COMMISSION ECOMMERCE REPORT HIGHLIGHTS GREATER RELIANCE ON SELECTIVE DISTRIBUTION AND RAISES THE PROSPECT OF ENFORCEMENT ACTION TO TACKLE RESTRICTIONS OF ONLINE SALES

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Yesterday the Commission published the much anticipated preliminary report in its ecommerce sector inquiry. The report was initiated in response to rapid growth in online sales activity over recent years and signals renewed commitment on the part of the EU in enforcing the competition rules in the ecommerce sector. The report identifies two clear trends as consumer goods manufacturers react to this growth: On the one hand manufacturers are increasingly looking to vertically integrate and on the other hand they are relying on selective distribution networks more than ever before. However, despite manufacturers taking these seemingly legitimate steps to adapt to the new online environment, the Commission has uncovered evidence of widespread contractual restrictions affecting online sales which give rise to serious competition law concerns and which are likely to be the subject of further enforcement action by the Commission following completion of the current inquiry.

The European Commission launched its sector inquiry into e-commerce in May 2015 as part of its wider Digital Single Market strategy to examine prevailing market trends in the e-commerce sector and potential barriers to competition, particularly in light of the significant growth in online sales activity over recent years. Earlier phases of the inquiry looked specifically at geo-blocking practices, leading to the publication of a draft Regulation in May 2016. The Commission is not expected to complete its inquiry until early 2017 but yesterday it published its initial findings in a preliminary report, which is now under consultation.

1. CONSUMER GOODS

The bulk of the report focuses on the Commission's findings in respect of e-commerce in the consumer goods sector following engagement (in the form of responses to questionnaires) with a large number of retailers (both on and offline), manufacturers, online market places, price comparison websites and payment service providers.

PARAMETERS OF COMPETITION AND THE MANUFACTURERS' RESPONSE TO INCREASED ONLINE ACTIVITY

The Commission examined the parameters of competition in consumer goods e-commerce and found, perhaps unsurprisingly, that whilst product quality is perceived as the key differentiator by manufacturers, retailers view price as the most important parameter of competition. Nonetheless, internal documents provided by manufacturers during the inquiry reveal a range of concerns about the impact of online sales growth on pricing.

Two clear trends in the ways manufacturers have responded to these pressures emerge from the report:

- First, many manufacturers have chosen to vertically integrate in order to compete downstream and retain control of their product offering downstream.
- Second, manufacturers are increasingly either implementing selective distribution networks for the first time or toughening up the criteria used for admitting distributors to an existing selective network.

These trends are considered further below.

INCREASED VERTICAL INTEGRATION

Vertical integration is a common response amongst manufacturers to increasing online activity downstream, which allows them to benefit from that growth and to claim back some control over downstream pricing. 64% of manufacturers have opened an online shop over the last ten years as a reaction to the growth of e-commerce and, whilst sales volumes through manufacturers' downstream online shops remain small, those volumes have more than doubled since 2005. This trend is particularly marked in relation to the supply of cosmetic and healthcare products, where 85% of manufacturers are vertically integrated to some extent.

GROWTH IN SELECTIVE DISTRIBUTION

Manufacturers are also turning to selective distribution in response to online growth, for example in order to protect market positioning, preserve brand image or to ensure that the online sales environment reflects the reputation or prestige of the brand. Over half of manufacturers now use a selective distribution network and 19% reported implementing such a network in order to respond to the growth in e-commerce. Of those manufacturers now operating a selective network, 67% reported having introduced additional selection criteria. Furthermore, such networks are being used to distribute a greater range of products than was previously the case.

The Commission saw evidence of a wide range of selection criteria being used, including requiring manufacturer approval for promotional or marketing campaigns and materials or committing not to sell online, or not to sell via discount websites, third party platforms or price comparison websites. Some retailers even reported having been refused admission to a manufacturer's selective distribution network on the grounds that they were selling online.

Some of the practices observed raise important competition law questions which the Commission is likely to examine as part of separate investigations in future. For example:

- Some manufacturers operating selective distribution networks may not be applying their selective criteria fairly or uniformly. Some discount retailers, for example, expressed concerns that they would not be admitted to some such networks even if they were to satisfy all relevant selection criteria. A quarter of manufacturers even reported that they do not provide their selection criteria to retailers that are interested in joining the selective network.

- It is particularly interesting to note that the Commission questions whether the provision in the Vertical Guidelines permitting manufacturers with selective distribution networks to insist that members of their network operate at least one bricks and mortar store should be disregarded in some cases, for example where the products in question are equally suitable for resale by pure online retailers.

OTHER DISTRIBUTION MODELS

The report also points to interesting changes in the channel mix used by retailers. In particular, pure online retailers are increasingly looking to open a bricks and mortar store, in part to allow consumers to collect products ordered online but also to open up opportunities to obtain supplies from manufacturers that refuse to deal with pure online retailers. For example, 8% of pure online retailers reported an intention to open a bricks and mortar store in the next two years. The evolution of retailers away from being 'single channel' providers (i.e. either offline only or online only) is also interesting. Many such providers began by supplying through a second channel on a small scale initially but are now moving towards an integrated 'omni-channel' approach.

Half of manufacturers use exclusive distribution to some extent, but they do so on a targeted, case by case basis, for example in particular territories or for particular products, rather than systematically across their business. Reasons for implementing an exclusive arrangement include, for example, the need to ensure successful launch of a new product or to protect against free-riding.

Distribution via an agency model was found to be very rare, although less so in respect of the distribution of clothing and shoes. It is interesting to note that there is no suggestion in the report of the Commission having uncovered evidence of manufacturers seeking to control downstream resale pricing by purportedly relying on an agency model which does not in fact meet the onerous requirements of genuine agency under EU law.

RESTRICTIONS OF ONLINE SALES

A range of restrictions of online sales were identified and retailers reported that a number of such restrictions were imposed upon them contractually. For example:

- 42% of retailers reported being subject to contractual pricing limitations or recommended resale pricing.
- 18% reported being prevented contractually from selling on marketplaces.
- 11% reported being prevented contractually from selling cross-border.
- 11% reported being prevented contractually from selling on their own website.
- 9% reported being prevented contractually from appearing on price comparison websites.
- 8% reported being prevented contractually from advertising online.
- Many such restrictions give rise to potential competition law concerns and may be the subject of further enforcement activity by the Commission following conclusion of the current inquiry. Some of these restrictions are considered further below.

CONTRACTUAL RESTRICTIONS ON CROSS-BORDER SALES

Contractual restrictions on cross-border sales were observed in all product categories considered by the Commission and ranged from outright bans on retailers selling outside of a given territory to less direct measures, including an obligation to translate the retailer's website into the languages of all territories where goods will be resold, retaliatory measures being taken by the manufacturer in response to extra-territorial online sales by the retailer and a requirement to seek manufacturer approval before reselling online in other territories. The report explicitly states the Commission's view that a requirement to seek consent for such extraterritorial online sales is akin to an outright prohibition on doing so. Furthermore, not all of these restrictions arose in the context of exclusive distribution systems (where it is ordinarily acceptable to prohibit active sales by the reseller into territories which have been exclusively allocated to another reseller or exclusively reserved to the manufacturer) and some appear to prohibit passive sales in any event. Such restrictions are likely to infringe competition law and further enforcement action by the Commission seems likely. Agreements requiring the use of geo-blocking techniques to give effect to these restrictions may also infringe.

CONTRACTUAL RESTRICTIONS ON SELLING VIA MARKETPLACES

Contractual restrictions on selling via marketplaces ranged from outright bans to restrictions on sales via marketplaces that do not meet quality standards or restrictions preventing resale via marketplaces that also permit auctions. Around half of marketplaces that responded to the Commission were aware of many such restrictions in operation. Justifications put forward by manufacturers in relation to such restrictions included the need to protect brand image, the need to combat the sale of counterfeit goods and the need to provide adequate pre and post-sale customer service. On the other hand, many retailers and marketplaces asserted that such restrictions are instead intended to reduce online sales and avoid the risk of increased pricing transparency and price competition.

In some circumstances, where the purported quality criteria a marketplace is expected to satisfy before a retailer may sell via that marketplace are impossible to meet, the use of such quality criteria may be akin to an outright ban. For example, a restriction preventing a retailer from reselling via a website domain that does not incorporate the name of the retailer's business would have the necessary impact of precluding resale via most marketplaces. Similarly, a requirement to obtain manufacturer consent to sell via marketplaces is interpreted by the Commission as akin to an outright ban.

The report acknowledges the current uncertainty in Europe about the compatibility of such restrictions with competition law and the fact that a preliminary ruling from the Court of Justice has been requested by a German court called upon to consider the question (Case C-230/16 Coty Germany GmbH v Parfümerie Akzente GmbH). Nonetheless, the Commission expresses its view that the findings of its inquiry suggest that a marketplace sales ban does not amount to a de facto ban on online sales and should not be seen as a hard-core restriction of competition (i.e. one that has the object of restricting competition). Whilst the Commission does not condone all such marketplace bans, it does take the view that each must be considered on its specific facts.

CONTRACTUAL RESTRICTIONS ON SELLING VIA PRICE COMPARISON WEBSITES

As is the case in respect of restrictions affecting marketplace sales, there is significant variation between Member States with regard to the use of restrictions preventing retailers from using price comparison websites. Some such restrictions prevent promoting via price comparison websites whereas others prevent retailers from actively providing pricing data to such websites or prevent the retailer from using the manufacturer's brand name on price comparison websites. Where manufacturer approval is needed before the retailer can use a price comparison website, the Commission's view is that the restriction is akin to an outright ban on using those sites. Although the Commission notes that such restrictions limit retailers' ability to use this avenue to promote their goods, the report also acknowledges that price comparison websites are not a sales channel in themselves and there is little indication that the Commission intends to take further enforcement action.

PRICING RESTRICTIONS

Retailers reported that the practice of manufacturers recommending a resale price is common. Whilst not problematic in itself, this practice can give rise to competition concerns when accompanied by, for example, monitoring of the retailer's pricing by the manufacturer, or pressure from the manufacturer to adhere to those recommended prices. The Commission saw evidence of widespread monitoring of retail pricing by manufacturers and of adherence by retailers to manufacturers' recommended pricing. Some retailers indicated that their adherence to recommended prices is motivated, in part, by reluctance to damage the commercial relationship with the manufacturer by discounting. Some in that position even reported manufacturers applying pressure to maintain recommended resale pricing. Such threats by manufacturers, which included threats to remove discounts, delay supplies or cease supply, were more common in the supply of clothing and shoes and consumer electricals. Arrangements of this nature give rise to a clear concern that manufacturers and retailers may be engaging in resale price maintenance in breach of competition law and the Commission is likely to pursue enforcement action in this area.

2. DIGITAL CONTENT

The Commission also sought engagement from digital content providers, including broadcasters and cable, mobile and web TV operators, and right holders, including producers, media agencies and vertically integrated right holders.

The report identifies three particular trends in the provision of online content services:

- Online transmission creates opportunities for established operators and new entrants by allowing for lower transmission costs.
- Online transmission allows user interfaces via multiple devices.
- Online transmission is leading to innovation and experimentation.

Nonetheless, the key driver of competition in relation to the distribution of digital content remains the quality of the content. Digital content providers therefore reflect consumer demand for quality content into upstream wholesale demand for that content and yet the terms on which such content is licensed remain largely unchanged.

In particular, contractual restrictions on licensed transmission technology, release timing and licensed territories are still common. This may make it harder for new entrants to secure the necessary content licences. Furthermore, many providers are required by right holders to prevent access from users in other Member States by means of geo-blocking.

The duration of many current licensing agreements, coupled in particular with provisions permitting automatic renewal or first negotiation rights, may also act as a barrier to new entry.

Furthermore, the use of complex advance payment systems may disproportionately disadvantage smaller players or new entrants.

The Commission appears to recognise the complexity of the distribution of digital content online and the need to consider each case on its specific facts. Further enforcement action in relation to potential competition infringements isn't ruled out. In fact, the Commission is already investigating territorial restrictions in the movie licensing agreements between the major Hollywood studios and Sky, while Competition Commissioner Vestager has stated publicly that she is considering opening an investigation into the alleged geo-blocking of online video games. However, considerably less is said in the report about such enforcement action in relation to digital content than is said about possible infringing conduct in relation to the online distribution of consumer goods.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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