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VBER - Dual Distribution

RBB Executive Summary

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RBB Economics have been instructed by Baker McKenzie, external legal counsel to the members of Brands for Europe (hereafter "BfE"), to assess the expected impact on members of BfE of the Commission's proposed changes to the VBER as it applies to dual distribution arrangements. This document provides a high-level summary of our findings.[1]

From our interviews with members of BfE and a review of their dual distribution arrangements and of the expected impacts of the proposed changes, we find that:

- **There is a consistent view across brands that their own retail operations and third-party retail operations are complementary.** The principal incentive of any brand owner is to maximise the overall sales of their brand(s) in the face of inter-brand competition. Brands take a holistic view of their businesses and try to grow sales through all available channels. For some brands, using certain partners is viewed as a necessity, given the scale and reach of those partners. Brand owners also find that working with third-party partners is helpful in ensuring consumers' needs are met especially where end-user needs are particularly complex or differentiated.
- Even in instances where there is a degree of horizontal downstream overlap between the supplier and the reseller, **brands consider dual distribution brings additional benefits to their businesses compared to only operating their own distribution operations**. For example, it is widely recognised that resellers can provide additional pre- and post-sales service or logistical capacity that benefits the brand as a whole. Consistent with

[1] RBB's full report, *VBER – Dual Distribution: Economic impact assessment*, is provided as Annex 3 to Baker McKenzie's submission of 17 September 2021.

this, brands' internal incentives are designed to encourage development of overall sales, regardless of distribution channel.

- **Certain information flows between brand owners and resellers are essential for dual distribution to work properly.** For example:
  - Data on resellers' inventory, stock levels and sales volumes are required for suppliers to plan manufacturing capacity across their direct and indirect channels. Without this information, it would be impossible for manufacturers to accurately forecast demand levels with the resultant impact on allocative efficiency.
  - The data types mentioned above are also necessary for brands to operate logistics and warehousing operations in an efficient manner.
  - For brands operating e.g., a franchising model, sharing staff training guides, store layouts and other information is critical for maintaining a consistent brand experience across wholly owned and franchised stores.
- **As well as the information that is fundamentally necessary for these arrangements to operate, other information flows generate additional benefits for brands, their partners, and ultimately end consumers**. For example:
  - Brand owners would want to coordinate, to a certain extent, marketing activity across their direct and third-party retail channels to ensure a consistent consumer experience and that there is sufficient production and distribution capacity available to support that activity.
  - Detailed product information (e.g., both value and volume data at the SKU level) can be (and is) used to better understand customer segmentation and trends in demand. Further, the more frequent and the more recent the data that is available, the better brands can understand these factors. This also has implications for brands' product development, production schedules and their management of inventory and logistics. This is particularly relevant in dynamic, fast-moving industries (e.g., fashion and sporting goods), where the rapidly changing nature of consumer demand means that brand owners need to have comprehensive discussions with their partners about their future requirements and the optimal placement of products in terms of price points in line with market conditions, to ensure supply meets demand.
  - Information obtained from partners is also helpful in understanding whether promotion or other marketing activity was successful. This enables suppliers to understand what products to focus on and how to allocate marketing or product development funds.
- **The proposed changes to the treatment of information exchanges in a dual distribution setting entail significant legal uncertainty.** Due to uncertainty about what might be deemed a restriction of competition, firms look to block exemption regulations to provide assurance that their agreements are lawful. Where information exchanges within a dual distribution model would fall outside the VBER and be covered by the Horizontal Guidelines instead, this would expose brands to significant uncertainty about the likely antitrust risk, given the inherent risk of divergent interpretation and enforcement. Many

brand owners would therefore take a cautious approach and consider (i) eliminating existing information flows, (ii) costly and inefficient ring-fencing of upstream/downstream operations, or (iii) eliminating dual distribution set ups altogether (either by ending their distribution relationships with resellers to focus fully on direct to consumer sales or vice-versa).

- Accordingly, **there are several significant costs (including forgone efficiencies) that members of BfE would be expected to incur to ensure that they minimise antitrust risk in light of the proposed changes**. For instance:
  - Additional compliance costs (e.g., monitoring costs). The loss of legal certainty is likely to give rise to greater caution in the way that distribution policies are implemented and operated.
  - Costs associated with running their business with less information exchanged with retailers/distributors (e.g., less granular or less frequent information) which is less likely to raise anti-competitive concerns. There are significant efficiencies which are generated by relying on commercially sensitive information from third-party retailers in combination with data from brands' own retail operations. This improves the efficiency of a variety of business functions including sales and operational planning, pricing and marketing. This, in turn, benefits partners through increased sales (in particular where suppliers share insights with third-party resellers) and end consumers through greater availability and range of products and better consumer experiences.
  - Costs of separating out brand owners' wholesale and retail activities to ensure that any information flows that result from the vertical relationship do not spill over into brand owners' retail activities. Over even a short time horizon, these costs can be substantial. As a large proportion of these costs are variable, there is a significant risk that these costs could be passed-on to end consumers through higher prices.
  - Some brands which currently have a high degree of separation (e.g., due to historical circumstances) between their own retail and third-party retail operations are seeking to integrate further to take advantage of the benefits described above. For these companies, the uncertainty associated with the proposed changes would severely limit the degree to which these brands can progress with any planned integration of their operations.
  - Conversely, a number of brands currently operate a business model which entails global or regional integration across a number of business functions, such as distribution, pricing, and marketing. Therefore, any changes required by businesses to reduce the risk of Article 101 proceedings would not just affect business operations in the EEA but would have significantly wider cost implications.
  - Losing the harmonised safe harbour of the VBER also creates the risk of multiple national investigations, national court challenges and inconsistent outcomes.

The Commission does not seem to have given sufficient weight to these critical considerations. When these fundamental points are understood, it becomes clear that any decision by the Commission which either restricts brand owners' use of information exchanges in the context of their dual distribution arrangements or effectively restricts the use of the dual distribution arrangements themselves must not be taken lightly. Indeed, it is important to briefly reflect on the balance between expected costs and benefits associated with the proposed changes. In this regard:

- From the outset, it should be noted that the Commission's apparent concerns that information exchanges between a manufacturer and its partners in a vertical relationship may lead to coordination downstream are only valid to the extent that the manufacturer in question has market power. This is because, to the extent that product A faces effective competition from products B, C and D, downstream coordination on prices of product A between the manufacturer of product A and the retailer/distributor of product A is unlikely to lead to anti-competitive effects (because of the existing inter-brand competition).

- The existing guidelines already provide the necessary tools to deal with potentially abusive conduct. First, the Commission retains the right to remove the benefit of the VBER in individual cases. Second, the VBER already excludes agreements entered into by suppliers with significant market power. Third, the VBER already excludes agreements that contain hardcore restrictions, such as resale price maintenance.

- Dual distribution itself is not a novel phenomenon. It has always been a common and well-established business tool, across a range of industries and at various levels of the supply chain. In part, the rise of online direct sales by manufacturers has been driven by firms responding to changing consumer preferences and needs (especially so since the rise of COVID-19). Importantly, the rationale for exempting dual distribution has not changed – i.e., the focus remains on the importance of *inter*-brand competition at the upstream supplier level.

- There is significant heterogeneity across brands in how their dual distribution networks are set up, what information is shared between brands and their third-party retailers or distributors, and how that information is used to improve efficiency and deliver better outcomes for end consumers. In all cases, dual distribution arrangements provide efficient means of delivering branded products to end consumers. The proposed changes to information sharing would be very far reaching and would (perhaps unintentionally) damage relationships and business models which the Commission does not seem to regard as problematic.

  - A number of specific brands already operate with integrated direct and indirect retail operations which provide benefits to end consumers and allow these brands to compete more effectively. For them, there would be significant costs in a potential scenario where they would separate out business units to comply with the proposed changes and these additional costs would likely be passed on to consumers.

  - Some brands already operate separated distribution channels, with limited information flows between their direct and indirect retail operations, but are looking to integrate further to take advantage of efficiencies and synergies. Such integration would result in additional benefits which would likely be passed on to consumers, but which would be lost as a result of the proposed changes.

  – Finally, some brands are looking to start (or further develop) their own direct distribution operations. For them, the proposed changes may make it harder to accomplish this (i.e., if significant cooperation between the brand and its partners is then not permitted then they would have to weigh the benefits of starting their own D2C operations against the loss of information flows from their retail partners.).

- The expected costs of the proposed policy change faced by businesses would be certain, would arise pervasively and may be passed-on to consumers not only through higher prices but also through reduced quality, range, service and innovation. On the other hand, the expected benefits (namely, the *possibility* of stronger intra-brand competition in those rare cases where exempting dual distribution leads to weaker intra-brand competition) would be rare and limited, even if they do arise. This is because any firm that qualifies for the VBER faces effective *inter*-brand competition (as its market share would be below the threshold) and therefore there is very limited scope for stronger *intra*-brand competition to lead to lower prices.

Therefore, we find that these proposed changes are unjustified and disproportionate. Our discussions with BfE members revealed many compelling pro-competitive explanations for information exchanges between them and their partners in the context of dual distribution arrangements. These discussions make it clear that any decision by the Commission to impose greater restrictions on brand owners' reliance on their dual distribution arrangements will have wide-ranging (and sometimes unintended) negative consequences. It should be incumbent on the Commission to clearly identify the source of anticompetitive harm that it seeks to address by its proposed intervention and explain why that particular intervention would be most appropriate to prevent harmful outcomes on a regular basis, without having the adverse side effect of eliminating at the same time the far more significant pro-competitive outcomes.