

8 Conclusions

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Background

8.1. Our terms of reference concern the supply in the UK for retail sale of fine fragrances. Fragrances are a range of products of different strengths: perfume, which has the highest concentration, through eau de parfum (EDP), eau de toilette (EDT) and eau de cologne to men's aftershave lotions which have the lowest. Suppliers of fragrances, often referred to as fragrance houses, generally sell perfumed soap and other bath and body products as part of their fragrance ranges. Some fragrance houses also sell cosmetics and skincare products, usually through the same retail outlets as fragrances but under different brand names. Bath and body products, cosmetics and skincare products are all outside our terms of reference.

8.2. Fine fragrances are premium-priced products, expensively packaged and presented, and marketed with a strong brand image. Their retail distribution is generally restricted to outlets which, in principle, provide an ambience which accords with the luxury image. This is a form of selective distribution. Retailers have to apply to the suppliers for approval as authorized stockists in respect of each outlet through which they wish to sell fine fragrances. Mass-market fragrances are sold at significantly lower prices through a much wider range of shops.

8.3. The reference was made following representations to the Office of Fair Trading (OFT) by certain retailers-notably Superdrug Stores PLC (Superdrug) and Tesco Stores Ltd (Tesco)-that fragrance houses had refused to supply them with fine fragrances despite the fact that they had created special sales points in selected stores designed to meet the suppliers' requirements. Meanwhile Superdrug, Tesco and other multiple retailers had begun selling fine fragrances, at prices below the suppliers' recommended resale prices (RRPs), obtained on the 'grey market', ie from sources other than the fragrance houses.

8.4. In making the reference the Director General of Fair Trading (DGFT) said he was concerned that restrictions on the supply of fine fragrances might be accompanied by a lack of effective competition at retail level and wanted the MMC to investigate the allegation that the restrictions were being used to maintain resale prices. He also drew attention to the refusal of certain magazine publishers to accept advertisements from Superdrug for its selling of fine fragrances, allegedly because this would jeopardize the advertising revenues from the fragrance houses.

8.5. Some aspects of the selective distribution systems operated by the fragrance houses are caught by Article 85(1) of the Treaty of Rome, 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). The standard retailer contracts of two houses, Yves Saint Laurent Parfums SA (YSL Parfums) and Parfums Givenchy SA (Parfums Givenchy), were granted exemptions by Decisions of the EC Commission in December 1991 and July 1992 respectively (see paragraphs 2.11 to 2.13, and Appendix 2.1 which sets out the full text of the first of these Decisions). The exemptions apply until 31 May 1997. The EC Commission said that these Decisions fixed the principles and criteria by which it would be guided in considering analogous cases. It envisaged granting 'comfort letters' to other companies which notified selective distribution contracts conforming to these principles. The standard contracts approved by the Decisions covered the supply of cosmetics and skincare products as well as fine fragrances, but as noted in paragraph 8.1, these other product categories are outside our terms of reference.

8.6. In making the reference to us, the DGFT noted that some features of the fragrance houses' distribution practices 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 whether the approved criteria were being applied even-handedly.

8.7. Although we have recorded by way of background the DGFT's statements on making the reference, we have made our own decisions as to the conduct of the inquiry within the framework set by the terms of reference.

The monopoly situations

8.8. Our terms of reference (Appendix 1.1) require us first to investigate and report whether a monopoly situation exists in relation to the supply in the UK for retail sale of fine fragrances, and if so:

- (a) by virtue of which provisions of sections 6 to 8 of the Fair Trading Act 1973 (the Act) the monopoly situation is taken to exist; and
- (b) in favour of what person or persons the situation exists.

Section 6 of the Act deals with monopoly situations in the supply of goods and is therefore the relevant section for our inquiry (section 7 deals with services and section 8 with exports). It envisages two different kinds of monopoly situations, usually referred to as 'scale' and 'complex'.

8.9. In order to determine whether a monopoly situation exists we must among other things measure the total supply of the goods concerned and the shares of individual suppliers. We consider that the size of and shares in the fine fragrances market should be measured by reference to the value of the products sold rather than the volume because, given the wide variations in the concentration of the different products, there is no satisfactory measure of volume for this purpose. This is the approach we have adopted for the most part in Chapter 3 in describing the market, although Table 3.6 gives information in both value and volume terms.

The scale monopoly position

8.10. A scale monopoly situation under section 6(1)(a) or (b) of the Act is taken to exist when at least one-quarter of all the goods of a particular description which are supplied in the UK are supplied by or to the same person, or by or to members of the same group of interconnected bodies corporate.

8.11. Table 3.7 shows that the group of companies with the largest share of supplies by fragrance houses to authorized domestic retailers in 1992 was L'Oréal (UK) Ltd (L'Oréal), with [*] per cent of the total. (We use the term 'domestic retailers' to mean retailers in the UK other than duty-free outlets.) For the purpose of applying the test specified in section 6(1), however, we have to look more widely and take account also of the other forms of supply, namely supplies to duty-free retailers and supplies to domestic retailers by grey-market traders.

8.12. Most of the fragrance houses told us that they supplied duty-free retailers-chiefly the operators of airport shops and air and shipping lines-not through the group company which distributed fine fragrances to the UK domestic market but through a connected company abroad. This was because those groups handled duty-free supplies centrally for all countries. The main exceptions to this were Chanel Limited (Chanel) and Giorgio Beverly Hills Incorporated (Giorgio), both of which obtain most of their supplies for the domestic market from factories in the UK and which have therefore chosen to supply UK duty-free outlets from this country. Supplies to duty-free outlets in the UK from connected companies abroad still fall to be counted, under the terms of section 6(1)(b) of the Act, in applying the test for a scale monopoly situation (see paragraph 8.10). In some cases, however, we have not been able to collect precise information on these supplies and have therefore had to estimate them (see paragraphs 3.35 to 3.36).

8.13. The grey market consists of supplies which originated with a fragrance house but at some stage were sold outside its authorized distribution network. We were told that most such supplies in this country have been bought by unauthorized UK traders from sources abroad. Although they might, for example, be genuine L'Oréal products which a L'Oréal group company has originally supplied in another country, these goods are not 'supplied in the UK for retail sale' by a L'Oréal company. These supplies do not therefore fall to be counted as part of the fragrance houses' share of the UK market for the purpose of determining whether a monopoly situation exists. They are, however, part of the total market against which the shares of individual suppliers must be calculated. Because of the unauthorized nature of these supplies, reliable information on their value is not available and we have again had to make our own estimates (see paragraph 3.76).

8.14. Table 3.7 shows that when our estimates of duty-free and grey-market supplies are added to the total market, L'Oréal's supplies to domestic retailers fall to [*] per cent of that enlarged total. L'Oréal was one of the companies which was unable to give us information about its related companies' supplies to duty-free retailers in the UK. We estimate that the value of these supplies would have been of the order of £[*] million and L'Oréal agreed that this was not an unreasonable figure for Prestige & Collections, the principal fine fragrance arm of the L'Oréal group.

*Figures omitted. See note on page iv.

The addition of this amount to L'Oréal's sales to domestic retailers increases its share of all supplies to around [*] per cent. Even allowing for the uncertainty over the value of both duty-free and grey-market supplies, we are satisfied that neither L'Oréal nor any other supplier has a share of all supplies which approaches the 25 per cent level specified in the Act.

8.15. As to the category of persons to whom supplies are made (see paragraph 8.10), Boots The Chemists Ltd (Boots) is by some way the largest buyer and retailer of fine fragrances. As mentioned in paragraph 3.73, the wholesale value of Boots' purchases of reference products in 1992 was some £40 million, about 26 per cent of the total of authorized supplies to domestic retailers. Again, however, it is necessary to take account of duty-free and grey-market supplies. Boots is not involved in either of these areas, and its £40 million of purchases falls to 17 per cent as a share of the overall total (Table 3.7).

8.16. In view of the findings just described in paragraphs 8.14 and 8.15, we conclude that there is no scale monopoly situation in relation to the supply in the UK for retail sale of fine fragrances.

The complex monopoly position

8.17. A complex monopoly situation under section 6(1)(c) and (2) of the Act is taken to exist when at least one-quarter of all the goods of a particular description which are supplied in the UK are supplied by or to members of the same group consisting of two or more persons (not being a group of interconnected bodies corporate) who, whether voluntarily or not and whether by agreement or not, so conduct their respective affairs as in any way to prevent, restrict or distort competition in connection with the production or supply of goods of that description.

8.18. In April 1993 we informed the suppliers listed in paragraph 1 of Appendix 8.1 of our provisional conclusion that a complex monopoly situation existed in that those suppliers engaged in the following practices:

- (a) refusing to supply reference products to retailers which the suppliers have not authorized as retailers of reference products; and
- (b) recommending resale prices for reference products to their authorized retailers.

We invited the suppliers to comment on our provisional finding and on the issues which appeared to us to arise from it.

8.19. Nearly all the suppliers listed in paragraph 1 of Appendix 8.1 responded in writing and most of them attended hearings. Few of them disputed our provisional finding. Parfums Christian Dior (UK) Ltd (Dior), however, submitted that we should not conclude that a complex monopoly situation existed on account of either of the two practices identified above. Broadly, Dior argued that both the EC Commission and the European Court of Justice (ECJ) held that such practices did not 'prevent, restrict or distort competition' under Article 85(1) of the Treaty of Rome, and that accordingly the MMC should not hold that they did so for the purposes of section 6(2) of the Act. Further, Dior argued that the practice of only supplying certain authorized retail outlets was the very essence of a selective distribution system. The EC Commission had recognized that such systems could have pro-competitive, efficiency-creating effects. Dior cited a number of ECJ Cases which it said supported this position. Dior recognized that particular features of a particular selective distribution system might take that system into Article 85(1): the issue would then be whether exemption could be granted under Article 85(3). The operation of a particular system might also take it into Article 85(1), for example the unfair or discriminatory application of the criteria for admission. These, however, in Dior's view, were separate considerations from whether Article 85(1) applied in the first place.

*Figure omitted. See note on page iv.

8.20. Dior also argued that there was no authority in EC law for maintaining that the practice of recommending resale prices was contrary to Article 85(1), provided it did not result in concerted practices at the retail level, or between retailers and suppliers. Dior referred to previous MMC reports in which the subject of RRP had been considered. In one of these cases (Matches and disposable lighters¹) the MMC had not seen the recommending of resale prices as giving rise to concern. In another (Ice cream and water ices²) the MMC had found that the practice of some suppliers of recommending resale prices restricted competition and was one of three practices which formed the basis of a complex monopoly situation. The MMC had concluded in that inquiry, however, that the practice of recommending resale prices in the supply of reference goods did not operate against the public interest.

8.21. Prestige & Collections (UK) Ltd (P&C), the principal subsidiary of L'Oréal in this market, said that it had no agreement with any of the other companies (other than those in the L'Oréal group) listed in our letter. It submitted a report by Lexecon Ltd (economic consultants) which, it said, showed that the fine fragrance industry in the UK was highly competitive and that the major players did not and could not so co-ordinate their activities as to prevent, restrict or distort competition. The EC Commission had recognized that selective distribution enhanced competition in this market.

8.22. In paragraphs 8.8 and 8.34 we have noted the statutory questions which we are required to answer under our terms of reference. Section 6(1)(c) and (2) of the Act were set out at paragraph 8.17. In order for a complex monopoly situation to exist we have to find that the relevant group conduct their affairs so as to prevent, restrict or distort competition. If the first question is answered in the affirmative we then go on to consider *inter alia* whether any facts found in the course of our investigations operate against the public interest. These two questions are entirely separate. Dior also argued that in order to decide whether a complex monopoly situation existed we were required to analyse the relevant practices in the light of EC law and in particular the provisions of Article 85, thus determining the situation on the basis of only those practices which fall within the article. We carefully considered the arguments put by Dior. We believe, however, that the practice of refusal to supply within the context of a selective distribution system will inherently involve a restriction of competition, most obviously because it entails unwillingness to supply retailers who do not meet the suppliers' criteria.

8.23. The effect can be clearly seen in the UK fine fragrance market at the present time in that a number of retailers, including Superdrug and Tesco, have been refused supplies by the fragrance houses. If these retailers wished to sell fine fragrances, they were obliged (at least in the short term) to obtain supplies from grey-market sources, which have a number of disadvantages compared with supply from the fragrance houses. Unauthorized retailers are thus restricted in their ability to compete. The fact that there are substantial numbers of authorized retailers who may compete with each other does not alter the position that competition at retail level is restricted by the fragrance houses' selective distribution policies.

8.24. The fragrance houses' selective distribution agreements with their authorized retailers have other features which also restrict or distort competition:

- (a) they prohibit authorized retailers from selling on their supplies of fine fragrances other than to consumers or to other authorized retailers and distributors, whether in the UK or in other EC countries;
- (b) they impose requirements concerning the proportion of the individual products or stock-keeping units (SKUs) in fragrance brand ranges which retailers must stock;
- (c) in some cases they require a minimum rate of stockturn; and
- (d) in most cases they allow the supplier to terminate the agreement if a specified annual level of purchases is not achieved.

¹The supply of matches and disposable lighters: a report on the supply for retail sale in the United Kingdom of matches and disposable lighters, Cm 1854, March 1992.

²Ice Cream and Water Ices: a report on the supply in the United Kingdom of ice cream and water ices, Cmnd 7632, August 1979.

The first of these provisions is a corollary of the basic principle of selective distribution which restricts supplies to authorized retailers and distributors. The other three may affect a retailer's ability or willingness to sell other brands, as well as encroaching on a retailer's usual freedom to take its own stockholding decisions.

8.25. We conclude that refusal to supply retailers who do not meet the criteria of the suppliers' selective distribution systems is a practice which restricts competition within the meaning of section 6(2) of the Act. The first two parts of Chapter 4 and the paragraphs in Chapter 7 giving the suppliers' views on selective distribution show that all the suppliers listed in paragraph 1 of Appendix 8.1 operate such systems, which necessarily implies that those companies refuse or would refuse to supply retailers not meeting their criteria. We consider the public interest implications of the practice later in this chapter (see paragraphs 8.65 to 8.108).

8.26. As to the second practice referred to in paragraph 8.17, viz the recommending of resale prices, it is quite true that authorized retailers are free to set their own resale prices and to disregard the suppliers' recommendations. The question whether the recommendations may nevertheless restrict competition depends on the extent to which they are observed in practice. This may be affected in turn by the fact that supplies are distributed selectively.

8.27. The evidence we received on the degree of observance of RRP is summarized in paragraphs 3.96 to 3.100 and in Chapter 6. Departures from RRP have undoubtedly increased in the last two or three years but RRP remains the norm and departures from it the exception. Of the three biggest authorized retailers (which between them have over half the market), Boots told us that its general policy was to price at RRP in all its stores, although it would match price competition at local level and had begun to conduct national price promotions for limited periods; Debenhams PLC (Debenhams) said that its prices were usually in line with suppliers' recommendations, although prices were temporarily reduced during promotions (mainly to account holders); and House of Fraser (Stores) Limited (HoF) said that it generally observed RRP and matched lower prices offered by other retailers only in response to approaches from individual customers. Several retailers commented that, given the costs entailed in selling fine fragrances and the low margins relative to other product categories, an authorized retailer had not much scope to sell at below RRP if it was to make a profit. In summary, most of the leading authorized retailers sell fine fragrances at the recommended prices for most of the time.

8.28. One of the main reasons given by the fragrance houses for recommending resale prices was that retailers needed or wanted guidance on appropriate retail prices. This indicates that the suppliers are regarded as having expertise in the pricing of fine fragrances. Allders Department Stores Ltd (Allders) said that it saw RRP as reflecting the fragrance houses' expert judgment of the value of the product, while Estée Lauder Cosmetics Ltd (Lauder) argued that retailers benefited from the suppliers' research and expertise in determining an RRP. Given also the very large number of individual products available, recommended prices are therefore likely to carry weight with retailers. If RRP did not exist, typical retail prices might be published in trade journals but they would not carry the same authority as a fragrance house's recommendations.

8.29. In the absence of RRP, we believe there would be more variation in retail prices. We therefore consider that the recommending of resale prices in this market, in the context of selective distribution policies pursued by suppliers, is a practice which restricts competition within the meaning of section 6(2) of the Act. We consider later the implications of the practice for the public interest (see paragraphs 8.109 to 8.118).

8.30. As recorded in Chapter 3 (paragraphs 3.81 and 3.95), until recently all the suppliers listed in paragraph 1 of Appendix 8.1 recommended resale prices. P&C told us, however, that it had ceased doing so with effect from April 1993, although it intended to keep this decision under review and would probably give authorized retailers a guide to the market positioning of new brands at the time of their launch.

8.31. Table 3.7 shows that the suppliers listed in paragraph 1 of Appendix 8.1 together account for some 70 per cent of all supplies of fine fragrances in the UK for retail sale. If we add our estimates of the duty-free supplies of those houses which were unable to give us figures, the proportion supplied by the companies in paragraph 1 of Appendix 8.1 and their connected companies abroad rises to over 80 per cent.

8.32. We conclude that a complex monopoly situation exists as defined in section 6(1)(c) and (2) of the Act in that the suppliers listed in paragraph 1 of Appendix 8.1 (being members of one and the same group for the purpose of these provisions) engage in one or both of the practices referred to in paragraph 8.18 and supply more than one-quarter of the fine fragrances supplied in the UK for retail sale.

8.33. In informing the suppliers of our provisional conclusion as to the existence of a complex monopoly situation, we also told them of our provisional view that this situation operated in favour of the suppliers themselves and the other companies listed in paragraph 2 of Appendix 8.1. These are the ultimate or, in some cases, intermediate holding companies of the suppliers, plus other connected companies which are major sources of reference products for the suppliers. We also wrote direct to these companies to inform them of our provisional view. One of them, Avon Cosmetics Ltd (Avon), argued that although it manufactured fine fragrances for Giorgio using materials which Giorgio provided, this was an entirely arm's length relationship and Avon was in competition with third party manufacturers for the business. Giorgio confirmed this. We consider therefore that the monopoly situation does not exist in favour of Avon. With that exception neither set of companies disputed our provisional view on this point. We conclude that the monopoly situation which we have identified exists in favour of all the companies listed in Appendix 8.1, except for Avon.

8.34. Having reached these conclusions on the existence of a monopoly situation and on the questions in subparagraphs (a) and (b) in our terms of reference (see Appendix 1.1), we have to consider the remaining questions, viz:

- (c) whether any steps (by way of uncompetitive practices or otherwise) are being taken by that person or persons for the purpose of exploiting or maintaining the monopoly situation and if so by what uncompetitive practices or in what other way;
- (d) whether any action or omission on the part of that person or persons is attributable to the existence of that monopoly situation and if so what action or omission and in what way it is so attributable; and
- (e) whether any facts found by the Commission in pursuance of their investigations under the preceding provisions of this paragraph operate or may be expected to operate against the public interest.

The effect on our inquiry of EC law

8.35. Like some previous MMC monopoly inquiries, notably *The Supply of Beer*¹ and *New motor cars*,² the present inquiry involves important EC aspects. In carrying out our terms of reference we have to take account of the relevant provisions of both UK and EC law.

8.36. Our functions are set out in the Act, which requires us to investigate and report on the questions referred to us by the DGFT. If we find that a monopoly situation exists, therefore, we are required as part of our investigations to consider the questions listed in paragraph 8.34. If we find that there are facts which operate, or may be expected to operate, against the UK public interest, we are required by section 54(3) of the Act to specify those facts and the particular effects, adverse to the public interest, which in our opinion those facts have or may be expected to have. We must also consider what action (if any) should be taken for the purpose of remedying or preventing those adverse effects and we may, if we think fit, make recommendations as to such action.

8.37. As recorded in paragraph 8.5, the EC Commission has issued Decisions under Article 85(3) of the Treaty of Rome giving exemption from the terms of Article 85(1) to the standard retailer agreements used by two of the fragrance houses. The Commission has indicated to other suppliers its willingness to give 'letters of comfort' assuring them that, if the retailer agreements which they use follow the provisions of those covered by the two Decisions, those agreements may also be regarded as exempted from the terms of Article

¹*The Supply of Beer: a report on the supply of beer for retail sale in the United Kingdom*, Cm 651, March 1989.

²*New motor cars: a report on the supply of new motor cars within the United Kingdom*, Cm 1808, February 1992.

85(1). The EC Commission made its Decisions applicable for periods of about five years so that it could then re-examine the effects of the suppliers' distribution systems on competition. It also required the suppliers to submit information enabling it to check whether the minimum annual purchase amounts imposed on authorized retailers 'continue to meet the conditions for exemption laid down in Article 85(3)'.

8.38. We recognize that UK competition authorities must take account of EC law in dealing with the rights and obligations which arise from its provisions, and we have done so. In considering the selective distribution agreements operated by the fine fragrance suppliers in the UK, we have kept in mind the provisions of the two EC Commission Decisions and their current endorsement of the arrangements which they cover. It is nevertheless open to us to examine the effects of the distribution systems on the UK public interest, to make findings and, if we think fit, to make recommendations.

The market

8.39. Before addressing the remaining questions in our terms of reference, we summarize the principal features of the market and of the leading suppliers which are relevant to our consideration of these remaining questions.

Market definition

8.40. The EC Decisions, in analysing the case for exempting the fragrance houses' selective distribution systems, comment that 'the relevant market is that for luxury cosmetic products'. This, they say, is because of 'the low degree of substitutability in the consumer's mind between luxury cosmetic products and similar products falling within other segments of the sector', ie non-luxury products. This assessment was based on the findings of a report prepared for the Commission by Professor Weber (see paragraphs 3.2 and 3.49 to 3.51).

8.41. Consumers buy fragrances for reasons which go well beyond the strictly functional. The suppliers of fine fragrances seek to create an image of luxury and see all aspects of the production, promotion, presentation and sale of the products as contributing to this. They regard this image as crucial to the marketing of products for which the consumer will be asked to pay a high price relative to other fragrance products. These intangible aspects of fine fragrances distinguish them from mass-market fragrances and there is a clear dividing line between the two categories in the method of distribution. The price definition in our terms of reference (Appendix 1.1) brings virtually all products marketed through selective distribution systems within the scope of our inquiry. (It also brings in certain other products in a middle category, sometimes known as volume prestige brands, whose distribution is less restricted, but these form a relatively small part of the market.) We therefore take the view that fine fragrances constitute a largely separate market from non-luxury fragrances. We also believe that fragrances are a separate market within the overall supply of beauty products (ie including cosmetics and skincare, the other product categories covered by the EC Decisions) because those products are bought for a different purpose.

8.42. Given these factors we consider that the products covered by our terms of reference can be regarded as forming a distinct and coherent market for the purpose of our analysis.

Suppliers and the international context

8.43. The supply of fine fragrances is a world-wide business conducted largely by international groups of companies pursuing global marketing strategies. Within the EC in particular each fragrance house aims to follow a consistent policy within the framework now set by the EC Decisions. The main decisions on the development and pricing of new brands are made at group headquarters. The supplying companies in the UK are for the most part, therefore, marketing and distribution subsidiaries of overseas parents. A few of the groups have manufacturing operations here but of the total amount of fine fragrances supplied to the UK domestic retailers, over 80 per cent is imported (see Table 3.9).

8.44. Traditionally the leading suppliers of fine fragrances were French houses, some of these with a pedigree extending back to the last century. Many of the main players are still French-L'Oréal, Yves Saint Laurent, Chanel, Christian Dior, Givenchy and Guerlain-but there are some prominent US suppliers, notably Estée Lauder, Calvin Klein, Elizabeth Arden and Giorgio (Calvin Klein and Elizabeth Arden, however, are now owned by the Unilever group), and a number of smaller suppliers based in other EC countries. Some companies besides Unilever own two or more fragrance houses: for example L'Oréal owns Prestige & Collections, Parim (which markets Lancôme products) and Golden (which markets Caractère and Vanderbilt); LVMH Moët Hennessy Louis Vuitton SA (LVMH) owns Christian Dior and Givenchy; and Société Nationale Elf Aquitaine (SNEA) has recently acquired Yves Saint Laurent in addition to owning Sanofi Beauté. The position is further complicated in that some companies market fine fragrances under several house names. Prestige & Collections, which markets under the Armani, Cacharel, Lanvin, Guy Laroche, Ralph Lauren and Paloma Picasso names, has the largest number. The leading houses generally own their brands but some of the smaller suppliers to the UK market distribute fine fragrances under licence.

Sales and market shares

8.45. As noted in paragraph 8.11, the UK market comprises three elements: supplies by fragrance houses to authorized domestic retailers, grey-market supplies to domestic retailers, and supplies to duty-free outlets. We estimate that the breakdown is as follows:

TABLE 8.1 Wholesale sales of fine fragrances in the UK, 1992

	<i>£ million</i>
Authorized supplies to domestic retailers	151.3
Grey-market supplies to domestic retailers (estimated)	30.0
Duty-free supplies (estimated)	<u>52.2</u>
Total	233.5

Source: MMC (see Table 3.7).

8.46. Table 3.7 sets out the sales of individual fragrance houses to domestic and, where available, duty-free retailers. By groups of companies the leading suppliers in order of market share are L'Oréal, SNEA, Unilever, Lauder and LVMH. Taking individual companies separately, the leaders are P&C, Lauder, Parfums Yves Saint Laurent Limited (YSL), Calvin Klein Cosmetics (UK) Limited (Klein), Chanel and Dior.

Promotion and distribution

8.47. Heavy expenditure on promotion is a characteristic of this market. In 1992 the suppliers spent £76 million on advertising and promotion in support of reference brands, representing 44 per cent of the value of their sales to domestic retailers. The biggest element (£30 million) was the cost of 'beauty consultants', ie sales assistants who work in the shops of authorized retailers but whose pay and training costs are in some cases met wholly or partly by the fragrance houses. £25 million was spent on media advertising, primarily in magazines (£11 million) and on television (£9 million). Other major items were point-of-sale material at £15 million and goods supplied for 'gift with purchase' promotions at £6 million. The presentation of the products in the shops and the use of in-store promotions such as a gift with purchase are matters to which the fragrance houses attach great importance.

8.48. In order to keep in step with changing fashions, to refresh the appeal of their ranges and so maintain their competitive position, most houses frequently launch new products. These entail particularly heavy expenditure on advertising and promotion.

8.49. The fragrance houses see selective distribution as an essential element in their ability to present and promote their products to the public. Their avowed policy is to supply only those retailers who provide high standards of ambience and service and who are prepared to meet certain commitments, for example to hold a wide range of stock and to assist the suppliers' promotional activities. (Paragraphs 8.119 to 8.122 set out the elements of the fragrance houses' selective distribution contracts more fully.)

8.50. The main categories of authorized retailer are department stores, which account for 53 per cent of suppliers' sales, and chemists shops which account for 40 per cent. In 1992 the biggest chemists chain, Boots, had 26 per cent of sales made by fragrance houses to authorized retailers (see paragraph 8.15 for Boots' share of the total market). The two leading department store groups are Debenhams which had 17 per cent and HoF which had 10 per cent.

The grey market

8.51. The grey market exists because there is a demand for fine fragrances from retailers who are unable to gain approval as authorized sellers or who choose not to apply. The sources of supply are concealed because they are likely to be authorized distributors and retailers who sell to unauthorized buyers in breach of their supply contracts with the fragrance houses. As noted in paragraph 8.13, we were told that most grey-market supplies in the UK had passed into unauthorized hands abroad before being imported.

8.52. The grey market is not confined to the UK and has probably existed for many years. The findings of a survey of small chemists carried out for us by Research International Limited (RI) suggested that most such retailers who sell fine fragrances rely wholly or mainly on the grey market for supplies. The grey market appears to have grown in recent years, however, probably because of a combination of greater availability of supply and higher demand resulting from the entry of large retailers such as Superdrug and Tesco. These retailers told us that supplies were variable as to the quantities and brands available and as to price. Fluctuations in the sterling exchange rate are likely to be a factor here.

8.53. Information we received (see paragraph 3.76) suggested that the level of grey-market supplies in 1992 was £25 million to £30 million at wholesale prices, the bulk of it imported by four or five traders who sell on to other intermediaries or direct to retailers.

8.54. The fragrance houses argued that the sale of their products by unauthorized retailers obtaining supplies from grey-market sources damaged their reputation because the normal high standards of ambience and service were unlikely to be achieved and the products might be in poor condition. They described to us the efforts which they made to stop their products leaking into the grey market (see paragraph 3.79), though they thought it would never be possible to eradicate the flow altogether. Some authorized retailers considered that these efforts appeared ineffectual, however, and suggested that the parent companies of some fragrance houses might be misguidedly turning a blind eye to the problem in order to achieve sales targets in the short term.

Prices

8.55. As noted in paragraphs 8.27 to 8.29, it is the almost universal practice of the fragrance houses to recommend resale prices for fine fragrances and these prices have generally been followed by authorized retailers. The fragrance houses use RRP to position their products in relation to equivalent products (eg 50ml EDTs) available on the market, taking account of such factors as brand strength and the resources available for promotion. Wholesale prices are then set at a level which would give the retailer what the supplier regards as a suitable gross margin if the RRP is observed. The average gross margin on supplies to domestic retailers is 38 per cent and there is comparatively little variation.

8.56. The RRP for a given product category cover fairly wide ranges: for example, 50ml EDTs in female fine fragrances range from under £13 to £42, although 70 per cent are between £23 and £36. There are clusters of products around particular price points (see Figures 3.1 and 3.2). RRP for male fragrances tend to be significantly below those for female fragrances of the same concentration.

8.57. Wholesale list prices rose in line with or slightly above the rate of inflation between 1986 and 1990, a period of rapid growth in demand, but have fallen a little in real terms since then. This decline has brought UK prices more into line with those elsewhere (see paragraph 8.97).

Duty-free sales

8.58. Table 8.1 shows that estimated supplies to duty-free outlets in 1992, at £52 million, accounted for about a quarter by value of the fragrance houses' sales to UK retailers. The wholesale prices at which the fragrance houses sell to duty-free retailers are much lower, however, than the prices at which they sell to domestic retailers, in some cases less than half. This suggests that, measured by volume, sales to duty-free outlets may be approaching 40 per cent of the fragrance houses' total sales to UK retailers.

8.59. The fragrance houses explained that this big differential in prices was caused by three factors: first that their costs in supplying duty-free outlets were much lower than the costs of supplying domestic retailers, especially as regards advertising, marketing and sales promotion; secondly that duty-free outlets were highly attractive places in which to sell fragrances, which put the owners or operators of the outlets in a strong position to negotiate low prices; and thirdly that some of the principal duty-free retailers had to pay very high rent or commission to the owner of the airport or ship concerned.

8.60. Retailers at airports owned by BAA plc (BAA) are required by BAA to sell at prices at least 21 per cent below the domestic RRP. This compares with the saving of some 15 per cent as a result of VAT not being payable. (Strictly speaking fragrances are sold tax-free rather than duty-free since they are no longer subject to excise duty in the domestic market.) The saving at other airports is normally 20 per cent, and on ships and aircraft it can vary widely.

8.61. BAA estimated that on average 40 per cent of the sales of fragrances through its airports was made to non-UK residents.

Public interest issues

8.62. We turn now to the remaining questions in our terms of reference (see paragraph 8.34).

8.63. As stated in paragraph 8.25, we consider that the refusal by those fragrance houses in whose favour the complex monopoly situation exists to supply retailers who do not meet their criteria restricts competition. Such refusal to supply is inherent in a policy of selective distribution. We conclude that in pursuing selective distribution policies these fragrance houses are taking steps by way of uncompetitive practices for the purpose of exploiting and maintaining the complex monopoly situation.

8.64. We now examine the effects of the selective distribution system. We begin by considering the arguments in principle for and against the use of this practice in the supply of fine fragrances, and subsequently the effects of its operation in the UK market for fine fragrances. We then consider certain individual aspects of the system, namely the recommending of resale prices in the context of selective distribution, the assessment of retailer applications for authorized status and the inclusion in the suppliers' retailer agreements of requirements as to stocking and minimum purchases. We also examine the allegation that the fragrance houses, in order to protect their position and that of their authorized retailers, put pressure on certain magazine publishers to reject Superdrug advertisements for fine fragrances at discounted prices.

The principle of selective distribution in the UK fine fragrances market

8.65. Selective distribution, while it may be justifiable in certain circumstances, in principle presents a number of disadvantages. In the case of fine fragrances these are as follows:

- since the system allows the suppliers to demand that authorized retailers maintain high standards of decoration and service, retailers' costs may be higher than they otherwise would be;

- these costs are passed on to consumers, who have no opportunity to buy the products in stores offering lower amenity value, less service and lower prices: repeat purchasers, for example, may not need the advice which is available in authorized outlets;
- there is less price competition at retail level than would obtain if other retailers, which have lower costs and place greater emphasis on price competitiveness, were able to obtain supplies from fragrance houses;
- as a result there is less pressure from domestic retailers for the suppliers to cut their wholesale prices; and
- the products are available in a much smaller number of shops than would otherwise be the case, which may be inconvenient for consumers.

These effects are of course mitigated to the extent that fine fragrances are available in unauthorized outlets supplied from the grey market, but other disadvantages for consumers may arise, for example the loss of quality control.

8.66. Tesco put it to us that the fragrance houses' marketing and distribution policies were responsible for maintaining very high prices and very high retail margins. It considered that selective distribution was not necessary to marketing with a luxury image. It suggested that the EC Decisions approving the YSL Parfums and Parfums Givenchy systems were influenced by considerations relevant to skincare and cosmetic products rather than to fine fragrances. The retailing of fine fragrances did not require the use of trained staff. The adverse effects of selective distribution on competition were not therefore justified by any objective need and the adoption of similar systems by all the suppliers of fine fragrances magnified those effects.

8.67. As recorded in paragraph 2.17, the MMC's 1970 report on *Refusal to Supply*¹ listed four circumstances in which restriction of supply, under reasonably competitive conditions, might present no conflict with the public interest. Two of these are relevant to fine fragrances:

- (a) where a supplier wishes to cater for a limited class of customer who will pay for exclusivity; and
- (b) where the product needs services to be provided by distributors.

8.68. As to the first point, we have seen that it is an essential feature of fine fragrances that they are marketed as luxury products. Consumers choose to buy them not only for the scent but for the image of luxury, quality and exclusivity which, in varying degrees, the suppliers create by the advertising and promotion of the products. The suppliers argue that the shops in which consumers buy the products have a key part to play in the creation and maintenance of this image. The ambience which the shops provide-created by the shop's overall physical appearance both inside and out, by the layout and quality of fittings and the positioning of the fragrance department, and by the number, appearance and quality of the staff-is a major element in the consumer's perception of the products. The suppliers maintain that it is essential to their whole marketing strategy that they should be able to control the distribution of their fine fragrance products and thus ensure that the right ambience is maintained. Fragrance houses drew our attention to a number of examples of fragrance brands which had been devalued in the eyes of consumers as a result of the products being distributed too widely and losing their exclusivity.

8.69. As to the second point, we were told that authorized retailers of fine fragrances have to provide experienced or specially trained staff who can advise customers about the various products and brands available. They have to devote an appropriate amount of selling space and to equip it to a high standard. They have to stock a high proportion of the SKUs of the brands they sell in order to provide consumers with the degree of choice which the fragrance houses consider necessary. They may be required to sell the fine fragrances products of a number of competing suppliers in order to contribute to the overall impression of luxury. All of this is expensive-even allowing for the fact that the suppliers make various contributions to the costs involved-and has to be undertaken on a long-term basis if it is to be commercially successful. Few

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.

retailers, it is argued, would be willing to make this investment if they were not assured that the products would be made available only to other retailers who achieved certain minimum standards.

8.70. Both the fragrance houses and their authorized retailers maintained that most retailers of grey-market products were 'free-riding' on the investments of others. The argument is that the suppliers spend heavily on product development, advertising and promotion in order to bring to the market products which consumers want to buy and for which they are willing to pay prices which are high in relation to other fragrance products on the market. Authorized retailers contribute to this process in the ways described in paragraph 8.69. Unauthorized retailers, it is said, seek to take advantage of these investments by concentrating on the best-selling SKUs without providing the ambience and service which the suppliers consider necessary, and are thus able to sell at lower prices than the authorized retailers who incur additional costs. In these circumstances enough consumers are prepared to buy fragrances at unauthorized outlets, despite the relative lack of service and choice, to threaten the profitability of authorized retailers. The end result, the argument runs, is that consumer choice will be reduced, the exclusive appeal of fine fragrances will be diluted, and the market will be undermined.

8.71. To a large extent, we accept these arguments. Fine fragrances cannot in any sense be regarded as essential products. They are bought not so much for their utility as for their ability to enhance the consumer's self-esteem and not least as a show of wealth. The image which the suppliers of such goods create through advertising and promotion is an essential element of the product itself.

8.72. The utility value of fine fragrances is even less than that of most other luxury goods. They are a conceit, a confection created as much by the copywriter as the *parfumeur*. They rely in many cases on the borrowed glamour of being associated with a fashion house-whose clothing would be out of reach of the pockets of most of the fragrance consumers-or more recently with international celebrities. To the extent that they are bought to serve a functional purpose there are many other fragrance products available, at lower price levels, which will serve that purpose.

8.73. To the extent that fine fragrances are bought for their image, we have taken the view that mass-market fragrances are not a substitute. But the key point is that such a purchase is wholly optional. The luxury image indeed depends partly on the price being high relative to other fragrances aimed at achieving a higher volume of sales. For the person buying for personal use the price signals the self-indulgent nature of the luxury purchase. We accept that self-indulgence (sometimes called the 'pampering' or 'feel good' factor) is a powerful motivator for this type of purchase. For the person buying a fine fragrance as a gift-a substantial element in this market-the relatively high price signals the value placed on the relationship (or desired relationship). Provided there is effective competition, the suppliers of these products should be free to follow whatever marketing strategies, within the constraints of the law, they judge will be most successful.

8.74. We are not convinced that a high level of specialist training is necessary for staff who sell fine fragrances. Many witnesses told us that such training is more important in relation to the sale of cosmetics and, especially, skincare. We accept that staff selling fine fragrances need some element of expertise and that this is sometimes useful to guide customers' choice. For the most part, however, we regard the beauty consultant as an aspect of the luxury ambience rather than as performing an essential advisory function. We can well believe that beauty consultants specializing in the products of a particular house can achieve much higher sales than general sales staff, but that reflects their ability in selling rather than anything else.

8.75. Besides fitting into the fragrance houses' policies, selective distribution brings benefits to consumers:

- it helps to preserve and promote the image of luxury which consumers evidently value;
- it enables a wide choice of products and brands to be offered at a single retail outlet, thus giving the consumer breadth of choice and the ability to purchase complementary products;
- it promotes inter-brand competition; and
- to some degree it enables expert advice to be provided so that consumers' choices can be well informed.

8.76. These arguments and advantages have to be set against the disadvantages listed in paragraph 8.65 and the points raised by Tesco summarized in paragraph 8.66. The central point here is that the consumer cannot have it both ways. The consumer evidently values the luxury image of fine fragrances. Authorized retailers play an essential role in preserving the image by investing in high standards of retail ambience and service. It is unreasonable to expect that these standards would be preserved if the products were also available through retail outlets which had lower standards and were able to cut prices on the back of their lower cost base. Some variation in standards is inevitable and healthy-a chemists shop cannot be expected to match the range and specialist staff of a department store-but the imposition of certain minimum standards appears to us fully justified.

8.77. We therefore believe that the disadvantages of selective distribution of fine fragrances may be outweighed by the advantages and that it may therefore be justified in principle. We need to examine, however, whether the way in which selective distribution actually operates in the UK market for fine fragrances presents any effects adverse to the public interest.

The application of selective distribution in the UK fine fragrances market

Market concentration

8.78. The first point to note is that there is a large number of suppliers. Paragraph 3.34 refers to the use of the Herfindahl-Hirschman Index (HHI) as a measure of industry concentration. The degree of concentration found depends on the treatment of fragrance houses which are in common ownership. The MMC would normally regard sister companies as not being in competition with each other but there is some reason to think that the fine fragrance industry, where the promotion of the individual house or brand name is very important, may be an exception. On the basis that individual houses are taken separately, the level of concentration as illustrated by the HHI is very low. Even if the interconnected groups are treated together, the degree of concentration is still moderate. The greater the number of suppliers in a market, the harder it is for them collectively to follow anti-competitive forms of conduct. Allowing for supplies to duty-free retailers, we estimate that the top five supplying groups have about 60 per cent of the whole market.

Authorized retailers

8.79. A second important point is that there are significant differences in the policies which the various suppliers follow. One difference is the number of retail outlets or 'doors' which each of them has authorized. This ranges from nearly 2,000 in the case of Golden's Vanderbilt brand down to some 250 in the case of Muelhens Ltd (Muelhens), a supplier which entered the UK market only two years ago and has around [*] per cent of the market (see Table 3.14). The number of authorized doors depends on several factors:

- the number of retailers willing to stock the products, which in turn depends largely on expected consumer demand;
- the size of the supplier and hence its ability to service retailers with supplies of product, point-of-sale display materials and testers, training and promotional activity; and
- the particular criteria used by the supplier in assessing retailers' suitability: some look for a higher standard of fitting and staffing than others, depending on the position they wish to achieve for their products in the market.

8.80. Some suppliers told us that they had fewer authorized doors in the UK, relative to the country's total population, than in France, Germany and Italy. This was due not to any deliberate policy but simply to the fact that there were fewer outlets of the right standard in the UK than in the other countries mentioned. This is perhaps not surprising given that UK sales of fine fragrances are also lower, in relation to population, than in those countries. But we return to the question of the number of authorized retailers later (see paragraph 8.172).

*Figure omitted. See note on page iv.

8.81. Suppliers' policies on in-store promotions also differ, for example in relation to the use of price promotions, other forms of promotion such as 'gift with purchase', and restricted launches of new products.

8.82. Despite the variations in the number of authorized outlets, a consequence of the suppliers' distribution policies is that sales of fine fragrances among authorized domestic retailers are relatively concentrated. Paragraph 8.50 shows that three retailers-Boots, Debenhams and HoF-have over 50 per cent of the authorized domestic sales. The question therefore arises whether this concentration of sales has led to weak competition at retail level.

8.83. From the information which we received from the suppliers and retailers it was clear that the authorized retailers placed most emphasis on non-price competition or on other ways of giving consumers value for money rather than straight price reductions below RRP. Retailers compete by investing in new stores or in refurbishing existing stores in order to create attractive sales areas; by stocking a wide range of product types and brands; by providing a high level of trained staff; and by participating in promotional activities, whether on their own initiative or that of suppliers. Some retailers told us that they did not like to sell fine fragrances at discounted prices because that would tend to devalue the products in the eyes of consumers. They therefore preferred to give consumers more value by, for example, offering two or more fragrance products together at a favourable price, or issuing vouchers which could be redeemed against future purchases from the same department.

Pricing behaviour

8.84. Nevertheless authorized retailers were following a variety of pricing policies at the time of our inquiry. Some of them were offering straight discounts, although these were usually confined to a limited number of products and short periods of time. We formed the clear impression that this price competition was primarily due to the entry into the market of large retailers which looked to the grey market for supplies, although the recession may also have been a factor. Boots told us that having experienced disappointing sales during most of 1992 it cut the prices of 29 of its best-selling lines by 25 per cent in all its stores in the few weeks before Christmas that year in order to boost its market share. (It had since mounted a similar price promotion before Mother's Day in 1993.) Several department store chains and Lloyds Chemists responded with their own price cuts. But most of the major department stores said that while they would match the prices of local competitors, they would not generally initiate price cuts.

8.85. Apart from reasons of marketing policy, a major factor influencing authorized retailers' willingness to cut prices is the size of the gross margin which they make and the costs which have to be met out of it. The average gross margin on authorized supplies of fine fragrances, assuming that the retailer sells at RRP, is about 38 per cent. Retailers told us that this was well below the average for their overall business. The gross margin cannot be seen in isolation from the financial contributions which the fragrance houses make to retailers' costs (see paragraph 8.91). Taking account of all relevant factors, however, including the fact that fine fragrances usually occupied the most valuable selling space close to the store entrance, some retailers told us that their net profitability on sales of fine fragrances was low. One reason for their continuing to accept this situation was that the availability of fragrances attracted customers into a store, which benefited from the reflected glamour of the perfume hall. Since authorized retailers view the profitability of fragrances as relatively low, however, it is not surprising that they generally prefer to sell at the full price, ie RRP.

8.86. We noted that the subject of pricing policy had been raised at meetings of the Cosmetic & Perfumery Retailers Association (COPRA), to which a number of the leading authorized retailers belong. Boots, whose representative had the chair of COPRA at the time of our inquiry, said that the Association was a low-key gathering with no decision-making power. It had hoped that COPRA might be a channel for putting pressure on the fragrance houses to choke off supplies to the grey market but it had not proved to be an effective body. Be that as it may, we consider it inappropriate that an association of competing retailers should discuss pricing policy.

8.87. We have looked carefully for any evidence that suppliers use their selective distribution policies as a means of seeking to maintain resale prices, an action which would be unlawful by reason of the Resale Prices Act 1976 if taken directly. No clear evidence of this kind came to light. A number of the suppliers' retailer agreements specify in terms that retailers are free to set their own resale prices, while the retailers we questioned generally said that they were well aware of their freedom in this respect. In most cases the

suppliers told us that they did not monitor the prices at which their products were sold by authorized retailers. Sometimes, however, retailers informed the suppliers that they intended to sell particular products at a discount, whether as a matter of courtesy or in order to request additional supplies. In one case a retailer told us that two suppliers had communicated their displeasure at the price cuts, although no action had been taken or threatened with a view to preventing the retailer's action. One retailer told us that the fragrance houses had changed their attitude over the last five years and no longer tried to influence retail prices, but another said that the houses did not approve if their fragrances were retailed at less than RRP.

8.88. We were shown Muelhens' note of a meeting which it held with Superdrug in March 1993. Muelhens put it to Superdrug that there was a risk that if it supplied Superdrug and discounting by Superdrug led to other retailers discounting, the latter might seek to restore their margins by forcing a cut in Muelhens' margin. This would force Muelhens out of business. Superdrug said that this showed that authorized retailers put pressure on fragrance houses not to supply Superdrug. We do not see this as a necessary inference. If retail prices fall it is normal commercial behaviour for a retailer to seek a reduction in wholesale prices, and any question of anti-competitive behaviour would depend on the particular circumstances and conduct involved. It is natural that Muelhens, a recent entrant which is not in a strong financial position, should be concerned about its viability. It would, however, be contrary to the Resale Prices Act for any fragrance house to refuse to supply a retailer on the ground that the retailer was likely to sell its products below RRP, unless the exception in that Act relating to the resale of goods as loss leaders applied.

8.89. Parfums Givenchy Ltd (Givenchy) sent us a copy of its supply agreement with its French parent company, dated January 1990. This included the provision that 'the subsidiary undertakes to devote all its efforts in the limits of laws applicable in the Territory (ie the UK but excluding duty-free zones), to cause retailers to apply the recommended prices mutually agreed' by the two companies. Givenchy said that this provision had no effect. It agreed that its inclusion in a current agreement was anomalous seeing that the EC Decision exempting the Parfums Givenchy retailer agreement from the terms of Article 85(1) specified that retailers must be free to decide their selling prices.

8.90. We asked suppliers and retailers about discounts off trade prices and whether retailers had pressed suppliers for wider gross margins. As described in paragraph 3.88, a few of the large retailers have succeeded in negotiating discounts from some of the suppliers. In general, however, the amount of discounting, other than in relation to settlement terms, is small. The stronger fragrance houses adopt a policy of selling at listed trade prices to all retailers and the strength of their brands has enabled them largely to stick to this, although a number give discounts to Boots, partly to reflect the cost savings which they have recently started to make in supplying to Boots' central distribution system. The absence of significant wholesale discounts restricts retailers' ability to offer discounts off RRPs while maintaining profitability (see paragraph 8.85).

8.91. On the other hand the suppliers do incur substantial costs which in other markets would be met by the retailers. The main example is beauty consultants (see paragraph 8.47), who in many cases-particularly in the larger department store branches-are employed directly by the fragrance houses. Whether the consultants are employed by the supplier or the retailer, their employment costs are often shared between the two parties. Other examples are the costs of counters, point-of-sale display materials and testers.

Suppliers' profitability

8.92. As described in Chapter 5, we asked the eight leading suppliers for details of their financial performance in recent years. The information we requested on the cost and price profiles of individual products confirmed the widely held view that manufacturing costs represent a small proportion of the retail price of fine fragrances. For the 24 products for which we obtained information, manufacturing costs were between 4 and 16 per cent of the RRP, excluding VAT. Although the profiles vary considerably, the following is a reasonably typical example:

TABLE 8.2 Typical cost and price profile of a fine fragrance product

	£	% margin*	% of VAT-inclusive RRP
Manufacturing costs	3.08		10.6
Manufacturer's gross margin	<u>2.68</u>	46.5	<u>9.3</u>
Price to UK distributor	5.76		19.9
Distributor's gross margin	<u>9.66</u>	62.6	<u>33.3</u>
Price to retailer	15.42		53.2
Retailer's gross margin	<u>9.26</u>	37.5	<u>31.9</u>
RRP ex-VAT	24.68		85.1
VAT	<u>4.32</u>		<u>14.9</u>
RRP including VAT	29.00		100.0

Source: MMC.

*The percentage margin is the gross margin expressed as a percentage of the VAT-exclusive price at which the relevant party (manufacturer/distributor/retailer) sells the product.

8.93. The fragrance houses submitted that substantial costs had to be met out of the gross margins taken at each stage of the supply chain. In the case of manufacturers, the costs would include some or all of research and development, the design of advertising campaigns, product development, central marketing, royalties, administration and finance charges.

8.94. As to the wholesalers' profitability, Table 5.2 summarizes the information we received from seven leading suppliers on their sales, costs and profits. It shows that their consolidated gross profit averaged about 68 per cent over the last five years. The great bulk of this was absorbed by advertising, promotion, selling, marketing, distribution and administration costs. The wholesalers were left with an average operating profit before interest and tax, expressed as a percentage return on sales, of around 12 per cent in the period 1988 to 1990, falling to around 7.5 per cent in 1991 and 1992. The returns on sales of individual suppliers varied from a high of 34 per cent by one supplier in 1988 to a low of minus 13 per cent by another supplier in 1990.

8.95. A number of suppliers gave us additional information about the overall profitability of the UK fine fragrance business of the groups to which they belonged. [†] said that its parent company had made a loss on the supply of fragrances to the UK in 1992. [†] said that its group had made losses on UK operations on a consolidated basis in each of the last three years. L'Oréal said that the policy of its group was to take all profits in the subsidiary distribution companies, so the factory and the international headquarters did no more than recover their costs in supplying products to the UK. (As will be seen from paragraph 5.24, the YSL Parfums group operated on similar principles.)

8.96. This financial information shows that the leading suppliers' profitability varies widely, with some companies being much more profitable than others. It also shows that profitability has on average been significantly lower in the last two years than in the preceding three although again the experience of individual suppliers has varied: for example, one supplier's return on sales rose from minus 10 per cent in 1988 to 16 per cent in 1992, while another's fell from 34 to 15 per cent over the same period.

International price comparisons

8.97. We asked the suppliers how wholesale and retail prices in the UK compared with those in other EC countries and in the USA. The general view, albeit this was not the experience of every supplier, was that prices had been higher in the UK than in most other countries until the last two or three years.

†Details omitted. See note on page iv.

Latterly most of the leading suppliers had adopted a policy of seeking to harmonize wholesale prices throughout the EC. The effect of this, coupled with the fall in the value of sterling following its withdrawal from the European Exchange Rate Mechanism in September 1992, had been to bring the general level of wholesale prices in the UK below other EC countries. Prices tended to be lower still in the USA though we were told of a number of products where this was not the case.

8.98. Retail margins were said to be a little higher in other countries than the 38 per cent average in the UK.

Prices and profitability in the duty-free market

8.99. As mentioned in paragraph 8.58, we found that the wholesale prices paid by duty-free outlets were well below, and sometimes less than half, those paid by domestic retailers (see paragraphs 3.108 and 3.109). Given the size of this differential we asked a number of suppliers for information on the relative profitability of their sales to these two trade channels.

8.100. The information which suppliers provided (see paragraphs 3.111 to 3.120) suggested that sales to duty-free outlets brought a greater return to the suppliers than sales to domestic retailers. Obviously this depends on the relative costs involved, some of which have to be allocated on a judgmental basis. The suppliers allocate most of their expenditure on advertising and promotion to their domestic sales. In addition they told us that the costs involved in servicing duty-free outlets, for example on sales consultants, sales promotions and point-of-sale material, were much lower than the equivalent costs on the domestic side. There were also administrative savings resulting from the very high sales volumes going through a relatively small number of outlets.

8.101. There is ample scope for differences of view on cost allocations but it would seem to us reasonable, having regard to the volume of duty-free sales, for advertising and sales promotion costs to be regarded as contributing to duty-free sales as well as domestic sales. The fact that a substantial proportion of sales in duty-free outlets supplied via the UK is made to non-UK residents (an estimated 40 per cent in the case of BAA airports) does not change the argument in principle. On this basis it appears to us that the fragrance houses' sales to duty-free outlets may be significantly less profitable than their other sales.

8.102. The fragrance houses also put it to us that duty-free outlets were highly attractive sales locations because of the heavy flow of customers, many of whom would be in holiday mood and hence uniquely disposed to buy. Fragrance houses saw duty-free outlets as a means of attracting new customers and believed that these sales largely added to, rather than substituted for, sales through domestic shops. They therefore saw duty-free sales themselves as a form of promotion. The operators of duty-free sites understood this and were able to negotiate low prices. In the case of airports and some ships the duty-free shops were operated by concessionaires who had to pay high rents, normally set by a process of competitive tender, to the owner.

8.103. What this amounts to is that supply for duty-free sale is a highly competitive area for the fragrance houses, resulting in very low prices being charged. To the extent that prices are lower than the cost savings in supplying duty-free outlets might justify, one effect may be that suppliers look for higher prices in the domestic market than they otherwise would. The benefit of low wholesale prices on the duty-free side goes partly to consumers in so far as the retail price saving is greater than the VAT concession, partly to duty-free retailers where shops are operated under concessions, but mostly to the owner of the site. BAA told us that its income from duty-free perfume sales at its airports represented on average 56 per cent of retailers' revenue from those sales.

8.104. It appears to us that the availability of fine fragrances in duty-free outlets is a distortion of the market, although the effects are difficult to assess. While some duty-free outlets, notably airports, may in any case be good selling locations, it is the duty and tax concessions which attract shoppers and make them particularly disposed to buy. The distorting effect on markets of these arrangements has long been recognized but the EC Council of Ministers decided in 1991 that duty and tax concessions on intra-EC travel should continue for a transitional period lasting until 30 June 1999.

8.105. Duty-free sales represent a striking example of market segmentation. Supplies of fine fragrances destined for duty-free outlets are delivered to bonded stores and can thereafter be sold only to travelling customers (or other duty-free shops). Since no excise duties are payable on fragrances, however, use of bonded stores is not required by law. The suppliers and retailers involved use them as a matter of convenience, not merely for administrative reasons but because they remove all possibility of these low-priced goods being sold into the domestic market. This stands in contrast to the provision in the EC Decisions which requires that authorized retailers should be free to sell on the products to other authorized retailers throughout the EC.

Market dynamics

8.106. It was put to us by some of the suppliers that not only was there a large number of competitors in the market, but the fortunes of individual companies could change quickly. We have already alluded to the wide variations in profitability, which in some cases reflect varying sales performances. Klein's sharp improvement in profitability is clearly linked to its very strong sales growth, for example. The market shares of some of the leading houses have changed significantly over the years (see paragraph 3.33). New suppliers have entered the market, whether as new houses (such as Klein or Giorgio) or taking over the marketing of products of existing houses (such as Muelhens). The most successful entry was that of Klein which, having marketed its first brand (Obsession) in the UK in 1986, achieved a [*] per cent share of authorized supplies to domestic retailers by 1992.

8.107. Improvements in sales performance are usually the result of the successful launch of new brands. Examples are Chanel's Coco in the late 1980s and more recently Dior's Dune. We were told that the number of launches had increased sharply (see Table 3.11) and it has been estimated that on a world-wide basis only a fifth of new products launched today will recoup their launch costs within three years, compared with half six years ago.

Conclusion on the operation of selective distribution in the UK fine fragrances market

8.108. None of the aspects of the market which we have described gives us serious cause for concern. Fine fragrances is a business where both suppliers and authorized retailers have traditionally placed the emphasis on non-price competition, indeed where price cutting has been seen as a threat to the attractiveness of the products. The UK was evidently a high-price market relative to other European countries (as well as the USA), which suggests that competition was less strong here. The situation has changed and is continuing to change, for various reasons: increased competition among suppliers encouraged by the period of rapid growth and good profitability in the late 1980s; the subsequent fall in demand in the recession; the increase in the size of the grey market and the entry of prominent retailers using grey-market supplies; and the EC Commission's efforts to reduce geographical segmentation of the EC market by requiring that authorized retailers must be free to sell to other authorized retailers throughout the Community. The various elements which we have examined indicate that the market is currently competitive. We conclude that, although the operation of the selective distribution system as a whole is a step taken by the suppliers for the purpose of exploiting and maintaining the monopoly situation (see paragraph 8.63), it is not a fact which operates or may be expected to operate against the public interest.

Individual aspects of the operation of selective distribution

Recommended resale prices

8.109. We asked both suppliers and retailers about the importance of RRP's and what they thought would be the effect of a prohibition on price recommendations.

*Figure omitted. See note on page iv.

8.110. Most suppliers said that RRPs were an important, though not essential, element in their marketing strategies. The setting of RRPs enabled suppliers to position their products precisely in relation to other products on the market, both their own and their competitors'. Some suppliers gave us copies of internal papers showing in detail how the RRPs of a new brand were chosen. Typically the supplier starts with a view of its target customers and the kind of fragrance it wishes to introduce (oriental, floral etc). The intended selling price is usually an early decision so that manufacturing and marketing costs can be planned at levels which will give the company its desired margins, assuming the planned level of sales is achieved. Suppliers agreed that their wholesale prices could, in the absence of RRPs, be used to indicate to retailers the desired positioning of a product.

8.111. The reason most often given by suppliers for setting RRPs was, however, that it was helpful to retailers. RRPs served the dual purpose of guiding retailers on what would be an appropriate retail price to charge and on the gross margin which it would be reasonable for retailers to take. RRPs were also helpful to consumers who, particularly when buying a fine fragrance as a gift, often needed guidance on the perceived relative value of the many different products available. P&C, however, said that with the evolution of the market it had come to the view that RRPs had become more important to unauthorized retailers as a discount point than to authorized retailers, whose pricing freedom should be recognized. P&C had therefore recently ceased issuing recommended prices, although it would keep this decision under review.

8.112. Suppliers thought that there would not be much impact if RRPs were abolished. Some thought that it would cause difficulties for retailers, who in certain cases would still look for external guidance on appropriate selling prices. The effect on prices was unlikely to be great since authorized retailers' margins were tight. Chanel thought that some retailers might increase prices. P&C said that its experience since dropping RRPs was that large retailers had been quite content but some smaller ones appeared at a loss. One leading retailer had increased its prices in order to take a wider margin. P&C had known that its initiative in dropping RRPs entailed certain risks and was monitoring the position.

8.113. In this connection our attention was drawn to the position in France where, we were told, the competition authorities had called on suppliers to stop setting RRPs for certain products sold through pharmacies. Most of the houses said that this move had not caused difficulty or had any major impact on the market.

8.114. Leading authorized retailers' views on RRPs varied somewhat. Some attached importance to the role of recommended prices as a guide both to retailers and consumers, and to the convenience for retailers. If retailers had to decide selling prices for themselves the extra effort and cost involved would be significant considering the very large number of products involved. Some thought the abolition of RRPs would not cause much practical difficulty. None of the retailers we asked thought that the disappearance of RRPs would have much effect on the level of prices. Boots thought that the main effect would be to cause difficulties for unauthorized retailers, whose main selling point was the claim that they sold at so much below RRPs. In the absence of RRPs, they would have difficulty in finding an appropriate bench-mark for describing their discounted prices. A few suppliers drew our attention to instances where unauthorized retailers had made incorrect claims about RRPs in price comparisons (see paragraphs 7.100, 7.125 and 7.138).

8.115. The MMC's 1969 report on *Recommended Resale Prices*¹ concluded, *inter alia*, that RRPs in conjunction with other factors, among which it mentioned the restriction of outlets, might prevent price competition in retailing and that in such cases prices were likely to be higher than they otherwise would be. It is indeed the combination of RRPs and selective distribution which has led us to the view that the setting of RRPs is a practice which restricts competition in this market (see paragraphs 8.27 to 8.29). The issue surrounding RRPs is to be distinguished from resale price maintenance. The Resale Prices Act 1976 prohibits suppliers from seeking to require retailers to resell goods at prices set by the suppliers and the EC Decisions exempting two suppliers' retailer agreements from the provisions of Article 85(1) specify that retailers must be free to determine their own selling prices. As stated in paragraph 8.87, we have found no clear evidence that fragrance houses have sought to maintain resale prices. The question in the present context is whether the lesser action of recommending prices in itself has adverse consequences.

¹ *Recommended Resale Prices: a report on the general effect on the public interest of the practice of recommending or otherwise suggesting prices to be charged on the resale of goods*, HC 100, February 1969.

8.116. We have seen that, although the main authorized retailers sell at the recommended price most of the time, departures from RRP are now by no means unusual. Although retailers regard RRP as the benchmark for their pricing behaviour, those recommendations are not in practice preventing price competition. One of the leading duty-free retailers told us that there were signs of a decline in its sales of fragrances because consumers perceived that the price advantage of buying duty-free had been eroded by discounting in the domestic market. Unauthorized retailers are, in our judgment, the chief instigators of price competition and they use RRP as the means of trumpeting their own price offerings. For this reason it would not surprise us if more of the fragrance houses were to follow P&C's example in discarding RRP in present circumstances.

8.117. Given the large number of fine fragrance products on the market (ie not simply the many brands but the many product types and sizes within each brand) we see some merit in the argument that RRP are a convenience to retailers, especially small ones. We also consider that authorized retailers might increase prices in some cases if RRP were abandoned, since they regard their margins on fine fragrances as being comparatively low (see paragraph 8.85).

8.118. Our conclusion is that the recommending of resale prices for fine fragrances in the context of selective distribution is a step taken by way of uncompetitive practice for the purpose of exploiting the monopoly situation, since it helps the fragrance houses to justify the wholesale prices which they charge to retailers and may lead to reduced price competition among retailers. We further conclude, however, for the reasons that we have set out, that this is not a fact which operates or may be expected to operate against the public interest.

The assessment of retailer applications for authorized status

8.119. The EC Commission's Decisions give exemption from the provisions of Article 85(1) to the standard retailer contracts of YSL Parfums and Parfums Givenchy. As described in Chapter 4, these contracts set out the conditions on which the suppliers select retailers for inclusion in their authorized distribution networks. There are a few differences between the two Decisions but in summary the main conditions covered by one or both are as follows:

- the staff must have a professional qualification or at least three years' experience;
- the store's location and fittings must reflect the brands' prestige and the shop name must not be associated in the public's mind with any restriction in decoration or service;
- the products must be suitably stored;
- sufficient sales area must be provided for the brands in question and the outlet must stock sufficient competing brands to reflect the image and reputation of those brands;
- the products must be sold only on the approved premises and in their original packaging;
- the retailer must assist the supplier's promotional activities;
- the retailer must agree to hold a stock comprising two-thirds of the references (SKUs) of each of the ranges marketed by the supplier and must turn over its stock at least twice a year; and
- the retailer must agree to achieve a minimum level of annual purchases from the supplier, the minimum requirement not to exceed 40 per cent of the average achieved the previous year by all authorized outlets in that country.

8.120. The standard contracts also include further provisions which may be summarized as follows:

- authorized retailers throughout the EC may sell the products to each other subject to certain safeguards designed to prevent supplies from being sold outside the network;

- the products are to be sold only through retailers who have signed authorized retailer contracts. In order to ensure consistency in the marketing of the products, the supplier undertakes to withdraw them from outlets not meeting the conditions laid down;
- the supplier may not interfere in the pricing policy of the retailer, who is free to set the resale price of the products;
- the retailer may sell competing products (*Note:* This applies whether or not a supplier chooses to *require* retailers to stock competing brands); and
- the contract is for one year, renewable for successive periods of one year unless three months' notice of termination is given.

8.121. The retailer contracts also lay down the procedure for retailers to apply for admission to the distribution network. The supplier is committed to inspecting the premises for which an application is made within three months. If the application comes nowhere near meeting the criteria, the supplier informs the applicant of the rejection decision and the reasons for it. If the application is capable of succeeding subject to certain improvements being made, the applicant is informed accordingly and if the work is carried out within six months, an account will be opened within nine months of the inspection. If the application fully meets the criteria, an account is opened, again within nine months from the inspection.

8.122. An important change brought about by the EC Commission's Decisions is that any application which meets the criteria must be accepted and an account opened within the nine months specified. Previously most suppliers would reject applications, or put applicants on a waiting list, if they considered that they already had enough authorized retailers in a particular area. In its Decisions, the EC Commission cited judgments of the ECJ that selective distribution could constitute an element of competition in conformity with Article 85(1) provided, *inter alia*, that retailers were chosen on the basis of objective criteria of a qualitative nature and that such conditions were laid down uniformly for all potential retailers and were not applied in a discriminatory fashion.

8.123. In addition to YSL and Givenchy, the other principal distributors of fine fragrances in the UK are introducing revised retailer contracts to come into line with the provisions approved in the EC Commission's Decisions. Several suppliers told us that the changes which had been made were not, however, very far-reaching compared with their previous arrangements. Some of the smaller suppliers have not yet finalized their revised contracts.

8.124. Most of the leading suppliers in the UK have also drawn up check-lists for assessing retailer applications (see paragraphs 4.18 to 4.28). The check-lists are broadly consistent with the retailer agreements in terms of headings and content, although considerably more detailed. They use point-scoring systems for the various aspects covered. An application must achieve an overall minimum score to be accepted and in many cases a minimum score on particular questions which the supplier regards as critical. Most of the check-lists also, however, include some questions which are not explicitly scored. The suppliers have various arrangements for achieving consistency in applying the criteria although only YSL uses a single inspector for all applicants.

8.125. By using qualitative criteria to determine whether or not to supply a retail outlet, as described in paragraphs 8.119 to 8.124, the fragrance houses prevent other retailers from receiving authorized supplies of fine fragrances. By including in their agreements with authorized retailers the requirements listed in paragraph 8.119, the fragrance houses influence the conduct of those retailers and may deter others from seeking authorized status. We conclude that these are steps taken by way of uncompetitive practices for the purpose of exploiting and maintaining the monopoly situation, and we go on to consider the public interest questions which this raises.

8.126. We found that, where fragrance houses had introduced revised retailer agreements and check-lists since the EC Decisions were published, the documentation was for the most part fully in line with the Decisions and internally consistent. The samples of completed check-lists which we examined appeared to show that the assessment process had been carried out thoroughly and even-handedly. Given the extent of judgment involved in scoring applicant outlets, however, it would be necessary for an independent expert to

visit a considerable number of shops at about the same time as the suppliers' inspectors in order to test conclusively whether applicants were being assessed consistently. We return to this subject below (see paragraphs 8.132 to 8.134).

8.127. The burden of the complaints made by Superdrug and Tesco, both before and during our inquiry, is that the requests they had made to the fragrance houses for authorized status had not been handled in accordance with the principles of the EC Commission's Decisions, although Tesco also challenged some aspects of the Decisions themselves (see paragraph 8.66).

8.128. Superdrug said that repeated approaches which it made by telephone to leading fragrance houses in the five years up to 1991 to discuss supply terms had been rebuffed. In November 1991 it embarked on a trial programme of fragrance sales, using supplies obtained from grey-market sources, and submitted formal applications for authorized status. Its fragrance sales were made only through selected stores which it had refitted for the purpose in order to demonstrate its long-term commitment to the sector. Superdrug complained that it had encountered delaying tactics from all the 25 fragrance houses to which it had submitted applications. Only three small houses had agreed to supply it and Superdrug had entered into an agreement with one of them.

8.129. Superdrug maintained that its refitted stores met the criteria in the EC Decisions but the fragrance houses applied the criteria in a discriminatory and subjective manner. It inferred that their motivation was to limit the number of authorized stockists and to maintain RRP's by not supplying known discounters. Superdrug further argued that some authorized retailers clearly failed to comply with the suppliers' criteria. The sale of fine fragrances on aircraft and ships also departed from the required standards.

8.130. Tesco argued that the selective distribution system favoured traditional forms of distribution over more up-to-date forms. But the demand structure created by the suppliers' promotional activities made it essential for any retailer wishing to offer a successful range of fragrances to have access to premium-priced products, ie fine fragrances.

8.131. Tesco told us that it had been selling fine fragrances in 25 of its larger superstores since 1991. It had been forced to rely on grey-market sources, which had various disadvantages compared with being an authorized retailer (see paragraph 6.82). It considered that the Health and Beauty World areas of its superstores, in which it sold fragrances, had high-quality fittings which took it ahead of many authorized retailers. Its efforts to secure authorized status had, however, been unsuccessful. Some suppliers which it approached had responded slowly or not at all. Some had given reasons for rejection which Tesco considered vague and irrelevant, or which displayed discrimination. Tesco believed that its approach was not inconsistent with the suppliers' desire to maintain a luxury image. It suggested that their underlying motive was to maintain retail prices.

8.132. In order to obtain an independent assessment of the conditions in which fine fragrances were being sold in the UK at the time of our inquiry we commissioned Verdict Research Limited (Verdict), a well-known firm of retail analysts, to undertake a survey of 101 retail outlets. Verdict drew up its own check-list incorporating the criteria which it considered the most relevant and appropriate from the check-lists of a number of the leading fragrance houses. The aim was not to replicate the suppliers' own assessments but to develop an approach which would enable a variety of retail outlets to be evaluated in an objective and consistent way. Since Verdict's survey was concerned with physical conditions, it did not seek to take any account of the shop name (see second subparagraph of paragraph 8.119).

8.133. Details of the Verdict survey and its results are set out in Chapter 4. Among the main findings were:

- the scores ranged widely from a high of 97 per cent to a low of 45 per cent, the average being 69 per cent;
- the highest-scoring category was airport duty-free shops (average 85 per cent), the lowest were independent chemists (51 per cent) and supermarkets (54 per cent);

- the average score for department stores was 73 per cent, with a range from 97 to 53 per cent. The outlets of multiple chains generally scored more highly than independent stores; and
- in some cases the scores of different outlets of a single multiple retailer varied substantially.

8.134. Verdict suggested that, as a rough guide, 60 per cent might be regarded as a possible pass-mark. Any individual fragrance house using Verdict's check-list-it must be remembered that the houses have their individual check-lists which differ both from each other and from Verdict's-might of course choose a different pass-mark depending on the particular standards it wished to see achieved. (The standard contracts approved by the EC Commission's Decisions say that the shop's location `must reflect the prestige of the YSL/Givenchy brand' and the fittings `must not detract from YSL/Givenchy's brand image'. This clearly leaves it open for one supplier to apply different standards from another provided it does so consistently.) Taking 60 per cent as the pass-mark, however, 22 of the 101 outlets surveyed by Verdict fell below the mark, of which ten were supermarkets, seven were independent chemists, three were department stores and two were outlets of a multiple chemist. In addition to all the supermarkets, some of the independent chemists are likely to have been unauthorized outlets. Givenchy told us that 62 of the 101 outlets were among its authorized stockists, including only three of the ten independent chemists surveyed. Of the 62, four were scored by Verdict below 60 per cent.

8.135. We also commissioned a postal survey of smaller retailers, chiefly pharmacies but also including some drugstores, which was carried out by RI (see paragraphs 4.41 to 4.48 and Appendix 4.4). The vast majority (93 per cent) of the 995 respondents said that they acquired some or all of their stock from the grey market although one-third said that they used both grey-market and authorized suppliers. Most of those using only grey-market supplies had never been authorized, apparently because their annual sales were too low to justify authorized status (nearly 80 per cent had annual sales of fine fragrances below £10,000). Fifty had applied for authorization and three-quarters of those had been turned down. The reasons given were usually that there were other authorized distributors too near their outlet or that the fragrance house was not planning to expand (see paragraph 8.143).

8.136. Two hundred and eighty-two respondents were currently authorized stockists. Asked how the fragrance houses responded when they first applied for authorization, 17 per cent said that they were refused without explanation, while the rest were either accepted straight away, received visits from the fragrance house and/or were asked to make changes before they could be authorized. Of those asked to make changes, 41 per cent were asked to train their existing staff to a higher standard while the other requested changes were to do with the shop's physical condition and fittings.

8.137. On the basis of the evidence we had received and the representations made to us, we put two issues to the suppliers for comment:

- whether they defined the criteria for authorized retailers in terms which might lead to unfair discrimination against certain types of outlet; and
- whether they discriminated in the application of the criteria for authorizing retailers in order to refuse supplies to retailers thought likely to sell at discounted prices.

We also invited them to comment on the findings of the Verdict and RI reports and on the complaints made by Superdrug and Tesco.

8.138. The fragrance houses maintained that their assessment questionnaires and check-lists had been carefully drawn up with a view to ensuring that all kinds of retail outlet could be evaluated objectively and even-handedly against the same set of criteria. (One house, Dior, said that it had two versions of its check-list, one for chemists and one for department stores, because it considered that the circumstances of the two categories were different.) Most of the houses said that in principle any kind of retailer was eligible, although we found no case of a supplier having authorized a supermarket. Sanofi Beauté Ltd (Sanofi) said that supermarkets presented difficulty in that consumers did not appear to see them as the place to find fine fragrances, although moves to create separate environments within a store might change this. Guerlain Ltd (Guerlain) said that it would only approve outlets which were department stores, pharmacies, perfumeries or

beauty salons. Lauder pointed out that its check-list made specific provision for out-of-town locations, and for outlets with no windows (though shops with window displays scored more highly).

8.139. Chanel said it was axiomatic that selective distribution involved differentiating between outlets: the important thing was that there should be equal treatment of equal situations on the basis of objective criteria. There was a large number of suppliers of fine fragrances following different distribution policies, hence the market would determine the appropriateness or otherwise of the different criteria applied.

8.140. All suppliers denied that they refused to authorize retailers on grounds of their pricing policies. Chanel pointed out that this would be illegal under both the Resale Prices Act 1976 and Article 85(1) of the Treaty of Rome. There were therefore legal remedies available to any retailer which considered that it had been treated in this way and the drafting of the Resale Prices Act had recognized and made allowance for the difficulty retailers might have in presenting conclusive evidence on the point. Lauder emphasized that applications for authorized status could be refused only on grounds covered in its assessment questionnaire and check-list.

8.141. The fragrance houses' comments on the Verdict report varied a good deal. Some criticized it extensively, others considered that, given the nature of the task, Verdict's report was a sound piece of work and accorded fairly closely with their own evaluation approach.

8.142. Many of the suppliers pointed out that Verdict had not taken account of the shop name, or '*enseigne*'. Nor had it been able to include the training and experience of staff. (It was thought that staff would not be willing to provide information on this subject to Verdict, and although some retailers gave the information to us direct (see paragraphs 4.31 and 4.32), it was not possible to add this to Verdict's findings in a systematic way.) Most of the fragrance houses regarded both of these criteria as essential elements in the assessment process. Among other comments made were the following:

- Verdict had omitted a number of criteria which were permitted in the EC Commission's Decisions and which were important, eg height of display cabinets, size of windows; on the other hand Verdict had included one factor, parking, which most suppliers did not include and regarded as irrelevant;
- Verdict had evaluated some aspects in a broad way, eg condition of decoration, whereas the supplier check-list specified the date of last redecoration; Verdict's survey therefore entailed greater subjectivity;
- Verdict appeared to place undue emphasis on the newness of the shop or its fittings; and
- some of the individual outlet scores were seen as odd, eg Superdrug stores scoring ahead of John Lewis's Peter Jones store in Sloane Square: this cast some doubt on the validity of the scoring system.

8.143. YSL said that its authorized retailers generally scored very well in the Verdict report. The few that did not had yet to be re-evaluated under the new arrangements introduced following the EC Commission's Decision and might have to be dropped. YSL also argued that most of the respondents to the RI report which had applied for authorized status had probably done so over two years ago, before the new system was in place. This would explain the fact (paragraph 8.135) that applications had been turned down for quantitative reasons (ie that the supplier did not want any more authorized retailers at all or in a particular area) which were not permitted under the EC Commission's Decisions.

8.144. With regard to the complaints from Superdrug and Tesco, many of the fragrance houses gave us detailed accounts of their contacts with these two retailers. Several suppliers said that Superdrug had not formally applied for authorization, or even contacted them at all in some cases, before November 1991. From the accounts given, it appears that there were some delays in responding to Superdrug's applications made around that time. Lauder argued, however, that the criticism of delay was unfair: it and probably all other fragrance houses had been involved in an intensive reappraisal of their selective distribution procedures during 1992 as a result of the EC Commission's Decisions. As soon as the new procedures were ready in January 1993, Lauder had inspected the Superdrug and Tesco stores for which application had been

made. Some suppliers said that they had put comments to Superdrug and Tesco following their inspections, or had requested written information needed to complete the evaluations, and had not received a reply.

8.145. Some leading houses had, however, formally rejected Superdrug's applications. In doing so they had placed weight on Superdrug's image, ie its standing as regards the shop name criterion. These suppliers had employed independent consultants to carry out surveys of consumer attitudes, the results of which they showed to us. The suppliers argued that Superdrug's image was created principally by the great majority of its stores which had not been refitted and chosen by Superdrug to sell fine fragrances. YSL said that it was willing to discuss the shop name problem with Superdrug and agreed that the adoption of a different name for those stores from which Superdrug wished to sell fragrances might solve the problem. Elizabeth Arden Ltd, on the other hand, said that it would not refuse to authorize Superdrug outlets solely on account of the Superdrug name, while Klein said that its attitude to Superdrug would depend more on its approach to partnership in marketing the Klein brands than on the image projected by Superdrug's name.

8.146. Some suppliers considered that Superdrug's chosen stores still failed their criteria on other grounds, however: for example, the fragrance counters themselves were of a good standard but they were sited at the back of the stores and were not matched by the rest of the environment, including the other ranges of goods sold.

8.147. Some suppliers said that Tesco had not applied for authorization, or had failed to pursue applications when asked for information needed to support them. Suppliers questioned Tesco's claims for the suitability of its outlets and pointed out that these were not borne out by Verdict's findings. They also argued that Tesco's image was that of a grocer or food retailer, which was unsuitable for the retailing of fine fragrances. In their contention the fact that authorized retailers such as Harrods and Boots also sold food was irrelevant: what mattered was their general image and reputation. As with Superdrug, some of the fragrance houses cited the results of surveys showing that in consumers' eyes the image of the fragrance brand concerned would be harmed if it were available in Tesco stores.

8.148. We have considered what light these views and pieces of evidence shed on the practical application of the suppliers' selective distribution systems. Our general view is that the suppliers have introduced-or in some cases are introducing-procedures which for the most part faithfully observe the terms of the EC Decisions. We were not persuaded, by the evidence we received, that the fragrance houses are failing to implement those procedures thoroughly and in good faith. One difficulty we have faced is that the present time is a period of transition as the suppliers introduce the new arrangements. It appears to us from evidence presented by Superdrug and from the Verdict report that some authorized outlets probably do fall below the standards which the fragrance houses have espoused. Dior indeed told us that about a third of its authorized retailers had been found on re-evaluation to fall below the required standard: these would be given time to improve themselves but would ultimately have to be dropped if they failed to do so. It is clearly important that the suppliers should implement the new arrangements even-handedly with respect to their existing networks, as well as to new applicants, in order to eliminate these anomalies.

8.149. In examining the fragrance houses' documentation and in questioning them at hearings, we came across a number of instances where their procedures had weaknesses or were not being applied even-handedly:

- Dior's agreement said that its products should not be sold near to a counter which sold food but it became clear that it was ready to interpret this condition flexibly in the case of Boots stores. Similarly the wording of its agreement unequivocally ruled out sale by mail order, yet Dior was prepared to make an exception for Harrods. On the latter point, Dior agreed that the wording of its contract needed examination. (We agree, incidentally, that it is not contrary to the principles of selective distribution for an authorized retailer to be allowed to supply customers by mail as long as it maintains suitable premises and has staff who can advise customers about the products over the telephone if necessary. Indeed we consider that this represents an important service to consumers given that the number of shops selling fine fragrances is restricted.)
- The draft for use by Lancôme (part of L'Oréal) in evaluating retailer applications for authorized status specified that the retailer's name should be assessed partly according to whether it had any possible

similarity with a name known for cut prices'. L'Oréal said that since the form was a working draft it had never been used in the UK by Lancôme. The relevant section was being revised to make it clearer that an outlet could not be classified as too down-market to stock Lancôme products simply because of its habitual policy on prices.

- The standard retailer agreements of P&C and YSL provided that if an authorized retailer decided to relocate the outlet it should be able to obtain authorization for the new location subject to certain conditions, one of which was that the new location must be in the same town or even the same district. This seems to be a hangover from the time before the EC Decisions when suppliers were permitted to limit the number of authorized outlets in any particular area.
- Guerlain's agreement provides that retailers may sell to authorized retailers in *other* EC countries, ie other than the UK. But it also prohibits retailers from exporting new products for a year. In both respects the agreement is at variance with the provisions approved by the EC Commission.
- None of the agreements we examined expressly permits the retailer to sell competing products, although this is a requirement of the exemptions.
- As noted in paragraph 8.124, most of the check-lists included unscored questions, sometimes covering very important aspects. The influence of these questions on the overall mark which determines whether an application succeeds or not is unclear.

The relevant suppliers should attend to these weaknesses so that all concerned can have confidence that the selective distribution system is being fairly and consistently applied.

8.150. As regards Superdrug, it is not for us to adjudicate on its applications for authorized status for some of its outlets. From what we have seen, we would expect that, for suppliers which attach less importance to the shop name criterion, the refitted stores will in some cases either achieve the standard for authorization or be capable of doing so without fundamental change. Other leading suppliers have rejected Superdrug's applications, provisionally or finally, on the ground that its shop name fails the criterion in the EC Commission's Decision in the Parfums Givenchy case that it 'must not, in the public's mind, be associated with any restriction in decoration or service'.

8.151. Superdrug argued that the EC Commission had not intended that the name criterion should be used as a ground for rejecting an application which was satisfactory in all other respects. Its own commissioned research showed that most consumers did not attach great importance to the nature of the outlet in which they bought fine fragrances.

8.152. The name criterion presents obvious difficulties because it is capable of subjective and arbitrary interpretation. It seems to us important that the supplier should, as a number of them have done in Superdrug's case, look to an independent and authoritative party to survey consumer opinion and advise them on the implications, although ultimately the decision must be one for the fragrance house itself. The suppliers need also to take great care to respect the condition in the EC Commission's Decision that 'the down-market nature of a retail outlet or of its name cannot be deduced from the retailer's habitual policy on prices'.

8.153. There are legal remedies available to any retailer which considers that an issue relating to the grant or withdrawal of authorized status has not been dealt with in accordance with the procedures approved by the EC Commission's Decisions. The Decisions require a fragrance house to give an unsuccessful applicant the reasons for its failure so that 'the retailer will always be able to challenge the implementation of the admission procedure with respect to him, notably where the selection criteria have been applied in a discriminatory manner' (extract from the YSL Parfums Decision). We consider that the best way to do this would be to give the applicant a copy of the completed assessment form so that the system is completely transparent.

8.154. One possible remedy is for the retailer to complain to the EC Commission itself. The Commission indicated in the Decisions that it would be keeping the industry under review. The Commission has wide powers to investigate such matters and to impose penalties for actions contrary to its view of the law, although in practice it might choose to pursue the matter informally in the first instance.

8.155. On the other hand one of the fragrance houses pointed out that the Commission could reject a complaint on the grounds of a lack of sufficient Community interest if it could be regarded as unimportant in economic terms or in relation to issues of legal precedent. Moreover it would be in line with the principle of subsidiarity for the Commission to leave matters to the national courts where cases can effectively be dealt with at national level. Another possibility therefore is for an aggrieved retailer to seek redress in the UK courts, which have concurrent jurisdiction with the Commission in the enforcement of EC competition rules and a duty, in the event of a breach of EC competition law, to provide an effective remedy. The retailer could choose to seek an injunction and/or to pursue the supplier for damages. Finally a retailer could submit a complaint to the OFT. The DGFT has the power to consider such matters and take further action if he considers it appropriate to do so. We asked the fragrance houses for their views on the available remedies and a summary of these appears in Appendix 8.2.

8.156. We are, however, doubtful that these routes would in all cases provide a remedy which was effective in terms of time and cost. As noted above, the EC Commission may choose not to accept a complaint. Yet it seems to us that a retailer, particularly a small one, might well be put off by the expense of litigation through the national courts, including the possibility of having to meet the suppliers' costs if the case were lost. There may be an imbalance of economic power between a fragrance house and a small retailer, and however carefully the arrangements for assessing retailers are prescribed it will never be possible to eliminate the scope for a fragrance house to manipulate the selective distribution system to keep out unwanted retailers. In these circumstances it appears to us important that retailers should have an additional means of redress open to them which is less formal and costly than court proceedings: see paragraph 8.188.

Standards in duty-free outlets

8.157. As regards Superdrug's argument that the sale of fine fragrances in duty-free outlets conflicted with the principles of the suppliers' selective distribution system, we note that all the duty-free airport shops which Verdict looked at scored very high marks. The main duty-free retailers told us that their staff received specific training on fragrances and that the fragrance houses took a close interest in the standards of fittings and other aspects of the shops. Fine fragrances were available for self-selection for customers who were in a hurry and knew what they wanted, but other customers could get advice from experienced counter staff in the same way as in a domestic outlet. Allders told us that the terms of Allders International Limited's agreements with the fragrance houses covering the sale of fragrances through its airport shops were very similar to those which Allders itself had in respect of its stores. We believe therefore that, as regards standards of ambience and service, the fragrance houses treat such land-based duty-free outlets consistently with domestic outlets.

8.158. The sale of fine fragrances on board ships and aircraft presents different considerations because lack of space normally precludes both the stocking of a wide range of products and the normal standards of appearance of a retail shop. The fragrance houses argued, however, that international travel was itself glamorous and hence an appropriate context for the sale of their products. We were told that the stewardesses were given training so that they would be able to answer passengers' questions about the fragrance products on offer. We consider that consumers regard the purchasing of duty-free goods on board ships and aircraft as a quite different activity from domestic shopping and that the availability of fine fragrances during international travel does not detract from their image as luxury products.

Conclusion on retailer assessment

8.159. Our general view is that the fragrance houses' arrangements for assessing retailers' suitability for inclusion in their authorized networks accord with the principles of selective distribution-which we have concluded is appropriate for the distribution of fine fragrances-and with the criteria approved by the EC Commission. Although we have noted some anomalies and some aspects of the fragrance houses' procedures which need improvement, these are not such as to cast doubt on this view. We have already concluded that the fragrance houses' arrangements for determining whether to supply retailers are steps taken for the purpose of exploiting and maintaining the monopoly situation (see paragraph 8.125). The result of our

analysis, however, leads us to the further conclusion that these are not facts which operate or may be expected to operate against the public interest.

Stocking and minimum purchase requirements

8.160. As mentioned in paragraph 8.119, the standard retailer agreements approved by the EC Commission's Decisions require retailers to stock two-thirds of the SKUs of each brand which is marketed by the supplier and is to be sold by the retailer; and to purchase, as a minimum, at least 40 per cent of the average level of purchases made from the supplier the previous year by all authorized outlets in the country concerned. The YSL agreement also requires the retailer to achieve a stock-turn of at least twice a year. Some suppliers told us that they required new retailers to make a specified minimum initial purchase, which may be greater than the minimum stockholding referred to above.

8.161. These requirements encroach on a retailer's normal freedom to decide its stocking policy and may cause it to incur higher costs than it otherwise would, particularly as sales tend to be concentrated in the last two months of the year. They may limit the number of competing brands which the retailer can afford to stock, and are likely to deter some retailers from seeking authorized status. The number of SKUs marketed by the larger suppliers runs into hundreds (see Table 3.13). We therefore put it to the fragrance houses that their selective distribution systems might cause authorized retailers' costs to be too high and might encourage the growth of the grey market. We also put it to them that the stocking requirements might be seen as a form of line forcing by obliging retailers to stock more brands (ie from a particular house) and more SKUs than the retailers considered were justified by customer demand.

8.162. Suppliers' responses showed that they implemented these requirements in different ways. Some suppliers, eg Lauder, P&C and Sanofi, which control several house names said that they had separate agreements for each house so that a retailer did not have to take on the brands of more than one house. Some suppliers said that they did not require a retailer to take all the brands even within a particular house, but others do require this. The effect of the stocking requirement also varies according to the number of brands and the number of SKUs per brand. The position among the ten leading suppliers to the domestic market ranges from Giorgio, which has a total of five brands and 59 SKUs, to Lauder, which has a total of 20 brands and 255 SKUs, and P&C, with 15 brands and 262 SKUs. Lauder and P&C, however, are among the suppliers which deal separately with their different houses. The supplier with the largest number of SKUs from a single house is Guerlain, with 21 brands and 246 SKUs.

8.163. There is a further complication in that the figures we have been quoting do not refer only to reference products but to all the products marketed under reference brands (see paragraph 2.2 for our explanation of this term). These are, however, the figures which are relevant for the present purpose because the fragrance houses make no distinction between reference and non-reference products in applying the requirement that the retailer must stock two-thirds of the SKUs in a particular brand range. Moreover some suppliers, notably Lauder, require retailers to stock the non-reference brands under which they market cosmetics and skincare, as well as all the reference brands from the same house. On the other hand Lauder is one of a small number of suppliers which does not impose the two-thirds requirement but is prepared to negotiate on an appropriate level.

8.164. The fragrance houses said that the range-stocking provision was an essential element of their selective distribution systems. The different SKUs marketed under a single brand name were a series of linked products. Customers might, for example, want to buy a soap, a body lotion and an EDT from the same range in order to achieve the effect of 'layering' with the same scent (see paragraph 3.48); or might wish to choose between different concentrations of fragrance products. Customers regarded breadth of choice as an element in the luxurious nature of fine fragrances. Having a range of products available at all times was part of the retailer's contribution to preserving this image.

8.165. Suppliers said that they helped to finance the holding of stocks by giving (normally) 30 days' credit. Most also said that they operated buy-back policies so that a retailer could return products that were not selling, albeit usually on payment of a handling charge (these charges range up to 25 per cent).

8.166. The suppliers argued further that in the absence of the two-thirds stocking requirement some retailers would choose to stock only a small number of the best-selling lines, or to hold stocks only at peak periods, notably in the run-up to Christmas. This in itself was unlikely to be a successful retailing strategy in the long term because it did not offer customers adequate choice. But if such 'cherry-pickers' cut the prices of the few lines they stocked, they would take trade away from other authorized retailers, who would then be unable to stock the wide ranges which they currently held. In this way consumer choice would be reduced.

8.167. Several suppliers said that they had had no complaints from their authorized retailers about these provisions of the retailer agreements. The two-thirds provision gave retailers sufficient flexibility to decide not to stock SKUs which they thought would not sell, and most retailers chose to stock much more than the minimum required. It was also argued that fragrance houses had no interest in continuing to market products which were not selling. Dior said that it had reduced the number of its fine fragrance SKUs from 143 in 1988 to 89 in 1993 in order to focus on the faster-selling units.

8.168. Suppliers submitted that the minimum turnover requirement was necessary to ensure that they did not have to incur the significant costs involved in dealing with a retailer whose sales were inadequate to justify this expense. It also helped ensure that the retailer had an incentive actively to promote sales.

8.169. Suppliers drew attention to the fact that their ability to impose requirements with regard to range-stocking and minimum purchases had been constrained by the EC Commission's Decisions. Previously they had typically had a provision in their retailer agreements requiring the retailer to stock the full range, or in some cases a 'representative range' of products which was then subject to negotiation, while turnover requirements had been entirely at the supplier's discretion. YSL told us that the EC Commission had asked it to modify its standard agreement to include the two-thirds provision. The Commission had also been concerned that a fragrance house could use minimum turnover requirements as a means of effectively preserving a quantitative limit on the number of its authorized retailers. The Commission had therefore wanted to constrain a supplier's freedom in this respect and, after a process of negotiation, had settled on the 40 per cent provision.

8.170. We entirely agree that these provisions as approved in the EC Commission's Decisions represent an improvement on the previous position. It is still necessary to consider whether they are a sufficient improvement and whether the particular form of the new provisions is satisfactory.

8.171. We see the case for the fragrance houses being able to require a particular level of range-stocking but the two-thirds figure is high bearing in mind that in most cases the retailer has to take a number of brands from a single house. The retailer also has to take products from several different companies in order to satisfy the provision that a sufficient number of competing brands must be stocked (see paragraph 8.119). In the Decision in the Parfums Givenchy case the EC Commission gave its opinion that a minimum of four competing brands was 'not unduly high'.

8.172. We noted that authorized retailers do not appear to complain about the range-stocking requirement. On the other hand, its main impact is likely to be in deterring other retailers from seeking authorization. The RI survey showed that the great majority of independent pharmacists rely solely or partly on the grey market for supplies of fine fragrances. The responses from these retailers showed that the main reason for using the grey market was that they considered their sales were too low to justify seeking authorized status, and that a major element in this judgment was their perception that the fragrance houses required high levels of ordering and stock-holding (see Appendix 4.4). While many of these retailers might fail to satisfy other criteria for authorization, such as the quality of fittings, it seems to us from this evidence that the range-stocking requirement may deter a significant number of small retailers from applying for authorized status, particularly in view of the requirement to stock a number of competing brands. Bearing in mind that the main impetus for price competition in this market has come from unauthorized retailers, who are vulnerable to the vagaries of the grey market, we consider that entry to the fragrance houses' selective distribution networks should be no harder than is consistent with safeguarding the objectives of the system, so that the likelihood of the network becoming closed and uncompetitive is reduced.

8.173. The minimum purchase requirement also may act as an impediment to entry into the retail network. A potential entrant will find it hard to predict the level of sales which it may achieve before it has any experience of selling the products. It may be reluctant to incur expenditure on upgrading a shop in order to meet the fragrance houses' requirements if there is a risk of its supplies being cut off after a year because of failure to achieve a particular turnover, the level of which depends on the sales achieved by all other retail outlets in the country in the previous year. While such decisions inevitably involve risks, there is every reason not to add to those risks unnecessarily.

8.174. The evidence that these requirements have the adverse effects postulated above is not strong, however. The respondents to the RI survey are likely in many cases to have drawn on their experience of the situation before the EC Commission's Decisions of December 1991 and July 1992 were implemented. The revised provisions concerning range-stocking and minimum purchases which the Decisions introduced are improvements on the previous situation and may in themselves help to encourage new retailers to apply for authorized status. It is too early to say whether the improvements go far enough.

8.175. We conclude that the imposition of range-stocking and minimum purchase provisions as defined in paragraph 8.160 are steps taken by way of uncompetitive practices for the purpose of exploiting and maintaining the monopoly situation for the reasons given in paragraph 8.161. But we further conclude that these are not facts which operate or may be expected to operate against the public interest.

The advertising issue

8.176. We have investigated Superdrug's complaint that certain magazine publishers had refused to accept advertisements which it wished to place in their magazines to advertise its selling of fine fragrances, and its allegation that this was the result of pressure by the fragrance houses. Superdrug's complaint is summarized in paragraph 6.101. We questioned the publishers about the matter both in writing and, in the case of three of them, at oral hearings.

8.177. Those publishers which said that they had refused the advertisements gave the following reasons for doing so:

- (a) Superdrug's image was not complementary to the exclusive image of the magazine concerned. Publishers wished to satisfy the requirements of their existing advertisers and would not achieve this by allowing advertisements which did not fit with the exclusive image. The quality of the advertisement was as important as the quality of the product being advertised: although Superdrug's second advertisement would have been visually acceptable, the perceived image of the company was not. To have accepted this advertisement would have been a publicity victory for Superdrug.
- (b) The fragrance houses were excellent customers and the publishers did not wish to jeopardize their relationships with them by becoming involved in the dispute with Superdrug. Publishers considered advertising revenue from the fragrance houses to be extremely important. Some publishers told us that particular magazines might not survive if the fragrance houses withdrew their advertising. This would be both because of the resulting lack of revenue and the change there would be in the nature of the magazine if the revenue base was replaced by other advertisers.
- (c) There was concern that Superdrug was operating outside the approved distribution systems. To accept advertisements from any unauthorized retailer would amount to facilitating the promotion of products obtained from the grey market. The publishers did not wish to become associated with the controversy surrounding this issue. Publishers also thought that outlets relying on grey-market products might be unable to supply a full range and that the products' quality might be unreliable, eg because they were beyond their shelf-life or counterfeit. They also considered that retailers stocking grey-market supplies did not have the sales advice or environment usually associated with quality beauty products.

8.178. Some publishers told us that they had agreed or offered to accept Superdrug advertisements in some of their less exclusive magazines and some said that they would be prepared to negotiate with Superdrug for advertisements which were not for fine fragrances.

8.179. The publishers emphasized that the fragrance houses had not put pressure on them to refuse Superdrug's advertisements, although one said that there had been a 'vague implication' in respect of one of its magazines (see paragraph 6.129).

8.180. We asked the fragrance houses whether, within the last three years, they had contacted any publishers to discourage them from accepting advertisements for fine fragrances from unauthorized retailers. Most of the fragrance houses said that there had been no such contact. L'Oréal, however, told us of an episode in November 1991 when Lancôme (the house name of its subsidiary Parim Limited) had made representations to the publishers of *Hello!* magazine about the appearance of Superdrug advertisements for its selling of fine fragrances at cut prices (see paragraph 7.132).

8.181. There is no provision in the British Code of Advertising Practice, applied by the Advertising Standards Authority, which suggests that a publisher should accept all advertisements provided they satisfy the basic criteria of legality, decency, honesty and truthfulness. On the contrary, the code specifies that publishers have the unfettered right to accept or reject advertisements. That is not to say that refusal of advertisements may not raise competition concerns. In the 1988 report on Specialised Advertising Services¹ the MMC concluded that the refusal by publishers of specialist magazines for campers, climbers and walkers to accept advertisements which contained prices or price comparisons was anti-competitive.

8.182. In the present case we consider that it is not surprising that the publishers of up-market magazines such as *Vogue* and *MarieClaire* should have refused advertisements from Superdrug, which was not a regular advertising customer. The publishers told us that their policy was to ensure that the advertisements which appeared in their magazines were in harmony with the style and quality of each title. They did not often refuse advertisements but that was because they were rarely asked to carry material which was unsuitable.

8.183. As regards the allegation of pressure by the fragrance houses, the only clear evidence to support this is the information from L'Oréal (paragraph 8.180), which concerns an incident well before the events of which Superdrug complained. The information shows that Lancôme (and possibly one or two other fragrance houses, though we have been unable to establish that) sought to persuade *Hello!* to stop taking Superdrug advertisements for cut-price fine fragrances. We consider it unacceptable for advertisers to exert pressure on a magazine publisher in this way. No similar pressure appears to have been applied in relation to the advertisements which Superdrug sought to place in late 1992 and early 1993. It was a matter of normal commercial judgment that the publishers should consider the likely reaction of the fragrance houses, whose advertising is of major importance to the magazines concerned. In such circumstances a publisher has to weigh the pros and cons of its decision, including the possible effect on its reputation of a refusal to accept advertising. From our standpoint a further consideration is that the magazines in question did not represent the only means by which Superdrug could advertise.

8.184. We have not found evidence which persuades us that it was pressure from fragrance houses which caused the magazine publishers concerned to reject Superdrug's advertisements.

Conclusions

8.185. We have concluded that a complex monopoly situation, as defined in section 6(1)(c) and (2) of the Act, exists in relation to the supply in the UK for retail sale of fine fragrances (see paragraph 8.32), and that this situation exists in favour of the suppliers and other, related companies listed in Appendix 8.1 (see paragraph 8.33).

¹*Specialised Advertising Services: a report on the matter of the existence or possible existence of a monopoly situation in relation to the supply in the United Kingdom of the service of accepting advertisements for publication in specialised magazines intended for campers, climbers and walkers*, Cm 280, January 1988.

8.186. We have concluded that the following are steps taken, by those fragrance houses in whose favour the complex monopoly situation exists, for the purpose of exploiting and maintaining the monopoly situation:

- pursuing selective distribution policies (paragraph 8.63);
- recommending resale prices in the context of selective distribution (paragraph 8.118);
- using qualitative criteria to determine whether or not to supply a retail outlet (paragraph 8.125); and
- including in their agreements with authorized retailers provisions concerning range-stocking and minimum purchases (paragraph 8.175).

We have not found any actions or omissions which are attributable to the monopoly situation. We have concluded that none of the steps listed above is a fact which operates or may be expected to operate against the public interest.

8.187. This being the case, the question of remedies and recommendations does not arise. There are, however, certain suggestions which we would like to make.

8.188. In paragraph 8.156 we stated our view that a retailer should have available an additional means of redress in the event of any disputes arising over the grant or withdrawal of authorized status. What we have in mind is that the fragrance houses, together or separately, might draw up a straightforward scheme for independent arbitration in such circumstances. One possible model is the schemes introduced by certain oil companies for settling disputes with the licensees of their petrol filling stations. An example is set out at Appendix 8.3. We believe that a scheme on these lines, but tailored to the particular circumstances of the fragrance houses' selective distribution systems and capable of being implemented quickly, would be a useful supplement to the OFT's general oversight of competition matters.

8.189. In addition we wish to draw attention to two particular aspects of the selective distribution agreements approved by the EC Commission's Decisions, namely the range-stocking and minimum purchase requirements. We have discussed these at some length in paragraphs 8.160 to 8.175. Although we find no effect adverse to the public interest, there is some evidence to suggest that these requirements may deter some retailers, who might otherwise meet the suppliers' criteria, from applying for authorized retailer status. These requirements impose a financial burden which some retailers may find difficult to bear.

8.190. These revised provisions are still in the process of being introduced by the fragrance houses. The provisions were arrived at by a process of negotiation between the EC Commission and the fragrance houses concerned and it is difficult to predict what their effect will be. The particular figures chosen—namely two-thirds of the range and 40 per cent of average purchases per outlet—are inevitably arbitrary and may not be equally appropriate for all EC countries. In the UK, the retailing of fine fragrances appears to be more concentrated than in some other EC countries, with a high proportion of authorized sales being in the hands of Boots and a few department store chains. Specialist perfumeries, which we were told are a major element of the market in some other member states, are virtually absent from the UK. The smaller retailers in this country are mostly chemists, for whom fragrances are only one among a number of product categories in their total offering.

8.191. The fragrance houses are not obliged to require all their authorized retailers to achieve the two-thirds and 40 per cent levels in the YSL Parfums and Parfums Givenchy Decisions. These figures represent the maxima which a house can insist on. It is open to a house to apply lower figures or indeed not to impose minimum requirements at all, and some told us that they did apply such flexibility. Moreover one house, Dior, calculates the 40 per cent minimum purchase figure separately for all department stores and Boots on the one hand and for chemists on the other. Another way in which the suppliers can help the smaller retailer is by being willing to accept returns of stock which is not selling, without applying excessive handling charges. It seems to us that such flexibility is sensible in UK conditions and we would urge all the fragrance houses to adopt a similar approach taking account of the considerations which we have set out. An attraction for the fragrance houses is that a flexible approach might encourage some retailers to stop looking to the grey market for supplies.

8.192. We suggest also that the OFT should monitor the effect of the range-stocking and turn-over requirements on the UK market in order to assess whether they do appear to exclude retailers unnecessarily from the authorized networks, and whether competition and choice are thereby impaired. This might be done by asking the fragrance houses to make annual returns, on a voluntary basis, giving factual information about the application of these provisions (eg number and total cost of the SKUs a retailer had to stock, value of minimum purchases required) and stating the number of retailers for which they had refused or terminated authorization because of these two provisions. The OFT would then be in a position to advise the EC Commission, when it comes to review the exemption Decisions in 1997, whether some changes should be made, such as reductions in the two-thirds and 40 per cent levels currently specified. Some of us believe that the appropriate figures might be one-half and 30 per cent respectively, but detailed examination will be needed in the light of experience before any such revised levels can be fixed.

8.193. As we have noted, the present time is a period of transition as the fragrance houses implement the revised arrangements which flow from the EC Commission's Decisions. These new arrangements are inevitably not yet fully tried and tested. The EC Commission made the Decisions applicable until May 1997 so that it could then re-examine the effects of the two distribution systems on competition. We welcome that intention. It appears to us appropriate, in view of the extent of the changes introduced by the Decisions and other developments in the market, that a thorough review should be carried out at that stage. In that context we suggest that the OFT should in the meantime monitor the number and nature of any complaints from retailers, taking account of the analysis and comments in our report.

J D MONTGOMERY (*Chairman*)

C M BLIGHT

F E BONNER

S EILON

J EVANS

S N BURBRIDGE (*Secretary*)

18 August 1993