Vertical restraints: new evidence from a business survey

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Contents

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1 Executive summary

Overview

The appropriate treatment of certain vertical restraints under competition law has been widely debated in recent years, in particular due to the rapidly increasing use of e-commerce.[1] While concerns regarding consumer harm from certain types of vertical restraints have been raised in many markets, authorities and other practitioners also acknowledge that vertical restraints could have pro-competitive effects.

This report, commissioned by the Competition and Markets Authority (CMA) and delivered by Oxera and Accent, presents primary evidence on why businesses use vertical restraints and how these may affect manufacturers, distributors and consumers. In particular, the study seeks to gain insights into:

- the specific vertical restraints that are used and whether they vary across markets;
- how the landscape has changed as a result of the rise in the prominence of the Internet as a sales channel;
- the reasons for choosing particular agreements;
- the likely impacts, both positive and negative, on consumers.

For this purpose, individual in-depth telephone interviews were undertaken with 33 mostly small and medium-sized UK-based manufacturers and retailers. Although the responses cannot be considered representative of UK businesses as a whole (due to the sample size and the prevalence of participants from smaller businesses), the study is one of the few examples of gathering primary evidence on their actual experience of vertical restraints and, as such, gives important insights into firms' views on this key business practice.

What type of vertical restraints are most common?

The study shows that the businesses interviewed use a wide range of vertical restraints, with the most common being selective and exclusive distribution agreements (often excluding online retailers and platforms). In addition, many manufacturers specified recommended retail prices (RRP) to their retailers, in some cases accompanied by recommended ranges of discounts as well. There was variation in the ways in which RRPs were used. Some manufacturers merely specified an RRP, whilst others took active measures to ensure that the retailers priced at or close to the RRP (in terms of level of prices or ranges of discounts).

What is the impact of the Internet on businesses?

Participants noted that the rise of e-commerce has led to increased competitive pressure on manufacturers and retailers. It has facilitated monitoring of rivals' pricing practices and the discovery of new distribution channels, and has increased price transparency for customers. These elements have intensified existing price competition, making it more difficult for manufacturers and retailers to maintain price differentials between sales channels (bricks-and-mortar and online retail) as well as against rival products.

[1] Vertical restraints refer to agreements or contract terms between two firms that are in different layers of the supply chain—for example, an agreement between a manufacturer and a retailer or distributor of the product.

In general, businesses also recognise the market expansion effect of the Internet, allowing them to reach a wider set of customers. Some of the businesses interviewed recognised that the Internet has given them an opportunity to advertise themselves on a wider scale, which in some cases helped to establish their brand in the market.

Why do businesses use vertical restraints?

Vertical restraints (and related practices such as specifying RRP) offer ways to manage the competitive impact of increased e-commerce in many sectors. While there are many reasons why firms use such restraints, the main reasons stated by participants were to prevent free-riding and therefore maintain the pre- and after-sales service quality, and to protect brand image.

Prevention of free-riding

Conceptually, in the context of this study, free-riding refers to the situation where pre-sales service for consumers (such as advice on the quality of products) is costly for retailers to provide; and therefore, an individual retailer may have an incentive to not provide such a service itself and instead rely on other retailers to provide the service to consumers (i.e. they 'free ride' on the efforts of others). This is because customers can visit 'full-service retailers' (e.g. those providing free advice) to decide on their preferred product, but then purchase it from the cheaper retailer that does not provide any service support.

The economic literature highlights that certain vertical restraints, in particular selective and exclusive distribution, can prevent this type of behaviour.[2] These restraints limit the number of retailers selling a given product, which in turn may prevent/reduce the scope for free-riding by other retailers thereby providing higher margins and incentivising retailers to provide a higher service quality.

In the absence of such vertical restraints (e.g. in the absence of exclusive distribution), the product may be available from more retailers and consumers could benefit from cheaper prices and wider product availability in the short run. In the longer term, however, such changes could bring about lower retail service standards and a poorer quality experience of the underlying product. Therefore, the absence of any protection of retailers' incentives to invest in such services, is likely to hurt manufacturers, and potentially also retailers and consumers.

Findings from the survey are generally consistent with the economic literature. Manufacturers who view pre- or after-sales service as important for their products cited the need for these types of arrangements with retailers, because the quality of service and the customer experience at point of sale are essential to the manufacturers. Some participants also highlighted that it is in the interest of many consumers to receive such personalised service for these products, which are often technical in nature.

Protection of brand image

Participants also noted that they use vertical restraints or related practices to protect their brand image. This was achieved by using selective distribution as well as specifying an RRP (although the responses suggest that the retailers did not always price at the relevant RRP). In particular, some participants seem to use these practices to influence how the brand is sold (e.g. through which retailer) in order to ultimately signal the quality of the product and/or service to the customer.

[2] Although these may not be the only, nor necessarily the most direct, ways of preventing this.

Some participants, particularly those with luxury brands, appear to use these practices to maintain the status good image of the product to its target consumers. However, several responses also suggest that some manufacturers and retailers could be using selective distribution or aiming to make retailers sell at RRP to reduce competition for their own benefit, without a clear link to consumer benefits.

Interestingly, although the protection of brand image through selective distribution agreements would be expected to reduce intra-brand competition, the interviews highlight that there could in fact be an increase in inter-brand competition, for example, due to adjacent positioning of competing brands within a specific retailer. A participant highlights the use of this method to enhance its brand image, as adjacent positioning may convey similar values and quality standards. This impact is not commonly discussed in the literature.

Concluding remarks

The insights from this small sample of UK businesses confirm much of the understanding from the economic literature on the costs and benefits for consumers from vertical restraints. Many of the businesses interviewed articulated the expected efficiencies relating to preventing free-riding and maintaining brand image. While none of the participants explicitly mentioned the removal of double marginalisation as a rationale for any of their vertical restraints, one or two merchants set their RRP by adding what they considered to be a reasonable retail margin.[3] [4]

It is also clear from the responses that the restraints are seen to be attractive because they limit the direct competition faced by the relevant manufacturers or retailers, particularly from online channels. Removing these restrictions is likely to lead to some short-term price reduction and may increase availability for consumers; however, the responses indicate this could be at the cost of lower quality (or lower perceived quality) and service, and lower availability in the longer term.

[3] While it is recognised that RRP does not prevent a retailer charging a lower or higher price than that which is recommended, the underlying aim, as stated by manufacturers in the survey, is consistent with seeking to ensure that sales are not reduced as a result of high margins on the part of downstream distributors.

[4] Specifying an RRP might not solve the problem of double marginalisation if the retailer has market power. If the RRP is set at a level below the retailer’s profit maximising level, it will be able to price above the RRP due to the market power. However, a well-advertised RRP could constrain the ability of the retailer to do this, since consumers may look unfavourably upon a retailer that has clearly priced above RRP.

2 Introduction

2.1 Purpose of the study

The Competition and Markets Authority (CMA) commissioned Accent and Oxera to undertake a survey of businesses to better understand the rationale behind businesses using vertical restraints with their trading partners, and how this has been affected by the growth of the Internet as a marketing and sales channel.

This study, along with a roundtable discussion organised by the CMA in January 2015, forms a part of the CMA's research into the potential effects—both pro- and anti-competitive—of these agreements.

This research is being conducted against the background of ongoing debates among practitioners about the appropriate treatment of certain vertical restraints under competition law, especially in light of the growth of the Internet and online businesses. In particular, concerns have been raised about the ways in which manufacturers and/or retailers can use certain types of vertical restraint to reduce competition in the marketplace, and therefore harm consumers. At the same time, it is recognised that some of these agreements have beneficial effects on the final outcome experienced by consumers.

The balance between these concerns and benefits depends on the specific nature of the agreement and on the market features, including the growth of the Internet, which has had a significant impact on the competitive dynamics in many markets. While the growth of the Internet has lowered the distribution cost for suppliers in many markets, it has also created new challenges for businesses—for example, in ensuring that consumers continue to have access to the product through the high street and/or receive pre-sales service from retailers where required.

The survey undertaken for this study therefore sought businesses' views on these issues and explored whether and how these differ across different types of markets and over time. In particular, the specific goals of this study were to answer the following questions.

- What vertical restraints are businesses using and what are their main motivations for doing so? How does this motivation differ across different businesses (e.g. size or sector)?
- If businesses can use two different types of restraint to solve a specific problem, how do they choose one over the other? Do they consider their rivals' practices when adopting and choosing between vertical restraints?
- Has the growth of the Internet changed the way they use certain vertical restraints? Has this affected their motivations for, and choice behind, certain restraints?
- How do specific vertical restraints, including in light of the growth of the Internet, affect firms across different layers of the value chain and what is the impact on consumers?

The rest of this report is structured as follows.

- An overview of the methodology and participants is set out in section 2.2 below;
- Section 3 discusses the evidence from the interviews regarding the impact of the Internet on businesses;

- Section 4 briefly summarises the economic literature on the rationales of vertical restraints;
- Section 5 presents the main findings of the study with regard to the above research questions; and
- Appendix A1 includes a detailed description of the approach followed, the topic guide used for the interviews and a high level summary of the characteristic of each participant.

2.2 Overview of methodology and participants

To explore these questions, Accent carried out a qualitative survey in the form of 33 in-depth interviews with businesses. The interviews were designed to be relatively open-ended to ensure a level of flexibility in the precise topics discussed. The qualitative approach allowed an exploration into how and why businesses use vertical restraints and how these differ (if at all) from those cited in the economic literature.

Throughout the process, Oxera worked closely with Accent to ensure that the interviews explored the relevant research questions in full. The steps followed are described in detail in Appendix 1 (section A1.1).

The survey participants—most of whom were recruited through cold-calling—included manufacturers, retailers (bricks-and-mortar, online and hybrid retailers) and platforms. Table 2.1 shows the number of participants in each category. Most were small or medium-sized businesses.[5]

Table 2.1 Breakdown of participants by business type

	Retailer	Manufacturer	Platform	Total
Small	8	8	0	**16**
Medium	2	11	0	**13**
Large	1	2	1	**4**
Total	**11**	**21**	**1**	**33**

Note: Small businesses are those with a UK turnover of less than £5m, medium businesses have UK turnover of between £5m and £50m, and large businesses have UK turnover of over £50m.

Source: Oxera analysis.

The study also aimed to involve businesses selling different types of product, such as branded goods, products with an important associated service aspect, and pure services. The participants and their characteristics are listed in Appendix 1 (section A1.3).

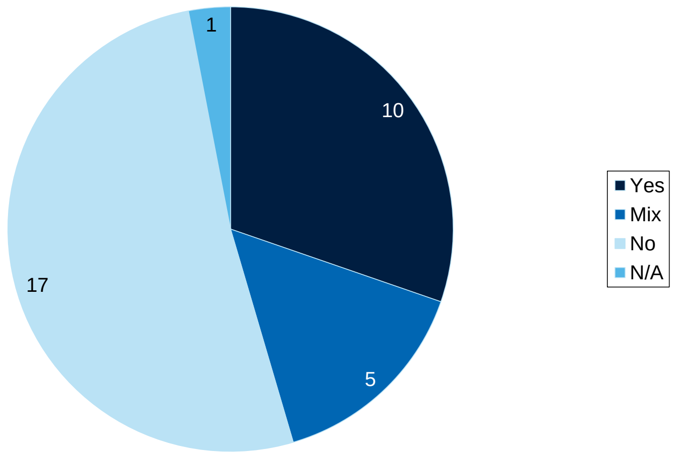
Figure 2.1 shows whether the participants sold high-end branded goods.[6] This could be a manufacturer or retailer of, for example, designer fashion products,

[5] It has been recognised that the recruitment method has the potential to bias the sample towards smaller businesses, although additional steps were taken to ensure that many medium-sized businesses were interviewed as well.

[6] A product was classified as a high-end branded good if it was either a luxury brand, high-end technical product, or other consumer goods where brand is important. This was based on judgement by Oxera, rather than self-identification by participants. This was because participants sometimes use the term 'high-end brand' if their products were more expensive than competing products. Luxury brands refer to products that are generally considered by consumers to be very high quality, and thus fairly expensive. Examples include designer clothes and shoes. High-end technical products are those that are very high quality and require precision manufacturing. Examples include custom-made prescription product and optical products for chemical analysis in hospitals and labs. Other branded products in the sample include premium musical instruments and premium brands of consumer electronics.

high-end technical products, or premium consumer electronics where branding is important. Of the 33 participants, 15 sold products where brand is important, either exclusively or together with lower-end products.

Figure 2.1 Prevalence of high-end branded goods among participants

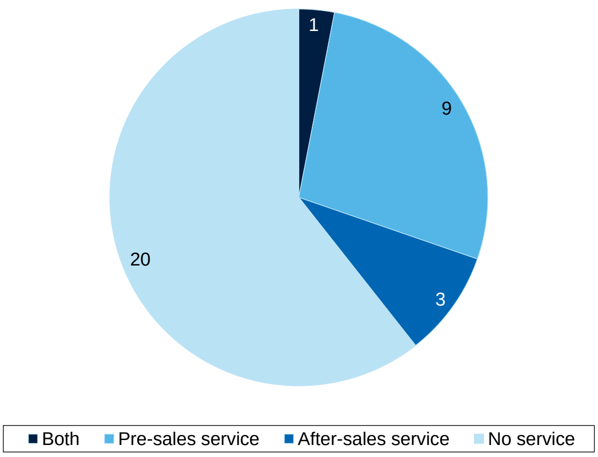


Note: 'Mix' refers to businesses that sell a range of products, some of which are high-end brands and some which are lower-end. N/A refers to a participant that provides a service, as opposed to selling a good.

Source: Oxera analysis.

Figure 2.2 shows whether the participant sells a product that includes pre- and/or after-sales service by the retailer. Products in the survey that may require pre-sales service included bespoke bicycles, a custom-made prescription product and electrical appliances (such as washing machines and TVs). These tended to be products of a complex technical nature where quality was not easily identifiable by the consumer and the consumer needed advice or other services such as product installation. Products for which the retailer provided after-sales service within the warranty period were bespoke bicycles and construction equipment.[7]

Figure 2.2 Provision of pre- or after-sales service by participants



Source: Oxera analysis.

[7] The provision of after-sales service is usually a choice by the business, and thus there is no set criteria for which products will require this. For example, one retailer of white goods provided after-sales servicing of these, while another did not.

3 Evidence on the impact of the Internet

As noted in section 2, one of the key economic developments in the last five to ten years has been the growth of the Internet, leading to increased opportunities for businesses. This has strengthened competition in many markets and led to large benefits accruing to consumers and businesses. In general, it has:

- reduced search costs for consumers and increased transparency for both consumers and suppliers;[8]
- changed distribution methods and costs for businesses—for example, by creating a direct route for manufacturers to reach end-consumers;
- increased the potential geographic reach and scope of both manufacturers and retailers.

As with any increase in competition, this has led to greater opportunities for some market participants, but also more pressure on businesses, particularly with respect to price.

The survey confirmed these developments. For example, many participants remarked that the rise of online shopping and price comparison websites has greatly increased price transparency. As a result, retailers are having to be more price-conscious.

> ‘There is so much information out there for the consumer now, again quite rightly to do comparisons on specification, on quality, on pricing.’ RQ14
>
> ‘We [retailer] find that almost everybody who purchases in store will have had some part of their journey online. Either researching the product or checking prices etc.’ RQ32

In several cases, participants suggested that there is less price variation among retailers due to the pressures of the Internet, and with customers being able to check prices much more easily and being more aware of alternative options. In some cases, this homogenisation applied also to product specifications. The growth of online platforms—such as Amazon and eBay—has raised particular challenges in, and placed downward price pressures on, many markets.

> ‘Yes much more it used to be a variation. The Internet changed it because people can find out other price. Whereas before you had to phone around.’ RQ02
>
> ‘You [retailer] will find that the price specification and the product are very similar because they have to be … if you were £10 out, £20 out you wouldn’t sell the product because there is such a keen competition on each market segment.’ RQ14
>
> ‘you’ll [manufacturer] always find that if somebody reduces £1 then Amazon will reduce £2. It becomes a downward market. In the end there’s no value left in your brand and your goods. Your ability to sell to other customers is diminished.’ RQ13
>
> ‘Because there is so much information out there for the consumer now, again quite rightly to do comparisons on specification, on quality, on pricing.’ RQ32
>
> ‘We [retailer] find that almost everybody who purchases in store will have had some part of their journey online. Either researching the product or checking prices etc.’ RQ32

The general increase in competition appears to have led to a downward pressure on margins. For example, one retailer highlights how they have had to

[8] However, it may have at the same time increased informational costs thereby not increasing the ease with which consumers can verify the quality of certain types of products (sometimes due to inherent nature of the product that require first hand inspection). Online review systems may have partly mitigated this problem in some markets.

increase their efficiency. A manufacturer also noted the pressure from retailers to increase its efficiency.

> 'We've [retailer] got smarter at training our staff, we've got smarter at making sure that when we have quieter days, the staff are making sure they know the brands and the styles inside out, so it makes their job easier when a customer comes in and you're fitting them, […] which is quite a big investment, […] we've had to heighten our game […].' RQ04
>
> 'We [manufacturer] definitely have reduced prices across the board dramatically since two or three years ago. Part of that is on the reduction overhead in the UK, so we have taken some sort of big overhead cuts in the last two or three years. And secondly we've just had to reduce our margins, so we operate on very, very tight margins now.' RQ28

Several businesses also noted that their monitoring processes have been made easier through the use of the Internet. For manufacturers, finding suitable partners is also less costly.

> 'the good thing is again with the Internet, and the good thing I've been doing this for many years, you could know who the good partners are you know because by who they're already working with […]' RQ09

One response indicates that the Internet can have an indirect positive effect on manufacturers' revenues due to the growth of sales for retailers.

> 'I would say indirectly it [the Internet] must have because most retailers that we work with now have grown their online, so had they have not done that then we wouldn't….our turnover level would probably be different.' RQ28

Regarding benefits to consumers, some participants highlighted that the Internet has benefited consumers shopping online by providing a wider choice and range, as online retailers can stock much more than physical stores.

> 'I think they [consumers] get a better choice really … before, you would only be able to buy from those 15 or 20 lines, now you can buy all two or three hundred at any one time if you really wanted.' RQ08
>
> 'at the moment we [online retailer] can offer customers, as I say, four or five million books. When you've got a bookshop, how on earth are you going to be able to do that.' RQ15

The responses also indicate that the Internet has had an effect on manufacturers' business models. For example, one manufacturer used to supply retailers for the retailers' own-brand sales, but has recently used the Internet to establish its own brand.

> 'it's helping us build a brand, really, 'cause historically, up until about ten years ago, everything was sold with other customers' brand names, but we've changed that now … with the web, it's allowing us to start building a much stronger brand.' RQ18

Another smaller supplier with limited funds to support their own website, stated that the Internet allowed them to build its brand using well-established online platforms. One manufacturer highlighted the potential benefit to consumers in the form of lower prices due to a reduction in intermediaries in the sector.

> 'there has definitely been a squeezing of the supply chain to narrow down from what used to be through...brands would sell through wholesalers, who would sell through retailers, who would sell to the consumer. You know now it is brand either direct to or

> brand via one retailer. So that is shortening and of course when you take layers out you reduce the price.' RQ08

However, this is not a general phenomenon. Although, in principle, the Internet provides manufacturers with the scope to reduce or even eliminate the use of intermediaries, this may not always be easy to do, particularly for small manufacturers aiming to distribute internationally. Some participants highlighted that local distributors are preferable because they have a network of local dealers, which can improve service, since local dealers and distributors know the culture better.

> 'It's difficult from here to sell to other countries, so by having agents … they're always in the country, so in Korea, we've got a Korean guy who does it, […] so obviously they can service the accounts much better.' RQ18
>
> 'You need obviously to be able to talk to somebody; you need to walk them through it; you may need to show them; you may need to give them some advice. All those things are far more difficult in another language and far more difficult in terms of all the things that you would expect. You know I can't provide someone in India the same level of service that I could provide here in the UK.' RQ17
>
> 'We [manufacturer] could sell direct to folk on-line but then you've got all these issues of distance selling regulations […]. We could retail a few ourselves but it would shrink the business a lot. […] whilst there is a network of shops out there that's how we will trade.' RQ21

Overall, the Internet could create both opportunities and threats for businesses depending on market circumstances. While many businesses may benefit from the Internet due to wider market coverage, others may lose out due to pressure on margins and increased ease of free-riding, as discussed in detail in section 5.

4 Summary of the economic literature

In this section we summarise the reasons why businesses might use vertical restraints, as described by the economic literature. It is particularly useful to understand if it helps businesses to respond to the impact of e-commerce as described above. It also allows us to explore whether, and to what extent, the responses to the interviews provide any support to these rationales.

Businesses can use a wide range of vertical restraints, which include:[9]

- selective distribution: the number of distributors/retailers through which a particular product is sold is restricted in some way;
- exclusive distribution: a supplier agrees to sell its products to only one distributor in a given territory;
- exclusive supply: a supplier is obliged or induced to sell its products to only one buyer;
- single branding: a retailer is obliged or induced to source its products from one manufacturer/supplier;
- quantity forcing: a buyer and a supplier agree incentives or obligations that result in the buyer sourcing most of its products from one supplier.

In addition, some businesses could use restraints regarding the level of the retail price. One such restraint is resale price maintenance (RPM) where a manufacturer sets a fixed or minimum resale price that is to be charged by the retailer. RPM is presumed to be illegal under EU competition law. Manufacturers may also simply recommend a retail price to the retailer (the recommended retail price or RRP). Although the specification of an RRP by a manufacturer is, by itself, not a vertical restraint, forcing retailers to price at RRP could amount to RPM.

The economic literature highlights that manufacturers and retailers may use these restraints for a number of reasons, including potentially anti-competitive as well as pro-competitive ones.

In particular, they may be used to reduce competition in the market in the following ways.[10]

- Softening intra-brand competition: vertical restraints, such as selective and exclusive distribution, necessarily reduce intra-brand competition to some extent due to the reduction in the number of retailers allowed to distribute a specific product. Strict enforcement of RPM agreements by a manufacturer across all retailers may also reduce intra-brand competition if this prevents retailers from charging lower prices than they would otherwise have charged.
- Softening inter-brand competition: vertical restraints can also be used to reduce competition among manufacturers/suppliers. For example, if multiple manufacturers in a market use selective distribution systems that exclude online retailers and prevent online sales, this might reduce price transparency among consumers and make it difficult to compare prices across products, thereby weakening competition. Similarly, single branding

[9] Definitions based on European Commission (2010), 'Guidelines on Vertical Restraints', 19 May.
[10] For example, see: Rey, P. and Stiglitz, J. (1995), 'The role of exclusive territories in producers' competition', RAND Journal of Economics, 26: 3, pp. 431-451; Rey, P. and Vergé, T. (2005), ' Bilateral control with vertical contracts', RAND Journal of Economics, 35:4, pp. 728-746.

that prevents a retailer from stocking competing brands/products, if used across a large number of retailers, can also foreclose competing manufacturers by eliminating the competitor's route to market.

- Facilitating collusion: manufacturers and/or retailers may use RPM to facilitate collusive outcomes. For example, using RPM across all their retailers makes it easier for manufacturers to monitor and enforce a price-fixing agreement, relative to a situation whereby retailers can offer independent discounts to consumers.

As such, the literature suggests that vertical restraints that reduce intra-brand competition are less harmful for consumers if competition among manufacturers (i.e. inter-brand competition) is strong.

In addition, the literature highlights a number of pro-competitive or efficiency-enhancing effects of vertical restraints, including: addressing vertical and horizontal externalities to reduce free-riding and increasing incentives for retailers to provide pre- and after-sales service; to reduce transaction costs; to allow manufacturers to signal the high quality of the product; and to signal whether a product is a status good. Table 4.1 describes them in detail.

Overall, the literature indicates that, while vertical restraints can reduce competition, it can also benefit consumers in a number of ways including better advice on product choice by retailers, better support services in relation to a specific product (for example, installation or repair services), wider availability, better signals about the quality of the product and higher utility from 'status' products (i.e. those which are not widely used by consumers and therefore those who use it may derive additional benefit from the social status associated with using the product). Therefore, any scope for consumer harm due to a reduction of competition arising from vertical restraints needs to be balanced against these potential benefits to consumers.

Table 4.1 Pro-competitive reasons for vertical restraints based on the economic literature

Potential reasons	Description
To address vertical externalities	Manufacturers may use restraints such as selective or exclusive distribution and RPM to ensure that retailers earn sufficient margins to have the appropriate incentives to stock the product, and provide pre- and/or after-sales service to consumers on behalf of the manufacturer.[11] Products for which this rationale is likely to be more relevant include complex technical products, products requiring personalised service, and experience goods where quality is observable only after use. This is because pre-sales advice and direct contact with customers are more important for generating sales in such products. Vertical restraints may also be used to address the problem of double marginalisation that arises from the separation of ownership of the manufacturing and the retail operations. In particular, this separation implies that each supplier sets prices independently without taking in to account the impact of the others' pricing decisions, with the result that the final retail prices are too high, retail efforts are too low and joint profits are not maximised. Vertical restraints (for example, maximum RPM which acts as a price ceiling) can be used to solve this 'coordination problem' between the manufacturer and retailer.

[11] For example, see Winter, R. (1993), 'Vertical control and price versus non-price competition', *Quarterly Journal of Economics*, 108:1, pp. 61-76; Marvel, H. and McCafferty, S. (1985), 'The welfare effects of resale price maintenance', *Journal of Law and Economics*, 28, pp. 363-379; Mathewson, F. and Winter, R. (1998), 'The law and economics of resale price maintenance', *Review of Industrial Organisation*, 13, pp. 57-84.

Potential reasons	Description
To address horizontal externalities or free-riding	Manufacturers and retailers may use vertical restraints to prevent competing retailers or manufacturers from free-riding on the efforts of a specific retailer for a specific product. For example, selective distribution could be used to prevent free-riding by other retailers on the technical advice on a specific computer product provided by a retailer. Similarly, single branding could be used to prevent free-riding by competing manufacturers on the training provided by a specific manufacturer to the retailer for its products. Examples of products for which the incentive to free-ride may be stronger, and hence the need for vertical restraints higher, are: new/complex products; products whose quality is difficult to ascertain; and when personalised advice is necessary. Given the higher scope of free-riding by online businesses, it was expected that participants would state this as one of the key motivations.
To reduce transaction costs	The costs of identifying trading partners and providing information and negotiating with them may be lower with vertical restraints. For example, quantity forcing or single branding agreements may reduce the costs of a manufacturer by increasing the size of each order and potential reducing the number of separate orders from customers. RRPs may also assist manufacturers to effectively convey information about market conditions such as demand trends to uninformed retailers.[12]
As a signal of high quality of product	Vertical restraints could be used to signal to the consumer the high quality of a product. This could be signalled, for example, by restricting the distribution network to retailers with a reputation for quality (such that the fact that the retailer is stocking a product signals pre-selection of high-quality products for consumers). Manufacturers may also specify RRPs for the same reason. The literature highlights that this signal is more credible when enough consumers are informed about the quality of the product and can differentiate between a high-quality and a low-quality product.[13]
As a signal of a status good	Branded-goods manufacturers may use vertical restraints when consumers use their products to signal social status and derive a higher benefit if the product's use is limited among consumers. Restraints such as exclusive distribution can be used to maintain a high price and limit usage, and thereby maintain the brand's image and the customer base. This is more likely for luxury products such as high-end brands of clothing, handbags and other fashion items.

Source: Oxera analysis.

As discussed in the remainder of this report, many of the reasons given by participants in this study are in line with the reasons presented in the above table. In particular, this highlights that businesses often use vertical restraints for pro-competitive reasons, such as to ensure good customer service and to deliver high-quality products, thereby benefitting consumers.

However, the study also indicates that in some cases, the use of these agreements may not be motivated by efficiency-enhancing reasons, and may not lead to consumer benefit. Furthermore, some of the reasons for using vertical restraints as discussed in the literature (e.g. to reduce double marginalisation and ultimately prices for end-consumers) were not mentioned (or rarely alluded to) by participants.

[12] Verouden, V. (2008), 'Vertical Agreements: Motivation and Impact', Issues in Competition Law and Policy, pp.1813-1840; Buehler, S. and Gärtner, D. (2013), 'Making Sense of Nonbinding Retail-Price Recommendation', *American Economic Review*, 103:1, pp. 335-359.
[13] Wolinsky, A. (1983), 'Prices as signals of product quality', *Review of Economic Studies*, 50: 4, pp. 647-658; Marvel, H. and McCafferty, S. (1985), 'The welfare effects of resale price maintenance', *Journal of Law and Economics*, 28, pp. 363-379.

5 Main findings from interviews

This section sets out the key findings of the study with respect to the following questions.

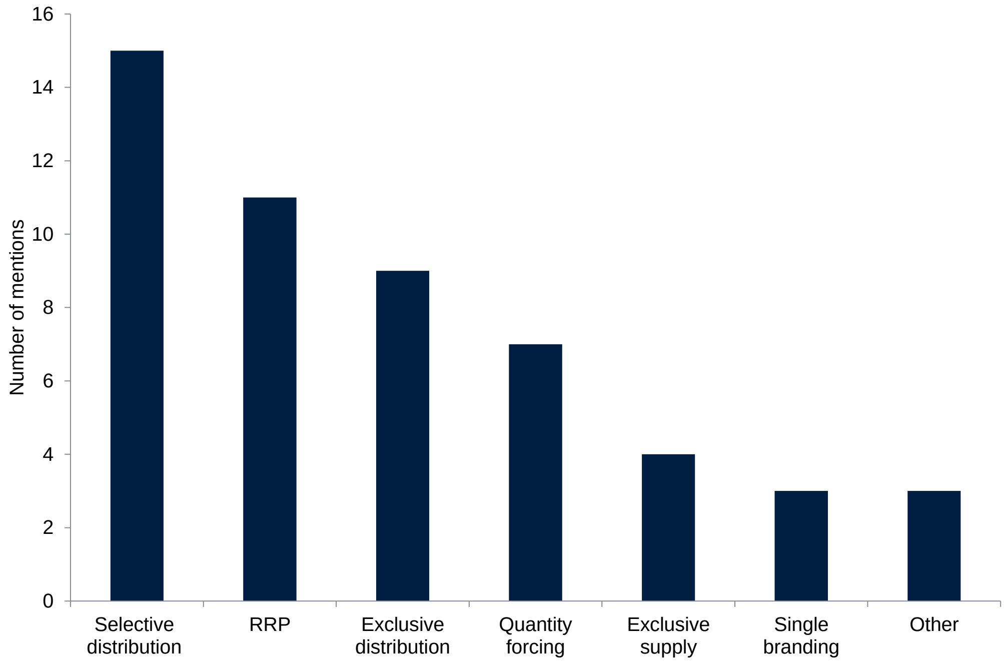
- What vertical restraints are businesses using and what are their main motivations for doing so? Do the motivations differ depending on market characteristics?
- What are the effects of specific vertical restraints on (a) the manufacturer/supplier; (b) the distributor/retailer; (c) other third-party distributors/retailers; and (d) consumers?
- Do businesses feel that certain types of vertical restraints have been imposed upon them by a more powerful trading partner, or have they always seen the benefits of the restraint to their business?
- Has the growth of the Internet changed the way they use certain vertical restraints?

We describe below the types of restraints that were discussed during the interviews. The findings with respect to different kinds of restraint are then discussed in detail in sections 5.1 to 5.4. Given the relatively small number of participants and the qualitative nature of the study, the discussion uses specific examples and case studies to highlight the valuable insights and key messages collated from the research.

Figure 5.1 shows the types of restraints and related practices mentioned in the survey. Many participants use multiple restraints, with the most common being selective distribution (mentioned by 15 participants) and exclusive distribution (mentioned by 9 participants).[14] Exclusive supply agreements (which would in effect be similar to exclusive distribution) were mentioned by 4 participants. There were 11 instances of manufacturers providing an RRP to retailers. Quantity forcing and single branding were also mentioned.

[14] Of the 15 participants who mentioned selective distribution, 6 noted that the agreement aims to prevent online sales (e.g. through online platforms). In most cases, it was not clear whether the agreement excludes online retailers and platforms as a whole, or prevents online sales by the retailers within the selective distribution network.

Figure 5.1 Frequency of the types of vertical restraint discussed



Note: Other restraints are all those that could not be classified as one of the other restraint types. Six participants are not accounted for here because they did not mention any relevant restraints.

Source: Oxera analysis.

Table 5.1 shows the restraints and related practices mentioned by participants, for each type of relevant product. As shown, the use of selective distribution and RRP was common for businesses selling high-end branded products, as well as those providing pre- or after-sales service.[15]

Table 5.1 Vertical restraints used by participants, by type of product

	High-end brand	Pre-sales service required	After-sales service required
Selective distribution	8	3	1
RRP	7	4	2
Exclusive distribution	3	2	2
Quantity forcing	4	4	2
Exclusive supply	3	1	1
Single branding	1	1	1
Other	3	3	0
Total number of participants	**13**	**9**	**4**

Note: High-end brand includes participants that fit into both the 'yes' and 'mix' categories of Figure 3.1 and use relevant restraints. One participant sells a product requiring both pre- and after-sales service, so, in total, 12 participants mentioned the need for some form of service.

Source: Oxera analysis.

[15] Of the 13 participants who sold high-brand brands and spoke about relevant practices, 7 (over 50%) mentioned the use of an RRP. By contrast, 4 of the 13 participants who did not sell high-end brands but spoke about relevant practices (i.e. 31%) mentioned the use of an RRP. Although these are small samples, this might reflect the insight from the literature that manufacturers of high-end brands are more likely to specify an RRP—for example, to signal the quality of the product to consumers.

5.1 Distribution agreements

As shown in Figure 5.1, both exclusive distribution and selective distribution agreements were commonly mentioned by participants, with 9 and 15 instances respectively. Exclusive supply was also mentioned by four participants.

5.1.1 Rationale

The responses from businesses regarding why they use such distribution agreements were broadly in line with the reasons highlighted by the economic literature, albeit some were more commonly mentioned than others. The most common reasons stated were incentivising sales effort by retailers (in particular, pre-sales service), preventing free-riding by other retailers—both of which are related to the rationale of addressing vertical and horizontal externalities—maintaining brand image (including using brand image to signal the quality of the product as well as to maintain the ‘status good’ image of the product to consumers) and to secure a good commercial deal.

Incentivising sales effort and preventing free-riding

As noted in the literature, one of the reasons why a manufacturer may want to restrict the number and type of retailers through selective or exclusive distribution is to address the vertical and horizontal externalities that exist in such a relationship. In particular, these restraints may be used to ensure that each retailer has sufficient margin and hence the appropriate incentives to put in the effort necessary to sell the product (see Table 4.1). One participant alluded to this rationale as follows.

> ‘if there is another shop opening then so long as it's not right on my doorstep, it’s not going to cause me an issue and if anything it increases the awareness that people have of the brand … But at the same time, **if you flood the market too much then, it then makes it very hard for anybody to sell anything**.’ RQ04 [emphasis added].

As set out in Table 4.1, the literature indicates that this incentive is particularly important for products that require some form of customer service, either before or after the sale. Examples would include complex technical products where specialist knowledge is required to make a choice or where specifications change frequently, products that require a degree of personalisation, and experience goods where the quality is not observed by the end-consumer.[16]

As such services can be expensive for retailers to provide, they need to recoup these costs. By restricting the number of retailers, the manufacturer seeks to ensure that the effort and service provided by one retailer is not undermined by free-riding by other retailers who are not providing the service.

Indeed, of the 13 participants selling products requiring pre- or after-sales service, 8 used at least one of a selective distribution, exclusive distribution or exclusive supply agreement.[17] These participants highlighted free-riding concerns as one of the key reasons for using these restraints.

[16] In the survey, examples of such products included high-end machines which require technical advice, a prescription product where personalised advice was necessary, bespoke bicycles which may require after-sales customer service, and special adult shoes which require expertise and training in shoe fitting.
[17] Of the other five participants requiring service, one used agency pricing which could also prevent free-riding (and is discussed further in section 5.4). The other four did not use any distribution agreement, although three used some other form of vertical restraint ore related practice (two used quantity forcing, and one used a preferred supplier agreement), so only one used no relevant restraints. The participant using no relevant restraints manufactured a very high-end, technical product with limited demand due to the extremely high price point, so it appears that free-riding may be less of an issue in this case.

> ‘If they’re taking the time to fit the [product], to add the value […] etc. then it seems only fair that you are long term rewarded for that effort and therefore they come back and buy the products from you. What we don’t want to have is a company whose…you know, **they do all the work and then some Internet reseller nicks all the business**.’ RQ05 [emphasis added]
>
> ‘there’s normally **someone that’s done the work and you want to reward the person** that’s done that six month sale cycle, not be undercut by 1% just because it’s cheaper through this way or this way.’ RQ24 [emphasis added]

In addition, it seems that exclusivity agreements with one retailer could be introduced to ensure a successful launch of a new product. One reason for this could be the need for significant marketing during launch, both by the manufacturer and the retailer, and without exclusivity provisions, free-riding possibilities would disincentivise such marketing effort by the retailer. One participant explains this as follows and highlights that the exclusivity agreement could also continue beyond the product launch period.

> ‘[…] it’s a bit like you know when [product] is launched, they choose one…or if you launch something, marketing materials, you choose one initial partner. So quite often you have an agreement….You’ll have an exclusive agreement for the first season with one department store and that might be maintained because they might just keep ordering.’ RQ09

It appears that the growth of online businesses has significantly increased the scope for free-riding, as it is much easier for customers to browse a product and receive advice in a store and then purchase the product at a cheaper price online. This in turn may have increased the importance of selective distribution in maintaining retailers’ incentives to provide the requisite service, and has led some businesses not to sell through online channels, including online platforms such as Amazon and eBay. For example, one manufacturer highlighted the following.

> ‘one of the things that we do ask is that our dealers do not put our [products] on [retailer] […] we’ve got a very good reputation for the quality of our product and of the way that we look after customers and so, similarly, the way our dealers look after their customers – the end user. So it’s very easy to ruin a reputation and anything sold on [retailer] does tend to run the risk of spoiling the reputation that you’ve worked years and years to build up.’ RQ21

The responses also suggest that the pressure from lower prices online may lead smaller stores to stop stocking the product altogether. For example, one retailer explained the following.

> ‘[Manufacturer] had a bit of an issue with it being sold into both online and retail, you know, sort of bricks and mortar environment, and there was a big issue with **retailers like myself not being able to take the product because it was being discounted heavily online**.’ RQ04 [emphasis added]

This is broadly in line with the economic literature which highlights that manufacturers may use vertical restraints such as selective distribution (or RPM) to maintain retailers’ incentives to stock the product.

As such, when choosing whether to implement a selective distribution policy, manufacturers face a trade-off: if they choose not to have the policy, they will have a broader reach, but are likely to have lower service standards because they are not protecting retailers against free-riding; if they decide to have the selective distribution policy, they have a smaller retail footprint but a better quality service from retailers, which could nonetheless increase overall sales.

Protection of brand image

Businesses cited protection of their brand image as another common reason for using a selective distribution system, and, to a lesser extent, for exclusive distribution systems. It appears that the term 'brand image' was used by participants to reflect:

- the perceived or actual quality of the product and/or service;
- the status good nature of a product.

In particular, some responses indicated that manufacturers use selective distribution to signal to consumers that the product is of high quality (actual or perceived), and in selecting the retailers, manufacturers tend to consider the image of the retailer (including whether they sell similar brands) and whether that image aligns with that of the manufacturer. For example, manufacturers stated the following.

> 'you got your upmarket shops and your downmarket shops I suppose, you know it would want to be in the right place.' RQ10
>
> 'I think the supermarkets will kill it straightaway you won't have brands left. What will happen is they will take away all of the prestige of a brand and then there won't be brands left to take their place.' RQ08
>
> 'it's more about being seen in the best stores, you know, it's being seen with the best partners, being seen in the best malls, you know, that brand.' RQ09
>
> 'we only sell to good shops, top end, because we're top end, so we do maintain our standard.' RQ18

This shows that manufacturers use the retailer reputation and image to signal the quality of their product and enhance awareness among their target customers. The choice of retailers may also be influenced by the positioning of competing brands within a store—for example, by conveying similar values and/or quality. For example, one manufacturer indicated a preference for positioning its brand with competing premium brands.[18]

> 'the job is really you always want to set up next to the best and like minded brands. If we have a choice we would sit alongside [Brand 1, 2 and 3].' RQ08

Indeed, the adjacent brand positioning within a chosen retailer may lead to higher inter-brand competition and, hence, even if selective distribution reduces intra-brand competition, it could at the same time increase inter-brand competition, and benefit consumers.[19]

In markets involving more technical products, the quality of the product could also include the quality of pre-sales service that the retailer provides because poor-quality service by a retailer may reflect badly on the manufacturer's brand. For example, a manufacturer of a consumer product with some technical features stated the following.

> 'one of the things that we do ask is that our dealers do not put our [products] on [retailer] […] we've got a very good reputation for the quality of our product and of the way that we look after customers and so, similarly, the way our dealers look after their customers

[18] Selective distribution criteria are sometimes related to brand attributes other than brand protection. One manufacturer's criterion was that they would only sell to retailers that comply with its ethical and fair trade standards.
[19] Not all manufacturers may have the same preferences. For example, one manufacturer of a consumer good in the study stated that it would be better if its goods were not sold alongside those of its competitors. This product was branded, but was not a high-end product with very high prices.

> – the end user. So it's very easy to ruin a reputation and anything sold on [retailer] does tend to run the risk of spoiling the reputation that you've worked years and years to build up.' RQ21

Overall, this rationale is broadly consistent with the academic literature, which highlights that manufacturers may use vertical restraints to signal the quality of their product and to differentiate themselves from competitors.[20]

Some of the responses suggested that manufacturers use selective distribution to maintain their brand image in the sense of signalling to consumers the exclusive status of the product. This is similar to the rationale that vertical restraints may be used to signal the status good nature of a product (see Table 4.1). Two manufacturers of fashion brands mentioned this rationale and also seem to indicate that more widespread availability of the product would reduce the value of their product to the target consumer.

> 'they just come out expensively and that's also why people like them. A lot of people say oh can I get that for this price, I say if I would show you that for that price you wouldn't like it. […] I feel that our product is good value for money because … it's not everywhere, you know, it's not exposed.' RQ09
>
> 'But some consumers actually really enjoy paying full price and having a great service and a great experience and buying the very latest things.' RQ08
>
> 'Virtually every supermarket price is a principal weapon they use to attract business. […] As a brand your business wouldn't be sustained. I am sure you would sell; you would have a fantastic first two years if you sold it to [retailer] or [retailer] and you would be dead within that period. They would have destroyed the brand, the whole premise of the fashion brand.' RQ08

Securing a good commercial deal

The above reasons for the use of selective and other distribution agreements may be beneficial for consumers through their effect on quality and customer service. However, some responses suggest that manufacturers and retailers use these restraints only to secure a good commercial deal, without a clear link to the consumer benefits.

For example, some manufacturers stated that they used exclusive distribution for bargaining purposes in negotiations with retailers, by offering an exclusive distribution agreement if the retailer agreed to stock their product, or to purchase higher volumes. In these cases, the vertical restraint may lead to a reduction in intra-brand competition without a clear benefit to consumers (although inter-brand competition may be maintained, or as noted above, even enhanced due to adjacent positioning of competitors within the chosen retailer).

> 'Oh it's driven by them [the retailers] because they want exclusivity but that will come with a minimum, you know, then you say that's fine but you've only ordered X amount, if you up it to three times that we'll talk….we'll consider it. […] I'd use it as a way to ensure an account that I'm [the manufacturer] trying to negotiate, so I would say oh I'll give you exclusivity […] it could be they can say we will only buy you if you're not working with X, Y, Z and you'll say well I am so if you place this kind of order I can leave, you know, I can leave them and justify going with you.' RQ09
>
> 'we will supply just to you if you take our products on board for that area.' RQ36

[20] The extent to which the product is actually of superior quality may vary. In particular, a manufacturer of a low-quality product is less likely to be able to sustain its reputation of high quality through selective distribution if customers are sophisticated and informed. Some of the responses from luxury/high-end fashion manufacturers suggest that consumers are sophisticated.

Box 5.1 Case study: manufacturer of custom-made prescription product

The need to provide a high quality product and to protect retailers' incentives to provide pre- and/or after-sales service for complex products can lead businesses to use vertical restraints such as selective distribution, and to specify an RRP. A manufacturer of a custom-made prescription product illustrates this rationale. This manufacturer's distribution network comprises primarily independent bricks-and-mortar retailers and small buying groups, and it states that it has a policy of not supplying Internet resellers for two reasons:

- **to ensure safety and quality for the consumer** given the complexity of the prescription: 'it would be very unhealthy and risky for a patient to try and access our product without going through a [specialised retailer]';
- **to prevent Internet resellers from free-riding** on the efforts of the [retailer] in providing [the product and service]: 'What we don't want to have is a company … [that] do all the work and then some Internet reseller nicks all the business.'

In selecting retailers, the manufacturer has a preference for smaller firms. The distribution network can include other retailers, but they do not actively pursue large retail chains that are volume-driven. As stated by the manufacturer, they seek [retailers] who would 'sync with [their] values, that are looking to elevate [the service], have more than experience with their patient, are really committed to…to do something a little bit…a little bit more than just the average [retailer] will do'. The selection criteria also takes account of the population and demographic profile in an area, to assess the network spread.

This selection criterion also appears to assist smaller retailers to compete effectively with larger ones as they can 'differentiate themselves as well from the likes of the Internet, and the bigger…the bigger, bigger volume chains and therefore they could more have an emphasis on quality, more of an emphasis on an experience and adding value to the patient'.

The manufacturer also suggests that there has been a reduction in quality of service in the broader mass market [i.e. not custom-made product] due to commoditisation following the growth of online sales and the consequent downward pressure of price. This is because: '[retailers] in an effort to try and protect and say, you know, any margin that they can, reduce the amount of time they spend, reduce the effort they spend, don't add as much value to the patient, therefore the patient leaves the practice and say well that was fine, I don't really know what I'm getting now out of my experience there and I certainly haven't got what I paid for'.

The participant suggested that there is likely to be a reduction in consumer choice in the near future due to the aggressive competition from online sales. In particular, the participant indicates that the custom-made product provision may be threatened: 'there are already the warning signs of certain, in certain practices that just say, do you know what, I can't [make] any money out of [product] cause I'm being killed by the Internet, so therefore I just don't really bother doing that anymore, I'll focus on [a different but related product].'

Source: Oxera.

5.1.2 Impact on market players and consumers

The rationale behind the use of these distribution agreements gives some indication of their impact on all levels of the supply chain. The key impact for manufacturers, for both exclusive and selective distribution, is that their brand image is protected, through brand differentiation among consumers and/or improving the quality of the overall product (including the service provided by the retailer), thereby leading to higher sales.

One manufacturer said that their selective distribution policy of not selling to large retailers reduced their chance of becoming reliant on one, powerful retailer, thereby saving their business and that of many of their bricks-and-mortar retailers.

> 'if, for instance, there was one big dealer who was selling [product] with 20% discount, they'd be asking for more and more volume obviously […] I think if we were to go to

somebody like [retailer] and agree that they could have our product then I'm pretty sure it would happen and we'd end up with a big customer probably, who needs lots of [product], who is discounting them and it would end up cutting off all the rest of our business and we'd end up with a big powerful customer who's got an awful hold over us and won't pay us on time and who we make little margin off and ultimately we wouldn't be here.' RQ21

This suggests that, in the long run, such distribution policies may help maintain consumer choice and access, at the manufacturing level (by ensuring that manufacturers make sufficient margins and that incentives for continued operation and further entry are maintained) and at the retailer level (by ensuring that there are enough retailers, including physical stores).

When discussing exclusive distribution agreements, many retailers spoke of the benefit they get from being able to sell a product that is unique in a certain geographical area. A similar impact arises from selective distribution, where retailers that are allowed to sell the product can differentiate themselves from others. For example, one retailer of a high-end branded product stated the following.

'We want to be individual, we want to be unique and we want the best of the best, you know, to complement the rest of our product range really.' RQ12

With regard to the impact on consumers, as highlighted by the literature, this is likely to depend on the type of product being sold. As noted in section 4, for products requiring specialist knowledge, selective distribution may be used to ensure that consumers can purchase the products only from retailers that are able to give full information. As discussed, this policy also prevents free-riding and ensures that retailers do provide that information and service. Some of the responses in the study provide support for this. For example, participants stated the following.

'it would be **very unhealthy and risky for a patient** to try and access our product without going through [a specialised retailer].' RQ05 [emphasis added]

'You know, we [manufacturer] have to be happy that they can actually look after the customers. So we wouldn't, for instance, set a café on as a dealer who could sell the [product] but then, if a customer needs a repair doing, if they've fallen off and broken something, that café couldn't necessarily do the repairs, **so we make sure that they're capable of doing after-sales work and any warranty work** that might become available – you know, necessary – and part of our agreement is that if there is any warranty replacements required we supply the part but they supply the labour.' RQ21 [emphasis added]

'we've [manufacturer] been approached by [retailer] or somebody claiming to be the buyer for [retailer]. Yes, wouldn't do that. What do they do for their after-sales? You know, they would just get returns and send them to us. That's **not really a very good service to the end user**.' RQ21 [emphasis added]

At the same time, these practices may hinder the development of online platforms such as Amazon and eBay. For example, an online platform noted that selective distribution restricts the range of products it can offer, meaning that it's offering is less appealing to consumers.

'Therefore foreclosing access to these products and you know limiting supply and limiting the choice that we [online retailer] can build on our website.

[…] It is one of our [online retailer] key competitive advantage … both the breadth of selection and the full spectrum of value.

[…] But it does then mean that consumers are paying higher prices.

> […] What they [sellers] don't like is the price competition on (company) is exceptional transparent. You have got a vast range of offerings and you can see which ones are cheapest very quickly, and that I think is one of the things they don't really like [about online sales].' RQ07

This negative impact on online platforms may have a knock-on effect on consumers, in the form of reduced consumer choice in the short run and reduced price transparency. As mentioned above, a reduction in price transparency could also reduce inter-brand competition if all manufacturers adopt similar policies. Consistent with the positive impact of the Internet, one manufacturer believed that consumers benefit from having increased access to their products via the Internet.

> 'I think more people would be just happy to have another avenue to be able to buy the product.' RQ19

However, one participant active in the school wear industry, suggested that not having exclusive or selective distribution can also harm consumers due to stocking problems. The participant suggests that having uniform available from multiple retailers can increase the inventory risk for retailers considerably. Furthermore, consumers are not necessarily better served, because this may prevent retailers from guaranteeing consumers a one-stop shop.[21]

> 'I think the problem is...and is actually the opposite is a factor because you don't know what the other person is selling. So how do you buy when you don't know if somebody else has sold all the 34 or the 36? So the danger is you either end up with too much stock or too little stock and to be honest it doesn't help anybody. So you are probably stocking you know maybe double the amount of schools because you have all gone on to dual supply. **But actually it is much harder to control the stocks and things.** So you are more likely to find that kids go back to school without blazers you know, because they haven't got the buying pattern right; whereas if it is just one retailer that retailer knows exactly what the, you know what the profile of the kids are and they can go and do the measuring days. So that they know exactly what you know what is required in order for every child to go back to school with the uniform.' RQ27 [emphasis added]

Overall, the responses suggest that the impact of removing a selective distribution system would depend on the trade-off between the potential consumer benefits from lower prices from higher intra-brand (and potentially higher inter-brand) competition in the short run, and potential harm from lower service quality by retailers in the short run and the reduction of the retailer base in the long run.

[21] Retailers know roughly how many of each size uniform will be sold to an entire year-group. If this group all buy from one retailer then this retailer will have a good idea of how many of each size uniform will be sold. However, if this group is split across two retailers, it is difficult for each retailer to know how many of each size they will sell. This is because each retailer is unaware of what the other might sell. It is then more likely that a retailer ends up with too little or too much stock.

Box 5.2 Case study: manufacturer of bespoke bicycles

If a manufacturer requires retailers to provide after-sales service, vertical restraints, such as selective distribution, and specifying an RRP can be used to protect the retailers' incentive to do this. A manufacturer of bespoke bicycles demonstrates how this works in practice. This manufacturer sells through approved dealers (bicycle retailers), only supplying a dealer once they are confident that a sufficient level of service can be provided.

Services that are required to be carried out by the dealer are a pre-delivery inspection of the bicycle, and 'after-sales work and any warranty work that might become available'. By requiring this, it benefits the consumer as there is 'somebody there who can provide that care'. It also benefits the manufacturer; if their product was sold from a 'tin shack at the bottom of the garden', this wouldn't be 'conducive to a good image of the brand'.

This policy has led the manufacturer to refuse to supply certain online retailers that 'would just get returns and send them to us … [which isn't] a very good service to the end user'. This has a separate benefit for the manufacturer because they are not supplying a large, powerful retailer that 'is discounting … [and] would end up cutting off all the rest of our business'. This protects the manufacturer from big companies that 'tend to have too much power and try to flex their muscles too much and hurt the small companies'.

The participant highlighted that, without selective distribution, there can be a free-riding problem in the provision of after-sales service. For example, consumers may buy cheaply from a dealer that is far away and then find that their local dealer will not provide the service since they did not buy the bike from that dealer. This problem has been exacerbated by the Internet, since it is much easier now to buy online from a dealer that is far away. The manufacturer noted that 'if an end customer buys a bike on-line, like I've explained before, and they're miles and miles from where they bought it, what happens if something goes wrong?'

To prevent this happening, the manufacturer asks that all its dealers sell at the RRP, but is aware that this is 'totally unenforceable'.

Source: Oxera.

5.1.3 Imposition of restraints and impact of the Internet

Overall, exclusive distribution agreements tended to be imposed by retailers or mutually agreed. This is to be expected as it is often the retailer that benefits the most directly out of exclusivity due to being the sole retailer of a unique product in an area.

> 'the retailers tend to be very protective about their area, their geographical area.' RQ03

However, it seems that the balance of bargaining power needs to be right for this to happen. For example, one retailer was asked whether they have had an opportunity to ask a manufacturer to implement exclusive distribution, but they replied that they were not in a position to be able to do that.

> 'No, that wouldn't happen … we're only a small company, we're only based in the North East, so we haven't got that much, I wouldn't think we'd have that much clout with them, as such, compared to other national companies who would buy an awful lot more than what we would. So if that situation did arise, they're going to listen to those guys more than they're going to listen to us.' RQ29

The study indicates that selective distribution agreements tended to be imposed by manufacturers, although there was a general feeling that this was mutually beneficial and, in some cases, also benefited the consumer, as discussed in section 5.1.2.

Although the Internet seems to be a key factor behind some selective distribution policies, one retailer noted how the Internet has actually led to the demise of exclusive distribution agreements. There were two interdependent factors driving this: a reduction in the number of physical stores; and an increase in the number of consumers shopping online:

> 'I think historically going back many years that was probably the case [that exclusive distribution agreements were used]. Now I don't think it is the case because for two reasons, first of all there are much fewer retailers in bricks and mortar now. So obviously that makes a big difference to other manufacturers because they have got less of a pool to draw from. But also obviously with the rise of the Internet then you know people can sit at home and order what they want wherever they want from wherever they want so.'
> RQ14

Some participants commented on the legality (or illegality) of such restraints. One manufacturer stated that it believed it was illegal to restrict supply to retailers, although it operated a policy of not supplying Internet resellers. A couple of participants noted that selective and exclusive distribution agreements were often verbal, rather than in a formal contract, making it difficult to apply legal concepts. An online platform stated that it was aware that selective distribution is allowed in cases where pre- or after-sales service is needed, but believed that many platform bans did not meet this criterion, with manufacturers instead just trying to reduce transparency.

Box 5.3 Case study: three manufacturers of high-end fashion brands

The literature highlights that owners of luxury brands may use vertical restraints to protect their brand image. In this study, three participants supplied luxury brands of clothing and footwear. All three of these used selective distribution policies, with two also specifying an RRP.

A common theme among these manufacturers is that they wanted their products to be 'next to the best and like minded brands [such as] [Brands 1, 2 and 3]'. This acts as a signal to consumers that the brand is of a high quality. It is thus an important policy for these brands that they 'wouldn't sell to a discounter' who might 'devalue the brand'. Instead, these manufacturers sell into retailers with the 'right brand adjacencies', such as department stores.

The protection of brand image can mean several things. For these luxury fashion brands, the manufacturers were concerned about the availability of high-end brands for consumers. One was concerned that if it was forced to sell to supermarkets, this might 'take away all of the prestige of a brand and then there won't be brands left to take their place'. This would have a negative impact on consumers since some of them 'actually really enjoy paying full price and having a great service and a great experience and buying the very latest things'.

As well as the shopping experience, these interviews suggest that consumers enjoy owning something that is more exclusive. One manufacturer is of the opinion that 'our product is good value for money because … it's not everywhere, you know, it's not exposed'.

Two of the manufacturers give an RRP to retailers, again in order to protect the brand image and signal quality. However, both noted that this does not have a huge impact, partly because their selective distribution policies mean that the retailers they work with are not 'massively interested in discounting'. Also, 'it wouldn't make sense for them with the cost of shipping, the cost of, you know, all the other, you know, all the cost associations, their rent, their staff, it wouldn't make sense for them to be selling at a ridiculously low price.'

One manufacturer also noted that distributors' degree of selectiveness may depend on the popularity of the product, suggesting that the degree of selectiveness depends on the balance between lower/higher sales and any impact on price. 'If you're on fire you can sell to everybody, you know, and you know if people know you've got the red sole like one of our competitors who's got a red sole on your shoes, he sells to everybody and everybody just wants to buy as much as they [can] because it has 100% sell through but [if] you're more marginal, you've got to pick and choose, you know, who you think the best partners are.'

Source: Oxera.

5.2 Price agreements

In addition to a selective or exclusive distribution agreement, manufacturers may have price agreements with retailers. As noted in Figure 5.1, many participants mentioned that they specified RRPs, including recommended price ranges. As discussed in section 4, although the specification of an RRP by a manufacturer is, by itself, not a vertical restraint, forcing retailers to price at RRP could lead to outcomes similar to those from other price restraints such as RPM. In many cases, it appears that retailers did not consider that the RRP had any impact. However, limited number of responses suggest that manufacturers monitored RRP more closely and aimed to ensure retailers price at RRP.

5.2.1 Rationale

In some respects, the reasons stated by participants for manufacturers specifying an RRP are similar to those set out for the distribution agreements. In particular, businesses stated that they specify RRPs to maintain their brand image and signal that the product is of a certain quality.[22]

However, it is not always clear that the relevant product had particularly high quality or conveyed social status from which consumers would benefit. For example, some manufacturers stated the following.

> '[…] obviously you give a stupid price out in the marketplace, you actually might have everyone come to you but it doesn't … it devalues our product and we don't want that.' RQ24
>
> 'either damage our market price by selling it too cheaply […] or selling the product too expensive and damaging our market price.' RQ17

Again, as with distribution agreements, the responses seem to indicate that manufacturers may specify RRPs in order to prevent free-riding and therefore to protect a retailer's incentive to provide pre-and after-sales service. In particular, for a retailer to provide high quality pre-sales service, it needs to be confident that consumers will ultimately purchase its products.

By specifying the same RRP across all retailers, the manufacturer may aim to provide a level playing field and potentially discourage other retailers not offering the service from undercutting on price, thereby increasing the probability that the consumer will buy from the same retailer that provides the service. A similar argument of preventing free riding can hold in cases where after-sales service is provided free of charge to customers. Rather than paying retailers for the provision of this service, some manufacturers instead specify the same RRP to all retailers.[23]

One of the participants indicated that both of these free-riding problems could be mitigated by setting the same RRP for all retailers:

> 'we do ask if people will sell them at the recommended retail price so that all dealers have a fairly level playing field. Because of the part of the agreement where the dealer that sells the bike is responsible for the warranty and after-sales, if you've got somebody on-line who's selling lots and lots of bikes and they're going miles away from that dealer

[22] This rationale is similar to that for selective distribution—indeed, the two restraints can be alternatives. In the case of luxury brands, in particular, some of the manufacturers may sell into retailers who would be unlikely to discount, thereby reducing the need for an RRP.
[23] However, it may be easier for businesses to charge for after-sales than pre-sales service. Hence, it seems that using a restrictive vertical restraint to prevent free-riding on after-sales service may be less justifiable than using agreements for pre-sales service.

how does the dealer do the after-sales servicing and, […] and it causes, obviously, conflict with the end user and we don't want that.' RQ21

Some participants that operated in sectors where pricing is more opaque (for example, technical products) indicated that manufacturers used the RRP to indicate to the retailer the appropriate retail price level and margin.

Respondents did not directly mention aiming to prevent double marginalisation as a reason for engaging in price agreements, despite this being a justification highlighted in the literature.

5.2.2 Impact on market players and consumers

As noted above, manufacturers may or may not monitor whether the retailers are pricing at the RRP, and may do so to a smaller or larger extent. As such, the RRP may or may not have an impact on the final retail price.

Some of the responses from participants indicate that, even if there were no RRP, retailers are likely to have set the same or similar price as the manufacturer's RRP in order to achieve their target margins and recoup their costs. It appears that this is because manufacturers are aware of the approximate level of margin that a retailer requires/aims for and therefore set the RRP such that it corresponds with this margin.

'[…] **But from a business perspective, you don't want to go lower than it, because your business won't be here**. […]I think it's just that over however, you know, years and years and years, businesses have been aware of what margin they need to make in order for it to be successful.' RQ04 [emphasis added]

'it wouldn't make sense for them with the cost of shipping, the cost of, you know, all the other, you know, all the cost associations, their rent, their staff, it wouldn't make sense for them to be selling at a ridiculously low price.' RQ09

'in general the dealers all sell at the same price and the product is such that people are happiest buying from their nearest dealer, mainly so that they've got the after-sales back-up and everything. And most people are prepared to pay full price. So it's [significantly lower prices by certain retailers] not something that crops up very often.' RQ21

Some other manufacturers indicated that, although they specify an RRP, they do not stop retailers from offering discounts. It appears that this was partly because manufacturers were aware of potential legal issues, and were therefore wary about dictating the price to retailers.

'But we [manufacturer] don't because it is illegal to talk about price, we are not allowed to.' RQ08

'**Price fixing is illegal** by and large across...what can you price fix in the UK, pharmaceuticals probably and that is about it.' RQ02 [emphasis added]

'Legally, we [manufacturer] have no right to dictate what somebody sells the price at. We have a Recommended Retail Price that is on our order forms, but **it's down to the retailer to sell at what they see is correct**.' RQ13 [emphasis added]

'We [manufacturer] can have those discussions, we can offer advice, **but we can't insist upon it**. At the end of the day, what a dealer sells for is entirely up to them. We just don't necessarily have to like it.' RQ21 [emphasis added]

However, there were also instances of manufacturers being more forceful in implementing the RRP level or range. This was achieved through close monitoring of retailer behaviour and a punishment mechanism for deviation from the RRP range. For example, manufacturers may withhold rebates or refuse to supply retailers that consistently deviated from the RRP. Some participants also mentioned a potential termination of contract.

> ‘Well we [manufacturer] have a team of five people, which travel the world. They all have individual relationships with those individual companies; they’ll monitor their online presence; **they’ll monitor their pricing in the market**; they’ll monitor their marketing.’ RQ17 [emphasis added]
>
> ‘If you [retailer] start discounting then you will just get your supply stopped...all of a sudden they will find an excuse.’ RQ02
>
> ‘Well they ... if they do get down we [manufacturer] have the right to basically … that rebate that they get back on other projects, **we have the right to withhold it**.’ RQ24 [emphasis added]

Overall, the responses suggest that the rise of the Internet has led to manufacturers more closely monitoring their retailers’ pricing relative to the RRP. Since online retailers tend to face lower costs than traditional bricks-and-mortar retailers, they can often set lower prices. Given the increased ease of price comparison for consumers, this appears to have led to manufacturers increasing their efforts to reduce the price difference between online and bricks-and-mortar retailers.

Some retailers stated that this has negative impacts on retailers due to the restrictions on their freedom to compete, and leads to higher consumer prices.

> ‘But I think that’s been the case with quite a lot of Internet, you [consumers] don’t seem to be able to get as good a discounts now, do you, online, as you may have done sort of five or ten years ago? RQ04
>
> ‘And that might mean that they [retailers] are allowed a discount but no more than say 10% below RRP … it does then mean that consumers are paying higher prices.’ RQ07

The responses suggest that RRP, similar to selective distribution, also provides retailers with the incentive to display products in their stores. Participants noted that this is beneficial for manufacturers due to greater brand presence, and for retailers due to the larger number of customers. Some indicated that consumers also benefit from increased access and choice due to the availability of in-store service.

> ‘then it would mean that potentially **you wouldn’t find them on the high street** because we [retailer] wouldn’t be able to support the price.’ RQ04 [emphasis added]
>
> ‘we [retailer] have basically access to the full range of products and from the manufacturers perspective it shows that if they have a consumer interested in their product they can go and…and actually see it in store.’ RQ32 [emphasis added]
>
> ‘if the consumer is wishing to invest in a premium product they want to be able to see it and be….and **someone who has got competent knowledge to explain the product to them**, so we [retailer] are able to ensure that they make the right decision.’ RQ32 [emphasis added]
>
> ‘Their [the manufacturer] idea is to get as much products in as many shops as possible because the **more it is on display there more people see things and that is an advert in itself**. When you don’t see things and they end up just on the Internet a lot of things that people just don’t buy them or the market goes down.’ RQ02 [emphasis added]
>
> ‘the customer has got somewhere to go if he or she needs to work that piece of software and also can see the ranges of goods and accessories available.’ RQ02 [emphasis added]
>
> ‘One of the consequences [of one retailer selling much cheaper than the others] is that small independent retailers who make up the vast bulk of our customer base by number tend to need to operate at a higher margin than he operates at because he’s selling at

> much bigger quantities … That means that ultimately, **those retailers would then stop selling our product and we would lose distribution** … **We want our end users to be able to buy our product from as many retailers as possible, wherever they want to buy** because they will continue to visit those outlets. Most of our outlets in the UK are not specialist […] outlets, they are [product] stores or electrical distributors who sell [product] as an extra product … But if they decided that they don't want to sell [product] anymore, that would ultimately affect our sales. So it is concerning to us on that basis. **We don't want to be overly concentrated in to big suppliers** because we know particularly with our experience with [retailer], that we then risk losing complete control of our brand and product and the future.' RQ31 [emphasis added]

5.2.3 Impact of the Internet

The responses suggest that the ability to sell online has created a need for manufacturers to consider their online pricing strategy as well, which could create tension between them and their distributors and/or dealers if not managed carefully. It seems that this is because the manufacturer could sell directly to end-users through the Internet, bringing them into direct competition with retailers. Manufacturers had resolved this in two main ways. The first was simply not to sell online and rely solely on the bricks-and-mortar retailers. The second was to ensure that the manufacturer's online prices are no lower (and sometimes actually higher) than those offered by bricks-and-mortar retailers.

> 'We did sell direct for a while but … we ended up in competition with our own dealers because we didn't reduce the price' RQ35
>
> 'We don't want to upset our wholesale customers, 'cause the wholesale side of the business is still, obviously, the main side, so we're careful … But what we can do then, we put them on at slightly higher prices.' RQ18
>
> 'The only thing [manufacturer] have done is they actually sell online themselves but it's not any concern to us because they sell... their price is well marked up. It's a good £100 a unit above us on everything and on all dealerships.' RQ33

This tension manifests itself in another way if the manufacturer is selling internationally. A manufacturer noted that selling products into multiple countries introduces three key factors into the pricing: exchange rates, taxes and differing retail industry structures. It appears that this often means that net prices will vary across countries. Moreover, products may be specific to a particular national market. A manufacturer indicated that if they were to sell online, this could undermine the pricing and product differentials.

> 'the biggest problem is within certain markets, certainly overseas markets we have a defined offering in terms of price and products that might well be private label, it might well be that it's specific markets … specific product for that specific market and the pricing that we have for that market can vary to what it would be within other markets, say Europe for instance. So I'm not able then to have an online priced marketing offering purely because it would undermine those different markets.' RQ17
>
> 'we don't actually retail the product ourselves online … it could make it very difficult with our dealer network, because in different countries we've got different rates of duty and taxes and the margins required by the dealers in different countries varies as well, so you can end up with quite different prices in different parts of the world, for the same product.' RQ16

Box 5.4 Case study: a retailer of consumer goods

Retailers often find vertical restraints imposed upon them when manufacturers are large and retailers comparatively small. A small retailer of consumer goods finds itself in this position, with manufacturers tending to be fairly concentrated. The retailer makes roughly 95% of sales through its store, and 5% online (through its own website, Amazon and eBay).

The retailer says that it is common to find that these products are sold at the RRP, so ‘if it is 199 quid in my shop it is 199 quid on the Internet. So it is not going to be 198 quid on the Internet it is 199. So people can Google all day, they will come up with the same price.’

This is not a choice by the retailer, instead it is enforced by manufacturers. If a retailer ‘decided to sell the thing at 399 instead of 499 and as a discounter you will find that goods won’t turn up, they will be out of stock’.

Although the manufacturer is enforcing the RRP, it is sometimes in the ‘best interest’ of the retailer to go along with this and not discount ‘because they [the retailer] are making a profit out of it’ and, as a result, the retailer is ‘not going to complain.’ However, there can be an incentive to discount. This retailer is currently selling some products below the RRP because they ‘are desperate to sell and get some cash through the door and clear some space’. The manufacturer has not yet said anything about this because the market is struggling so the manufacturer is happy to sell any stock, but the retailer believes this will last only ‘until somebody complains’.

The Internet has not disrupted this agreement. This is because manufacturers enforce the RRP across all retail channels. In fact, the retailer says that ‘they [manufacturers] have become much more strict now … the Internet changed it because people can find out other price’. The Internet has, however, had a small impact in that a consumer can now buy from abroad, which might lead to small price differences because of a ‘slight exchange rate cause’. However, comparing prices from ten shops online for the same product, there was ‘less than 7% or 8% between them’.

There are some potentially positive impacts from these restraints. ‘If companies couldn’t make a profit … they just become even more Internet driven, people would not go into the shops’. By still having bricks-and-mortar retailers present in the market, manufacturers ‘get as much products in as many shops as possible’. This is beneficial to them because ‘the more [their product] is on display the more people see things and that is an advert in itself.’ Also, manufacturers ‘have a product specialist who can answer any question on a [manufacturer]’. This could benefit consumers too, who have ‘somewhere to go if he or she needs to work that piece of software and also can see the ranges of goods and accessories available’.

Source: Oxera.

5.3 Quantity forcing and single branding

As seen in Figure 5.1, quantity forcing and single branding were the other restraints mentioned by participants (total of 10 mentions).[24] While the two are different types of restraint (see section 4), if the threshold of minimum volume in quantity forcing is very high, this can lead to outcomes similar to those that arise from the use of single branding, as the retailer will be sourcing the vast majority of its supply from one manufacturer. Unlike distribution agreements, quantity forcing and single branding involve conditions relating to competing brands, and hence affect inter- rather than intra-brand competition.

Quantity forcing (which includes range stocking requirements) was the more commonly used of the two agreements (7 instances), and, in some cases, appears to be imposed by larger manufacturers on smaller retailers. This suggests that the balance of bargaining power is important when considering the ability to use quantity forcing.

[24] One participant mentioned both, so this corresponds to 9 different participants.

Several manufacturers suggested that the main reason for specifying a minimum order is to ensure that a sufficient number of products are displayed prominently in stores, thereby increasing the brand presence and sales. One manufacturer achieved this through the use of a 'range stocking' agreement.

> 'There are frequently a range stocking agreements, so that if you want to be able to sell a certain type of product then you must stock a representative range, of that type of product.' RQ32

Other reasons stated by participants for either quantity forcing or single branding agreements included: cementing the viability of the business relationship; ensuring that the retailer has the necessary expertise; and preventing the retailer from selling competing products.

> 'You've [retailer] got to sell that much else they won't even bother selling to you. They're not going to sell to someone that just orders two machines a year.' RQ33
>
> 'there are some dealers that are focussed almost exclusively on our [i.e. one manufacturer's] product or on a small number of principals, in which case they're [retailers are] **much more likely to have a lot more direct expertise**, in terms of being able to advise customers and things, […].' RQ16 [emphasis added]
>
> 'they can't market, promote or anything that would be competing … if we've got a partner in I don't know, in Denmark for instance, that partner is exclusively dealing with us as a product range, they are not able to supply anything that would be competing … if it's competing it's not workable.' RQ17

Overall, the responses suggest that the effects of these restraints on market players and consumers vary. For example, a manufacturer stated that the 'range stocking' agreement can attract more customers to individual retailers due to the larger portfolio and choice. Manufacturers using such restraints also tend to benefit since they increase their presence in stores. However, this also means that other manufacturers are inevitably prevented from using the specific retailers, and hence may lose sales.

> 'It's…by having some…an agreement with the manufacturer it gives us [retailer] access to…to these models and it generates business.' RQ32

Whether such agreements could harm retailers due to the risk of unsold stock would vary across specific markets; however, one participant suggests that retailers can also shift the risk of unsold stock on to the manufacturer. This is in contrast to other participants who noted that the bargaining power usually lay with the manufacturer. Here, the retailer is able to reduce the impact of quantity forcing by returning unsold stock.

> 'You're tied in to buy the stock for those forecasts because if you don't have the ability to supply to the forecast there are punitive and damaging penalties if you don't have the stock, but they are under no liability to take the stock. If a product doesn't sell through to their forecast, which is arbitrary anyway, they're under no obligation to take the stock and **any stock they have which is unsold they can return to you**.' RQ13 [emphasis added]

Some participants stated that quantity forcing may exclude smaller retailers because they are unable to meet the volume commitment and may be an alternative means of reducing the extent of the retailer network.

> 'What [manufacturers] do is make the amount you have got to purchase so high that a lot of people can't afford it … they lost a few dealers earlier this year … It was just a crude way of narrowing down the dealer base.' RQ02

> ‘Some people actually stopped selling it because they were only selling one or two items.’ RQ33
>
> ‘we were taking on the business as a going concern, [manufacturer] … wanted to put in certain restrictions as to the pairage that they wanted you to take, and the shelf space that they had within the store, and we decided that wasn’t going to work for us, so we had the conversation and then said no, thank you.’ RQ04

This narrowing of the retailer base could have a knock-on effect on some consumers through reduced access to these products. The extent of this impact would, however, depend on the availability of the product through other retailers, including online retailers.

5.4 Broader market developments

The above highlights that manufacturers are facing increasing difficulties to control the distribution of their products and, in some cases, their prices and the signal it sends to consumers. It also shows that some retailers, especially bricks-and-mortar ones, are under significant competitive pressure due to aggressive pricing from online retailers, and may not always stock a product or provide the necessary service.

Some responses indicate that in order to address some of these challenges, manufacturers and retailers are switching to different business models, such as agency or concession models.[25] For example, one manufacturer of a luxury branded product, mentioned that it had moved to a concession model around 2011, which had allowed it to be in control of how the brand is portrayed to the consumer and of pre-sales service.

> ‘As I say that is one of the big changes that has happened in recent years, is that idea of giving the brand responsibility to take the message in the right way to the end consumer even though it is coming under the name of for example in this case [retailer].’ RQ08

Another participant (a retailer) highlighted that many retailers in his sector have moved to an agency pricing model within a buying group, which, in turn, negotiates with each manufacturer on its members’ behalf. This means that all retailers in the group must set the same price for products sourced through the group, as determined by the buying group (which also sells directly online).[26]

The retailer explains that the main benefit of agency pricing is that it does not need to monitor competitors’ pricing or other activities and does not face competition from these retailers, helping it reduce the impact of aggressive competition to some extent. However, the retailer noted that this model also has its limitations, as it does not allow the buying group member to compete with other retailers through discounting.

> ‘The beauty of agency is it is an easy system for us because a lot of the work is taken out of the pricing. It also has its limitations because if in the marketplace that product exists as a generic product rather than a specific agency product then obviously you are over to different pricing structures. And obviously we are bound by our agency agreement to sell at the price that is predetermined.’ RQ14

[25] In a concession model, the manufacturer uses a retailer’s store space, but uses its own staff and systems for sales. In return, the manufacturer pays a commission to the retailer. The manufacturer can also control its products on the retailer’s website. In an agency model, the retailer acts as an agent on behalf of the manufacturer which sets the final prices to consumers. In this setting, a retailer gets a commission from the manufacturer for its services.
[26] However, retailers are also free to purchase directly from manufacturers other products that are not available through the buying group. For these, they will freely set prices as in the traditional wholesale model.

6 Concluding remarks

6.1 Summary

Overall, the interviews indicate that businesses use a wide range of vertical restraints, with the most common being selective distribution and exclusive distribution. Many participants also specified an RRP to retailers. On the whole, the type of restraint used does not vary hugely by type of business; the one exception being for the supply of high-end brands (including high-end fashion and technical products), where selective distribution was mentioned by a majority of participants.[27]

Broadly speaking, the participants highlighted a number of business rationales for using these restraints. Two of the key rationales—mentioned particularly by suppliers of branded goods and products that need some form of pre- or after-sales service—were to prevent free-riding by retailers, thereby maintaining the pre- and after-sales service quality, and to protect brand image.

These have also been discussed in the economic literature as potential reasons for vertical restraints. Although commonly highlighted in the literature, participants did not explicitly mention eliminating double marginalisation as a rationale (except for a few references to reductions in transaction costs).

With respect to free-riding, the responses broadly indicate that selective and exclusive distribution systems incentivise retailers to increase service standards, although at the same time they restrict the reach of manufacturers and retailers (including online retailers). Participants also noted that restrictions on distribution also incentivised retailers (and especially stores) to stock products in the first place.

Those participants who mentioned maintenance of brand image as the reason for using selective distribution or specifying an RRP seem to refer to two separate rationale for using these agreements and/or practices: to signal the high quality of the product and/or service to the customer, and to maintain the image of the product being a status good for consumers (particularly for luxury brands). However, some responses also suggest that manufacturers and retailers use these practices only to secure a good commercial deal without a clear link to any (actual or perceived) benefit to consumers.

As such, the responses indicate that the Internet has served both to increase and to decrease the complexity and challenges of doing business. For example, while some participants mentioned that the Internet makes finding business partners easier, helping them expand their business, others noted that it increases price competition, thereby putting pressure on margins. Overall, the responses suggest that the increased competitive pressures, particularly in terms of pricing, from online sales strengthens the need to have certain vertical restraints in order to prevent free-riding and deliver the benefits of better pre-sales service.

In general, it was not always clear from the interviews whether certain restrictions were always imposed or were requested by one of the manufacturer or the retailer. For example, although, in most cases, selective or exclusive distribution appears to be put in place by the manufacturer, many participants indicated that this was mutually beneficial to both manufacturers and retailers. In

[27] It was not possible, in the time available, to explore in detail how businesses chose one type of vertical restraint over another. However, the available responses suggest that businesses did not make a conscious choice between different restraints. Typically, the relevant restraint was used by the business for a number of years, or evolved slowly with the market.

the case of RRP, this was almost always specified by the manufacturer, although the responses do not confirm whether this was requested by the retailer. (In any event, as discussed in section 5, the responses suggest that, in many cases, the RRP was not strictly enforced.)

Overall, the responses highlight that the impact on consumers from having vertical restraints would depend on the type of the practice, the position of the relevant parties and the market context. For example, many of these restraints reduce intra-brand competition in the short run, and may also reduce inter-brand competition, thereby leading to higher prices. However, as discussed above, consumers can also benefit in the short run, for example, from being able to own products that are not ubiquitous or from a higher quality of pre-sales service from retailers, such as product information and purchasing advice.

Furthermore, in the medium to long-term, the existence of these restraints could provide additional benefits to consumers. For example, removal of all restraints that impose some restrictions on online sales could lead to crowding out of bricks-and-mortar retailers, and hence reduced product availability for consumers. However, there is also the risk that in the long-term they will have a negative impact on consumers due to a reduction in competition, which could reduce consumer choice and lead to higher prices.

As discussed in this report, the relevance of these pro-competitive rationales would differ across markets, and it is therefore critical to conduct a case-by-case analysis of specific vertical restraints, taking account of the economic and market context.

6.2 Lessons learned and future research

This study, being one of the first to gather primary evidence on vertical restraints, provides several valuable insights into why and how businesses use such practices, and what the potential short- and long-run impacts on consumers are. In addition, it highlights areas of future research that could help better understand some specific aspects of the use of vertical restraints and the potential impact on consumers. In particular:

- largely due to time constraints in the interviews, the study could not fully explore whether, and how, businesses choose between different vertical restraints. Further research on this aspect would be useful to understand the relative impacts on market participants and consumers, and whether one type of restraint is more effective than another in achieving the same goal (e.g. differences in cost of monitoring or enforceability);
- the small sample size of the participants limited the extent to which this study could investigate the key factors that would affect the assessment of a specific restraint. For example, while some of the responses indicate that the balance of power between suppliers and retailers is important for such an assessment, further research could explore fully how the relative market power affects the use of specific restraints and the impact on the market;
- an appropriate assessment of a specific vertical restraint would need to take account of the trade-off between the short- and long-term costs and benefits of the restraint. Further research on this aspect would be particularly useful. Such a study would need to be more targeted towards consumers, potentially through a survey, for example. Evidence on businesses that have either stopped or started using a restraint in recent years would also be useful to assess the impact on consumers.

Furthermore, this study highlights some valuable lessons that should be kept in mind for any future research. For example, considerable time needs to be spent on recruitment of a wide range of businesses, especially medium-sized businesses, as they are likely to be aware of the relevant issues and provide the most balanced view, as well as more online retailers, to allow further insight into this growing market. Extending this study to a large-scale business and consumer survey would be helpful to explore some of the less commonly mentioned restraints, and whether there are systematic trends in the usage and rationale across industries.

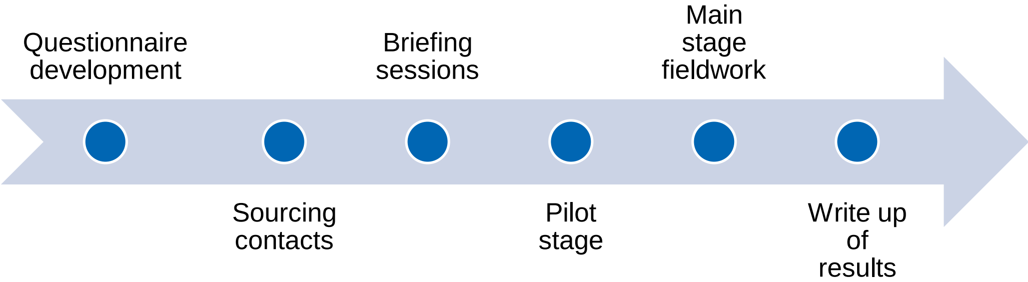
A1 Methodology and participants

This annex sets out the detailed methodology adopted for this study together with a high-level description of participants. Section A1.1 outlines the steps, followed by the topic guide in section A1.2. Section A1.3 provides a high-level overview of the participants.

A1.1 Approach and methodology

Figure A1.1 outlines the main steps followed from inception of the survey to producing this report. The individual steps, and the challenges encountered, are explained in more detail below.

Figure A1.1 Main steps of the methodology



Source: Accent Research

Questionnaire development

The questionnaire for the in-depth interviews was developed with close cooperation between the CMA, Oxera and Accent. It explicitly avoided any direct questions about potentially illegal behaviour, used plain, easily accessible wording, and attempted to steer the participants away from emotive topics that could have introduced bias into their responses.

Sourcing contacts

An important element of the project was sourcing potential participants. Originally, the survey was intended to recruit 50–60 participants through four routes: the participants from the CMA roundtable, Oxera's own contacts, trade associations, and calling businesses directly. In reality, due to the very low response rate among roundtable participants and other existing contacts at the pilot stage, the focus of the main-stage fieldwork shifted to being largely based on direct calls.

For the purpose of calling businesses directly, Accent purchased samples from MarketingFile.com.[28] This database was chosen over the alternatives (such as Dunn & Bradstreet) due to the comparability of the SIC codes on the database (UK2003 SIC codes), with the sectors identified as being of interest for this study. Table A1.1 shows the list of SIC codes chosen.

[28] These are ultimately sourced from the Experian National Business Database.

Table A1.1 SIC codes identified as sectors to be targeted for potential participants

SIC	Sector
Manufacturing	
1771	Manufacture of knitted and crocheted hosiery
1772	Manufacture of knitted and crocheted pullovers etc.
1810	Manufacture of leather clothes
3542	Manufacture of bicycles
3230	Manufacture of television and radio receivers, sound or video recording or reproducing apparatus and associated goods
3162	Manufacture of other electrical equipment
2971	Manufacture of electric domestic appliances
2941	Manufacture of portable hand-held power tools
2942	Manufacture of metalworking tools
2862	Manufacture of tools
2452	Manufacture of perfumes and toilet preparations
1823	Manufacture of underwear
1824	Manufacture of other wearing apparel and accessories
1920	Manufacture of luggage, handbags and the like
1930	Manufacture of footwear
3340	Manufacture of optical instruments and photographic equipment
3622	Manufacture of jewellery and related articles
3640	Manufacture of sports goods
Retail	
5010	Sale of motor vehicles
5245	Retail sale of electrical household appliances and radio and television goods
5246	Retail sale of hardware, paints and glass
5242	Retail sale of clothing
5243	Retail sale of footwear and leather goods
5233	Retail sale of cosmetic and toilet articles
5142	Wholesale of clothing and footwear
5143	Wholesale of electrical household appliances and radio and television goods
5145	Wholesale of perfume and cosmetics
5247	Retail sale of books, newspapers and stationery

Source: Accent Research.

The initial lists purchased were based on a relatively high minimum acceptable turnover of at least £2m. It quickly became apparent, however, that many of the corporate-level leads did not result in recruits, or even allow us to approach the right person in the organisation. We found that smaller organisations were more willing and, at the same time, either directly involved in, or affected by, the agreements of interest. On that basis we purchased additional samples with a lower turnover limit of at least £500,000.[29]

Recruiter and interviewer briefing session

The recruitment and interviewing teams consisted of experienced Accent executives, each with more than 15 years' experience. At the start of the pilot stage, an extensive briefing session involving the CMA and Oxera was

[29] In addition, Accent purchased a separate list of trade associations that were also sourced from the Experian National Business Database.

organised for recruiters and interviewers. During this session both recruiters and interviewers were briefed in great detail on the objectives of the research, and the sensitivity of the issues under discussion. They were also provided with a comprehensive overview of possible vertical restraints, in order to assure that they had a good understanding of the issues being surveyed.

Pilot (feasibility) stage and adaptation of the method

The pilot phase was intended as a proof of concept on whether the participants were willing to talk openly about both the restraints themselves and their motivations for using these. While the responses themselves were satisfactory, and the participants were willing for their answers to be quoted openly in the study, the major challenge was the lack of response from three of the four proposed routes, as noted above.

Following the pilot phase, the recruitment was therefore re-channelled towards direct calling rather than any substantial changes to the methodology or the survey questionnaire.[30] Based on the feedback from the eight pilot interviews, the overall interview target from the complete study was revised downwards from 62 to 33.

Furthermore, it was agreed that there was a necessity to be flexible on quotas for the main stage and to seek to achieve interviews falling out naturally from random sampling. The sample included large, medium and small firms; producers, suppliers and sellers; high- and non-high-end products; and products with or without pre- and/or after-sales services. Eligible participants were those with vertical restraints, as well as those affected by such restraints who do not necessarily themselves have any vertical restraints with others in the supply chain. Table A1.2 shows contact and response rates for the types of businesses split by manufacturing and retail (mirroring the main split among the 33 participants in the research).

Table A1.2 Contact and response rates

	Manufacturing	Retail	Trade Associations	Grand total
Editing	1	2		3
Unused sample	206	192	137	535
00. Seen But No Call Made	43	45	13	101
RECRUIT	**20**	**15**		**35**
03. Firm call back	0	5	1	6
04. Call again	17	16	18	51
05. Engaged	4	2		6
06. No Reply/Answerphone	163	217	32	412
07. Refusal	116	106	3	225
08. Not Available During Survey	3	2		5
11. Number Not Recognised	0	5	6	11
12. Wrong Number	0	1	1	2
14. Not In Scope	59	52	29	140
16. Specify	13	14	1	28
20. Duplicate	2	6		8
All Sample	**647**	**680**	**241**	**1568**

[30] The pilot/feasibility stage was envisaged to consist of 2–3 interviews with each group of leads (CMA Roundtable contacts, industry associations, lawyer contacts and cold calling), giving a total of 8–12 interviews. In the end, eight interviews were achieved, of which one was through Oxera contacts and the remainder through cold-calling.

Note: The total number of recruits shows as 35, differing from the number of final participants. This is because two recruits dropped out of taking part due to time constraints.

Source: Accent Research.

Main-stage fieldwork with interim feedback

The main stage fieldwork was conducted from early January 2016 to mid-February 2016. To provide consistency in the interview process, only two executives from Accent carried out all the interviews. The interviews lasted on average 35 minutes, although the length varied considerably, from 20 to nearly 60 minutes.

Throughout this phase the CMA, Oxera and Accent worked closely together, providing feedback on the interviews conducted and constantly refocusing the questions to ensure that the full research brief was fulfilled. For example, Oxera provided the CMA with two interim updates of the emerging results during the main-stage fieldwork, and had discussions with Accent to guide the direction of questioning.[31]

These discussions also indicated that it was not possible to cover every research question in the time available. In particular, it was often not possible to explore whether businesses consciously chose one type of restraint over the other, or whether they had considered alternatives to their existing restraints.

A1.2 Topic guide

The topic guide used by Accent to conduct the interviews is reproduced below for reference.

A1.2.1 Warm up (5 mins)

Can we start with you describing what your business does and what your role is within the organisation?

MODERATOR: Please be mindful of what we learnt through the recruitment stage and ask further questions to check things out if you are unsure about anything.

MODERATOR: Please say the following if the consultant wants to listen in: Thank you. Now before I go onto my next questions, I would like to bring in the consultant. She will only be listening and will not participate during the interview in any way, though I will pause towards the end to give her the opportunity to suggest if I need to ask you any additional questions.

A1.2.2 Industry level questions (5 mins)

1. What kinds of sales channels do producers of goods and services typically use to sell their products?

MODERATOR: We are interested here in the use made of bricks-and-mortar operations compared with the use and development of online options.

2. How has the balance of bricks-and-mortar and online sales options changed during the last 5 to 10 years? Why do you think it has developed as it has? Is this trend likely to continue in the future? Why do you say that?

[31] The interim updates and feedback could only be provided one to two weeks after the interviews were completed due to the need to complete a sufficient number of interviews for such an exercise to be useful and the time required to transcribe the interviews.

3. Who have been the winners from this change and who the losers would you say? Why has this been the case?

MODERATOR: Please explore in regard to producers, retailers, online platforms, consumers, etc.

A1.2.3 Company level questions (20 mins)

4. Where does your organisation fit into the market that you have just described?
5. Who are the other key players in the market?

MODERATOR: Please explore: who are the main competitors? What types of organisation they regularly work with in the overall supply chain? How these relationships impact on profitability and ability to deliver good customer service? Issues that might come up could refer to conditions being placed upon how they or others operate, market leadership, strength of competition.

6. What are the main channels to market for your organisation?

MODERATOR: Please explore roles of bricks-and-mortar retailers, online sellers, online platforms.

7. Has the growth of online channels affected your company? If yes, what has been the impact? If not why not?

MODERATOR: Please seek examples and probe for impacts on price, cost of selling/producing, pre-sales service, customer-oriented services, turnover, profitability, and image.

8. What safeguard measures (if any) do you take to look after your part of the market? How does this differ between online and more traditional aspects of the market?

MODERATOR: Please seek examples and please probe for issues like price protection, high quality pre-sales service, strong investment in customer-oriented services, dealing with excessive competition in the market, guarding profitability levels for them or key strategic partners that they might support through pricing or distribution agreements.

9. **For producers**: Do you have any sort of selling agreements with your dealers (e.g. regarding how your products are distributed/sold or how prices are set)? If so what types of agreements have you been able to develop? If not did you consider any and why do you not use them?

   For sellers: Do you have any sort of selling agreements with any of your suppliers (e.g. regarding prices or the way products are sold)? If so, what kind of agreements do you have? If not did you or your suppliers consider any and why do you not use them?

MODERATOR: Please probe using: selling to a selected group of dealers, agreeing the channels these dealers use to sell your products, maybe selling through one dealer in a specific area and/or selling to certain kinds of customers, agreeing the price at which a product is sold, limiting discounts, a minimum advertised price, always giving a particular dealer the best price.

MODERATOR: Then, for each type of selling agreement please pursue the topics set out below. However, please bear in mind that the total time available is 30 minutes, so if the list is extensive please select 2 or 3 themes to explore in appropriate depth.

10. Why do you have this kind of relationship with your sellers/suppliers? What are the benefits of this relationship to your company?

MODERATOR: Please seek examples. Please probe for issues like price protection, need to maintain high quality pre-sales service, need to maintain strong investment in customer-oriented services, dealing with excessive competition in the market, guarding profitability levels for them or strategic partners.

11. Are there any disadvantages to you as a company in having this kind of agreement?

MODERATOR: Please seek examples. Probe gently on possible illegality issues.

12. If not already covered, what impact do you think this sort of agreement has on the customers who purchase the products or services you produce/sell?

MODERATOR: Please probe for positive and negative effects and seek examples.

13. What impact do you think this type of agreement has on your competitors? Does it vary by kind of competitor (e.g. online versus offline sellers)?

MODERATOR: Please seek examples.

14. What do you think would have been different if you hadn't had this arrangement in place? And what might happen if you moved away from this arrangement?

MODERATOR: Please seek examples.

15. Did you consider other types of agreement when you were considering putting this in place?

MODERATOR: Probe whether these would have achieved the same goals? Why chose not to use them? Would they consider them now and if so why? Is legality a factor in not choosing them?

16. During the last 5 to 10 years, has your company changed the way it uses this agreement? If so, why?

MODERATOR: Please seek examples. Probe gently on possible illegality issues. Please probe for whether the increase of online has influenced the development of this type of agreement.

17. Do you think this kind of agreement has become more or less widely used in your sector in the last 5 to 10 years or so?

MODERATOR: Probe why and how? Please seek examples. Probe gently on possible illegality issues.

18. And in the future, do you think your company will change the way it uses this kind of agreement? If so, why (e.g. will it be to maintain and enhance market position)?

MODERATOR: Probe for whether the increasing prominence of online selling will influence using this particular kind of agreement? If so why and what do you think the impact on the business will be? Please seek examples.

19. How do you know whether agreements like this work? How do you monitor this? What evidence do you gather?

MODERATOR: Please seek examples

MODERATOR: Please ask about next signalled agreement as appropriate

As noted in section A1.1, there was usually not enough time to cover all of the topics listed in this guide.

A1.3 High-level characteristics of participants

Table A1.3 sets out the characteristics of each participant. The definitions used for the classifications are as follows:

- Small businesses have a UK turnover of less than £5m; medium sized have UK turnover between £5-50m; and large businesses have UK turnover of over £50m.
- High-end brands are ones that are either luxury brands or very high quality, technical products. Examples include designer fashion labels, high-end electrical appliances, and optical products for chemical analysis. Those with a mix of high-end brands are retailers or manufacturers of a range of products, some of which are high-end and others that aren't. One participant has N/A because they are a platform providing a service, rather than selling goods.
- Pre-sales service is any form of service given to the customer before a sale is made. This could be technical advice on a product (e.g. for electrical appliances) or bespoke fitting services (e.g. for shoes or custom-made products). After-sales service is any form of service given to the customer after a sale is made. This is usually repairs and warranty work.

Table A1.3 High-level characteristics of participants

Participant number	Size	Type of business	High-end brand?	Service required?
RQ01	Small	Manufacturer	Yes	Pre-sales
RQ02	Small	Retailer	Mix	No
RQ03	Small	Manufacturer	No	No
RQ04	Small	Retailer	No	Pre-sales
RQ05	Medium	Manufacturer	Yes	Pre-sales
RQ06	Large	Manufacturer	No	No
RQ07	Large	Online platform	N/A	No
RQ08	Medium	Manufacturer	Yes	No
RQ09	Medium	Manufacturer	Yes	No
RQ10	Small	Manufacturer	No	No
RQ11	Medium	Retailer	No	No
RQ12	Small	Retailer	Yes	No
RQ13	Small	Manufacturer	No	No
RQ14	Small	Retailer	No	Pre-sales
RQ15	Medium	Retailer	No	No

Participant number	Size	Type of business	High-end brand?	Service required?
RQ16	Medium	Manufacturer	Yes	Pre-sales
RQ17	Medium	Manufacturer	No	No
RQ18	Small	Manufacturer	Yes	No
RQ19	Small	Manufacturer	No	No
RQ20	Large	Retailer	Mix	No
RQ21	Small	Manufacturer	No	After-sales
RQ22	Medium	Manufacturer	No	No
RQ23	Medium	Manufacturer	Mix	No
RQ24	Medium	Manufacturer	Mix	Pre-sales
RQ27	Medium	Manufacturer	No	No
RQ28	Large	Manufacturer	No	No
RQ29	Small	Retailer	No	After-sales
RQ31	Medium	Manufacturer	No	No
RQ32	Small	Retailer	Mix	Pre-sales
RQ33	Small	Retailer	Yes	Pre-sales and after-sales
RQ34	Small	Manufacturer	Yes	Pre-sales
RQ35	Medium	Manufacturer	Yes	Pre-sales
RQ36	Small	Retailer	No	After-sales

Source: Oxera.

www.oxera.com

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