of the image that is projected to others can be better assessed when the customer is provided with some feedback by a sales representative. Because many luxury goods are “experience goods” (e.g. we do not know how good a lipstick looks or a perfume smells on us until we’ve actually worn it), a “bad experience” with an unsuitable product may make consumers switch away from the brand altogether – even though a better “match” for the individual’s preferences might in fact be available in the brand portfolio. A “bad match” in the short run (e.g. through poor advice at the point of sale) has a cost both for the manufacturer, as it may lead the customer to switch brand altogether (long-run substitution to another brand), and potentially for the customer herself (if by switching brand she ends up with a suboptimal choice).

3.2 CONTRACTUAL RESTRICTIONS ON DISTRIBUTION ARE DIRECTLY MOTIVATED BY THESE CONCERNS

53. The specific restrictions that we observe in the formulation of distribution agreements for luxury goods are typically motivated by the concerns we have just discussed.
54. A first concern for the manufacturer is to ensure that the product is sold only in outlets whose “image” (location, type of outlet, outlet name, quality of fixtures and fittings, other brands sold) is consistent with the image the manufacturer is seeking to achieve for the product. Surroundings that do not conform to the luxury image of the product in one location will tend to diminish the value of the product to the consumer also at another – better – location. Ensuring consistency in the “image” of the product across points of sale may therefore be very important to the overall valuation of the product by consumers in this industry.
55. The presentation of the product (e.g. the product display) within the retail outlet is equally important. Such presentation involves a greater investment for luxury products than for many other products, and is therefore subject to the vertical externalities discussed in the theory section of this paper. Without any vertical restraints, retailers would have a tendency to invest too little to ensure a quality “presentation” of the product. It may also be difficult to project a coherent image for the product in the first place.

56. Contractual restrictions can be used in a relatively straightforward way to deal with presentation issues, since shop characteristics and retailer investment in the presentation of the product are in principle observable by the manufacturer (and can be verified by an outside court). Instead of providing indirect incentives for effort, the manufacturer can directly specify the required standards the retailer needs to adhere to in the contract. This is precisely what happens in practice in many cases: contracts with retailers list a set of “qualitative criteria” the retailer agrees to meet and maintain.
57. **[CHANEL Confidential]**. Besides the image of the product, the manufacturer wants to achieve the optimal “match” between customer and product. One aspect of this problem is that the manufacturer will want to ensure that the retailer carries the widest variety of the manufacturer’s products. This generates the greatest likelihood that a customer will find a good match within the product portfolio. As we have discussed, a retailer serving multiple manufacturers will have too small an incentive to carry the full product line. To ensure that retailers do not only carry a small number of best selling products but a wider product range, the contract can stipulate requirements of the range of products that has to be offered. Again this is an easily enforced restriction that takes care of a serious vertical externality problem. **[CHANEL Confidential]**. This is an economically reasonable and efficiency-enhancing restriction in contracting environments in which the matching issue between product and customer is an important element of the retailing activity.
58. A second aspect of “matching” consumer and product is harder to enforce: the “feedback and advice” that is offered to the customer about the image the customer projects as a result of choosing a particular product. The problem the manufacturer faces here is that when there is competition in the retail market, there are strong incentives for each retailer to minimise expenditure on trained staff, and free ride on the matching services of other retailers. A customer could thus visit one retailer, get all the advice she needs and then buy the product from another outlet that does not offer these services but offers the product at a lower price.
59. Of course the advice will be better, and the cost of offering the advice lower, if the sales staff are better trained at advising customers. Making training available and requiring retailers to send staff to the training provides a direct way for the manufacturer to address part of this incentive problem. Furthermore, to the extent that quality can be assured by staffing levels, these can be directly written into the contract and monitored.
60. However, the amount and quality of the retailer’s effort in giving matching advice to the customer is ultimately hard to monitor for the manufacturer (and even more so for an outside court). Regular training can reduce the sales staff’s cost of providing effort, but for the staff to actually make the effort and apply the training, indirect incentives have to be given to the retailer. As a result, optimal vertical contracts need to provide appropriate monetary incentives to the retailer. Since effort cannot be observed directly, such monetary incentives can only be given by conditioning them on the result of the effort. However, the result of the effort is making a sale. The manufacturer therefore has to give the retailer some payment per sale made. This is nothing else but guaranteeing an extra retail margin to compensate for the retail (matching) effort involved. As we have seen from the discussion of the theory, an extra margin to incentivise sales effort can only be implemented by limiting competition between

retailers. It is therefore not enough to contractually specify the size and quality of the sales staff. To guarantee efficient service quality, incentives have to be given through the retail margin, and thus vertical restraints that limit intrabrand competition can be justified for efficiency reasons.

4. HOW DIFFERENT IS THE INTERNET AS A DISTRIBUTION CHANNEL?

61. How is the analysis we have just outlined affected by the availability of the internet as a distribution channel? Recent lobbying efforts²⁶ are seeking to overturn the acceptability of established contractual restrictions as far as internet retailing is concerned. This is based on the claim that the internet fundamentally revolutionises retailing, and that the use of vertical restraints eliminates the benefits the internet can generate. Based on this argument, eBay is lobbying for a change in the vertical restraints guidelines that would effectively establish a presumption of unlawfulness for any restrictions on internet retailing. In this section we explain that there is no economic justification for such a policy. First, the arguments for the efficiency of selective distribution systems are not fundamentally changed when considering the internet as a distribution channel. Second, most of the real benefits from the internet can still be achieved in the presence of restrictions on distribution.
62. In a general sense, an internet store is an outlet like any other. The basic motivation for the introduction of vertical restraints applies in exactly the same way as for bricks-and-mortar stores. First, the concerns about controlling the brand image are legitimate independent of the retail channel. Second, the possibility of an internet outlet free-riding on the image and services provided by bricks-and-mortar stores is just as legitimate as concerns about some bricks-and-mortar stores free-riding on others. The analysis of the efficiencies of selective distribution systems applies independently of the specific retail channel. In this section we show that the specific technology of internet retailing even aggravates the efficiency issue and makes appropriate vertical restraints more important. Indeed, the restrictions that are currently in place for internet distribution in contracts such as those of CHANEL appear well motivated by an effort to address these incentive problems.

4.1 WHAT IS DIFFERENT ABOUT THE INTERNET AS A RETAILING TECHNOLOGY?

63. The distinctive feature of the internet as a retailing technology is that it allows the basic transaction activity to take place at relatively low cost. Internet retailing is also unconstrained by shelf space in the retail outlet, so that concerns about ensuring that the retailer carries the full product line will not necessarily arise to the same extent (unless the internet retailer has a business model in which it needs to carry inventory of the products offered).
64. At the same time, the implications of internet distribution for the image that luxury goods would like to project are unclear. If internet distribution were perceived as similar to an

²⁶ "Empowering Consumers by Promoting Access to the 21st Century Market – A Call for Action" (eBay 2008).

upscale department store, there may be little dilution of brand image. But the luxury image could be seriously undermined if internet distribution were perceived as similar to a discount store. This uncertainty alone may create legitimate reasons for manufacturers to abstain from the internet as a distribution channel.

65. As discussed, in the case of bricks-and-mortar stores “image” issues can be relatively easily taken care of by directly imposing specific conditions on the sales environment in a retailing contract. While in principle this solution is also available for internet retailing, in practice it is much more difficult for brand owners to control systematically the “image” projected by internet outlets. Design requirements cannot always be easily accommodated by the website design of an internet retailer (indeed it is as a response to this problem that CHANEL has developed an “internet sales module” software that internet retailers could plug directly into their website).
66. In addition, in internet retailing there are large economies of scale associated with selling many different goods based on the same type of interface. For many goods the optimal presentation would rank offerings by price. For luxury goods such a presentation may well have a diluting effect on the brand image. However, imposing an appropriate sales environment through a different screen presentation would increase the costs of internet retailing.
67. Internet retailing is also a very poor technology for providing sales-related services such as personalised advice (the “product matching” role of the bricks-and-mortar retailer). As we have argued, this function of the distribution channel is very important to ensure an efficient sales structure for luxury goods. An internet store cannot provide the “matching” services (between the customer and the product) that can be provided in a bricks-and-mortar store. In a conventional outlet the customer can try out the product in real light, compare the match with his/her image and have a specialist in-store advisor provide feedback. Physical proximity to the product and the sales person providing the feedback is essential for providing the service. None of this is possible in the case of internet purchases, as the store website can at best contain a photo and a description of the product but does not allow trying out the product and getting direct feedback.
68. In this respect the luxury goods industry is quite different from other industries in which retailing has shifted more dramatically to the internet. Take for example the case of domestic appliances or computer equipment. Subjective assessments of aesthetic value (real light, atmosphere, trying out a fit etc.) are relatively unimportant for these products. What is crucial for the customer is objective information about characteristics and performance. This information can be very efficiently provided over the internet. It is therefore not surprising that manufacturers have found it beneficial to move a large proportion of sales for these products to the internet. In fact, today it is very hard to get any good sales advice at a bricks-and-mortar retailer about a computer purchase. The difference in the characteristics of computers (or domestic appliances) and luxury goods very much explain the different importance of the internet as a sales channel.

69. On the other hand one could argue that it is no easier to select fresh produce over the internet than to buy personal luxury goods items, and yet fresh groceries are purchased in significant quantities over the internet. While that may be true, this is irrelevant for the assessment of vertical restraints. With fresh produce it is not possible to make the selection of an especially nice apple and then buy that same apple on the internet at a lower price. Hence, an internet retailer has no opportunity to free ride on the costs a bricks-and-mortar grocery store incurs by providing a consumer with the ability to inspect the product. In this case there is no reason for a manufacturer to limit distribution over the internet and, in fact, manufacturers do not impose such limitations.
70. This analysis does not imply that the internet cannot play any role as a sales outlet for luxury goods. Customers who already know their ideal match for a product and simply wish to re-order (i.e. repeat purchasers) may very well prefer the convenience of an internet-based order over a visit to the store. Hence individuals who have been “matched” in the past, or care little about the “match”, may well benefit from the existence of internet sales. To the extent that this is true there will be an incentive for manufacturers to have an internet presence.
71. For the efficient design of a distribution network, a luxury goods manufacturer may thus want to reap the benefits of an internet sales channel (in terms of convenience for consumers), while ensuring at the same time that this does not negatively impact the part of the business that relies on personalised “matching services” and that such a presence does not detract from the projection of a luxury image to customers.
72. When luxury goods producers want to use both the bricks-and-mortar sales channel and the internet channel the difference in the two sales technologies leads to a significant problem. By its technology the internet distribution channel cannot provide the matching services of the bricks-and-mortar store. The internet retailer will therefore have lower costs, and so the internet distribution channel generates the same problem as a bricks-and-mortar retailer who does not exert sales effort. Internet retailing can therefore generate strong incentives for customers to obtain matching services in a bricks-and-mortar store, and then make the purchase from an internet-only store at a lower price.
73. The problem of internet retailing free riding on bricks-and-mortar “matching” services would never arise if the retailer could charge for the service separately. Then the customer would pay for the service whether it takes place in the bricks-and-mortar outlet or not. Competition between bricks-and-mortar outlets and internet retailers would equalise the price of the product but incentives for effort would not be reduced because effort would be compensated directly. The problem with such a solution is that service (or “matching” effort) cannot be measured except when it leads to a purchase. There are theoretically two ways that a customer can pay for service. First, the customer could pay for a given service time. But then it is difficult to prove that the employee worked hard enough to justify the payment. Alternatively, the employee is paid for a successful match. But then the customer can always claim that he/she did not find a match and still buy on the internet, avoiding payment for the service. Essentially, any sales effort that aims at matching the consumer with the right product cannot be contracted for. As a result, sales effort must be compensated through the purchase

price of the product. In the next subsection we discuss how efficient retailing solutions can be obtained through contractual restraints.

4.2 EFFICIENT SOLUTIONS TO THE CONTRACTING PROBLEM FOR THE LUXURY GOODS INDUSTRY

74. There are in principle a number of possible efficient contractual solutions to the incentive problems we have identified.

a) Imposing conditions on presentation

75. Because product presentation is directly observable, it should be possible for the manufacturer to impose directly contractual conditions on how the product must be presented for sale on the internet. Since the basic incentive problem is the same as for bricks-and-mortar stores, manufacturers should be allowed to impose requirements on how the product is to be showcased – as is the case today for a bricks-and-mortar store. Of course, the requirements will have to be different because the presentation technology differs. But while such constraints entail costs for retailers, there is no economic basis for a concern that the manufacturer could generate significant anti-competitive benefits to himself by increasing the retailing costs of his distributors. Thus insofar as luxury goods manufacturers are concerned about the implications of internet sales for the “image” of their products, they must retain the ability to write such restrictions into contracts – independently of other vertical restraints. This also means that manufacturers must be able to exclude from their distribution systems internet retailers that do not comply with these criteria.

b) Differential pricing for brick-and- mortar stores and internet retailers

76. One possible way to generate efficient outcomes with respect to retailing effort would be for the manufacturer to charge *different* wholesale prices to bricks-and-mortar retailers and (pure) internet retailers. In such a solution the internet retailers would have to pay a *higher* wholesale price. This could be achieved, for example, by offering bricks-and-mortar retailers a per-unit discount on the wholesale price to guarantee them an additional margin. Such a discount should be interpreted as a compensation for the costs of the sales effort. Competition between internet and bricks-and-mortar outlets would still lead to arbitrage, and possibly to greater retail price convergence between retail channels. But the retailer would still have incentives for sales effort. Allowing a manufacturer to charge systematically different wholesale prices would avoid undermining the purpose of selective distribution, while at the same time allowing customers to benefit from internet offerings.

77. The problem with this solution is that it may be misunderstood as price discrimination and as such not accepted by competition authorities. We note, however, that from an economic perspective differential wholesale pricing does *not* amount to price discrimination because the difference simply reflects compensation of the retailer’s effort cost by the manufacturer. These are therefore different transactions that should be allowed to occur at different prices. Conditioning the wholesale price on whether a retailer provides sales services or not is *not* a form of price discrimination.

78. It should also be noted that differential pricing of this type would *not* undermine progress towards a “unified European market”, in the sense that this is commonly understood, namely the “convergence” of retail prices between countries/regions. Since an internet retailer will still compete with all bricks-and-mortar outlets in this scenario, price differences may be arbitrated away (or at least reduced). If one views such convergence as one of the potential benefits of the internet, this benefit would be preserved when internet and bricks-and-mortar outlets face different wholesale prices.²⁷
79. Of course, differential pricing does not directly solve the problem of ensuring that internet distribution will optimally present a product image. For this purpose one would still need the right of the manufacturer to contractually restrict the internet presentation. But under a regime of differential pricing the manufacturer would always make optimal decisions about restrictions imposed on internet presentation (and if the internet was in danger of diluting the luxury image of the brand, the manufacturer should be able to optimally decide to exclude this channel).

b) Resale price maintenance

80. An RPM solution would be problematic in Europe as RPM remains per-se illegal here. Nonetheless, *in principle* RPM would have a similar effect to allowing differential wholesale pricing. The manufacturer could eliminate undercutting by internet outlets through a minimum price floor, which would allow him to guarantee the bricks-and-mortar retailer a margin for effort incentives. Again the internet presence would lead to a tendency for price equalization across different geographic regions. Economically this solution is less efficient than the one of differential pricing since the internet retailer has to be given the same margin as the bricks-and-mortar retailer. This leads to inefficiently low sales through the internet channel.
81. As with a differential pricing strategy, it would be necessary to allow manufacturers to impose restrictive conditions on internet presentation to take care of the image issues we have discussed earlier.

c) Vertical Integration into Internet Retailing by the Manufacturer

82. An alternative approach to escaping the free-riding problem would be for the manufacturer to integrate vertically into internet retailing. Vertical integration would allow the manufacturer to sell only from its own site and not allow internet retailing by any other firm.
83. Note that a firm that is vertically integrated into retailing has generally no obligation to allow competing retailers to carry the product. There are no economic reasons why a manufacturer should be treated differently if it chose to vertically integrate into internet retailing. Vertical integration into internet retailing would resolve the incentive issue because the manufacturer would fully take into account the incentive effect on retail effort when setting the internet price.

²⁷ We leave it open at this point whether “market integration” is a desirable objective for competition policy rules. We do not believe that policies based on this objective can be justified on grounds of economic efficiency.

It would also resolve the problem of controlling the internet presentation of image because the manufacturer does not have to make compromises over internet presentation with an internet retailer who also sells other products.

84. It is impossible to establish theoretically whether this is the most efficient solution. For example, for bricks-and-mortar retailing, vertical separation is probably more efficient because of economies of scope in retailing. This might be a factor for internet retailing as well, although economies of scale might make a centralized internet retailing operation feasible. There may also be benefits to the company of having its products presented alongside other luxury products, because consumers may want to shop where they find the greatest selection. In such circumstances it may not be a good solution to have a website that only offers one's own brand.
85. On the other hand, a centralised vertically integrated internet site would allow the manufacturer to completely control the image of the luxury product. It would not involve specific investments by a separate retailer to adapt their internet presence to the requirements of manufacturer. Indeed, since any such effort would involve considerable non-contractable investments by the retailer, this may fall into the typical class of cases in which the theoretical literature suggests that vertical integration may be optimal. Hence, whether vertical integration into retailing or a decentralised solution with differential pricing is preferred will depend very much on the specific demand characteristics of the good and the particular product line. Both solutions would go in the right direction in terms of establishing efficient incentives for sales effort – although they may differ in the degree to which product presentation can be optimally designed.

d) Other Restrictions on Internet Retailing

86. If none of the solutions we have discussed so far are available, the only other solution that can address the incentive problem for bricks-and-mortar sales effort is to limit the scope for internet-only offerings. We tend to observe such restrictions in practice today, presumably because the other solutions we suggest currently are considered problematic for antitrust reasons. Selective distribution agreements for luxury products typically require three restrictions on internet retailing: (a) Manufacturers typically stipulate that only a retailer with an authorised bricks-and-mortar presence can be active as an internet retailer. (b) The price charged for internet sales has to be the same as in the bricks-and-mortar store. (c) There are often quantitative restrictions on internet sales that establish a maximum share of internet sales in total sales for a retailer.
87. These restrictions directly address the problem of internet free-riding that could undermine the incentives for the provision of retailing effort. Joint ownership of bricks-and-mortar and internet operations combined with uniform pricing across the two outlet types may reduce this problem because the retailer internalizes effects across the two outlet types. However, the incentive problem can only be truly solved when a sales restriction is imposed. Otherwise a bricks-and-mortar retailer could qualify as an authorised internet retailer by having a retail outlet that satisfied all qualitative and other requirements set by the manufacturer. But by taking advantage of its freedom to set the final price (as recognised in the contract), this

retailer could then set a low price *both* for the brick-and mortar-store and the internet channel. The retailer would meet the relevant contractual conditions, but it would effectively make most of its business as an internet retailer. As the internet has no geographic boundaries (other than those created by transport cost), customers would have an incentive to seek matching effort at their local bricks-and-mortar store and then buy (and pay) only at the internet store. A retailer that has no restrictions on internet sales can effectively become the equivalent of an internet-only business that runs a small bricks-and-mortar outlet simply to qualify as an internet retailer. Then none of the incentive problems are resolved.

88. It should again be clear that any issues concerning the presentation of product image on the internet outlet are not directly resolved through this solution. As in all other cases they are most efficiently resolved by allowing the manufacturer to directly impose restraints on the internet presentation, just as the manufacturer imposes presentation conditions on bricks-and-mortar outlets.
89. The restrictions that we observe in CHANEL's contracts are therefore reasonable given the potential for free-rider problems, and the difficulties that can arise with adopting other efficiency-enhancing solutions that we have outlined. While the exact proportion can be debated, a quantitative limitation of this kind is precisely what economic analysis would suggest as a natural and necessary response to the free riding problem in the absence of the instruments of differential pricing, RPM, or vertical integration into internet retailing.
90. The solution of restrictions on internet sales volume is undoubtedly less efficient than the other solutions we have suggested above. It also reduces the scope for internet retailing to lead to the convergence of retail prices across different regions. We believe it is indeed one of the costs of a restrictive policy towards vertical restraints that potentially more efficient retailing structures are not chosen because of concerns about antitrust liabilities.

5. IS RESTRICTING THE INTERNET AS A DISTRIBUTION CHANNEL ANTICOMPETITIVE?

91. In recent times arguments have been put forward that restrictions of internet distribution should be generally seen as anticompetitive, unless the manufacturers concerned can prove otherwise. This has been advanced especially forcefully in the recent "Call for Action" paper circulated by eBay, which explicitly identifies selective distribution as one of the key "threats" to realising the benefits of the internet.²⁸ The paper calls for the "EU's Vertical Restraints Regulation (Regulation 2790/1999) to be amended to ensure that restrictions on dealers' abilities to use the Internet are prohibited" (p.14). Central to this policy advice is the claim that the economic analysis of vertical restraints with respect to the internet should be viewed as fundamentally different from the established economic analysis because a different sales

²⁸ "Empowering Consumers by Promoting Access to the 21st Century Market – A Call for Action" (2008). Other "threats" are the allegedly "outdated trade mark law", "divergent consumer protection rules", and "potentially incorrect implementation and enforcement of the EU Services Directive".

technology is involved. However, this claim has no basis in economics. The analysis of vertical contracting does not depend on any specific technology. As we have demonstrated above, the analysis remains fundamentally unchanged.

92. Once this is clarified, it becomes clear that the critical view of vertical restraints promoted in the eBay paper is essentially a return to old arguments about vertical restraints, that the economic literature of the least 40 years has shown to be incorrect. For instance, eBay's paper argues that manufacturers profit from limiting intra-brand competition, and that limits on vertical restraints therefore limit manufacturer market power. We show below this is simply incorrect.

93. The eBay paper also promotes a second argument against restrictions on internet retailing. It claims that the primary purpose of restrictions on distribution channels is price discrimination – i.e. maintaining price differences – across geographic markets, because this allows for greater rent extraction. The paper states that:

“... [some manufacturers] have strong interests in defending the status quo and in undermining challenges to entrenched distribution models. (...) Enormous margins are generated through the use of pricing “segmentation strategies”. These divide the market for each product into segments (often geographically), with different prices being charged in different segments. The objective: to control supply and prevent “intra-brand” competition in any one segment, thereby maximizing margins. Seeking to justify these margins, entrenched manufacturers have pointed to the value that their brands bring to the consumer – i.e. that the consumer actually benefits from paying a higher price. In light of the information now available to consumers, these claims are questionable and such strategies seem to serve only the interests of the manufacturers, and not those of the 21st Century consumer”.

94. Essentially, the paper argues that restrictions on internet sales are adopted because manufacturers increase profits through market segmentation. Without restrictions on internet retailing, consumers would be able to arbitrage between different prices in different regions, and this would lead to uniform prices. The eBay paper completely overlooks that precisely this feature of the internet greatly complicates the resolution of the free-riding problem facing luxury goods manufacturers. As we have explained in Section 4, any shopper has the option of comparing prices in their local bricks-and-mortar store with online offers from anywhere. But that means that having received costly “matching” services in the bricks-and-mortar store, the shopper can go home and purchase online if the online price is lower than the bricks-and-mortar price. As the online store has lower marginal cost (it does not have to provide the same services), prices will be competed down to a lower margin. This will make it difficult to maintain the density of bricks-and-mortar outlets, and will therefore reduce the benefits for those consumers who value the “matching” service. The internet's effectiveness in eliminating price dispersion across different retailers is precisely what undermines the incentive effects of a selective distribution system. Restrictions on internet selling of some sort are therefore needed to avoid the kind of free-riding problem that has motivated the adoption of selective distribution in the first place.

95. We address below in more detail the claim in eBay's paper that restrictions to internet distribution preserve market segmentation, and are anticompetitive.

5.1 THE "INTRA-BRAND COMPETITION" FALLACY

96. It is a common misconception, repeated in the eBay paper, that it is in the interest of a manufacturer to limit competition between retailers of his product. This is false because it is costly for the manufacturer to leave a margin to the retailer. The manufacturer *benefits* from greater competition between retailers, either because, for a given wholesale price, retail prices are lower and sales are greater, or because the same sales can be induced with a higher wholesale price. Indeed, an optimal response to greater retail competition typically involves lower consumer prices, higher sales, and higher wholesale prices. This is a direct consequence of the double marginalization problem discussed earlier in the paper.²⁹
97. This means that the manufacturer can only have an interest in ensuring a margin for the retailer if this provides incentives to the retailer for other sales-enhancing activities that the manufacturer cannot control *directly*. Indeed, we have seen that the empirical literature consistently finds that sales are expanded when there is private agreement to impose vertical restraints. But sales-enhancing activities benefit the customer – even when prices rise as a result. This observation has a direct policy consequence. Since activities of the manufacturer to guarantee retailer margins are only rational when sales-expanding activities are incentivised, manufacturers should not have to prove that this is the purpose of the restraint. In contrast, eBay's paper essentially calls on policy makers to disallow vertical restraints on the internet unless an efficiency enhancing effect can be demonstrated. This directly contradicts what economic analysis suggests.
98. The conclusion that a manufacturer should generally be interested in intra-brand competition, unless there is a need to support demand-enhancing efforts, also explains why the economic literature has focused on the importance of *inter-brand* competition, i.e. competition between manufacturers. Note that the idea that competition authorities should be concerned about promoting intra-brand competition when inter-brand competition is low is another version of the fallacy that we just discussed. Even when the manufacturer is a monopolist, its preferences about the intensity of downstream competition will be qualitatively aligned with those of a competition regulator in most standard models of vertical contracting.
99. One caveat to this general conclusion has been identified in a recent literature on secret individualised contracting between manufacturer and retailer (see Rey and Tirole (2007)).³⁰ In this literature, downstream competition leads to an erosion of upstream manufacturer

²⁹ The only exception to this statement is the commitment theory discussed in section 2. As we have shown there it is highly questionable whether it has any empirical relevance. The general claim that manufacturers have a general interest in relaxing competition between their retailers is incorrect even if the possibility of the commitment story is taken into account.

³⁰ Rey, Patrick and Jean Tirole, "A primer on foreclosure", Handbook of Industrial Economics, Vol 3, North-Holland 2007.

profits, and therefore the manufacturer has an interest in limiting such competition. There are however at least two reasons to think that this class of theories are of little relevance to the markets we are considering. First, the theory requires that the manufacturer can price discriminate against the retailers by setting different wholesale prices. However, our understanding is that (**CHANEL Confidential**).

100. In addition, the theory implies that the imposition of selective distribution agreements should lead to lower overall sales, a result that – as we have mentioned – is contradicted by the existing empirical literature. We do not therefore believe that the literature on secret individualised contracting can justify a presumption that the manufacturer generally benefits from restricting intra-brand competition.

5.2 IS PRICE DISCRIMINATION ANTICOMPETITIVE?

101. The most distinctive feature of an internet retailer is that it is not bound to a geographic location. This means that any internet retailer is in competition with all bricks-and-mortar outlets – independent of their locations. The eBay paper argues that this aspect of internet retailing can bring about fast and effective arbitrage across different geographic regions, leading to the convergence of prices across different regions, and that the internet therefore fosters the integration of markets. The eBay paper then alleges that the main reason for restrictions on internet distribution imposed by manufacturers is that this supports price discrimination in the final goods price between customers in different countries (or regions), which leads to higher profit extraction of the manufacturers. eBay concludes that it is anticompetitive for manufacturers to adopt restrictions that preserve price discrimination.
102. The fact that the internet retailers can compete with bricks-and-mortar retailers independently of location, and that this *can* favour greater price convergence, is not in dispute. However, the conclusions that the eBay paper draws about anticompetitive effects and the motivation for the adoption of restrictions on internet retailing are not supported by economic analysis or the facts. First, eliminating price discrimination does not have a systematic pro-competitive effect. Indeed, in many circumstances the prohibition of price discrimination leads to higher price levels. Furthermore, disallowing differential pricing between bricks-and-mortar retailers and internet retailers can reduce market efficiency. Indeed, some scope for price discrimination may actually be efficiency enhancing by increasing retail effort where there is the greatest demand for it.

Price discrimination does not raise all prices

103. It is wrong to assert that price discrimination implies higher average prices. Price discrimination on a geographic basis means prices are higher for consumers in some locations, and lower for consumers in other locations. Integration of markets that eliminates price discrimination would lower prices for some consumers but raise them for others. Average prices may go up or down depending on the exact form of the demand function. For this reason, the welfare effects of price discrimination are ambiguous. There is no sense in which the elimination of price discrimination leads to an increase in competition. Eliminating

price discrimination does not have any systematic *level* effect on prices, and provides no systematic incentive for the upstream firm to increase prices for better rent extraction.³¹

104. Katz (1987) has developed an argument that this established reasoning on price discrimination may break down for price discrimination by input suppliers into oligopolistic downstream markets.³² Superficially his setting is very similar to the one we consider here: one firm is present in many local markets (internet retailer) while other firms are only local. But to obtain his results of a systematic price effect, the internet retailer must have the option to backward integrate into manufacturing of the product. That is simply not realistic for an internet retailer that makes money by offering a broad product range. This paper is therefore not applicable to evaluating the effect of restraints on internet retailing.

Allowing price discrimination can make the market strictly more competitive

105. The result of Katz (1987) has been recently turned on its head for more realistic settings that model the bargaining behaviour between manufacturers and retailers. If the manufacturer can price discriminate by bargaining out individual market conditions it can be shown this strictly lowers prices. This is shown for example in O'Brien and Shaffer (1994)³³. Essentially, the retailer has an incentive to strike a bargain that puts it in a better position relative to the rival retailer. Hence, there is an interest in concluding a contract with low marginal costs and high fixed costs. This ex-ante competition between retailers lowers their effective marginal costs and thus leads to lower prices in the final goods market. It is therefore much more plausible that allowing for price discrimination in wholesale pricing will lead to lower final goods pricing.

Price discrimination may allow more efficient provision of services

106. There may be also regionally systematic differences in preferences over sales services, which mean that at the margin, a customised advice and "matching" service may not be valued uniformly in all regions. If this is so, then the optimal way of providing retailers with incentives to offer the service inevitably generates different margins (and sales prices) in different regions. To the extent that such differences exist, forcing markets with different preferences for bundled sales services towards a uniform margin would lead to under-provision of such services in the region that values the service highly, and to over-provision where it is not valued as highly. The outcome is likely to be inefficient.
107. In conclusion, claims about the anticompetitive effects of price discrimination do not stand up to economic analysis. Modern economic theory has firmly established that either there are no

³¹ This is a standard, well established result. See for instance Hal Varian (1989), "Price Discrimination", Handbook of Industrial Organization, Vol. 1, North Holland.

³² Katz, Michael, "The welfare effects of third-degree price discrimination in intermediate good markets", *American Economic Review*, 77 (1987): 154-167.

³³ O'Brien, D. and G. Shaffer, "The Welfare Effects of Forbidding Discriminatory Discounts: A Secondary Line Analysis of Robinson-Patman," *Journal of Law, Economics and Organization*, 10 (1994): 296-318.

systematic price level effects or there may even be a tendency for enhanced competition when there is upstream price discrimination.

5.3 THE EFFICIENCY BENEFITS OF THE INTERNET CAN BE OBTAINED WITHOUT RESTRICTING THE CONTRACTING CHOICES OF MANUFACTURERS

108. eBay's paper makes the claim that an extension of selective distribution restrictions to internet distribution undermines the ability to achieve the benefits of the internet. This is another false claim. Internet benefits can generally be achieved without restricting manufacturers' ability to design their contracts with retailers.

Market integration benefits

109. Even if one accepted (a) that vertical restraints (and especially restrictions on resale between retailers) can help support geographic price discrimination, and (b) that geographic price discrimination is undesirable as a matter of policy, it does not follow that intervention to restrict the use of selective distribution agreements would be an appropriate form of policy intervention.
110. The market integration effect of internet retailing arises because local bricks-and-mortar retailers are in competition with internet retailers that can sell to customers anywhere. As a result of such competition, prices in different geographic areas will tend to converge. If the manufacturer could extract more profit through geographic price discrimination and shutting down internet retailing it would have an incentive to foreclose internet retailers in order to re-establish the rent extraction possibilities of price discrimination.
111. In practice, European competition rules are perceived to limit the ability of the manufacturers to price discriminate geographically across their retailers. In fact, **(CHANEL Confidential)**.
112. Furthermore, there is no reason to allow *any* internet retailer to carry the product of a retailer to encourage a "price convergence" effect. The impact of internet retailing on price convergence is independent of the number of internet retailers that are served. Hence, even limiting internet retailing to a select number (or using vertical integration or using differential pricing as suggested earlier) will lead to the convergence of prices. As long as there are internet retailers that can sell to anyone, price convergence is facilitated (up to differences in transport costs).³⁴
113. There are some caveats to this conclusion. As we have seen earlier it may be necessary to impose limitations on the *volume* of internet sales relative to bricks-and-mortar sales, in order to maintain appropriate brick-and mortar incentives. This may limit the extent to which price convergence can occur in practice, because it is not possible for all consumers to purchase at

³⁴ Note that this statement does not imply that the price level would be unaffected by the entry of more than one internet retailer. It just claims that even with one internet retailer prices would converge. Geographic price variation and level of average prices are two distinct issues.

the lowest posted price. Hence, differences in price can persist because the quantity restriction means consumers cannot fully arbitrage. Note that quantity restrictions will only be a problem if alternative restraints are not allowed by policy. For example, if manufacturers are allowed to charge higher wholesale prices to internet retailers relative to the bricks-and-mortar channel, arbitrage on the final goods price between bricks-and-mortar retailers and internet retailers would still encourage convergence in the final goods price. This would be the case also if the manufacturer were allowed to vertically integrate into internet distribution. This would not happen, however, if the image of internet retailing were to dilute the luxury image of the product and luxury goods manufacturers decided not to use the internet channel at all. But in such a case the elimination of the internet channel would be efficiency enhancing, and not anti-competitive.

Reduction in Search Costs

114. A clear benefit of the internet is that it reduces the “cost” of searching for a product. This benefit may be smaller however for luxury products, for which good “matching” information will typically only be available at a bricks-and-mortar store.
115. In addition, it is unnecessary to force all manufacturers to sell their product through a single multi-product internet website in order to realise most of the search benefits of the internet. Technology allows for internet offerings by *different suppliers*, on *different sites*, to be easily searched and compared. Where there are sufficient gains from search (as with airlines) there are even several specialised search engines that facilitate such search.
116. We also note that in the particular case of luxury products, the internet might well provide information to a potential buyer about the *existence* of a particular product. Spotting the product on the internet might in turn provide an incentive for the potential buyer to visit the bricks-and-mortar store. To provide the right incentives to guide the searcher to the right store, there may well be benefits from bricks-and-mortar and internet outlets being jointly owned, i.e. for limiting internet sales to the sites of authorised bricks-and-mortar retailers.

Elimination of Shelf Space Constraints

117. The elimination of shelf space constraints is another well-known potential benefit of internet retailing. The internet store can offer all products in a product line, as well as products from many other manufacturers, without the constraint of limited shelf space. (Depending on the specific retailing model, the internet retailer may have to hold inventory.) However, selective distribution systems do not prevent these benefits, if they exist, from being realised. Manufacturers themselves benefit from being able to advertise their whole product line on the internet. Also, anyone who wants to sell luxury articles through the internet can do so (even as a small entrant) without having space constraints. This does not require all products to be sold on the same website. As long as search is relatively easy (and done through search engines) there is no reason for the lack of shelf space constraints not to be exploited even when some firms decide to use selective distribution (or restrictions on the presentation of their internet offerings).

More easily accessible product information

118. The internet unquestionably generates much easier access to product information. But again, this is the case independently of how firms organise their internet presence. Internet information will often be provided for goods that cannot be bought over the internet. This benefit can therefore be obtained entirely independently of contractual restrictions on retailing.
119. **In conclusion**, there are many benefits of the internet in terms of reducing search costs, improving price comparisons, facilitating market access to small suppliers, and generating relevant information about products. However, none of these benefits require for their realisation that manufacturers refrain from using selective distribution systems. Indeed, manufacturers have strong incentives to exploit these cost reductions unless they interfere with giving proper incentives in the vertical sales structure. We have shown that generally this can be achieved without in any way reducing the benefits achieved from the internet.

6. POLICY CONCLUSIONS

The economic research of the last 40 years has systematically limited the range of circumstances in which vertical restraints can legitimately be suspected to have anticompetitive effects. Empirical research has supported these conclusions in general. We have shown in this paper that none of these conclusions have to be reconsidered by the arrival of the internet as an alternative retail channel.

6.1 ECONOMIC ANALYSIS STRONGLY SUGGESTS A PRESUMPTION IN FAVOUR OF SELECTIVE DISTRIBUTION, INDEPENDENT OF SALES TECHNOLOGY

120. The economic research we have reported on in this paper has demonstrated that there are strong efficiency reasons for vertical restraints. While the literature has identified some anti-competitive effects, these only apply under fairly limited circumstances. Empirical research has demonstrated that voluntary vertical restraints typically lead to output expansions while government intervention against vertical restraints has been demonstrated to lead to significant output reductions and reductions in number of retail outlets. There is therefore a wide consensus in the economics profession that there has to be a strong presumption that vertical restraints are efficiency enhancing unless anticompetitive effects can be demonstrated.
121. This conclusion is particularly strong for selective distribution systems. We have shown that many of the anticompetitive theories do not apply to selective distribution. Furthermore we have shown that there is a strong and compelling efficiency reason that makes selective distribution particularly important in the luxury goods industry. In fact, in industries that do not have such characteristics, firms themselves choose to put few restrictions on internet retailing. This pattern again suggests that private vertical contracting is fairly effective at finding efficient retailing solutions.

122. The mere fact that a new sales technology is available does not imply that standard economic analysis does not apply, notwithstanding rhetoric about the “new economy” or the “21st Century economy”. As we have shown, the existing economic literature fully applies. In fact, all benefits of the internet can be obtained without putting limits on selective distribution systems. As a result there should be no special considerations for internet retailing when the vertical restraints guidelines are updated.

6.2 THE VALUE OF EXPERIMENTING ON OPTIMAL DISTRIBUTION CHANNEL STRUCTURE

123. There is a second reason to adopt a position that vertical restraints are generally legal unless anticompetitive effects can be demonstrated. This reason is, in fact, closely related to the changing retailing structures. In a quickly changing economic environment and with the advent of new technologies it is hard to find out what the most efficient contractual structures are. The convergence to such structures will be significantly slowed down if firms have to fear that the default view of a contractual restraint is that it may be anticompetitive.
124. As an example we have discussed the relative merits of vertical integration and contractual solutions for resolving the incentive problem in luxury goods retailing. We have discussed that the relative merits are difficult to evaluate in the absence of any direct market experience. Given that the internet distribution channel is still relatively new, it will be important for public policy to allow brand owners to experiment with the internet format to determine the relative strength of potential efficiencies and of different solutions to the free-riding problem potentially generated by internet retailing.
125. Particularly in the case of the luxury goods industry, it is highly undesirable for regulators to intervene at a stage in which the actual impact of using the internet as a sales channel is still untested for many players. The luxury goods industry may want to experiment with internet distribution to learn how severe the free-riding problem for bricks-and-mortar services may be, or how large the deterioration of brand image could be. Different types of product may very well have different optimal retailing structures. A good policy should therefore leave room for firms to experiment without creating an *obligation* to use the channel. Policy should not hinder the adjustment of retailing structures to new ways of doing business in a rapidly changing world.
126. Forcing manufacturers to allow anyone to sell their goods on the internet is bad policy and harks back to times when we did not understand the economics of vertical restraints.