CCP Response to Consultation on Vertical Block Exemption Regulation

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Introduction

The purpose of this note is to provide information to the European Commission (EC) in response to the consultation on its new draft Vertical Block Exemption Regulation and associated Guidelines . The topic is important not only because of the high level of debate of the breadth and depth of vertical block exemptions in recent years, along with varied international experience in this domain. The comments are based on research work of relevance to the proposals for EC's VBER, by members of the Centre for Competition Policy of the University of East Anglia.

On the general topic of vertical relations, we note the work of Caffarra and Kühn (2018) dealing with vertical restraints in multi-sided markets, Ennis and Fletcher (2020) on options for digital regulation and Deutscher (2019) on the use of ex ante regulation versus competition law. Given that digitalisation is a particular theme in the changing needs from a vertical block exemption regulation, as market positions of internet commerce has changed, we further reference Lam and Lyons (2020) and Lam and Liu (2020) which provide economic analysis of the relationship between data protection and data portability, respectively. Lyons (2012) notes the risks of vertical integration by software providers into manufacturing, and the potential ossification of what would now be called ecosystems that can result.

With respect to particular topics addressed in the EC's draft revised VBER, we organise comments by subject matter, while noting that some CCP work emphasises the linkage between topic areas (notably Fletcher and Hviid (2016), focusing on the link between MFNs and RPM).

[1] Suggested reference: Deutscher, E., Ennis, S., and Hviid, M. (2021) "CCP Response to Consultation on Revised Vertical Block Exemption Regulation". Centre for Competition Policy Consultation Response, 17 September.

Resale Price Maintenance (RPM)

With respect to retaining a hard-core treatment of RPM, there has been internationally divergent approaches to this issue. The consultation states that exemptions to the RPM rule will be considered. This is indeed an important area for further clarification.

We note that in a recent working paper, Ennis and Kühn (2021) argue that minimum advertised price policies should be considered in a different category from resale price maintenance. Minimum advertised price (MAP) policies constrain retailers to advertise prices outside the store above the minimum level set by a product manufacturer. As a vertical restraint on pricing, they are often considered by law and economic theory as a type of resale price maintenance (RPM). Case law and regulations in the EU and US diverge in their treatment of MAP. In the EC and UK, case law has treated MAP as a form of RPM. The Vertical Block Exemption Regulation in the past made no distinction between the two. Paragraph 174 of the draft VBER Guidelines provides a welcome opening of the door to allowing MAP in certain cases. Notably, the paragraph specifies instances in which MAP contracts may constitute RPM, but does not exclude the possibility that MAP can in certain circumstances be beneficial.

In the US, for example, MAP has been evaluated under the rule of reason – even before the 2007 Supreme Court decision in *Leegin* switched the presumption for RPM from per se illegality to a rule of reason approach.

The economic literature has mostly ignored MAP. Only recently has a small literature focused on MAP as a mechanism for limiting the price comparison possibilities for customers who decide which store to patronize. This recent work suggests that MAP is used to price discriminate between customers who shop around and are well informed about prices at different stores and those who do not shop around and use advertised prices to make their shopping decisions. As a result of MAP restrictions, the latter then pay a higher price.

Ennis and Kuhn (2021) discuss the role of MAP for "marketplace competition", i.e., the practice by brick-and-mortar stores of attracting customers for their entire shopping basket with good deals on some products. Marketplace competition focuses on popular items that generate high frequency of visits to the store. The retailer advertises a very low price for such products – sometimes even below marginal cost. The focus is on price advertising that is outside the store, not advertising within the store, so the authors are not focused on digital marketplaces advertising within their site.

The authors argue that there are core differences between MAP and RPM because MAP applies only to advertising but places no restriction on in-store retail pricing. As a result, MAP has different implications from RPM and merits a distinct legal treatment. A retailer's price advertising of a *specific product* is aimed at bringing customers into the shop and thus winning sales *for the entire shopping basket*. The reason for aggressive advertised pricing is the marketplace competition to win customers that will also buy other products with a high margin for the retailer. This practice obviously distorts price setting between different brands in a store. The practice may also hurt brand manufacturers and their incentives to invest. After a retailer advertises a product at a very low price, consumer willingness to pay for the product may fall due to (i) consumers feeling that they are treated unfairly when they are offered a higher price later or (ii) consumers fearing regret when they buy at a higher price than they previously observed, because they believe they might have missed out on a better offer somewhere else. These motivations are known to reduce the willingness to pay for a product and thus reduce demand. As a result, the incentives for manufacturers to invest in product quality may decline.

In sum, MAP is an instrument to limit the degree to which retailers use low advertised prices for their products to attract customers to their marketplace to sell unrelated products. MAP can correct distortions of inter-brand competition and maintain incentives for manufacturers to invest in product quality. Unlike RPM, MAP preserves the incentives for inter-brand competition within the store. However, it allows brand manufacturers to prevent an externality imposed on them by the retailer's efforts to enhance the demand for unrelated goods sold at high margin. For these reasons, MAP should not be treated as legally equivalent to RPM. MAP has a number of characteristics that distinguish it from RPM, notably including its ability to prevent use of a product in marketplace competition. Use of an individual product in marketplace competition can lead to distortions in pricing. More generally, marketplace competition merits closer attention from policymakers when examining competition at the retail level.

One of the insights from Fletcher and Hviid (2016) is that there may be a significant difference between RPM which is purely vertical ("You, the retailer must not sell at a price below that chosen by us, the manufacturer") and those who also have a horizontal element ("and the price we the manufacturer set will be the same at all retail outlets"). Looking across the existing economic literature they found that the harmful effects mostly related to the RPM which included both elements. Future research may be able to stablish whether it is appropriate to treat the purely vertical RPM differently (more leneiently) than the vertical *and* horizontal RPM.

Brand Bidding Restraints

The VBER and VBER Guidelines also impact brand bidding restraints. By means of this novel type of restraint, brand owners restrict how retailers use their brand names and trademarks as keywords in paid search advertising. The Commission's recent draft VBER (recital 13, Art. 1 (1) (n) in conjunction with Art. 4 (b) to (d)) and VBER Guidelines (paras. 188 and 192 (f)) qualify online advertising restraints as hardcore restrictions. . In light of the paramount role of paid search advertising in generating online sales, this strict treatment of brand bidding restraints warrants r further clarification.

With respect to brand bidding restraints, we note the research of Deutscher (2021). The paper tests and critically reflects on the restrictive approach European competition authorities have recently adopted towards brand bidding restraints. It contends that this harsh treatment of brand bidding restraints is not sufficiently grounded in the economic analysis of vertical restraints. The paper asserts that brand bidding restraints can have a number of procompetitive effects by internalising advertising-related externalities, addressing free-riding on display and traditional advertising and facilitating fixed cost recovery through price discrimination. The paper also considers different ways through which brand bidding restraints may harm competition and consumer welfare when they disproportionately affect infra-marginal consumers, prevent meaningful intra- and inter-brand comparisons or result in price discrimination on the basis of search costs rather than brand preferences. Moreover, brand bidding restraints are of particular concern when adopted in the context of dual distribution systems where vertically-integrated brand owners have an incentive to raise their retailers' costs to prevent them from cannibalising their own sales channel. This ambiguous competitive impact of brand bidding restraints suggests that a broad treatment of all types of brand bidding restraints as by-object or hard-core restrictions is unwarranted.

The paper further explores various legal filters to disentangle and balance the anti- and procompetitive effects of brand bidding restraints. In this respect, the paper suggests that existing trademark case law on the competitive use of trademarks as keywords in online advertising (Case C-

238/08 *Google France,* Case C-323/09 *Interflora*) does not provide an appropriate test to determine the legality of brand bidding restraints under competition law. Instead of mechanically transposing trademark principles into competition analysis through the use of a 'scope of the trademark test', competition authorities should carry out a standalone analysis of the competitive effects of brand biddings restraints and determine whether they are necessary to secure potentially procompetitive efficiencies and to enhance the brand image of a distribution system.

In their current state, the draft Guidelines omit to lay down a consistent framework for an effects-based analysis of brand bidding restraints. This is all the more surprising as the draft Guidelines provide detailed guidance on the analysis of other vertical online sales restraints, such as restraints on the use of online market places (paras. 313-322), parity obligations ('MFN clauses'; paras. 333-353)) and restrictions on price comparison websites (paras. 323-332), which the Commission labels as a specific form of online advertising restrictions (paras. 324, 327). Such disparate treatment of online and, notably, online advertising restraints sits uneasily with an effects-based approach and should, therefore, be reconsidered.

Instead of considering the competitive effects of brand bidding restraints, the draft Guidelines seemingly codify the sweeping presumption that online advertising restrictions have the same effect on online sales as online sales bans. Though this presumption appears to be limited to online advertising restrictions that 'have as their object to prevent the buyers or their customers from effectively using the internet' (paras. 188 and 192 (f)), it remains, however, unclear how much case-specific evidence would be required to activate this presumption. Nor do the draft Guidelines explain whether and under which circumstances this presumption can be rebutted by parties to a non-brand bidding agreement.

The scope of the presumption against brand bidding restraints and the analysis of their anticompetitive effects therefore need further clarification. With respect to the latter, the Guidelines could follow the approach set out in the CMA's 2017 Digital Comparisons Tools Market Study Paper E[2]. In ascertaining the competitive effects of brand bidding restraints, competition authorities should account for the market share of the parties to a non-brand bidding agreement, the specific design of the brand bidding restriction (narrow, broad brand bidding restriction, or negative matching agreements), as well as their impact on clicking behaviour, traffic and online sales channels.

The paper further suggests that the status of online search advertising as active or passive sales requires further clarification. A broad categorisation of online search advertising as active sales is unwarranted because it would entail the automatic exemption of all types of brand bidding restraints (outside selective distribution systems) irrespective of the customer location and the solicited/unsolicited nature of sales. Instead, the distinguishing factor in deciding whether online search advertising qualifies as active or passive sales should be whether it is geographically targeted to customer groups outside the retailers' assigned sales area. Absolute and indiscriminate bans of brand bidding should, therefore, be regarded as restrictions on passive (and active) sales. In this respect, the clarification brought about by Art. 1 (1) (l) and (m) VBER and by paragraph 200 of the draft Guidelines that search advertising which is not targeted at customers outside the retailers' assigned territory or customer group constitutes a form of passive sales is a welcome development. It is consistent with the technological features of this mode of advertising and the economic rationale underpinning the active/passive sales dichotomy.

[2] Competition and Markets Authority, 'Digital comparison tools market study - Final Report: Paper E: Competitive landscape and effectiveness of competition' (2017) 4.47 et seq..

Given the potential role of brand bidding restraints in facilitating price discrimination and fixed cost recovery in digital markets, the draft Guidelines should clarify the extent to which online advertising-related efficiencies or efficiencies obtained through price discrimination are cognisable under Art. 101 (3) TFEU and clearly set out the evidentiary requirements that the parties to brand bidding restraints have to meet to substantiate their procompetitive effects

Further work on this topic is found in the blog Deutscher (2020) concerning whether vertical restrictions on the use of brand-names are necessarily anti-competitive, in commenting on the European Commission's Guess decision. This contribution notes the importance of accounting for the interplay between different (display v. search) online advertising channels for the assessment of the competitive impact of brand bidding restraints.

Private Label and Branded Goods

The issue of whether private label and branded goods should be considered in the same market has been debated in competition cases for a long time. Traditionally, competition authorities have considered large price difference between branded and private label products as evidence that branded and private label products are in separate markets. Esteve Guasch and Kühn (2021) show that private label products should generally be considered in the same market as branded products in the same product group. For a first assessment, the competitive constraint from a private label product on branded products is well approximated by its market share in the product group. This means that private labels should always be included in the initial assessment of market definition in merger cases and for the purpose of determining critical market share thresholds when applying, for example, the Vertical Block Exemption Regulation.

The authors point out that the industrial organization literature, a product that is perceived to be "lower quality" and sells at a low price can impose very significant competitive constraints on a product that has perceived "higher quality" and higher price.[3] This price differentiation by perceived quality is known as "vertical product differentiation" in the academic literature.

Private label and branded products in supermarkets are a classic example for such vertical product differentiation. Differentiation occurs primarily because branded products are heavily advertised in public media and thus have developed a brand image.[4] Private label products typically are not advertised heavily and are sold mostly at a significantly lower price. Price differentials are maintained because consumers have a different willingness to pay for products with a strong brand image.[5]

Central to an analysis of market definition is determining the degree of substitutability between products. Since products are differentiated, some competing products will be closer substitutes than others. "Closeness of substitution" is often argued very loosely in competition cases, but it can be rigorously defined in economics, allowing empirical verification.

[3] See John Sutton (1986), "Vertical Product Differentiation: Some Basic Themes", *American Economic Review* for an overview of the literature on product differentiation along a "quality" dimension (as well as references within). "Quality" in this literature means any characteristic (e.g. advertising) that makes consumers willing to pay more for the product. Product differentiation arises from different willingness of consumers to pay for quality improvements.

[4] See John Sutton, *Sunk Costs and Market Structure Price Competition, Advertising, and the Evolution of Concentration*, MIT Press, 1991.

[5] This is not to say that there are no other quality differences between branded products and private label products. Conversely, some private labels have been advertised and tried to develop their own brand image. However, advertising generally is a dominating differentiating factor between brands and private label products. The exposition chosen here is only for illustrative purposes. Our empirical analysis does not rely on these concepts, and traces only the substitution patterns.

The economic concept capturing the idea of "closeness of competition" is the "diversion ratio". The diversion ratio from product *i* to product *j* is defined as the share of customers that switch from buying product *i* to buying product *j* in response to a price increase of product i. "Closeness of competition" is measured by the difference between the diversion ratios of product *i*'s competitors. If a product *j* has the highest diversion ratio for product *i*, then *j* is the closest competitor to *i*, because it is the greatest beneficiary of substitution from product *i* in response to a price increase.

A private label product can be viewed as a competitor of a branded product when its diversion ratio is significant relative to the diversion ratios of other competing branded products. When the diversion ratio is higher than those of other branded products, then the private label can even be a closest competitor to a branded product.[6] The detailed empirical analysis by Esteve Guasch and Kühn (2021) across five product groups suggests that it is not unusual that a private label product is the closest competitor to all the major brands in a product category. Their analysis shows this to be the case for product groups with large private label market share. These are typically product groups where the vertical dimension of differentiation dominates. When there is additionally horizontal product differentiation this will generally not be the case. However, for all product categories included in our analysis, private label products are close enough competitors to impose substantial competitive pressure.

These findings lead to two important conclusions:

(1) Private label products should by default be considered in the same market as the branded products in a product category.

(2) Market definition should only exclude private label from the market if there is other strong evidence that there is negligible competitive constraint from the private label product.

Most favoured nation (MFN)

We note that Fletcher and Hviid (2016) find that a number of recent cases have involved a hitherto rarely observed form of Most Favoured Nation clauses in which sellers through an internet retail platform agree not to sell at a lower price elsewhere, including through other retail platforms. They note that such Retail Price MFN clauses rely on some form of RPM for their existence. In particular such clauses mimic RPM agreement with both the necessary vertical element and also the optional horizontal element. As mentioned above , the latter appears from the existing academic literature to be particularly egregious in terms of anticompetitive harm. Given this, they argue that such clauses should be treated no less harshly than RPM under competition law. That insight is purely comparative and does not imply that they should be blacklisted, just that the treatment should be consistent.

While the consultation document points out that these have become more prevalent with platforms, they are not new. Indeed as pointed out in Akman and Hviid (2006), CMA's predecessor, the OFT (at a time when the UK was a member of the EU) successfully brought a case against such MFNs in Foreign Package Holidays: A Report on the Supply in the UK of Tour Operators' Services and Travel Agents' Services in Relation to Foreign Package Holidays" Cm 3813 (1997).

It is also worth highlighting that when it comes to parity agreements, most of the academic literature focuses on price rather than conditions. Non-price elements were important in the OFT case mentioned above and in the Amex case.

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[6] See Shapiro, C. (1996) "Mergers with differentiated products", *Antitrust*, Spring, 23-30.

For more discussion of the pro and anti-competitive effects, see the summary provided in Hviid (2015).

Wholesale and Agency Structure

Lu (2015) compares the wholesale structure and the agency structure characterizing a supply and distribution chain in a bilateral duopoly model with product differentiation at both the supplier level and the retailer level.She finds that the agency structure leads to lower retail prices, higher demand and higher consumer surplus.Examining firms' preferences over the alternative schemes, she shows that suppliers prefer the wholesale structure whereas retailers prefer the agency structure as long as the degrees of differentiation at the supplier level are not too low. The rise of the agency structure then implies that retailers are in a strong position, since suppliers would stick to the wholesale structure if they possess relatively higher market power.

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