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CLIENT ALERT

Competition Scrutiny of Digital Marketplace Intensifies as EU Signals Potential Enforcement of Vertical Restraints on E-commerce

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On Thursday this week (October 6), the European Commission (the Commission or EC) will present the results of the Preliminary Report (the "Report") on the E-commerce Sector Inquiry released on September 15 during a public event in Brussels. The sector inquiry was launched in May 2015, under EU competition rules (Article 101 of the Treaty on the Functioning of the EU and Article 17 of Regulation 1/2003), but forms part of the EU's Digital Single Market Strategy to develop a better understanding the competitive effects of electronic commerce of consumer goods and digital content in the EU.

The Report highlights the increasing significance of e-commerce in Europe. The EU is the largest e-commerce market in the world, and in spite of rapid growth, only 15 percent of Europeans aged 16 to 74 engaged in cross-border e-commerce, which suggests the presence of potential barriers to access of goods and services online from Member States. The Commission's findings are based on the responses received from thousands of questionnaires it sent to companies selling products and content online to investigate whether potentially anticompetitive contractual restrictions prevail.

The aim of the Digital Market Strategy is to achieve enhanced access for consumers and businesses to online goods and services across Europe and to remove unjustified barriers to entry into the marketplace. The four specific goals of the E-commerce Sector Inquiry are to (1) gain a more comprehensive understanding of competition issues, market dynamics, and business challenges in cross-border e-commerce; (2) provide guidance to businesses through subsequent enforcement, if appropriate; (3) analyze the legal framework governing online vertical restraints; and (4) complement legislative initiatives.

The Report is the second update on the EU's investigation of e-commerce. In March the Commission released its initial findings which showed that "geo-blocking"—the practice of restricting the sales of consumer goods and access to digital content across borders—is widespread in the EU due to unilateral decisions of suppliers of goods and sellers of copyrights, as well as cross-border sales restrictions inserted in supply contracts and limits to the scope of licensing agreements. The sector inquiry found that 38 percent of the responding retailers selling consumer goods online use geo-blocking, and 68 percent of digital content providers replied that they geo-block users located in other EU Member States. The Report provides a broader overview of the primary competition-related trends in e-commerce and identifies possible competition concerns while further probing into the phenomenon of geo-blocking.

The Report will be open to public consultation for a period of two months, and stakeholders are invited to submit comments until November 18, 2016. The Commission plans to publish its final report in the first quarter of 2017.

Key Preliminary Findings: Goods

The Commission highlighted several foundational principles regarding e-commerce in goods, and applied these principles to its Report findings. First, the Commission noted that price transparency is vital in that it directly affects consumer behavior—it lowers consumers' searching costs and allows consumers to quickly compare price information between offline and online channels. This price transparency, in turn, leads to increased price competition as between offline and online channels. The Report noted, however, that price transparency also allows competitors to monitor each other's prices—nearly 80 percent of retailers that use software to track competitors' prices adjust their own prices to those of their competitors. Interestingly, over 40 percent of retailers in the consumer electronics, household appliances, and computer games markets reported modifying prices in this way on at least a daily basis.

Second, the Report also highlighted the increased popularity of new e-commerce distribution channels, like online marketplaces, and noted that the emergence of new online channels affects manufacturers and retailers distribution and pricing strategies. The Commission found that manufacturers want tighter control over distribution through regulating price and quality of distribution—64 percent of manufacturer respondents reported that they opened their own online retail shops in the last 10 years as a reaction to the growth of e-commerce.

Third, manufacturers are also becoming more selective with regard to their online distribution systems in an effort to tightly control retailer quality and to prevent sale to unauthorized retailers—56 percent of the respondent manufacturers reported that they make use of selective distribution for at least part of their products and fully two-thirds of the manufacturer respondents with selective distribution introduced new criteria regarding how retailers should sell or advertise products online. Respondents in the household appliances and sports/outdoor markets indicated the highest degree of selective distribution.

The Report further notes that manufacturers are increasingly turning to vertical restraints (*e.g.*, pricing and channel restrictions) to control online distribution, with pricing limitations as the most popular among all respondents. The Report's preliminary findings also show that 38 percent of the retailers surveyed use geo-blocking measures in order to restrict cross-border online sales, and nearly 12 percent of retailers have contractual cross-border sales restrictions in at least one of their product categories. Finally, the report also commented on manufacturers' concern that certain large online retailers' increasing market shares are providing the retailers with stronger negotiating positions to insist on profit margin or otherwise ensure that minimum prices are applied throughout the distribution network.

Key Preliminary Findings: Digital Content

Copyright protection in the EU is "territorial" in that exclusive rights are enforced by national copyrights laws of the Member States rather than EU law. In order to distribute copyrighted digital content, a "digital content provider," such as broadcaster or publisher, generally must obtain a license from the "right holders" of such content, such as film producers or record labels. The sector inquiry aimed to identify territorial restrictions and geo-blocking in the online distribution of digital content, and to examine the prevailing copyright licensing models for online distribution and their impact on competition. The probe further focused on "exclusive licensing" amid concerns that it, under certain conditions, could result in barriers to market entry or the reduction of competition at the distribution level.

The report concluded that the key factor affecting competition in digital content markets is the availability of licenses from the right holders, which is largely determined by the scope of rights between right holders and digital content providers in licensing agreements. Rights relating to technologies limit the ways that digital content providers are allowed to transmit content, *i.e.*, via online, cable, or satellite transmission, as well as the ways that users may receive content, *i.e.*, via television set, computer, or mobile streaming devices. The temporal scope of rights is defined by "release windows" that distinguish between the different periods of time during which digital content providers are allowed to offer digital content. Territorial rights refer to the geographic area or areas in which a digital content provider may lawfully offer a product.

The preliminary results of the sector inquiry reveal that these contractual restrictions are the norm in digital content markets. In addition, many of these licensing agreements contain clauses enabling the right holder to monitor the implementation of geo-blocking measures, suspend distribution, or even terminate the licensing agreement or request compensation, where measures are not implemented in accordance with the rights holders' requirements. The Preliminary Report found that these contractual restrictions may inhibit new entrants from securing licenses to provide digital content online, regardless of whether they are already active in other geographic markets.

The Commission concluded that digital content providers seeking to enter a market may also have difficulty obtaining licenses due to the relatively long and stable exclusive contractual relationships between right holders and established digital content providers. The duration of the vast majority of licensing agreements with digital content providers was for at least two and up to ten years. New entrants' inability to access rights that are the object of long-term exclusive licensing agreement between their competitors and right holders may be exacerbated by contractual clauses in the licensing agreements such as first negotiation clauses, automatic renewal clauses, and other similar clauses.

The Preliminary Report noted, however, that vertical restraints such as exclusivity in licensing agreements could alleviate the problem of asymmetric information in the context of capital provision. This concern is particularly applicable in digital content markets, where one may encounter high uncertainty on the demand side and high sunk production costs on the supply side.

The Commission concluded that it will assess licensing practices on an ad hoc basis, taking into account the characteristics of the specific product and geographic markets, whether the licensing practices restrict competition, market power at different levels of the supply chain, and whether enforcement of the EU competition rules by the Commission is necessary in order to ensure effective competition. For instance, if geo-blocking is the result of agreements between right holders and digital content providers, it may restrict competition in the Single Market in breach of the EU antitrust rules, but any Commission enforcement measure against geo-blocking would also include an analysis of potential justifications for restrictions that have been identified.

Significance for U.S. Companies

U.S. companies doing business in the EU should take note of the results of the EC's Report. Antitrust sector inquiries are often contentious and result in significant EC enforcement action. The most recent sector inquiry—into the pharmaceutical industry—called into question the practice of extending a drug's patent protection to prevent the manufacture of generic drugs and resulted in separate enforcement actions against individual companies. Additionally, the EC already has pending antitrust action in relation to access of digital content. In January 2014 the EC opened an investigation into geo-blocking in the film industry, including the practices of the five major US movie studios—20th Century Fox, Warner Bros, Sony Pictures, NBC Universal and Viacom's Paramount Pictures—as well as Sky UK. The inquiry examined restrictions in contracts that allegedly prevent consumers from purchasing subscriptions outside of a movie studio's home market. Also, given the Report's emphasis on manufacturers' preference for price restrictions and competitors' e-commerce price matching, these areas may be ripe for EU enforcement in the coming months and years.

In a speech delivered in conjunction with the Preliminary Report's release, the Commissioner for Competition, Margrethe Vestager, cautioned that the report "should be a trigger for companies to review their current distribution contracts and bring them in line with EU competition rules if they are not." She added that some companies reevaluated their contracts during the sector inquiry. U.S. companies engaged in the sale of goods or distribution of digital content in the EU would be wise to do the same.

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