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ALERT MEMORANDUM

European Commission Publishes Final Report in E-Commerce Sector Inquiry

May 24, 2017

Summary

In May 2015, the European Commission (the "**Commission**") launched an inquiry into the e-commerce sector in the European Union ("**EU**") (the "**Sector Inquiry**"). On September 15, 2016, the Commission published a Preliminary Report. The Final Report (the "**Report**") was published on May 10, 2017.

The Sector Inquiry examined the operation of competition in relation to consumers goods (including clothing and shoes, consumer electronics, electrical household appliances, computer games and software, toys and childcare, media (books, CDs, DVDs, and Blu-ray discs), cosmetics and healthcare products, sports and outdoor equipment, and house and garden products) and digital content (focusing on audio-visual and music products).

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In the context of consumer goods, the Commission identified competition concerns such as restrictions on selling via online marketplaces and price comparison tools, vertical and horizontal price fixing (as well as dual pricing for online and offline sales), price parity clauses, and exchange of competitively sensitive information. As regards digital content, the Commission expressed concerns about the competitive effects of bundling rights to digital content, territorial restrictions, the lengthy duration of licensing contracts, and payment structures that favor incumbent content providers.

The e-commerce sector is a particular priority for the Commission. The Final Report states that "*the EU is one of the largest e-commerce markets in the world. The percentage of people aged between 16 and 74 that have ordered goods or services over the internet has grown year-on-year from 30 % in 2007 to 55 % in 2016.*" It notes that online sales have grown exponentially in the EU since 2000 with an annual average growth rate of approximately 22%, and that the rapid development of e-commerce affects both business and consumers.

Against this backdrop, the Commission is concerned to avoid diverging interpretations of EU competition rules with regard to business practices in e-commerce markets, thereby creating obstacles for companies that operate in multiple Member States – to the detriment of a Digital Single Market. This alert memorandum summarizes the findings of the Report and discusses the implications for businesses.

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I. E-Commerce Sector Inquiry: Overview

Background

On May 6, 2015, the Commission launched the Sector Inquiry as part of one of the three pillars of the Commission's Digital Single Market strategy: to improve access to digital goods and services. This "pillar" aims to "*remove the key differences between online and offline worlds, to break down barriers to cross-border online activity*."[1]

To this end, the Commission has put forward legislative proposals in a number of areas, including the harmonization of contract rules for the supply of digital content and online sales of goods, rules addressing "unjustified geo-blocking", and copyright reforms, and it is considering legislation to address *"unfair contractual clauses and trading practices identified in platform-to-business relationships*."[2]

In parallel, the Commission launched the Sector Inquiry with the aim of "*identifying possible competition concerns affecting European e-commerce markets*," particularly "*potential barriers erected by companies to cross-border online trade in goods and services where e-commerce is most widespread*."[3] It enabled the Commission to gather information on companies' conduct and barriers to cross-border online trade, looking specifically at online sales of consumer goods and digital content.

1 "Better access for consumers and business to online goods," Commission web page, May 16, 2017, available at https://ec.europa.eu/digital-single-market/node/78515.

2 "Mid-Term Review on the implementation of the Digital Single Market Strategy," Commission Communication, May 10, 2017, available at http://europa.eu/rapid/press-release_IP-17-1232_en.htm.

3 "Commission launches e-commerce sector inquiry," Commission press release, May 6, 2015, available at http://europa.eu/rapid/press-release_IP-15-4921_en.htm.

Fact-Finding and Initial Actions

The Commission gathered information from 1,051 retailers, 37 marketplaces, 89 price comparison tool providers, 17 payment system providers, 259 manufacturers, 248 digital content providers, 9 companies offering virtual private networks and IP routing services, and 30 large groups and hosting operators, from 28 Member States. It reviewed more than 2,600 agreements concerning the distribution of goods in the EU and received more than 6,800 licensing agreements from digital content providers and rights holders.

The Commission published a report of its preliminary findings in September 2016 and opened three new investigations in the e-commerce sector in February 2017:

— ***Consumer Electronics.*** The Commission is investigating whether manufacturers restrict the ability of online retailers to set their own prices for products such as household appliances, notebooks and hi-fi products – made worse by software that retailers use to adjust their prices automatically to those of competitors.

— ***Video Games.*** The Commission is investigating agreements between the owner of the Steam game distribution platform and five PC video game publishers, concerning geo-blocking practices.

— ***Hotel Pricing.*** The Commission is investigating agreements between hotels and the largest European tour operators, which may contain clauses that discriminate between customers, based on their nationality or country of residence.

The Commission reports that several companies in the clothing sector (Mango, Oysho, Pull & Bear, Dorothy Perkins, Topman), coffee machines (De Longhi), and photo equipment (Manfrotto) have recently reviewed their practices.[4]

4 "Commission publishes final report on e-commerce sector inquiry," Commission press release, May 10, 2017, available at http://europa.eu/rapid/press-release_IP-17-1261_en.htm.

Next Steps

The data gathered will be used in discussions around the renewal of the Vertical Block Exemption Regulation (“**VBER**”), which is due to expire in May 2022. The Commission does not foresee the need to pre-empt the review of the VBER as a result of the Sector Inquiry, however.

The Commission will also use the Sector Inquiry to set enforcement priorities. In particular, the EC will “*target enforcement of the EU competition rules at the most widespread business practices that have emerged or evolved as a result of the growth of e-commerce and that may negatively impact competition and cross-border trade and hence the functioning of a Digital Single Market*.” Moreover, the EC will “*broaden the dialogue with national competition authorities within the European competition network on e-commerce-related enforcement to contribute to a consistent application of the EU competition rules as regards e-commerce-related business practices*.”

II. Findings on Consumer Goods

Market Characteristics and Trends

The Report does not find a high level of concentration in consumer goods, either at the level of manufacturers or retailers. Although the Report does not claim to be reviewing specific ‘product markets,’ this may indicate that most of the distribution agreements the Commission reviewed fell below the market share thresholds under the VBER.

Respondents to the Commission’s information requests indicated that competition takes place across multiple parameters, including price, quality, brand image, and range of products. Manufacturers identified brand image and quality as the most important parameters of competition, in contrast to retailers, which viewed price as the primary concern.

Developments in the e-commerce sector have led to a number of changes in how market participants compete. First, the overwhelming majority (more than 90%) of retailers offer the same (or greater) range of models online as they do offline. Second, manufacturers are themselves increasingly present at the retail level in online markets through their own online shops or by selling products to consumers through online marketplaces. Third manufacturers have sought to exercise increased control over their distribution networks, for example by using selective distribution systems (whereby manufacturers use ‘authorised’ retailers that meet particular criteria), but also – to a lesser extent – some form of territorial exclusivity. Fourth, retailers typically deploy a multi-channel approach to sales, using both online and bricks-and-mortar stores.

Contractual Restrictions on Cross-Border Sales

The Sector Inquiry identified a number of contractual restrictions that the EC considers could raise concerns under Article 101 of the Treaty on the Functioning of the European Union (“TFEU”). Unilateral decisions by non-dominant firms fall outside the scope of EU competition law.

The Report identified the following types of territorial restrictions, which the Commission may treat as potential hardcore restraints (which therefore fall outside the scope of VBER): contractual restrictions against passive sales to customers in other Member States; restrictions on active sales into Member States that have not been reserved to the supplier or other distributors; limiting the ability of authorised retailers in a selective distribution system to sell to customers in other Member States; and limiting the ability of an “exclusive” distributor in one territory to make sales to members of selective distribution system in other Member States.

In total, 12% of retailers reported facing contractual restrictions on cross-border sales.

Restrictions on Selling Via Online Marketplaces

The Report found that 18% of retailers had restrictions in their agreements with manufacturers that prevent them from selling via online marketplaces. Manufacturers’ reasons for imposing these restrictions included protecting their brand, avoiding association with counterfeit products that may be sold via marketplaces, and looking to ensure adequate pre- and post-sales service (among others).

Bans on sales via marketplaces such as Amazon and eBay have been challenged in a series of cases in Germany and is the subject of an ongoing case before the Court of Justice (Case C-230/16 *Coty*). The Commission does not view marketplace selling bans as hardcore restraints. Specifically, it considers that a marketplace sales ban affects *how* products are sold, but not *where* or *to whom* they are sold, such that it "*should not therefore be considered as restricting the effective use of the internet as a sales channel*."

This position is supported by data in the Report that only a small number of retailers rely exclusively on online marketplaces (4%), retailers get a similar sales conversion rate on their own websites (4%) as on marketplaces (5%), and the overwhelming majority of retailers that do *not* sell on marketplaces (88%) were unable to identify any restrictions that prevent them from doing so – in other words, they decided for themselves not to sell via online marketplaces.

The Report notes, however, that the Commission may still scrutinise marketplace bans if parties to the agreements have market shares above the thresholds set out in the VBER, the agreements contain hardcore restraints, or there is a situation in which the Commission believes it would be appropriate to withdraw the protection of the VBER.

Restrictions on Using Price Comparison Tools

The Report found that 36% of retailers supply data feeds to price comparison tools and 9% of retailers reported having some form of restriction in their agreements with manufacturers that inhibit their ability to list products on price comparison sites.

The Commission has not previously assessed the compatibility of restrictions on the use of price comparison tools under Article 101 TFEU. Manufacturers expressed concerns that price comparison tools focus attention solely on price and not on other parameters of competition, such as quality or post-sales services. On the other hand, the Report states that "*absolute price comparison tool bans which are not linked to quality criteria, potentially restrict the effective use of the internet as a sales channel and may amount to a hardcore restriction of passive sales*."

It is questionable whether data from the Sector Inquiry support this conclusion. Price comparison tools have a lower sales conversion rate (3%) than other channels such as retailers' own websites (4%). And only 9% of retailers reported being restricted from using price comparison tools – a fraction of the 64% of retailers who chose not to do so. This does not suggest that listing on price comparison sites is necessary to sell products effectively online. Moreover, it is difficult to reconcile the suggestion that a restriction on listing on price comparison sites (essentially an advertising restriction) could be treated as a hardcore restraint, but a ban on listing products on marketplaces (a platform for making sales) is not.

In any event, the Commission considers that "*restrictions on the usage of price comparison tools based on objective qualitative criteria are covered by the VBER*" and that restrictions "*on the use of price comparison tools targeting specific territories may be a permissible restriction of active sales into this territory provided that it has been exclusively reserved for the supplier*" or another distributor.

Restrictions on Pricing

The Report notes that e-commerce has increased price transparency, leading to more intense competition on price and greater opportunities for users to compare options. Specific features of the e-commerce sector, though, may increase the risk of resale price maintenance or collusion between competitors.

Resale Price Maintenance. Manufacturers are free to recommend resale prices to their distributors and retailers. The risk of resale price maintenance (in breach of Article 101 TFEU) arises when manufacturers seek to enforce compliance with recommended prices through contractual restrictions, obtaining retailers' agreement, or some form of coercion.

The rules on resale price maintenance apply equally to online and offline sales. But the Commission notes that pricing transparency in online markets means "*it is now easier to detect deviations from manufacturers' pricing recommendations. This could allow manufacturers to retaliate against retailers that*

deviate from the desired price level." In other words, the ability to track online prices make it easier for manufacturers to enforce resale price maintenance compared with sales through bricks-and-mortar stores.

In this regard, the Report found that almost 30% of manufacturers systematically track resale prices, out of which the majority track resale prices manually (67%). Some manufacturers use software to track prices automatically (38%). Others track resale prices in a more targeted manner, for example focusing on premium products or key markets.

Price Collusion. Price fixing between competitors is the classic example of an agreement in breach of Article 101 TFEU. This applies to both online and offline sales. For a cartel to be effective, though, participants need a mechanism to monitor each other's prices to ensure they are complying with the agreed price. The Report found that "*price monitoring software may facilitate or strengthen (both tacit and explicit) collusion between retailers by making the detection of deviations from the collusive agreement easier and more immediate*."

In particular, the Commission found that approximately 50% of retailers track online prices of competitors. In addition to using online searches and price comparison tools, retailers reported using "spider" software that "crawls" the internet to gather information on rivals' prices, thereby allowing a high level of granularity, scope and immediate access to pricing data from hundreds of websites. The majority of retailers (78%) that use software to monitor rivals' prices subsequently adjust their own prices, in some cases deploying software to adjust their own prices accordingly.

This could reduce the incentives of firms to deviate from the agreed price in a collusive agreement, as any benefit to a company from "cheating" by deviating from the "agreed" price could be counteracted by other parties likewise adjusting their prices.

Dual Pricing. The Commission notes that charging different prices depending on whether a product is to be resold via online or offline sales channels is generally considered a hardcore restriction of competition under the VBER. This rule is controversial. The Commission states that dual pricing rules were "*one of the most commented sections of the Preliminary Report*" in particular to call for greater flexibility to incentivise retailers "*to support investments in more costly (typically offline), value added services*."

The Report notes that the Commission is open to considering efficiency-based justifications for dual pricing in individual cases. Thus, even though dual pricing is a hardcore restriction of competition, it may be possible for companies to benefit from individual exemption under Article 101(3) TFEU where a dual pricing arrangement is "*indispensable to address free-riding between offline and online sales channels in the case of hybrid retailers that are part of the distribution network of the manufacturer*."

Use of Price Parity Clauses

Price parity or "most favoured nation" ("MFN") clauses refer to agreements between a supplier and a platform whereby the supplier offers that platform equal (or better) terms than the supplier offers elsewhere. These often refer specifically to price, but can also address product range or customer service. The Commission investigated the use of MFN clauses in its eBooks investigations,[5] and several national competition authorities challenged the use of MFN clauses in the online hotel bookings sector. [6] The UK Competition and Markets Authority also investigated MFN clauses in its investigation into the private motor insurance market.[7]

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5 Case COMP/AT.39847 *Ebooks*, Commission decision of July 25, 2015 (concerning agreements between Apple and eBook publishers), and case COMP/AT.40153 *E-book MFNs and related matters*, Commission decision of April 4, 2017 (concerning agreements between Amazon and eBook publishers).

6 This includes investigations by the French, German, Italian, Swedish, UK and other national competition authorities.

7 Competition and Markets Authority, Private motor insurance market investigation, September 24, 2014.

Few retailers reported having price parity requirements in their agreements with marketplaces. Just 2% of retailers reported facing "narrow" MFN clauses, whereby a retailer agrees not to charge a higher price on the marketplace than it does on its own website. Likewise 2% of retailers reported facing "wide" MFN clauses, whereby a retailer agrees not to charge a higher price on the marketplace than it does on other marketplaces.

The Report states that where marketplaces play an important role, price parity clauses can reduce the incentives for retailers to compete on price and can impede the ability of new marketplaces to enter or expand (for example, by negotiating lower prices from retailers than incumbent platforms). On the other hand, they can lead to efficiencies, for example to avoid free-riding (*e.g.*, if a platform invests in promoting the retailers' product). Therefore, where MFN clauses are not covered by the VBER (*e.g.*, because the parties' market shares exceed the threshold level), the effect on competition has to be assessed on a case-by-case basis.

Other Online Sales and Advertising Restrictions

The Report notes that the types of restrictions discussed above do not constitute an exhaustive list of the restrictions that the Commission encountered during the Sector Inquiry, and new types of restrictions could emerge as the e-commerce sector develops.

The Report refers to a practice of certain manufacturers of limiting retailers' ability to "*use or bid on the trademarks of certain manufacturers in order to get a preferential listing on the search engines paid referencing service (such as Google Adwords)*." This is said to have the aim of preventing retailers' websites from appearing prominently, while preferencing the manufacturer's own retail activities. The Commission considers that the practice could raise concerns under Article 101 TFEU if it "*restrict[s] the effective use of the internet as a sales channel by limiting the ability of retailers to direct customers to their website*."

This is a novel and unsubstantiated theory that equates losing some level of prominence with a true restriction of online sales. This seems unwarranted, given that manufacturers can legitimately restrict *how* retailers sell products online (as shown by the Commission's approach to marketplace bans). And the Report does not attempt to identify the effect of such restrictions on retailers' online sales in practice (save for noting in general terms "*the importance of search engines for attracting customers to the retailers' website*").

In its separate "Mid-Term Review" of the Digital Single Market strategy, the Commission also referred to "*widespread concern that some platforms may favour their own products or services, otherwise discriminate between different suppliers and sellers and restrict access to, and the use of, personal and non-personal data, including that which is directly generated by a company's activities on the platforms. Lack of transparency, e.g. in ranking or search results, or lack of clarity in relation to certain applicable legislation or policies have also been identified as key issues*."[8] The Commission may look to investigate these practices further.

Exchange of Sensitive Information

Marketplace operators collect a wide range of user data such as product purchasing history, payment method, purchasing price history, frequency of visits, devices used, browsing history on the marketplace, and location data. In general collecting such a large volume of data can allow marketplace operators to improve the user experience and improve business performance (*e.g.*, through better targeted marketing activity). Likewise, retailers collect a range of user data for reasons such as marketing or performance analytics.

The Report refers, however, to concerns that competitively sensitive information may pass between parties that compete in certain product areas. For example, retailers may supply competitively sensitive

[8] Commission, "Communication on the Mid-Term Review on the implementation of the Digital Single Market Strategy," May 10, 2017, page 8, available at http://europa.eu/rapid/press-release_IP-17-1232_en.htm.

information to marketplace operators (*e.g.*, inventory levels, pricing plans), even though marketplace operators sometimes also act as sellers on their own platform, in competition with third party retailers. The same concern arises with respect to manufacturers that have their own online retail presence. A senior official from the German competition authority has already described Amazon's "*dual role*" as a marketplace operator and online retailer as a "*huge issue*."[9]

III. Findings on Digital Goods

Distributing digital content requires a licence from the copyright holder. The Report examined licensing arrangements between rights holders and digital content providers, covering film, TV, sport, music, and news content.

The Report observes that online rights are generally licensed within national territories – typically in a single Member State (or throughout a small number of Member States). A review of agreements submitted to the Commission showed that 57% of online rights were licensed for a single Member State. And out of the rights that were licensed for a single Member State only, 66% were licensed on an exclusive basis.

The Report acknowledges that exclusive licensing is not problematic in and of itself. Instead, the Report focuses on (i) territorial restrictions relating to geo-blocking, (ii) bundling of rights, and (iii) the duration of license agreements and payment structures that favour incumbent operators.

Territorial Restrictions

"Geo-blocking" denotes methods of preventing the transmission of digital content outside a particular territory. According to the Report, 70% of digital content providers implement at least one type of geo-blocking measure (*e.g.*, verifying a user's IP address or credit card address).

The Commission acknowledged that a unilateral decision not to make content available to users in other Member State falls outside Article 101 TFEU. On the other hand, the Report states that "*when coupled with contractual restrictions on cross-border passive sales, [an exclusive territorial license] might be detrimental to competition*," albeit any assessment would need to take account of "*the characteristics of the content industry, the legal and economic context of the licensing practice and / or the characteristics of the relevant product and geographic markets*."

The Report examined the licensing agreements submitted, finding that 59% of content providers are contractually required to implement geo-blocking. And geo-blocking requirements appear in the majority of licensing agreements for fiction TV (74%), films (66%), sports (63%), music (57%), children's TV (55%), and non-fiction TV (51%). It also found that 26% of licensing agreements included monitoring provisions (*e.g.*, allowing rights holders to carry out audits or requirements to inform rights holders of what geo-blocking measures were deployed) and 37% contained provisions for sanctions or compensation if the content provider failed to comply.

Arguably, though, investigating these factors misses the mark. They go to the question of whether and how geo-blocking is required, but not whether such requirements could be treated as restricting competition or fall within Article 101 TFEU.

Bundling of Digital Rights

Online transmission is just one way to provide digital content. Others include cable, satellite or mobile delivery. In practice, the right to deliver content online is typically bundled together with rights to transmit content via these other means. Of the online licensing agreements submitted by rights holders, 89% granted rights to transmit content both online and via another method. Just 11% of agreements were for online transmission only.

The Commission notes that bundling online and other content rights can be an effective strategy to allow content providers to offer the same products across multiple services, and this approach fits the remit of certain broadcasters (particularly public service broadcasters). The Report identifies concerns,

[9] MLex, "Amazon's double online role is a 'huge issue,' German antitrust official says," May 15, 2017.

however, that bundling rights could reduce output if those rights are not fully exploited by the content provider.

Duration of Licence Agreements and Payment Structures

The Commission investigated the duration of licensing agreements for digital content. The average duration varied depending on the category – 52 months for fiction and children's TV, 44 months for sports, and 32 months for music. And when looking at the sport and fiction and children TV sectors specifically, over 70% of all contractual relationships have lasted for at least six years. The fact that licensing agreements often have a long duration and are renewed leads to long term contractual relationships, raising concerns for the Commission that it is difficult for new players to enter the market.

According to the Report, incumbent content providers are also favoured by payment structures that involve advance payments and fixed fees, which do not depend on the number of content users. The Commission is concerned that these forms of payment "*might make it more difficult for new entrants to gain a foothold in the market*."

IV. Implications for Businesses in the E-Commerce Sector

The Report has confirmed the e-commerce sector as a priority for antitrust scrutiny. Commissioner Vestager commented that "*Certain practices by companies in e-commerce markets may restrict competition by unduly limiting how products are distributed throughout the EU. Our report confirms that. These restrictions could limit consumer choice and prevent lower prices online. At the same time, we find that there is a need to balance the interests of both online and 'brick-and-mortar' retailers. All to the benefit of consumers. Our findings help us to target the enforcement of EU competition rules in e-commerce markets*."

More cases may therefore follow the three new investigations that the Commission opened in February 2017. Enforcement actions will likely benefit from the Commission's efforts to gather information and documents as part of the Sector Inquiry. Moreover, the Commission envisages working with national competition authorities in Member States, some of which are already actively scrutinizing practices in the e-commerce sector.[10]

As regards the specific concerns discussed in the Report, certain of these are based on well-established theories of harm (*e.g.*, resale price maintenance), albeit they may feature new aspects that are specific to online markets (*e.g.*, use of software tracking technology to detect deviations from the agreed resale price). It is also possible that the Commission will develop novel theories of harm to challenge practices which it believes raise concerns.

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[10] The German Bundeskartellamt has challenged bans on retailers using online marketplaces or price comparison websites (*e.g.*, Case B2-98/11 *Asics*, decision of January 13, 2016; and *Adidas*, case closed on July 2, 2014). The UK Competition and Markets Authority has recently fined companies for vertical and horizontal price fixing in relation to online sales (*e.g.*, Case 50223 *Online sales of posters and frames*, CMA decision of August 12, 2016; and Case CE/9857-14 *Online resale price maintenance in the bathroom fittings sector*, CMA decision of May 10, 2016).