Title: Consultation Stage Impact Assessment on the UK's Future Regime for the Exhaustion of Intellectual Property Rights **IA No:** BEIS004(C)-21-IPO **RPC Reference No:** RPC-BEIS-IPO-5047(1) **Lead department or agency:** Intellectual Property Office (an executive agency of the Department for Business, Energy and Industrial Strategy)	**Impact Assessment (IA)** **Date:** 07/06/2021 **Stage:** Consultation **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** IPExhaustion@ipo.gov.uk

Summary: Intervention and Options

Cost of Preferred (or more likely) Option (in 2019 prices)			
Total Net Present Social Value £m	**Business Net Present Value** £m	**Net cost to business per year** £m	**Business Impact Target Status** Qualifying provision

What is the problem under consideration? Why is government action or intervention necessary?

Now that the United Kingdom has left the European Union, the UK government is making use of its regulatory freedom to decide its future exhaustion of intellectual property rights regime. The UK is currently unilaterally participating in the European Economic Area ("EEA") regional exhaustion regime without reciprocation. This means that the IP rights in goods first placed on the market in the EEA are considered exhausted in the UK. These goods can be parallel imported into the UK without the rights holder's permission. However, goods exported to the EEA from UK will need rights holder's permission as the IP on these goods is not considered exhausted by the EEA member states.

What are the policy objectives of the action or intervention and the intended effects?

UK participation in the EEA regional exhaustion regime ceased on 31 December 2020, and the government now intends to make a decision on the most appropriate regime for the future. In making this decision, the government's objective is to preserve a balance between incentivising innovation and the creation of new technology, products or cultural works while enabling competitive markets, consumer choice and fair access to IP-protected goods for the benefit of society.

What policy options have been considered, including any alternatives to regulation?

Option 1: UK unilateral application of an EEA regional exhaustion regime ('Do nothing' option but this is still a possible option).
Option 2: A national regime where parallel imports into the UK would not be permitted without the rights holder's permission. Rights holders would be able to prevent the re-sale to the UK of any IP-protected goods that were not first placed on the market in the UK.
Option 3: An international regime whereby parallel imports from any country would be permitted. This option would also include unreciprocated continuity of parallel imports from EEA member states.
Option 4: A "mixed" regime may consist of a different regime for a specific good, sector or IP right.

Does implementation go beyond minimum EU requirements?	N/A			
Is this measure likely to impact on international trade and investment?	Yes			
Are any of these organisations in scope?	**Micro** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent) N/A	**Traded:**	**Non-traded:**		

Economist signoff:	Stephanie Dales - Acting Deputy Director Europe and Trade Analysis	7 June 2021

Background

Intellectual property rights' role in innovation and creativity

'Intellectual Property' (IP) refers to creations of the mind. This includes inventions; literary and artistic works; and symbols, names and images used in commerce. IP is protected in law by rights such as patents, designs, copyright and trade marks, which enable people to earn recognition or financial benefit from what they invent or create.

IP rights exist to incentivise innovation through the offer of a temporary monopoly to creators and inventors. Investment in creativity and innovation leads to new products and services, through which businesses and individuals make an important contribution to UK economic growth. However, creativity and innovation involve cost to individuals and businesses, such as lost earnings or investment in research and development. IP-rich goods and services are typically difficult to bring to market but easy for others to copy. Such costs and risks can therefore discourage investment in innovation and creation. Granting inventors and creators exclusive rights helps to reduce such risk and so stimulates investment in innovation and creativity.

IP industries play a vital role in the growth of the UK economy. In 2014-16, IP right-intensive industries generated an estimated 43% of UK GDP and 28% of UK employment, or more than 8.4 million jobs[1]. UK businesses continue to invest significant resources in intellectual property. In 2018, almost half of UK firms' investment (£169 billion) was in intangible knowledge assets, rather than tangible assets like plants or machinery[2]. For 2014, just over half of this investment was protected by formal IP rights[3].

What is exhaustion of intellectual property rights?

Exhaustion of IP rights limits a rights holder's power to control the distribution of a good[4] after it is placed in a market. The principle under which "limits" are imposed is known as the "Principle of Exhaustion"; this means that after a good has been placed in the market by the rights holder or an authorised licensee, they are unable to prevent the subsequent sale and redistribution of that good in that market or region.

The exhaustion regime of a country or region grants rights holders and their authorised licensee the ability to control parallel trade. Some countries give the IP rights holders the right to exclude goods sold abroad from importation, a situation referred to as *national exhaustion*. Others permit parallel imports, where parallel distribution channels exist outside the control of the rights holders. This is the case of *international exhaustion*. The European Union (EU) and other members of the European Economic Area (EEA) pursue an intermediate policy of *regional exhaustion*, under which IP rights owners may exclude parallel imports from outside the EEA geographical area but such trade is legal inside the region.

Exhaustion can mitigate and limit the strength of intellectual property rights, by providing access to and availability of goods to consumers and businesses through a system of parallel trade[5]. Parallel trade occurs where goods sold abroad at a lower price are reimported by a distributor and can compete with domestic goods. Parallel imports can affect the degree of competition that rights holders and their licensees face, and their ability to price discriminate geographically, making it harder to charge different prices in different markets.

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[1] EUIPO report, available at: https://euipo.europa.eu/tunnel-web/secure/webdav/guest/document_library/observatory/documents/IPContributionStudy/IPR-intensive_industries_and_economicin_EU/WEB_IPR_intensive_Report_2019.pdf, (2019)

[2] ONS, 'Developing experimental estimates of investment in intangible assets in the UK: 2016' (2019)

[3] Goodridge, Haskel and Wallis, 'UK Intangible Investment and Growth' (2016)

[4] There are no rules on exhaustion relating to digital goods

[5] WIPO Standing Committee on the Law of Patents: Twenty-First Session; Geneva, November 3 to 7, 2014, "Exceptions and limitations to patent rights: exhaustion of patent rights" (http://www.wipo.int/edocs/mdocs/scp/en/scp_21/scp_21_7.pdf)

Problem under consideration and rationale for intervention

Now that the United Kingdom has left the European Union, the UK government is making use of its regulatory freedom to decide its future exhaustion of intellectual property rights regime. The UK is currently unilaterally participating in the EEA regional exhaustion regime without reciprocation. This means that the IP rights in goods first placed on the market in the EEA are considered exhausted in the UK. Therefore, these goods can be parallel imported into the UK without the rights holder's permission.

The government intends to make a decision on the most appropriate exhaustion regime for the future. There are a number of options available which will need to be tested through consultation, with evidence and views required on what regime should be implemented on a permanent basis, and if there is to be a change, how any new regime should be implemented.

Rationale and evidence to justify the level of analysis used in the IA

For this consultation stage impact assessment, the government has been unable to quantify the impact due to a lack of available data. Economic evidence on the impact is limited as there are no similar international examples where a country has left a regional exhaustion regime. Existing economic literature provides some evidence for certain sectors, but there is no evidence on what happens when a country changes its exhaustion regime across all IP rights simultaneously. Furthermore, parallel imports are legal and entail trade in legitimate goods, and apart from certain sectors such as pharmaceuticals, where regulators must track the origins of medicines that may affect public health, there is very little data collected on the scale of parallel imports into the UK.

This makes measuring the economic impact of a potential change to the exhaustion regime challenging. The Intellectual Property Office (IPO) commissioned Ernst & Young (E&Y) in 2019 to carry out a feasibility study to assess if it was possible to measure the scale and extent of parallel trade. The findings from the report highlighted that it was difficult to measure the scale of parallel trade into the UK. Efforts to engage businesses highlighted that their awareness and understanding of parallel trade was very limited.

While this impact assessment brings together evidence from both commissioned and academic research, there are still significant gaps which the government is looking to address in this consultation. Therefore the government has carried out a qualitative assessment of the costs and benefits and sought to describe who will be affected.

As part of the consultation, the government will seek to gather the evidence to identify the size of the market for parallel imports, and how different sectors and parties might be affected. The government will also continue to engage with sectors affected, to identify how parallel trade affects them and what data is available. The consultation document will ask specific questions around:

- how different businesses and sectors are affected by parallel imports;
- what information businesses can provide on the costs and benefits of different exhaustion regimes (including the current unilateral regime); and
- what the perceived opportunities and risks associated with different exhaustion regimes are.

Scope of the analysis

To be consistent with the Green Book and wider government approach, this impact assessment focuses only on the costs and benefits to the UK. The government does not consider the impacts of this policy to non-UK businesses or rights holders affected. UK businesses that export goods are out of scope of our assessment; this is because goods exported are dependent on the exhaustion regime of the destination country or region: in other words, the UK cannot directly affect how other countries treat UK exports.

Finally, this assessment does not look at the impact on imports for purely digital goods and services as they are not impacted by the exhaustion of IPR rights which relates to genuine physical goods.

Description of options considered

There are four policy options:

- Option 1: UK unilateral application of an EEA exhaustion regime ("Do Nothing").
- Option 2: Move to a national regime.
- Option 3: Move to an international regime.
- Option 4: Move to a "mixed" regime.

The government does not consider a national regime to be readily compatible with the Northern Ireland Protocol. This option is included in this consultation for completeness and to gather what evidence is available on economic impact.

All policy options are assessed against the "Do Nothing" option which, itself, is a potential option ("the counterfactual"). At this stage, the government does not have a preferred option.

Policy objective

The government needs to make a decision on the most appropriate exhaustion of IP rights regime for the future. In making this decision, the government's objective is to preserve a balance between incentivising innovation and the creation of new technology, products or cultural works while enabling competitive markets, consumer choice and fair access to IP-protected goods for the benefit of society. The government must also consider impact on wider government priorities, including the principle of unfettered access between the markets of Northern Ireland and Great Britain.

Who is likely to be affected?

The exhaustion regime affects a number of actors in the transaction of goods. From the rights holders' perspective, the choice of exhaustion regime affects their ability to control the supply of their good into a market. For firms using goods protected by IP procured from another firm as part of a production process, there will be several implications for the operation of the supply chain. For consumers, the choice of exhaustion regime determines the size of the market, the prices they pay and the choice of products available to them.

The list below, although not exhaustive, sets out how different parties are affected by the exhaustion regime and parallel trade:

- Distributors: engaging in international trade involves significant fixed costs for firms, in terms of finding suppliers, meeting regulatory requirements in import markets, and dealing with customs and taxes. These costs need to be spread over large volumes, implying that parallel imports are largely done in bulk at the wholesale level[6].

- IP rights holders and authorised licensees: through the control over distribution, they can control the supply of their goods to a geographical market. Rights holders can be businesses that own IP rights or are licensed to use them. They can also be businesses that are specialist IP inventors who do not manufacture their invention, but rather license their IP to others to make and sell their product.

- Manufacturers: may have complex supply chains which rely on IP goods. The manufacturing of complex products may entail the back and forth cross-border movement of products at different stages of the manufacturing process.

[6] See NERA 'The Economic consequences of a choice of a regime of exhaustion in the area of trademarks', (1999)

- Retailers: can play a vital role in the sale of parallel imported goods. Cross-border retailers (including online retailers) may source from multiple markets to achieve the best price from higher volumes, as well as taking advantage of any price differences. Others, such as pharmacists, rely on parallel imports of medicine to bring in products at lower prices than are available in the UK market. For certain goods, rights holders maintain a strong control over their distribution channel by selecting retailers that can sell their products, with the view to maintaining brand image and exclusivity, for example, high-end luxury goods.

- Consumers: are often unaware whether a good contains an IP right or where it comes from. Although consumers can purchase lower priced goods from other markets directly, there are often large costs that inhibit this, for example, transportation costs.

- Government regulation: regulation can determine the extent to which certain goods can be imported, for example, businesses need a licence to parallel import medicines into the UK.

- Others: parties affected may include demand for IP legal services. IP is a complex area and rights holders often use legal services to draft agreements to help maintain and control the use of their IP right.

The Ernst and Young report found that groups involved in parallel trade are difficult to identify. This is because the awareness of parallel trade is low; in many cases parallel trade is so ingrained in business models and supply chains that many businesses are not aware that the goods they buy and sell are parallel goods. The government would therefore welcome consultation responses from groups and businesses not yet captured in this list who anticipate impacts as a result of any potential change in policy.

Main drivers of parallel trade

There are several factors that motivate parallel trade[7]. Price differentials or the opportunity for arbitrage between different markets is the most identified reason, but there are others which can either enable or restrict parallel trade:

- Transportation costs and exchange rate differences play a vital role in determining the extent to which parallel imports are profitable[8]. Where transport costs are high and/or exchange rate differences are small, they will limit the extent to which parallel trade occurs.
- Price control in certain sectors by government can also create parallel trade opportunities. This is an important factor driving parallel trade in the pharmaceutical sector where the use of price caps keeps prices comparatively low in some countries.
- Promotional expenditure on advertising and marketing can also play a contributing factor to parallel trade. Authorised dealers often invest in these activities and the costs of doing this can be high. However, parallel importers do not incur these costs, but still benefit from the investments made. Consequently, they can purchase and sell products from abroad to UK consumers at a lower cost than the authorised dealers[9].
- Differences in product quality can also provide arbitrage opportunities to enable parallel trade. Rights holders may deliberately target different quality products for different markets. Distributors may see opportunities to move products across markets to earn a profit, i.e. to target lower quality product in an otherwise higher-priced market.

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[7] See IPO's Ernst and Young feasibility study (2019)

[8] See NERA 'The Economic consequences of a choice of a regime of exhaustion in the area of trademarks', (1999)

[9] NERA, 'The Economic consequences of a choice of a regime of exhaustion in the area of trademarks', (1999)

Which sectors are affected by parallel imports?

The extent to which a sector will be affected by an exhaustion regime will depend on the scale of parallel imports. Whilst there is a lack of data on the scale of parallel imports, we can use total imports as a proxy measure to identify the sectors or products most vulnerable to parallel imports. This figure also could be considered an upper bound for the scale of parallel imports.

The total value of all goods imported (N.B. not just parallel imports) to the UK was £426 billion in 2020[10] and there were around 246,000 businesses importing goods into the UK[11]. Imports of cars (£26 billion), medicinal and pharmaceutical products (£24 billion) and clothing (£20 billion)[12] were the product commodities which accounted for the largest values.

From discussion with stakeholders, the government believes the following sectors are also particularly affected by parallel imports: fast moving consumer goods, print and publishing, music and film, defence and luxury goods.

What are other countries doing?

The UK's main trading partners (excluding the EEA countries) in the main have an international exhaustion regime for IP rights, with some reservations for certain goods and IP rights:

- USA: has an international regime for copyright and patents. The USA has a national regime for trade marks but with parallel imports allowed in certain situations.
- China: has an international regime for patents and copyright. Exhaustion of IP rights related to trade marks is not covered in IP law.
- Japan: has an international regime for patents, trade marks and copyright.
- India: has an international regime for patents and trade marks. For copyright law, the principle of international exhaustion does not apply to cinematographic films and sound recordings.
- Switzerland: Switzerland does not form part of the EEA and has adopted a bespoke approach. For patented goods (e.g. medicines) where the price is determined by public authorities, a national regime applies. For trade marks, it has adopted a system based closely on the EEA regional regime. For copyright it employs an international regime except for audio visual works for which it has a national regime.

Generally, exhaustion of rights for design right protection matches the regime for other IP rights. For the countries mentioned above the government is not aware of an example of a specific carve out for designs.

While there is very little evidence on the effect from countries changing their IP regime, this impact assessment highlights some case study examples from Australia, New Zealand and Sweden.

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10 ONS trade statistics 2020

11 HMRC UK Importer and Exporter Population 2020

12 ONS trade statistics 2020

Case study: New Zealand and Australia, changes to exhaustion regime for copyright 1991-2003

- There is empirical analysis on the impact of relaxing restrictions on parallel imports for certain copyright products in New Zealand and Australia. Australia changed its exhaustion regime for copyright over a period from 1991 to 2003, whilst New Zealand changed its regime in 1998 and 2003.
- Australia has maintained a partial restriction on the parallel import of books, designed to delay the competition that local retailers faced from the release of new books into the market. As a consequence, a large difference in retail book prices between the Australian and New Zealand market emerged, with Australian consumers paying a higher price on average of 10% (NZ$3.06 per book).
- The removal of restriction on parallel imports of books in New Zealand did not appear to have significant negative effects on the domestic publishing industry. The number of new books published by domestic authors annually remained constant, whilst the number of authors employed increased overall.
- Similarly, the removal of restriction on computer software did not have a negative impact on the domestic industry.
- The Australian and New Zealand economies are net importers of copyright products, whilst the UK copyright market is larger and the UK is a net exporter of copyright protected goods. Therefore, there should be an avoidance of direct comparison between the UK and these countries.

Source: Deloitte Access Economics 'The Costs and Benefits of Preventing Parallel Imports into New Zealand' (2012)

Case study: Sweden, removing the restriction on parallel imports of patented medicine, 1995

- Before 1995 Sweden prohibited parallel import of pharmaceutical drugs, but on entry into the EU in 1995 it was required to adopt an EU-wide regional exhaustion regime. Research looked at the impact on drug prices from parallel imports of brand-name pharmaceutical drugs.
- Research showed that parallel imports increased substantially after Sweden joined the EU, both in terms of actual sales and number of licences granted to parallel importers. From 1995 to 1998, parallel import sales had grown to 1.0 billion SEK, which corresponded to 6% of the total market and 226 approvals to import pharmaceutical products.
- Analysis showed that prices of drugs subject to competition from parallel imports fell relative to other drugs over the period 1994-1999. Econometric analysis showed that competition from parallel importers led to significant reduction in manufacturing prices between 12 and 19%. Furthermore, manufacturers' prices continue to fall where they faced increased competition from parallel importers.

Source: Ganslandt and Maskus 'Parallel imports and the pricing of pharmaceutical products: evidence from the European Union' (2004)

Monetised and non-monetised costs and benefits of each option (including administrative burden)

Option 1 (baseline): UK unilateral application of an EEA regional exhaustion regime.

At present, parallel imports from the EEA into the UK are permitted. The current exhaustion regime forms the baseline counterfactual to assess other options against.

The government will consider each option below against option 1 as a baseline.

Option 2: National regime

In a national regime, parallel imports into the UK from anywhere in the world would not be permitted without the rights holder's permission. Rights holders would be able to prevent the re-sale within the UK of any goods that were not first placed on the market in the UK, thereby restricting the parallel import of goods from any other country.

The government considers that any trade of goods between Northern Ireland and the Republic of Ireland must take into account the principles of the Northern Ireland Protocol. In addition, movement of goods within the UK will involve additional complexity to take into account the principle of unfettered access for goods.

Benefits to rights holders and their licensees

A move to a national regime from a unilateral regional exhaustion regime is likely to benefit rights holders by granting them greater control over the distribution of products within the UK market. Rights holders could potentially maintain higher prices in the UK than in other markets by being able to exert greater control over the supply of their goods. They may see increased market share and return from their investment and this may encourage them to further invest in innovation and creativity.

A national regime would further strengthen rights holders' and their licensees' ability to maintain the exclusivity of their brand. In some sectors, rights holders maintain control over their distribution channel by selecting retailers that can sell their products, often as a means of maintaining brand image and exclusivity, for example, high-end luxury brands. Preserving the appeal of such goods requires an ability to maintain their high prices: a move to a national regime would strengthen rights holders' or their licensees' ability to control the supply of their good and therefore its price.

Moving to a national regime may further help to strengthen the ability of rights holders and their licensees to take enforcement action against infringement. In particular, the remedies available under a national exhaustion regime are likely to be more extensive than under the unilateral regional regime.

Finally, rights holders often target different quality products to meet regulatory standards in different markets. A move to a national regime from a unilateral regional regime would enable them to exercise greater control over their products and help them to preserve the regulatory needs around quality and safety of their product.

Benefit to businesses

A move to a national regime would further help licensees obtain the full benefits of their promotional activities. In some sectors, rights holders may license their product to businesses to sell on the condition they invest resources in promotional and pre and post-sale services. Often with the view to generate demand, sell more output and provide better services to consumers. A move to a national regime would help to ensure that licensees were able to benefit from their promotional investments and that parallel importers were not able to free ride on their investment by importing goods from abroad and selling them at a lower price. Furthermore, a national regime may further incentivise businesses to invest in building the local market and to provide pre and post-sale services to the benefit of local consumers[13].

Cost to businesses

The move to a national regime would allow rights holders to stop parallel imports of their products or potentially impose additional costs on businesses parallel importing their products into the UK. In particular, a move to a national regime may lead to increased costs for businesses. Such costs may include:

- Restricting the ability of businesses to source goods from a broader geographic area may directly limit the choice of suppliers for a product. Businesses may face reduced choice which may lead to higher costs. This may lead to disruption of normal business operations, which might compromise the competitiveness of businesses, particularly in the short term.

- One-off transition cost, which includes costs associated with understanding legislation and changing suppliers. This may include legal costs associated with reorganising existing supply contracts.

- Additional ongoing costs. This may include search costs associated with identifying the rights holder and seeking their authorisation to parallel import to avoid the risk of litigation.

- Additional transaction costs to businesses, such as search costs and increased time needed for delivery. High transaction costs act like a tax on purchases of a good, leading to a fall in quantity demanded and ultimately increasing costs. These costs may be incurred by both businesses and consumers[14].

Impact on business competition

A move to a national regime may also lead to reduced competition amongst businesses such as wholesale distributors, large multi-country retailers and businesses sourcing products and components globally. This is because rights holders only release their goods via authorised distributors, who may benefit from increased profits and market share at the expense of unauthorised distributors. This may result in certain businesses not being able to compete and deciding to leave the market. Should sufficient numbers of businesses leave the market who are an important source of competitive constraint, then it may result in increased prices and reduced choice for consumers.

Benefit to consumers

A move to a national regime from a unilateral regional regime may result in increased consumer benefits from purchasing a product which was developed specifically to meet their needs and also meets UK regulatory standards around quality and safety[15]. If rights holders create and innovate more under a national regime, then consumers may also benefit from more innovative and creative products entering the market.

Cost to consumers

The move to a national regime from the current unilateral regional regime:

- May adversely impact on consumers in terms of availability of goods and the price paid. The impact will vary between sectors, and consumers may be affected negatively.

- There may be increased delays in receiving supplies of IP-protected goods.

[13] A.Katz, 'The economic rationale for exhaustion: distribution and post-sale restraints' (2014)

[14] Deloitte Access Economics 'The Costs and Benefits of Preventing Parallel Imports into New Zealand', (2012)

[15] A.Katz, 'The economic rationale for exhaustion: distribution and post-sale restraints' (2014)

- The NHS has been one of the largest beneficiaries of the regional exhaustion regime, being able to source cheaper medicines in comparison to prices in the domestic market. A trade association, representing a majority of the total UK parallel import market value, has claimed that in 2019 the savings from parallel imports to the NHS was estimated to be around £110 million. The government would welcome further information on the impact on medicine supply resilience.

Other costs

There may also be increased legal costs to rights holders and to the government in taking enforcement action against unauthorised imports or sales of IP goods. A move to national exhaustion regime will provide rights holders with the ability to more closely control distribution of their products. Rights holders and their licensees may face additional costs of monitoring and tracking authorised imports. Furthermore, government agencies may see increased demand associated with ensuring goods imported are authorised by rights holders.

Overall likely impact

In aggregate, consumers and importing businesses and businesses that rely on goods with IP as source of their supply chain may lose from a move to a national regime from the current unilateral regime, whilst rights holders may gain. The aggregate impact to the UK economy is difficult to ascertain as it is dependent on the extent to which the restriction to parallel imports results in net transfer from UK consumers and business to UK rights holders.

Option 3: International regime

IP rights would be considered exhausted in the UK once they had been first put on the market in any other country. This means that these goods could be parallel imported into the UK from any country in the world without the rights holder's permission. An international regime would continue to allow imports from the EEA countries, but this would be extended to cover any other country.

Benefit to businesses

A move to an international regime from the current unilateral regional regime may bring additional benefits to some businesses as they may be able to access a larger international market of suppliers: with increased choice, competition and lower prices. Businesses would be able to parallel import goods from all over the world thereby benefiting from increased availability of suppliers and variety of products.

The increased competition amongst suppliers may put downward pressure on existing domestic supplier prices. Even in sectors where parallel imports do not arise, the existence of the threat of parallel imports may itself be sufficient to keep domestic supply prices from increasing.

Manufacturers that have a complex supply chain and import components that contain IP rights are particularly likely to benefit from a move to an international regime. Under the current exhaustion regime, the import of components sourced outside the EEA without the rights holder's permission may trigger an IP infringement claim. However, a move to an international exhaustion regime could remove such risk to manufacturers and sellers of equipment containing IP rights.

Cost to businesses

A move to an international regime from the unilateral regional regime may result in authorised licensees seeing increased competition from parallel importers, who are able to free ride on licensees' investment in promotional and marketing activities. Faced with increased competition from parallel imports, these businesses may see little return from their promotional and marketing investment and in the long run may decide to cut back on such investment.

Moving to an international regime from the current unilateral regional regime, may result in increased parallel imports of goods by retailers. However, retailers selling imported goods may have to provide the same warranties as they currently do for goods that are not parallel imports, but with less recourse to the initial manufacturer. This may create additional legal uncertainty and increased legal costs to retailers.

Benefits to consumers

A move to an international regime may positively impact on consumer welfare in terms of increased availability of goods, competition and lower prices paid. As highlighted above, increased competition amongst suppliers may put downward pressure on existing domestic prices. Even in sectors where parallel imports do not arise, the existence of the threat of parallel imports may itself be sufficient to keep domestic consumer prices from increasing.

The main benefits to consumers will arise as a result of changes to business supply and distribution (see above section on benefits to business) and these impacts will vary between sectors. Furthermore, the extent to which consumers benefit will depend on price elasticities for a product and the market structure within different sectors.

Cost to consumers

A move to an international exhaustion regime may increase consumer search costs. Intellectual property rights such as trade marks help to reduce consumer search costs. Brands sell different products in different countries under the same trade mark. For example, the same brand of an alcoholic drink may have a different formulation to reflect different tastes. Similarly, for books, UK consumers may expect content that is tailored to the UK market. Consumers therefore may have to spend more time identifying the product intended for them. There may be a loss to consumer welfare in purchasing a product that is not intended for their market.

Consumers may also lose access to pre or post-sales services as authorised distributors could cut investments in marketing and consumer support services if they feel parallel importers are free riding off their investments, this is particularly the case for high value consumer goods[16].

If the move to an international regime discourages rights holders from investing in innovation and creativity, then consumers' product choice may be lower than otherwise would have been the case.

Cost to rights holders

A move from the unilateral regional to an international regime may result in:

- A negative impact on the incentives to innovate, create and invest in R&D. If IP rights holders believe their returns could be limited in the UK market, they may invest less than they otherwise might have in ideas, new products and services for the UK.

- Limiting the strength and value of IP rights. It would limit the rights holder's scope to segment markets across countries and price discriminate between different countries. The restriction on the ability to parallel import would open the domestic market to greater competitive pressures and reduce or constrain their ability to increase prices. This increased competition and impact on prices would particularly affect sectors which currently face significant parallel importation from the EEA.

- Rights holders responding by choosing to strengthen their distribution chain with stronger contractual arrangements or vertical integration with downstream distributors. Such changes are likely to lead to an increased cost of managing their supply chain particularly in the short term.

[16] A.Katz, 'The economic rationale for exhaustion: distribution and post-sale restraints', (2014)

Other costs

Moving to an international regime may lead to increased costs on existing regulators to protect consumer welfare. This would be of importance for sectors where existing regulation seeks to protect against consumer harm. For example, there could be an increased demand on the Medicines and Healthcare products Regulatory Authority (MHRA) to verify applications for parallel imports of medicine that meet UK standards. The increased demand and the associated costs could increase with the scale of parallel imports.

Overall likely impact

In the long run, consumers and some importing businesses and businesses that rely on goods with IP as source of their supply chain may gain from a move to an international regime from the current unilateral regime, whilst rights holders may lose. The aggregate impact to the UK economy is difficult to ascertain.

Option 4: Mixed regime

An exhaustion regime may consist of a different regime for a specific good, sector or IP right than for other goods, sectors and IP rights. For example, Switzerland has a different exhaustion regime for pharmaceutical products. A regional or international regime is applied to all products except for patent protected products (e.g. medicines) where the price is determined by public authorities in which case there is a national regime. A mixed regime could implement a combination of other regimes described in this consultation provided that they are reconcilable with the Northern Ireland Protocol.

Potential benefits of a mixed regime

Mixed regimes are chosen to afford additional protection to encourage the growth of certain sectors that are strategically important to the economy.

It is difficult at consultation stage to describe or assess the potential benefits without knowing the precise form of a mixed regime. First, a mixed regime could take many different forms depending on the regimes applied to different sectors, IP rights and/or goods. Second, there could be unforeseen interactions between the different elements of a mixed regime, for instance when a product is subject to two or more different IP rights to which different exhaustion rules could apply. Therefore, the analysis of this option is less well developed than others in this assessment. The government welcomes further evidence to develop our assessment of this option.

Potential costs of a mixed regime

Affording additional protection to a certain sector may restrict the means by which suppliers compete which could inhibit competition between suppliers. This reduced competitive pressure may be detrimental to the consumer in terms of price or quality. Such regimes may require further regulation and monitoring to mitigate this loss.

Compared to the baseline option, a mixed regime may lead to increased complexity for businesses. They will need to assess the relevant exhaustion regime for the product they are seeking to import, which may be difficult to ascertain where they comprise different components or types of IP protection. This in turn may lead to increased transaction costs as businesses seek to understand which good, IP right or sector they may parallel import. It will also increase the search costs associated with identifying the rights holder to seek their authorisation to parallel import to avoid the risk of litigation.

From a regulatory perspective, a mixed regime is potentially more costly to administer than the current regional (and uniform) regime. It may lead to increased litigation to understand supply and distribution implications where different products or IP areas have different rules, particularly for products which have uses in more than one industry sector or are protected by more than one type of IP.

Overall likely impact

In aggregate, consumers and importing businesses and businesses that rely on goods with IP as source of their supply chain may incur costs from a move to a mixed regime from the current unilateral regime, whilst rights holders may gain. This is the least certain option in terms of the underpinning analysis. The aggregate impact on the UK economy is ambiguous as it will depend on the impact to a specific good, sector or IP right to which the mixed regime applies.

The government welcomes evidence on impacts of different treatment for a specific sector, product type or IP right. The benefits of a mixed regime would need to be weighed against potential additional complexity as well as the impact on competition, choice and price.

Impact on small and micro businesses

Small and micro businesses may be less able to deal with a potential change to the exhaustion regime and therefore could be disproportionately affected, mainly because they have significantly fewer resources available to cope with regulatory change and ongoing compliance costs. Any increased cost may compromise their efficiency. For example, a move to a national regime would increase the transaction costs for parallel importing firms. Such a change could cause disruption to their business operations and their ability to compete.

Small and micro businesses are an important source of dynamic innovation and creation within the UK economy, and contribute to growth and trade. There are large fixed costs and risks involved in expanding into international markets, as a result small and micro businesses often employ licensing and syndication agreements to expand into foreign markets. An international regime may deter these firms from expanding abroad if there is a risk that the goods for international markets could be parallel imported back into the UK market to compete with domestic goods.

The government expects that wholesale parallel distributors would be particularly affected. In the absence of the breakdown of parallel trading firms by company size, the government assumes they have a similar distribution as for general distributing firms of all sizes. Initial analysis shows that most distributors (over 90%) can be classified as small (having fewer than 49 employees). The government would encourage respondents to indicate the size of their business by number of employees in their response to the consultation to assist in refining this initial assessment.

Wider impacts

Whilst the choice of exhaustion regime is a UK domestic policy decision, there may be international ramifications. It is possible that other countries may respond to the UK's decision to select a specific exhaustion regime.

Monitoring and Evaluation

The evaluation strategy will be set out at the time of policy change.