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Entering uncharted territory: the Commission's thinking on territorial supply constraints

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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. One of the issues that the Green Paper deals with is the use by some suppliers of territorial supply constraints – described as impeding retailers' ability to source identical goods cross-border in a central location and distributing them to other Member States. 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. But as we explain below, simplistic measures to prohibit price differentials might well have unintended and opposite effects.

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. This stems from the Commission's long-standing commitment to eliminate barriers to trade between Member States. Within the competition rules, this has led to an extensive body of case law restricting suppliers' ability to prevent parallel trade of their products.

However, as soon as we move away from simple static economic models, 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 anticompetitive 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.)

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

While arbitrage clearly has a role to play, unfettered arbitrage opportunities can threaten the dynamic benefits that arise from efficient price discrimination, thus potentially harming economic welfare. A specific set of circumstances where such negative effects may occur is where arbitrage gives rise to free-riding concerns. A well-known example is a situation where a distributor considers investing in promotion of a particular brand in the area in which it is active, but refrains from doing so because of the risks of being undercut by rivals free-riding on the first distributor's efforts. It is well recognised that territorial restrictions such as exclusive territories, which effectively restrict arbitrage, may be a solution to this problem – as recognised in the Commission's Guidelines on Vertical Restraints.

The free-rider concern can readily arise in the relationship between suppliers and retailers. 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. 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.

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. This could fundamentally impact on the dynamics of competition in many markets.

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. This could lead suppliers to consider options such as (re-)introducing national sub-brands, or even divesting brands in current low-price countries. 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 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 the 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 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.

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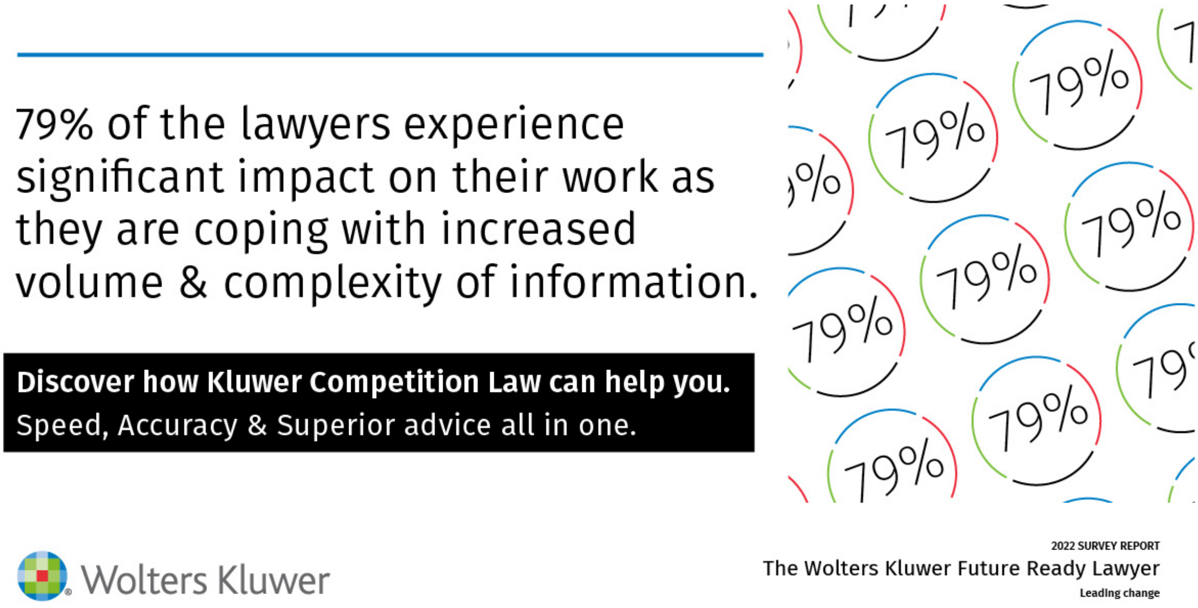

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