

2 Background

The product

2.1. Perfumery has existed for thousands of years. Perfume containers were made in a variety of substances in ancient Egypt, Persia, Greece and Rome. The use of perfumed ointments, creams and oils preceded the use of perfumes simply for their fragrance, which developed with the introduction of alcohol as a solvent base for fragrant natural essences. Toilet waters, the less concentrated forms of perfume, originated in Cologne-which gave the name Eau de Cologne-at the end of the 17th century. More sophisticated perfumes were developed in the second half of the 19th century, when chemists began to extract fragrant substances from natural essences and to synthesize fragrance components. One of the earliest modern perfumes-still available-was Jicky, introduced by Guerlain in 1889. In the years leading up to the First World War other famous parfumeurs, such as Coty and Houbigant, followed suit. During this period luxury packaging of perfumes was introduced. After the war fashion designers began to adopt perfumes to complement their fashions and enhance their revenue. The first was Chanel, with Chanel N° 5, followed by Lanvin with My Sin and Arpège. This development gained impetus after the Second World War with the entry to the perfume market of Rochas, Dior, Givenchy and Yves Saint Laurent. More recent developments have been the growth of fragrant products for men and the launching of perfumes under the names of film stars and other celebrities.

2.2. Perfumes, or fragrances, in general use are described according to their strength, that is, the concentration of perfumed essence:

- perfumes or concentrates (15 to 40 per cent concentration of essence);
- eau de parfum (EDP) or parfum de toilette (7 to 15 per cent);
- eau de toilette (EDT) (3 to 8 per cent);
- eau de cologne (EDC) (1.5 to 6 per cent); and
- male fragrances which include aftershave lotions.

These are the products specified in our terms of reference (see Appendix 1.1) where they have a resale price exceeding £15 per 50ml. They are described in this report as reference products and their brand names are referred to as reference brands. Reference brand ranges normally include some non-reference products as well (see paragraph 2.6).

2.3. The upper end of the fragrance market is occupied by premium-priced 'fine fragrances' from the leading fragrance houses. These fine fragrances are expensively packaged and presented, and marketed with strong brand images linked to the perfume characteristics and to the reputation of the house. Their retail distribution is generally restricted to outlets considered to provide a retail ambience, including specialist sales staff, which accords with the luxury brand image. The adoption of such restrictions by suppliers, involving refusal to supply outlets which do not meet the requirements, is usually referred to as 'selective distribution'. The resale price of £15 per 50ml specified in our terms of reference as the lower price limit brings virtually all such fragrances within the scope of the inquiry.

2.4. At the lower end of the market and outside the scope of the inquiry are low-priced, mass-distributed and mass-merchandised brands, whose retail distribution is not restricted. There are also imitations of the premium-priced fine fragrances, known as replica fragrances, which are sold at prices well below those for the genuine article.

2.5. While the upper and lower ends of the market are fairly strongly differentiated, a limited number of medium-priced fragrances, sometimes known as volume prestige brands, are generally distributed on a less restrictive basis than premium brands. Some products in these brand ranges have resale prices above the limit mentioned in paragraph 2.1 and therefore fall within our terms of reference.

2.6. The industry for personal care and beauty products covers several product categories, including toiletries (bath and shower products, deodorants, etc), skincare products and colour cosmetics, as well as fragrances. Manufacturers and distributors of fragrances (fragrance houses) generally sell perfumed products such as soap, bath gel and body lotion as part of their fine fragrance ranges, under the reference brand names. These products do not fall within the scope of the inquiry and are described as non-reference fine fragrance products. For some brands the number of such items is small, but for some there are as many non-reference products as reference products. In terms of sales, non-reference products represent about 13 per cent by value of the total sales of fine fragrance brands.

2.7. A number of fragrance houses also sell cosmetics and skincare products (which in some cases form the principal part of their trade). These products, which are usually sold in the same outlets as fragrances, often alongside them, are also outside the scope of the inquiry.

The origins of the inquiry

2.8. The reference was made following representations to the OFT by certain multiple retailers-in particular Superdrug, a subsidiary of Kingfisher plc, and Tesco-that they had been refused supplies of fine fragrances by certain fragrance houses. These retailers were selling fine fragrances, at prices discounted from the recommended resale prices (RRPs), which they obtained from the so-called 'grey market', discussed in Chapter 3, which appears to be created by authorized wholesalers or retailers of fine fragrances selling supplies to traders outside the authorized network in breach of their agreements with their suppliers. Superdrug and Tesco applied to a number of fine fragrance houses for authorized retailer status at branches where they had created special sales points which were intended to meet the suppliers' requirements. At the time the reference was made only one of the smaller suppliers of fine fragrances had agreed to supply them. Other retailers, including Asda Group plc (Asda), The Littlewoods Organisation PLC and The Perfume Shop Ltd (Perfume Shop), were reported as selling discounted fine fragrances obtained from the 'grey market', but they did not approach the OFT.

2.9. In making the reference, the DGFT expressed particular concern that the restrictions on supply of fine fragrances to retailers might be accompanied by a lack of effective competition at retail level and that the MMC should investigate the allegation that the restrictions were being applied in order to maintain resale prices in a manner that would be illegal if undertaken directly.

2.10. A related issue to which the DGFT drew attention in his press statement concerns the refusal of certain magazine publishers to accept advertisements from Superdrug for its selling of fine fragrances, allegedly on the grounds that this would jeopardize their advertising revenues from the fine fragrance houses.

The EC aspect

2.11. Agreements between suppliers and their authorized retailers may be subject to Article 85(1) of the Treaty of Rome (the Treaty), which prohibits agreements between undertakings which may affect trade between EC member states and which have as their object or effect the prevention, restriction or distortion of competition. Such agreements are void unless exempted under Article 85(3) of the Treaty, either individually or by category.

2.12. The selective distribution contracts of two fine fragrance houses-Yves Saint Laurent Parfums SA (YSL Parfums) and Parfums Givenchy SA (Parfums Givenchy)-were granted exemptions from the provisions of Article 85(1) of the Treaty by the EC Commission in December 1991¹ and July 1992² respectively. The

¹Commission Decision of 16 December 1991 relating to a proceeding under Article 85 of the EEC Treaty (Case No IV/33.242-Yves Saint Laurent Parfums), *Official Journal of the European Communities*, No L12, 18 January 1992, pp 24-35.

²Commission Decision of 24 July 1992 relating to a proceeding under Article 85 of the EEC Treaty (Case No IV/33.542-Parfums Givenchy system of selective distribution), *Official Journal of the European Communities*, No L236, 19 August 1992, pp 11-22.

Decisions embodying these exemptions allow the companies concerned to take account of a number of factors in deciding whether to supply a retail outlet with luxury cosmetic products, including fine fragrances. These include:

- the qualifications and experience of the staff;
- whether the location, name, external appearance and internal fittings of the outlet reflect the prestige of the supplier's brand;
- the scale and nature of other retailing activities in the outlet;
- the area set aside for selling the supplier's products; and
- the range of luxury cosmetic products stocked.

The standards by which these factors are assessed are to be applied in a non-discriminatory fashion. The Decisions do not permit refusal of supplies because of the pricing policy of the retailer or because of the number of authorized outlets in a given area. The supplier may require the retailer to accept certain obligations, notably to participate in the supplier's promotional activities, to carry a minimum range of stock and to achieve a minimum annual level of purchases from the supplier. The retailer must be permitted to sell on the products to other authorized retailers throughout the EC. The text of the Decision relating to YSL Parfums is set out in Appendix 2.1. The text of the Decision on the Parfums Givenchy contract is similar in almost all respects; the differences are mentioned where relevant later in the report.

2.13. In granting these exemptions the EC Commission accepted the promotion of a prestige brand image as 'an essential factor' in marketing fine fragrances and other luxury beauty products. It acknowledged the need for appropriate facilities, including 'specialized technical advice', at retail outlets as 'a legitimate requirement'. The Decisions are specific to the two companies. Other companies which operate in accordance with the terms of either Decision may effectively regard themselves as meeting the requirements of European law and the EC Commission has said that they may apply for 'letters of comfort' confirming that this is indeed the case. We were informed during the inquiry that a number of fine fragrance houses were in discussion with the EC Commission about their selective distribution arrangements. The findings of our examination of the various houses' current arrangements are set out in Chapter 4.

2.14. In making the reference, the DGFT said that it was not intended as an expression of disagreement with the exemptions granted by the EC Commission. He noted that some features of the distribution practices of fine fragrance houses were not covered by Article 85(1) and some were not covered by the exemptions. He wanted the MMC to assess the public interest effect of these restrictions and the even-handedness of application of the criteria outlined in paragraph 2.12. The DGFT informed the Director General for Competition in the EC Commission of the inquiry and its terms of reference.

Refusal to supply

2.15. Refusal to supply goods to persons or classes of persons requiring them for business purposes was the subject of a report by the MMC in 1970.¹ The MMC took the view that the main scope for damage to the public interest occurred in three situations:

- (a) where supplies were refused in order to avoid supplying a known or suspected price cutter;
- (b) where supplies were refused to a new distributor because the supplier's existing distributors threatened to boycott him; and
- (c) where the supplier was not operating under reasonably competitive conditions.

¹*Refusal to Supply: a report on the general effect on the public interest of the practices of refusing to supply goods required for business purposes and of entering into certain exclusive supply agreements*, Cmnd 4372, July 1970.

2.16. The first of these situations was made unlawful by the Resale Prices Act 1964 and is currently prohibited by section 11 of the Resale Prices Act 1976. However, section 13 of the 1976 Act permits a supplier to withhold goods from a dealer if he has reasonable cause to believe that dealer has been using such goods as loss leaders. The MMC said that in considering possible remedies the second of the situations could be considered with the first in so far as a threat to boycott was made in order to prevent supplies going to a price cutter. In the third situation the acts of a supplier might fall within the scope of monopolies legislation and, if so, refusals could be investigated thereunder and appropriate action recommended.

2.17. The MMC considered that no conflict need arise with the public interest under reasonably competitive conditions when supplies were restricted for the following reasons:

- (a) demand might exceed supply and, being unwilling to raise prices, a supplier might select his customers or impose some system of rationing involving refusal to supply;
- (b) a supplier might estimate that to add to the number of outlets he supplied would increase his distribution costs without compensatory advantages in terms of more sales and increased profits;
- (c) a supplier might estimate that he would do better by catering for a limited class of customer who would pay for exclusiveness than by extending his outlets and risking the loss of his exclusive trade; and
- (d) the product might need technical or other services (such as advertising or stockholding) to be provided by distributors or be appropriate only to users employing a certain level of technology.

The MMC added that the circumstances to which (a) related would for the most part occur only in the short term.

2.18. In the EC Commission Decisions exempting the YSL Parfums and Parfums Givenchy selective distribution contracts, account was taken of 'the aura of exclusivity and prestige' attached to the articles in question and of a need for 'specialised technical advice available in the retail outlet' (Section II A 5 of the YSL Decision). These factors relate to the considerations described in paragraph 2.17(c) and (d). The EC Commission did not, however, consider that it would be justifiable to grant exemption under Article 85(3) to the application of 'quantitative' restrictions on the number of retail outlets in any given area (the sort of approach described in paragraph 2.17(b)). Before the Decisions it had been the practice of some fragrance houses to restrict the number of authorized outlets in this way.