

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS  
COMPETITION COMMITTEE**

**ROUNDTABLE ON VERTICAL RESTRAINTS FOR ON-LINE SALES**

**-- Note by Germany --**

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## ROUNDTABLE ON VERTICAL RESTRAINTS FOR ON-LINE SALES

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#### 1. Introduction

1. The emergence and development of the internet has transformed consumer conduct and the business world considerably. Changes sometimes happen very fast and accurate predictions about these developments can be very difficult to make. Online sales have become important channels for the distribution of goods and services and exert a significant competitive pressure on traditional distribution and business models of producers as well as retailers. While some retailers use the new channels as complement to the traditional brick-and-mortar business, other players have begun to focus purely on online sales. Other business models include providing online platforms that act as an intermediary between sellers and buyers. In addition, completely new internet-based products and services have emerged and continue to be developed that may compete with existing ones, for example cloud computing (e.g. use of office software on a rental basis), e-books or social networks. All these developments have already considerably increased and have the potential to further improve the efficiency of the distribution of goods and services and thus to deploy significant welfare-enhancing effects, in particular to the benefit of final consumers. Beyond lower prices, reduced transaction costs as well as new or additional services (like convenient “business hours” or home delivery) consumers can benefit from - and increasingly make use of - the enhanced availability of information on different prices and quality (like test reports, the experiences of other consumers or the exchange of information on social networks). The increased availability of information (e.g. collection and evaluation of customer data in online shops) also allows businesses to better adapt product features, services and marketing efforts to customers’ preferences and competitors strategies.

2. Despite the challenges associated with such a highly dynamic and sometimes complex market environment, competition authorities regularly have to assess whether specific business practices may unreasonably restrict the increasing competitive pressure imposed by the emergence and growth of online sales. In this context, certain types of vertical restraints of competition (especially those associated with selective distribution systems, price-maintenance or best-price clauses) seem to be gaining importance in the daily routine of a competition authority where online sales are concerned. In particular, some brand producers try to adapt to the digital economy by restricting by various means the most dynamic new online distribution channels. Apart from restrictions by object that unambiguously infringe competition in a serious way, competition authorities and courts have to evaluate not only the effects of restraints of competition in these often dynamic and two-sided<sup>1</sup> (or: platform) online markets, but also the potential efficiency justifications for such restrictions. While the relevance of specific points of the analysis may be different in respect of online markets compared to more traditional markets, it seems, nonetheless, that the competition laws in their current form (at least in Germany) are well equipped and sufficiently flexible to also deal with the newly emerged markets and market forms. The challenge is rather to apply the competition laws in a new context.

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<sup>1</sup> The term “two-sided markets” also encompasses platform markets or multi-sided markets.

3. In the next section (2.), this contribution will provide an overview over issues that seem to be becoming more important and frequent concerning competition in online markets and its assessment, starting with selective distribution systems (under emphasis of resale-price-maintenance) and then turning towards the effects of two-sided markets and highly dynamic markets on competition on the market and its assessment. After that, an overview of ongoing cases as well as past decisions will be given (3.) before some concluding remarks (4.).

## **2. Vertical restraints in online sales**

4. Compared to conventional sales markets, the importance and magnitude of specific methods of competitive restraint as well as pro- and anti-competitive effects of firms' conduct may be different in online markets.

### **2.1 *Selective distribution***

5. Selective distribution systems seem to play a particularly important role in online sales. In order to promote non-price competition or improved quality of services offered by traditional brick-and-mortar stores, producers and distributors may seek to control the distribution channels, for example by (indirectly) prohibiting or severely restricting internet sales.<sup>2</sup> Frequently raised concerns by producers and retailers about online sales are that brick-and-mortar stores will no longer be able to offer valuable (pre-sale) services or specific product features to consumers for three reasons: Firstly, online sellers (allegedly) have a cost advantage and may be able to offer the same products for lower prices.<sup>3</sup> Secondly, consumers (allegedly) still make use of the valuable pre-sales services that brick-and-mortar retailers provide, only to buy the products cheaper later online from retailers offering only a low level of services (free-riding). The same concerns regarding the negative effects of free-riding are also voiced with regard to other investments made by producers and retailers, for example investments made in costly quality signalling (e.g. elaborate shop fittings), the ability to enter a new market (which could require extra margins for financing the launch of stationary shops) or any other potentially efficient and welfare enhancing but costly service or marketing measure. The third claim often raised is that a prohibition or restriction of internet sales and particularly the use of specific platforms is necessary to protect a ("high end") brand image or the investments required to establish such an image. This is sometimes linked to the claim that high prices are needed to signal the quality of the products or that a high-price brand image generates additional value for consumers (for example, by offering exclusivity), which would be jeopardised through online sales.

6. Courts and agencies need to assess carefully the merits of such claims in those proceedings where welfare enhancing arguments can be or have to be taken into consideration. Firstly, in a case of existing cost advantages of online sellers, a competition authority's focus should be on keeping markets open for these price efficient competitors. Secondly, free-riding may also function in both directions. Research in Germany suggests that more consumers inform themselves online before making a purchase in an offline store than the other way round. Moreover, researchers found that the impetus generated by information gathered on the internet to purchase goods in offline stores is six to ten times the (turnover) value of the impetus generated by information gathered offline to purchase on the internet.<sup>4</sup> Thirdly, another issue

<sup>2</sup> The described aims of producers and distributors are also classical justifications for resale price maintenance (RPM) offline or online.

<sup>3</sup> Such cost advantages may not always materialise. Online stores may have lower costs or advantages stemming from economies of scale. On the other hand, they may also have larger costs due to high levels of returns of online purchases, which are generally free for the consumer (for example, clothing or shoe sellers).

<sup>4</sup> See [http://www.dbresearch.de/PROD/DBR\\_INTERNET\\_DE-PROD/PROD0000000000277459.pdf](http://www.dbresearch.de/PROD/DBR_INTERNET_DE-PROD/PROD0000000000277459.pdf) and [http://krefeld.ihk.de/media/upload/ihk/imap/20100526/Praesentation\\_25052010.pdf](http://krefeld.ihk.de/media/upload/ihk/imap/20100526/Praesentation_25052010.pdf)

could be whether the additional consumer welfare generated by being able to buy a high end brand (as far as such arguments can be considered as justifications) or receive pre-sale services is likely to outweigh the welfare losses from restraints of competition and/or higher retail prices in a specific case. In cases where the relevant claims are made, it can also be discussed whether high prices are really needed or even effective as signalling devices when consumers are already familiar with the brand and the quality it stands for or can easily find that information. Brand image may also be linked to high quality by other means that are less restrictive to competition.

7. Apart from restrictions by object unambiguously infringing competition in a serious way, competition authorities will have to assess and weigh the pro- and anti-competitive effects of encountered vertical restraints of competition, which can sometimes be a complex task. Such selective distribution systems and the debate about their (potential) positive or negative effects on (intra-brand and inter-brand) competition have, however, already been subject to competition law analysis in offline markets as well.<sup>5</sup>

## 2.2 *Two-sided markets and dynamics of markets*

8. The analysis of potentially anti-competitive conduct can be more complex in online markets due to the specifics of the analysed markets. Online services like online sales, but also search engines, social networks or price comparison websites, are relatively new developments, which make markets highly dynamic. Constant innovation and new business models can allow newcomers to leapfrog formerly very successful and seemingly powerful companies. Innovation and growth can enable swift market entries or quick shifts in market share. Imbalances between the market participants inevitably occur in such dynamic markets, even if they may only be of a passing nature. This is a feature of entrepreneurial freedom, with all its opportunities and risks, and it is the nature of competition. While this may make the assessment of competitive concerns more complex in specific cases, competition authorities have already dealt with competition issues in dynamic markets in the past. It is well established that one element of the market conditions that are assessed in any antitrust or merger procedure is the market phase, which indicates the market's stage of development. While high market shares may be one indicator for market power in saturated and mature markets, they are of less significance in expanding or dynamic markets.<sup>6</sup>

9. Many online services are also offered on two-sided markets where they are (almost) free to the end-user on the one market side and financed through advertising or prices on the other.<sup>7</sup> On two-sided markets a supplier acts as an intermediary between different customer groups. Indirect network effects are characteristic for such markets, one of the best-known examples being the market position of a newspaper on the advertising market; which is influenced by its position on the reader market. Similarly, the service provided by issuers of credit cards or debit cards is the more attractive for end customers the more retailers accept these cards as a method for payment. In such cases, prices and quantities on both markets are interdependent. The competitive constraints for platform operators or intermediaries (e.g. high barriers to market entry) are influenced by the market conditions and the interrelation between the markets concerned. Direct and indirect network effects as well as economies of scale can benefit incumbent firms and may form significant barriers to entry for newcomers in some cases, so that oligopolistic or even monopolistic

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<sup>5</sup> See, for example, BKartA case B5-100/10, a case concerning selective distribution in the area of high quality sanitary fittings.

<sup>6</sup> See i.a. BKartA, decision of 5.10.2006, B7-84/06 – KLATencor/ADE, para. 47-51, where the current market share of a supplier only minimally mirrored its future market opportunities.

<sup>7</sup> While consumers on the one market side may not always pay a monetary price for using the platform, they may contribute in other ways, for example with “eyeballs” (e.g. reading the advertisements and banners) or information revealed about their consumption patterns or preferences.

market structures may result that are no longer subject to sufficient competitive pressure.<sup>8</sup> In cases concerning two-sided markets it is thus not sufficient to assess the market conditions on only one of the markets.<sup>9</sup> However, as the cited examples show, competition analysis by competition authorities in two-sided offline markets can offer fruitful experience.

### 3. Cases of vertical restraints in online sales

10. Due to the new business models and the rapid development of online markets, producers and distributors try to exert control over the distribution channels, also to find the most profitable way to incorporate these new business models into their distribution systems. The most frequent vertical restraints relating to online sales which the Bundeskartellamt encountered so far were per se bans on internet sales, the ban of sales through specific online platforms and the ban of online sales with lower prices (resale price maintenance). Also best price clauses and prohibited price communication through the internet have been an issue.

#### 3.1 *Ongoing Cases*

11. Due to several complaints of dealers about the implementation or tightening of selective distribution systems, the Bundeskartellamt is currently investigating major sporting equipment suppliers. One important point in these cases is whether a restriction of competition like the ban on the use of third-party platforms for the sales business of authorized dealers could be justified by the wish to protect a certain brand image. Here an analysis is needed of the competitive role of brand image, which seemed to be one main argument put forward for the constraints. In parallel, the loss of intra-brand competition due to the ban of highly price transparent sales environments has to be taken into consideration. Some small dealers may even quit e-commerce, deterred by the higher fixed costs and efforts (e.g. for logistics and payment processing) of an own internet shop as well as by the loss of traffic and range compared to ready-to-use offers by platform operators. Whereas consumers have to increase their searching effort, the suppliers seem to improve their market insights by pursuing stricter e-commerce policies, which could increase information asymmetries between both sides. Even if the guarantee of a certain level of service and support could be claimed as a leading motive, the indispensability of the constraints is not always clear (e.g. in the case of unsophisticated and well-known every-day products). Also of importance is that similar rules are planned by all major players in this segment. In view of this bundle of similar constraints, effects on inter-brand competition have to be assessed. One of these effects could be a softening of price competition.

12. The Bundeskartellamt is also investigating two online platforms. Here the analysis of internet-wide best price clauses addressing the consumer side is the key topic. The already mentioned barriers to entry typical of platform markets could be strengthened by this tool - in particular if it is used market-wide or by dominant market participants. If the best price guarantees function, consumers could decide to save learning and searching costs by sticking to familiar platforms. In recognition of this, the other market side may also refrain from taking part in a new platform. For example, the possibility of the entry by a maverick

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<sup>8</sup> On the other hand, the same effects can, in a more dynamic perspective, also be one important factor helping newcomers with new or better products/services to successfully leapfrog former seemingly uncontestable companies (one example may be the development and consequent concentration of the telegraph market in the United States of America. The dominant market leader was challenged by a newcomer introducing an improvement on the telegraph: the telephone).

<sup>9</sup> Offline cases where these features played a role are newspaper or credit card markets. See also BKartA, decision of 28.12.2004, B7-150/04 – SES/DPC, concerning technical platforms in pay-TV; BKartA, decision of 29.08.2008, B6-52/08, on the operation of two target-group relevant platforms (cosmetic trade fairs and trade magazines).

platform with cost advantages wishing to raise attention with low prices on both market sides could be foreclosed. Also innovative concepts could be hindered. Recently these considerations have been supported by the case of a start up business which programmed a software “app” specialized in discounted last minute offers and which successfully fought for an interlocutory injunction against the use of the best price clause by one of the platforms. Overall, competition between platforms could be softened if best price clauses are widespread in a certain market. On the other hand platform owners regularly emphasize that in a transparent environment the effort of bringing together two market sides could be exploited by free-riding. Besides the balancing of pro- and anti-competitive effects, the indispensability will have to be discussed.

### **3.2 Examples of decisions by the Bundeskartellamt**

#### **3.2.1 Hearing aids**

13. In October 2005, the Bundeskartellamt imposed a fine of € 4.2 million on Phonak GmbH (“Phonak”), one of the leading German manufacturers of hearing aids. Phonak was accused of having influenced the resale prices of its products in an anticompetitive manner and of having prohibited the publication of prices on the internet. Phonak denied that the conduct in question had an impact beyond the individual case but decided not to appeal against the decision.

14. In Germany, hearing aids are usually sold from the manufacturer to end consumers via hearing aid retailers. In the Bundeskartellamt’s view the sale of hearing aids is characterised by a lack of price competition, both at the production level and the retail level. This lack of competition results not least from the fact that there is insufficient product and price transparency for end consumers wishing to buy a hearing aid.

15. In the present case, a hearing aid retailer had published its prices for hearing aids from all manufacturers on the Internet. For some products the prices for Phonak hearing aids were clearly below the minimum price level which had so far been generally applied in the market. As a result, other hearing aid retailers from across Germany complained to Phonak about the price-cutter. Phonak reacted by refusing to sell to the respective hearing aid retailer in order to induce him to raise his resale prices and to refrain from publishing prices on the internet.

16. Providing unilateral non-binding price recommendations is in principle allowed in Germany under competition law. However, anyone who threatens or causes disadvantages to others or promises or grants them advantages in order to enforce such price recommendations, commits an administrative offence. A refusal to sell constitutes such a disadvantage within the meaning of the law.

17. At the same time, such resale price maintenance can foster illegal concerted practices in the horizontal relationship between the traders without them actually having to contact each other. This can be the case if the companies observe the recommendation in the conviction that the other companies are acting in the same way.

18. In the Bundeskartellamt's view, the action taken by Phonak had an impact on competition far beyond this individual case. Eliminating the only retailer of hearing aids that fostered price competition was a suitable and intended means to maintain or re-establish the predominant price stability on the German market for the trade in hearing aids. Moreover, where price competition is already limited at the retail level, any further prevention of competition advances is all the more severe. The same is true for limited competition on the producer side (interbrand competition), which makes competition at the retail level (intra-brand competition) all the more important.

### 3.2.2 *Contact lenses*

19. In 2009, the Bundeskartellamt imposed a fine of € 11.5 million on CIBA Vision Vertriebs GmbH (“CIBA Vision”), the market leader in the contact lenses business in Germany. CIBA Vision was accused of having illegally restricted the internet trade in contact lenses of its own brand and of having influenced the resale prices of internet traders in an anticompetitive manner. CIBA Vision disputed the allegation from a factual and legal point of view, but abstained from lodging a legal appeal against the decision.

20. The offences as found by the Bundeskartellamt included anticompetitive agreements on the exclusion of internet trading and the prevention, in particular, of sales via eBay with regard to specific contact lenses. Claimed efficiency reasons for the necessity of a (selective) ban of internet trading included health and safety reasons, as well as the protection of necessary investments against free-riding. The Bundeskartellamt analysed these potential efficiencies but could not follow the proposed reasoning: The argument in favour of necessary health and safety measures was not a convincing one, as contact lenses are prescription free in Germany, measurement and control services offered by (non-medical) optical stores are within the discretion of the consumers (and most often not required, especially not for repeat purchases of daily or monthly lenses), and soft lenses are also sold in a multitude of drugstores and supermarkets. The problem of potential free-riding on necessary investments for pre-sales services by brick-and-mortar sellers could not convince, as the products in question did not require any particular new investment measures. The Bundeskartellamt was of the opinion that the envisioned benefits created by a ban on internet sales could also be achieved by less restrictive means. In addition, CIBA Vision employed so-called “price management” measures, operating a surveillance and intervention system with several persons in charge of monitoring and controlling the traders’ sales prices on the internet. If the resale prices of individual traders were at a certain level below the non-binding recommended retail price, CIBA Vision staff would contact those internet traders and try – in many cases successfully – to induce them to increase their sales prices.

### 3.2.3 *Outdoor GPS Navigation Devices*

21. In 2010, the Bundeskartellamt imposed a € 2.5 million fine on Garmin Deutschland GmbH, a producer of portable navigation devices, and on one responsible individual for establishing a resale price maintenance system. Garmin voluntarily reported this conduct (so called kick- back programme) to the Bundeskartellamt, even though the system had already been abandoned by then. The price maintenance system was designed as a programme that rewarded retailers who sold at the recommended retail price and “punished” retailers who sold on the internet below the recommended retail price. As such, the system was also an example of a dual-pricing strategy. Retailers that were found to undercut the recommended price on the internet had to pay higher prices to Garmin. If these retailers increased their internet prices for the products in question to the minimum price set by Garmin, they were granted a retroactive compensating bonus. Garmin, as well as the individual concerned, settled the case. The fact that Garmin had abandoned and voluntarily reported this conduct was considered as a mitigating factor in the calculation of the fine.

## 4. **Concluding remarks**

22. The challenge for competition authorities will be to protect competition without impairing the competitive, dynamic and beneficial processes in online markets. Protecting competition should not turn into intervention in these dynamics or protection from competition. Therefore, competition authorities have to analyze carefully whether positions of market power are established that are no longer sufficiently controlled by competition. In this respect competition enforcement operates in a difficult area. Nevertheless, some vertical restraints imposed on internet sales have the clear aim to delay or soften the dynamic changes to the supply chains induced by the internet. In this respect intervention may be necessary to protect the dynamism and the new opportunities of the digital economy. While the importance and frequency of particular potentially anti-competitive conduct may have changed in online sales or

online services in general, the strategies employed by companies are not always new and experiences gained by competition authorities in offline markets can be adapted to online sales as well.

23. Competition authorities are paving new ground on a case-by-case basis. Issues that require further attention will include: How to deal with best price clauses or selective distribution systems of all kinds, which types of practices justify a stricter approach and which types could be presumed to be less harmful. Having in mind the challenges of applying competition law in fast changing markets, the competition authorities have to find the right balance between caution and intervention.