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Entering Uncharted Territory: the Commission's thinking on territorial supply constraints

On 31 January 2013, the European Commission (DG Internal Market) published a Green Paper on unfair trading practices in the business-to-business food and non-food supply chain in Europe.[1] Following a number of inquiries at national level including the *Groceries* investigation in the UK,[2] the Green Paper deals with a variety of practices, for example retroactive contract changes, that are considered to "grossly deviate from good commercial conduct".

Much of the Green Paper discussion centres on considerations of what constitutes fairness and good faith dealings in relations between food producers and retailers, in some respects addressing a policy agenda beyond economic and competition considerations. However, one aspect of the Green Paper that touches directly on conventional economic and competition issues is its concerns with the use by some suppliers of territorial supply constraints.[3] The Commission suggests that such constraints result in cross-country price differentials and asserts that these differentials negatively impact the market integration objectives of the EU, thus harming consumers. This Brief assesses the Green Paper's evaluation of territorial supply constraints.[4]

Cross-border price differentials and parallel trade

European policy makers have long been preoccupied with the fact that prices for identical products may differ between European countries. For example, the Commission for a long time published regular reports on price differentials for new cars in the EU, and has heralded any narrowing of these differentials as evidence of increased market integration and competition.[5]

This focus on cross-border price differentials stems from the Commission's long-standing commitment to eliminate barriers to trade between Member States, thereby creating a Single Market with a scale comparable to that of the U.S. markets.[6] In this context, the Commission has historically strongly encouraged parallel trade opportunities. Within the competition rules, this has led to an extensive body of case law restricting suppliers' ability to prevent parallel trade of their products.

Importantly, however, arbitrage and parallel trade can also give rise to negative effects on consumers. Implicit in the Green Paper's view is a highly simplified framework that equates price discrimination with an absence of competition. Under this naive view, if a supplier is prepared to offer a lower price in one territory then the higher prices charged elsewhere are presumed to be supra-competitive, and the process of free trade is assumed to bring prices down to the lowest level to the benefit of consumers.

In many circumstances, however, the reality is much more complex than this simple framework suggests. Price discrimination is a ubiquitous phenomenon occurring in countless markets, including highly competitive ones, and a policy response against price discrimination that relies on this simple template cannot be relied upon to deliver good outcomes for economic efficiency, consumers, or even for market integration.

1. Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0037:FIN:EN:PDF.

2. See Competition Commission, Final Report of the supply of groceries in the UK market investigation, 30 April 2008.

3. The Green Paper characterises such constraints as impeding retailers' ability to source identical goods cross-border in a central location and distributing them to other Member States.

4. RBB Economics has advised the European Brands Association (AIM) on the discussion of territorial supply constraints in the Green Paper.

5. See the Commission's press release of 26 July 2011, http://europa.eu/rapid/press-release_IP-11-921_en.htm?locale=en. These car price reports commenced in 1993 and were discontinued in 2011.

6. See, for example, the 1998 Ceccini Report on "the Costs of Non-Europe" which predicted a gain of at least 5% in European GDP from the scale economies and other benefits that would flow from removing internal trade constraints and barriers.

Impact of price discrimination on consumers

In a simple static model, price discrimination always leads to some loss of efficiency. For example, customers facing a high price who, at the margin, decide not to buy the product ("just-dissuaded customers") value the product more highly than marginal customers facing a low price who do decide to purchase the product ("just-persuaded customers"). This gives rise to a so-called "allocative inefficiency" – welfare would increase if, for example through arbitrage, the product was reallocated from the latter group of customers to the former.

However, such inefficiencies occur everywhere in the economy and do not in themselves justify taking a hostile stance towards price discrimination. As soon as we move away from simple static considerations, it is apparent that price discrimination is widely used as an effective instrument to achieve dynamic efficiencies and consumer benefits. For example, price discrimination may result in efficient fixed cost recovery, or allow additional markets to be served. Importantly, by enabling firms to compete aggressively for new customers without creating spill-over effects to other markets, price discrimination often gives rise to important dynamic benefits in terms of more intense competition overall.

Of course, aggressive pricing for new customers can in some cases end up giving rise to anti-competitive effects. But the circumstances in which such outcomes arise are highly specific and do not justify a general ban on price discrimination. Accordingly, the Commission's Article 102 Guidance Paper does not identify price discrimination in general as a distinct abuse but focuses on more specific practices, a principle confirmed by the ECJ in its *Post Danmark* judgment.[7]

Given its ubiquitous nature and clear dynamic efficiency benefits, price discrimination must be presumed pro-competitive in most circumstances. Consequently, cross-border price differentials cannot be presumed to arise from any anti-competitive or exploitative motivation of suppliers. The same applies to any steps taken by suppliers to preserve these differentials.

Arbitrage and the free rider problem

Arbitrage clearly acts to limit the scope for price discrimination. As a result, arbitrage can also threaten the dynamic benefits that arise from efficient price discrimination. In such cases, arbitrage risks harming economic welfare.

A specific set of circumstances where this may occur is where arbitrage gives rise to "free-riding" concerns. Free riding occurs when firm A benefits from the actions, for example promotion efforts, of firm B without contributing to the costs of these efforts. Free riding can harm economic welfare because it may reduce the incentives on the part of firm B to engage in promotion efforts to begin with, even though consumers value and stand to benefit from such investments.

The Commission's Guidelines on Vertical Restraints recognise that the free-riding concern represents an important justification for imposing restrictions on trade.[8] A well-known example is a situation where a distributor considers heavily investing in promotion of a particular brand in the area in which it is active. The distributor will engage in such promotion efforts only if it has a sufficiently strong prospect of recouping the associated costs through increased sales. In the absence of any restraints, however, other distributors could enter the territory on the back of the increased brand awareness that the first distributor's promotion efforts have generated without shouldering any of the associated costs. Given this prospect, the original distributor may not be able to recoup its promotion investment. This free-riding threat may prevent the distributor from making the investment in the first place.

7. Case 209/10 Post Danmark A/S v Konkurrencerådet, judgment of 27 March 2012, paragraph 30.

8. Available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:130:0001:0046:EN:PDF; see paragraph 107.

It is well recognised that territorial restrictions such as exclusive territories, which effectively restrict arbitrage, may be a solution to this problem and may thus give rise to efficiencies.[9]

The free-rider concern can readily arise in the relationship between suppliers and retailers. By purchasing from a low-priced country and transporting the goods to a high-priced country, retailers are acting as arbitrageurs, seeking to benefit from cross-country differences in prices charged by suppliers. However, in doing so, retailers may be free riding on the efforts of the supplier, potentially harming economic welfare.

Suppose a particular supplier sells into two countries: A and B. In country A, the supplier has over time heavily and successfully invested in long-term brand-building efforts, resulting in a strong brand that is highly valued by consumers. In country B, the supplier has not undertaken a similar investment, resulting in its brand being much weaker in that country. Reflecting the greater strength of the brand, the supplier charges a higher wholesale price in country A than in country B.

In such a situation, a retailer in country A can free ride on the past efforts of the supplier in that country by sourcing the product at the low wholesale price in country B and reselling it at a high price in country A. The retailer will be able to charge a high price in country A because the retailer ultimately benefits from the strong demand for the product, caused by the supplier's marketing efforts. However, the retailer does not bear any of the associated costs.

As a result, economic efficiency risks being harmed because the supplier in country A will, ultimately, no longer be able to reap the rewards of its past marketing investment. This may make the supplier reluctant to further invest in marketing in that country, or indeed in any other country where the supplier may be hoping to establish a high-valued brand.

Blanket rules aimed at reducing cross-border price differentials – unintended consequences

Although the Green Paper does not contain any concrete policy proposals, the logical consequence of its stated hostility to territorial supply constraints would be a regulation under which suppliers would effectively no longer be able to charge different prices to customers located in different countries. This outcome could be achieved directly, by a ban on price discrimination, or indirectly by providing retailers with increased cross-border sourcing opportunities.

In the short term, any such measures would act to reduce or eliminate cross-border differentials in wholesale prices. However, a number of unintended consequences would likely result from this that are highly likely to harm consumers. Indeed, they could well have the perverse impact of presenting a barrier to the achievement of the Commission's internal market objectives, raising prices and discouraging cross-border entry, investment and choice.

First, it would probably be wrong to expect prices to harmonise down to the lowest level. If suppliers are no longer able to offer low prices without affecting margins earned in other countries, their incentives to offer low prices to begin with are reduced. Whenever a supplier wishes to cut prices in a particular national market, the supplier would need to take account of the increased risk that retailers in other countries would seek to take advantage of this. In many cases, such price cuts will therefore become less attractive. For example, it will become less attractive to cut prices in a particular country in order to grow market share there. It may also become less attractive to run sales promotions. As such, the proposals that the Commission appears to have in mind risk fundamentally impacting on the dynamics of competition in many markets.

9. See the Vertical Guidelines, paragraph 164. At footnote 53, the Green Paper appears to recognise these efficiencies, but then simply sets them aside by asserting that restrictions on the ability of distributors to make active sales into an exclusive territory of another distributor "are not considered a territorial supply constraint". But since the free riding problem can arise in both situations, there is no basis for such a distinction.

Second, the very incentive to sell any given product across different national territories – the essence of the single market objective – could be undermined. Once retailers are able to source at the price charged in the lowest price country, suppliers will find it less attractive to sell identical products in multiple countries. Selling a given product in multiple countries will come at the cost of effectively reducing pricing freedom in any given country. Consequently, rather than selling identical products in various countries, suppliers could consider (re-)introducing national product varieties, national sub-brands etc. And rather than being active in multiple countries to begin with, some suppliers may ask the question whether they would not be better off divesting brands in current low-price countries, or even withdrawing from such markets altogether. Paradoxically, all of the above options are likely to lead to market fragmentation – the opposite of what the Green Paper appears to envisage.

Third, as in any free-riding scenario, negative effects can also be expected on suppliers' investment incentives. If suppliers are no longer able to reap the rewards of their efforts to increase the value of their brand to consumers, suppliers' incentives to engage in such efforts will weaken. The resulting reduction in investment is, in the long run, highly likely to be detrimental to consumers and will adversely affect choice and product quality.

Fourth, a negative impact is likely on entry. When a firm is launching an existing product in a new geographic market, the optimal price that the firm would wish to charge in that new market often differs from prices that it charges in established markets. But if suppliers were effectively prevented from setting different prices for different countries, the incentives of suppliers, both large and small, to enter new geographic markets may weaken. Again, this would go directly against the Commission's market integration objective.

Conclusion

From a historical perspective, it is obvious why encouraging cross-border trade and arbitrage is an integral part of the Commission's DNA. This explains the Commission's inherently negative stance towards cross-border price differentials: instinctively, the Commission feels that continued cross-border price differentials signal that the potential for arbitrage (and therefore the Single Market) is not fully exploited.

However, whilst arbitrage clearly has a role to play, it could be a huge mistake to assume that unfettered arbitrage opportunities will always increase economic welfare. By contrast, such opportunities would provide retailers with extensive free-riding opportunities. In turn, these are likely to provoke harmful longer-term consequences which would fundamentally impact on the dynamics of many markets, be highly likely to harm consumers and also damage the Commission's underlying objectives of creating a better integrated, more efficient and dynamic European market.

Given the fact that efficient price levels will often differ between countries, it is certainly not valid to characterise suppliers' use of different prices in different countries, as well as any steps taken by suppliers to preserve these differences, as being harmful to economic efficiency, consumer welfare, or even market integration. On the contrary, simplistic measures to prohibit price differentials might well have unintended and opposite effects. Doing away with territorial supply constraints might appear to be an attractive response, but appearances can be deceptive, and in this case it would certainly mean entering uncharted territory.