



# DIGITAL SINGLE MARKET E-commerce review

**Based on fresh findings from its inquiry into e-commerce restrictions, the European Commission (EC) increases momentum on tackling anti-competitive practices which may hinder the creation of the Digital Single Market.**

## Background to the digital single market review

The EC is taking bold steps to create an open and flexible market, reflecting the dynamic nature of a digital economy. It is doing so through the creation of a Digital Single Market ("DSM") strategy, made up of three pillars.

1. Access: e-commerce, parcel delivery, copyright and VAT
2. Environment: telecoms and media, security and personal data
3. Economy and society: data economy, standards, skills and Government

## The importance of the online economy

It is estimated that 315m Europeans access the internet daily, reflecting the huge demand for digital services. However, only 7% of EU small and medium sized businesses sell cross-border. The DSM review aims to increase this by breaking down national barriers, particularly for digital content which does not require physical delivery.

Reforming the European patchwork of national markets and legislation, particularly across national boundaries, is crucial to achieving European growth. The EU estimates that a fully functioning e-commerce market could deliver Europe-wide benefits of up to €154 billion<sup>1</sup> a year with consumers benefiting from greater choice and lower prices. However, realisation of these potential benefits depends on consumers having the confidence that their rights will be protected and their data will be used appropriately.

## The e-commerce sector enquiry

The EC's e-commerce sector inquiry (15th September 2016) reviewed trends and practices in e-commerce and investigated sales restrictions for both consumer goods and digital content. The EC gathered information from almost 1,800 stakeholders and 8,000 distribution agreements across the value chain. The report confirmed the growing significance of e-commerce, crediting it with increased price transparency, competition and choice. It has led to a change in distribution models, for example by:

- Increasing price transparency and encouraging switching by reducing search costs

<sup>1</sup> Civic Consulting, Consumer market study on the functioning of e-commerce and Internet marketing and selling techniques in retail of good: Final Report Part 1, September 2011, page 9

- Reducing barriers to entry as a lower upfront investment may be required to set up an online business compared to a traditional bricks and mortar business
- Incentivising firms to increasingly look to differentiate themselves on quality or other non-price factors such as brand and innovation

These impacts increase the intensity of price competition and promote innovation, arguably benefiting consumers. However, free riding of e-commerce businesses across sales channels is common, for example where consumers view in store then purchase on-line, placing pressure on traditional business models. Whilst price matching often occurs, this may not be viable long-term where business models have different underlying cost structures.

New distribution models are evolving. The EC notes their benefits but also identifies several business practices which may limit online price competition. A number of business practices which would have been considered as acceptable to date are now being considered as potentially anti-competitive in nature.

## Digital content

The e-commerce review focusses on upstream and downstream barriers to entry.

### Upstream barriers: Content rights

The availability of content licences was shown to be a key determinant of competition in the market. Digital licences and copyright agreements were found to be relatively long-term and often complex and exclusive – with copyright holders often setting out the territories, technologies and release windows that digital content providers can use. Contracts often provide for right to first renewal or automatic renewal. Resultantly, new entrants or smaller digital content providers may find it difficult to access rights that are under long-term agreements, impeding their growth.

Multiple business models exist over a diverse licencing regime. Therefore, any enforcement approach is expected to be conducted on a case by case basis, having regards to the characteristics of both product and geographic markets and whether licensing practices are restricting competition in practice.

### Downstream barriers: Territorial restrictions

In March 2016, the EC published its initial findings on territorial restrictions including geo-blocking. This is common place by retailers, e.g. a clothing store wanting to maintain a country price differential in its stores also needs to maintain that differential online. Where this decision is made as part of the retailer's commercial strategy, this is not a concern under

competition law unless the retailer has been found to dominate in the supply of that product. However, geo-blocking can also occur due to regulation or licencing conditions. The EC notes that c60% of digital content providers who responded have contractual agreements with rights holders to geo-block. Two key restrictions emerged:

- Direct contractual restrictions limiting retailers' ability to sell outside the Member State in which they are established. For example, when a broadcaster is only permitted to air content in one geography with other broadcasters having the rights to air the same content in different geographies.
- Restrictions on passive sales. Passive selling means responding to unsolicited requests from individual customers outside an authorised sales territory. This is generally prohibited under EU competition law, however, the nature of intellectual property rights has often been called on as implying an exemption from this prohibition. Regardless, in April 2016, the EC published a set of commitments as part of the UK Pay-TV investigations whereby it proposes to create a "passive sales" exception to exclusivity in audio-visual content licenses.<sup>2</sup> The conclusion of the EC's Pay-TV investigation, expected later in 2016, is expected to provide further guidance in this area.

## Selective distribution systems

Selective distribution systems are systems in which the products can only be sold by pre-selected authorised sellers. These are commonly used for technical consumer goods such as mobile phones and computers, which require a strong pre-sales advice and post-sales services and also by suppliers of luxury products in order to promote or protect the brand image.

The EC notes that the criteria for forming these systems are not always transparent nor justified by the nature of the goods. For example, discount retailers whose inclusion might promote price competition may be excluded despite qualifying on non-price grounds such as quality or conditions. It may be that these retailers are required to have at least one bricks and mortar store and not simply an online presence. Almost half of the manufacturers using selective distribution reported that they do not allow pure online players to join, potentially going beyond what is required to ensure high quality distribution.

The EC notes the Vertical Agreements Block Exemption Regulation<sup>3</sup> under which these schemes may be withdrawn. This could signal a more in-depth investigation into anti-competitive clauses restricting online sales, including a greater focus on assessing which types of goods are suitable for selective distribution systems.

<sup>2</sup> Hogan Lovells, DSM Watch: Proposed commitments in European Commission's UK Pay-TV investigation focus on allowing "passive sales" of broadcasting content outside territory, April 2016

<sup>3</sup> See European Commission, Guidelines on vertical restraints

## Price comparison tools

The use of price comparison tools was shown to be widespread, with more than a third of retailers reporting that they supplied data to price comparison tools in 2014. However, around 10% of retailers reported that they had agreements with suppliers that contain some form of restriction in their ability to use price comparison tools, ranging from outright bans to restrictions based on certain quality criteria.

## Online marketplaces

Online market places are important for small and medium sized businesses as they reduce barriers to entry for new suppliers and allow the establishment of businesses with relatively lower investment compared to a bricks and mortar presence. They also allow consumers to more easily compare prices between multiple suppliers, encouraging switching and promoting downward pricing pressure.

However, online market places may also act against consumers. Purchasers do not always receive goods consistent with those ordered and may have limited recourse for refunds or compensation, particularly as suppliers may exit the market altogether due to lower barriers to exit in online market places. Legitimate retailers may also be harmed as counterfeit goods undermine their brand image and positioning.

The EC notes instances where particular suppliers, for example discount stores, were not being permitted onto a market place. The EC found an inconsistent position across EU members on this. For example, France and Germany view online market places as a mechanism for restricting online sales. The rest of Europe appears less sceptical. The EC suggests that marketplace bans are not a hard core competition restriction, although this does not mean they are necessarily lawful. This issue is due to be heard by the European Court of Justice and the outcome of that hearing may lead to changes in the way in which online market places are designed and operated as well as potentially further claims.

## Pricing

Many retailers were found to use software to track the prices of goods offered by their competitors. This increases price competition and means price competition takes place at a wider geographic level. Retailers mostly offered the same prices online and offline, so this online price competition also benefits those shopping in store.

The EC found that discounts (including rebates) offered by distributors to retailers were offered across both online and offline channels. However, the amounts and schemes differed. This might be suggestive that distributors recognise the free riding of online stores and the dual benefit of supporting bricks and mortar stores. Although, in a recent case regarding Lego,

the firm's German subsidiary was found to have breached competition law by preventing discounts that retailers wanted to set.<sup>4</sup> This is an area where further clarity may be required.

The EC and national competition authorities, for example the UK's CMA in relation to insurance provision, have previously taken an interest in Most Favoured Nation ("MFN") contracts, whereby distributors are guaranteed that no other distributor will receive a better deal. The extent to which MFNs create harm depends on a number of factors and it is not clear cut. Following this e-commerce review, these might be expected to receive renewed attention.

## Conclusion

The EC has grappled head on with the issue of applying traditional competition law to a digital market place which is characterised by fast evolving contractual, technological and distribution practices. The EC acknowledges that there has been some discrepancy in the application of competition law by Member States in the area of e-commerce to date.

Some of these practices are driven by differences between traditional retail and e-commerce methods. For example e-commerce lends itself to increased use of selective distribution systems, although since the EC notes that almost half of the manufacturers using selective distribution reported that they do not allow pure online players to join, it can be expected that this will come under increasing attention at an EU level.

The EC notes that some companies may not be complying with competition law and that the legal framework may be unduly permissive. For example, territorial restrictions and geo-blocking agreements fall outside the scope of the rules on anti-competitive agreements. In respect of this, the EC has published draft regulation to restrict geo-blocking which, if implemented, could have far reaching consequences.

The final e-commerce report is expected in late Spring 2017. Given the high prevalence of anti-competitive restrictions, the EC is unlikely to be able to investigate every possible incidence. Enforcement action is expected on a case by case basis, similar to the approach that it adopted to inquiries in the energy and pharmaceutical sector and its ongoing Pay-TV investigation, which may be reviewed as a test case in this area. However, it may be expected that e-commerce participants will modify their own practices before the conclusion of this review to reflect the findings in this draft report and to ensure their operations are more compliant with competition law.

<sup>4</sup> Out Law, Lego Germany fined for preventing discounts, January 2016

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