

On the Antitrust Remedies to Promote Retail Innovation in the EU Car Sector

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1. Introduction

The European Commission has recently issued the third block group exemption Regulation on the application of the competition rules in the motor vehicle distribution sector.¹ In line with its general policy concerning vertical restraints,² the European Commission holds the view that, in the absence of market power, the overall benefits from restrictions in the distribution of cars normally exceed possible anti-competitive effects.³

However, the new rules for distribution agreements in the EU car sector are stricter than the general rules governing vertical restraints.⁴ The main reason for this

is that the Commission, by means of the new Regulation, aims in particular at promoting innovation of distribution formats, so far totally absent from the car sector.⁵

The Commission explains⁶ the lack of innovation in the car retailing sector by the fact that, on the one hand, almost every car manufacturer in the EU employed the same selective and exclusive distribution system exempted by previous Regulations. On the other hand, one of the conditions for the legitimacy of car distribution agreements under the previous sector-specific competition rules was that retailers undertook to provide repair services.⁷ As a consequence, retailers employing alternative formats such as supermarkets and internet-based firms were closed off, both because they did not normally fulfil the selective criteria set by the manufacturers, and were not able to comply with the obligation to provide repair services deriving from the exemption regime. In other words, the negative effect caused by vertical restraints in this sector laid, according to the Commission, not so much in the prejudice to the functioning of competition between manufacturers, the so called *interbrand* competition, but in the suppression of innovation of distribution formats, that is the restriction of dynamic *intra-brand* competition.

However, the specific remedies envisaged by the Commission in order to foster retail innovation in the car sector are far from being free of problems. In particular, even though car manufacturers are given the choice between a selective (both qualitative and quantitative) and an exclusive distribution system, the vast majority of them are currently opting for the selective system,⁸ and this could have the effect of perpetuating the foreclosure effect of innovative retailers from the motor vehicle distribution sector.

The question is raised whether, in order to foster dynamic competition at the retail level, the banning of the qualitative selective distribution system altogether would have been a better choice, as authoritatively

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1 Reg.1400/2002 on the application of Art.81(3) of the Treaty to categories of vertical agreements and concerted practices in the motor vehicle sector ([2002] O.J. L203/30). The two previous Regs. were Reg.1475/95 ([1995] O.J. L145/25), which expired on September 30, 2002, and prior to that Reg.123/85 ([1985] O.J. L15/16).

2 General policy as derived from Reg.2790/1999 ([1999] O.J. L336) and *Guidelines on Vertical Restraints* ([2000] O.J. C291/1). In the absence of market power and up to a short list of prohibited clauses (Arts 4 and 5 of Reg.2790/1999), manufacturers are in principle free to place whatever restrictions they wish on their distributors. The central element here is the recognition that in many cases such arrangements actually foster increased efficiency through the achievement of savings in transaction and distribution costs, thereby possibly stimulating competition between manufacturers of different makes—so called *interbrand* competition, see *Guidelines*, paras 6 and 115–118.

3 Reg.1400/2002 at Recitals 5–8. As well as for Reg.2790/1999, the exemption is conditioned on the fulfilment of a market share threshold, fixed by the Commission in order to reflect suppliers' market power, see Art.3(1) and (2) of Reg.1400/2002. Car manufacturers holding a market share of more than 30 per cent are not covered by the rules on vertical restraints, 40 per cent if they operate qualitative and quantitative selective distribution.

4 Recital 2 of Reg.1400/2002.

5 Explanatory Brochure to Reg.1400/2002, available on the DG COMP's website at http://europa.eu.int/comm/competition/car_sector/explanatory_brochure_en.pdf, p.14. Another important matter the new rules deal with is the effect of the previous regulation on price differences among States, an issue not directly covered by the present paper.

6 See Report on the evaluation of Reg.1475/95 on the application of Art.85(3) (now Art.81(3)) of the Treaty to certain categories of motor vehicle distribution and servicing agreements, Document COM (2000) 743 final, available on the DG COMP's website at http://europa.eu.int/comm/competition/car_sector/, especially pt.142 and pt. 401–416.

7 Recital 4 and Art.5(1)(1)(a) of Reg.1475/95.

8 Sector Group at Houthoff Buruma and Liedekerke Wolters Waelbroeck Kirkpartick, *Flawed Reform of the Competition Rules for the European Motor Vehicle Distribution Sector* [2003] E.C.L.R. 254, p.257.

suggested.⁹ In order to answer this question, insights from the more recent literature on the economics of innovation and related studies might prove to be useful.

2. The new regulatory framework for the EU motor vehicle distribution sector

Need for a policy change

Since 1985, vertical restraints undergone by manufacturers and retailers in the distribution of motor vehicles have been subject in the EU to a special regime.¹⁰ The whole concept was centred on the belief that the car was not an ordinary good. It was seen as a highly complex product requiring expert repair and maintenance work¹¹ at regular and irregular intervals, and at a range of locations.¹² Therefore, supplier's own sales capacity and reputation would have been compromised if cars had not been sold by dealers whose staff had sufficient expertise and equipment to sell, service and repair them to the right standard.¹³

Because of this, the Commission endorsed the necessity of a network of closely co-operating partners, with the dealers being obliged to also provide repair and maintenance work.¹⁴ This involved not only a selection of dealers according to qualitative criteria,¹⁵ but, essentially because of the necessity to transfer the knowledge required to repair and sell a car, a selection by the manufacturer according to quantitative criteria.¹⁶ The selective distribution system allowed manufacturers to

choose the dealerships they decided to supply, and to forbid those dealerships to sell to retailers not belonging to the same network. Moreover, the distribution could also be exclusive, the exclusivity relating to the territory in which the dealer could carry out sales without any other dealer of that make being present. Dealers were entitled to make passive sales to any consumers who entered their showrooms or contacted them, but could not actively seek customers outside their own territory. Finally, dealers could sell different makes, provided that they adopted some measures protective of the car-maker's brand and reputation.¹⁷

In a Report¹⁸ evaluating the working of Regulation 1475/95, issued after 15 years of this sector-specific policy, the Commission questioned the wisdom of the belief that, because of a car's intrinsic characteristics, a system of selective and exclusive distribution was (still) required.¹⁹ Especially, a car's peculiarities did not seem to justify the negative effects on competition and market integration that seemed to derive from the selective-exclusive system,²⁰ that is the closing-off of new distribution techniques such as internet sales,²¹ the insufficient price competition between approved dealers within the EU and the impediment to the cross border purchases of new vehicles. It was also shown that products that are comparable to cars, that is motorcycles, were distributed through less restrictive channels. In particular, the Commission recognised that, since all car manufacturers in the EU employed the same or similar selective and exclusive distribution systems exempted by the previous Regulation,²² there was practically no possibility of entry by retailers using a format

9 Reference is made in particular to the view expressed by the UK Competition Commission, in *New cars, A report on the supply of new motor cars within the United Kingdom*, presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty, April 2000, see under Section 2 for further discussion of this Report's results.

10 The Commission's former competition policy on car distribution was laid down in Reg.125/85, and only partially amended by the following Reg.1475/95, see n.1 above.

11 Otherwise cars could have represented a risk to life, limb and the environment.

12 It was also maintained that customers generally preferred to have a "one-stop shop" for their vehicle purchase and maintenance needs.

13 See Recital 4 of Reg.1475/95.

14 See Recital 4 and Art.5(1)(1)(a) of Reg.1475/95. This was sustained also because of possible "cross-fertilisations" between sale and servicing.

15 Selectivity was normally based on a mixture of technical and economic criteria required from the distributors, such as expertise, equipment and premises.

16 The underlying reasoning was that the car manufacturer could only work with a limited number of dealers and repair operators, if he wanted to be able to communicate extensively with them, so that they would service the car in the manner required.

17 Interestingly, the cumulative effect of similar vertical restrictions was not ignored by the two previous sector specific Regulations (see Recital 3 of Reg.125/85 and of Reg.1475/95), but no repeal mechanism was foreseen.

18 See Report on the evaluation of Reg.1475/95, as n.6 above.

19 The criticism expressed by the Commission in its Report came apparently as a surprise to some car manufacturers, see Buzzavo and Volpato, "Car Distribution in Europe: Between Vertical Agreements and Customer Satisfaction" Cockeas Research Network, Berlin Meeting, November 2001, p.6.

20 The Commission also refers to the fact that cars themselves might have changed (in spite of their increased technological complexity, servicing could have become easier—as big individual components can be replaced with greater ease—and in general less frequently), as well as consumers' wants and expectations.

21 The Commission sees the internet as particularly important because it serves also an integration scope, through developing parallel trade on a much larger scale, with all the benefits that would result from that, including a reduction in price differentials between the Member States of the European Union, see para.155 of the Report, n.6 above.

22 Selective and exclusive agreements covered most of the sales in the market, but not all of them, because carmakers often reserved to themselves some categories of buyers.

that was on terms different from the ones found throughout the industry.

The new rules

In the Commission's opinion, in order to remedy these problems, and especially to stimulate the development of innovative distribution methods and thereby enhance competition,²³ the new rules for car distribution and servicing in the EU had to be stricter than the general framework for vertical restrictions, that is Regulation 2790/1999.²⁴ The new rules' specific aim would have been *inter alia* promoting the access on the part of new distribution formats to the market, with the Commission having especially two potential candidates in mind, that is internet operators and supermarkets. Internet operators, in particular, not only could permit the offering to the consumers of new combinations of price and services, but could contribute to price transparency allowing the consumers to seek a competitive offer beyond their local dealer. Supermarket sites were also seen as able to enter the market and capture a significant share at least of the market for commodity vehicles.²⁵

Accordingly, whereas under the general policy on vertical restraints, exclusive and selective arrangements are exempted, unless the manufacturer has a market share of more than 30 per cent,²⁶ the same arrangements are not covered by Regulation 1400/2002.²⁷ The new Regulation bans systems combining selective and exclusive distribution and requires carmakers to choose one of those distribution formats. This means that if a manufacturer chooses the system of exclusive distribution, and for example assigns its dealers exclusive geographic market areas, dealers may be prohibited from opening additional outlets in markets covered by such systems or carrying out active promotion (such as

local advertising or email promotions) outside their sales area, but they are entitled to make passive sales, that is to respond to unsolicited requests, in favour of any end user or independent retailer, that is internet operators.²⁸ On the other hand, in a selective distribution system, cars can be sold only by dealers belonging to the network, but nobody enjoys protection from other resellers' competition by means of exclusive territories or customer groups.²⁹ This result is also assisted by the abolition of the "location clause" permitting manufacturers to require dealers to operate from a specific location, however only after a two year transitional period.³⁰ After the transitional period has expired, dealers within a selective system will then be entitled to open branches or showrooms anywhere in the internal market, whereas the car makers retain full control over the car dealer's primary establishment.³¹

Another important aspect of the new rules is that the link between sales and service has now been broken. The obligation that the dealer undertakes repair services was at the heart of the previous regime. Regulation 1475/95 exempted distribution agreements for new cars on the condition that the dealer not only undertook to sell new vehicles, but also provided after sales servicing.³² The new Regulation, instead, does not exempt agreements that do not allow dealers to sub-contract

23 See the Explanatory Brochure to Reg.1400/2002, n.5 above, p.14.

24 In a way, the new regulatory framework for the European car distribution sector can be seen as a remedy issued to solve specific problems, so that, once the problem is solved, the general rules on vertical restrictions could apply. The interesting thing here is that Reg.1400/2002 foresees at Art.6(1)(a) the withdrawal of the exemption in case of a cumulative effect, that is, practically, if the new rules happen to fail their scope.

25 These are generally the products of mass market manufacturers and are largely functional vehicles. Another major problem was seen in the obstacles still persisting to the operation of multi-branded dealerships.

26 See Art.4(b) point 3, Reg.2790/1999.

27 Similarly to the general Block Exemption Regulation on vertical restraints, the new sector-specific exemption does not foresee a list of permitted vertical restraints (the "white list approach"), but a list of vertical restraints which are not exempted and whose presence in an arrangement brings to the non exemption of the other parts of it (Art.4), as well as another list of less serious vertical restraints (Art.5).

28 Whereas, according to the general rules exempting the combination of exclusive and selective distribution, retailers can be prevented from selling to non-authorized distributors, see Art.4(b) third exception; see also Robert Whish, *Competition Law* (London, 2001), p.585.

29 Whereas carmakers are prevented from cumulating selective and exclusive restrictions, they cannot be forced to use the same system throughout the EU. The restrictive effects of the two systems should nevertheless be kept strictly separate. This means that if a manufacturer chooses the system of exclusive distribution assigning its dealers exclusive geographic market areas, its dealers are entitled to make passive sales to distributors located in markets where selective distribution is used, that is, also to unauthorised resellers. On the other hand, selected dealers must be free to sell cars to other dealers and to consumers in territories where the system of exclusive territories operates, see Recital 13 of Reg.1400/2002.

30 The prohibition of a location clause will then be applicable from October 1, 2005. This proposal to postpone the implementation of this prohibition came from the European Parliament, and was motivated by the fact that, in view of the impact of the changes, it was desirable to introduce the freedom of establishment only after a suitable and clearly defined transitional period. In particular, it was feared that this may have threaten the existence of less well-funded small and medium sized dealers, if they had to face competition in their immediate neighbourhood without preparation and at short notice.

31 Explanatory Brochure, n.5 above, question 55.

32 Art.5(1)(a). More precisely, the exemption applied only if the dealer undertook to honour the supplier's warranties and obligations for servicing and recall work, and to provide other repair and maintenance services needed for the safe and reliable functioning of the supplier's brand of cars, irrespective of where the cars were bought.

servicing and repair to authorised repairers who belong to the repair network of the brand in question,³³ and in that way practically *unbundles* servicing and distribution of new cars. According to the new rules, therefore, the dealer has the choice either to offer after sales services himself or to sub-contract independent, approved repairers for the performance of after sales service.³⁴ Manufacturers have the obligation to supply necessary technical information, diagnostic equipment and tools, and training to independent repairers.³⁵

Multi-branding is also reinforced under the new Regulation. The principle that dealers should be free to sell different makes was first stated in Regulation 1475/95. Whereas the supplier was prohibited from entering into agreements that imposed an obligation on its retailers to sell exclusively the supplier's brand of new cars, dealers wishing to sell multiple brands could be asked to do so under separate legal entities, with separate management and sales personnel or premises for each brand. According to the new rules, instead, suppliers should restrict themselves to imposing an obligation for motor vehicles of different brands to be exhibited in different areas of the same showroom.³⁶

A last issue of importance to the Commission is the protection of dealers' economic independence. The evaluation Report on the functioning of Regulation 1475/95 had in fact revealed that the dealers were still largely dependent on the manufacturers, and this despite the protection measures introduced in their favour by previous Regulations. The idea behind the provision of rules aiming at protecting dealers' economic independence is, according to the Commission, that an independent dealer sector is more likely to engage in pro-competitive behaviour and to be more innovative, to the benefit of consumers. With this purpose in mind, the Commission has set out a number of provisions that the parties are to incorporate into their agreement if they wish to benefit from the exemption. According to the new rules, the right of the supplier to terminate the contract of distribution is further restricted. Every notice of termination of a contract issued by a manufacturer must be written and clearly state the reasons for

termination ("detailed, objective and transparent reasons").³⁷ In case the dealer contests the reasons given and asserts that they are not justified (that is because the carmaker's actual motivation is its wish to put an end to the dealer's multi-brand sales), it will be up to the national courts or arbitrators to decide. The purpose of this requirement is to prevent suppliers from terminating an agreement for reasons that are incompatible with Art.81(1) EC and which cannot be exempted. In addition, the new Regulation provides, in line with Regulation 1475/95, that for contract's termination one year's notice has to be given if a network is re-organised or if compensation is paid to the dealer, and two years' notice has to be given in all other cases.³⁸ Moreover, dealers should have the ability to transfer their rights and obligations to other dealers authorised to sell the same brand, and by that to realise the value that they have built up.³⁹ Finally, the mandatory dispute settlement method introduced by Regulation 1475/95 has been broadened in scope, now comprising all disputes about the parties' contractual obligations.⁴⁰

The likely implementation of the new rules

The new Regulation has introduced a number of substantial changes as regards the compliance of motor vehicle distribution agreements with EU competition rules. Even though these provisions are not mandatory *per se*,⁴¹ the parties, in order to avoid being confronted with Art.81(1) and (2) of the Treaty will, in most cases, comply with the exemption requirements. To benefit from the block exemption, all existing agreements must adapt to the new rules until September 30, 2003. Because of the major changes introduced by the Regulation, many suppliers have decided to reorganise their distribution network.⁴²

An appraisal of the new rules as regards to the fulfilment of their specific aims, and in particular the aim to promote the access on the part of new distribution formats to the market, is at the present stage still very uncertain. Regulation 1400/2002 quite correctly does not prescribe carmakers and retailers how they should organise their networks, so that what will be the result of the re-organisations actually in progress cannot in principle be predicted.

33 Art.4(1)(g) of Reg.1400/2002.

34 Becoming a service only outlet is expected to provide a commercial lifeline to dealers being terminated by manufacturers in light of the continuing decline in the number of dealers.

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35 Also in this respect the new rules are stricter than those of BER 2790/1999, which would not have secured any such access to independent repairers.

36 Art.5(1)(a) and (c) of Reg.1400/2002. See Recital 27 for more exempted obligations.

37 Art.3(4) of Reg.1400/2002.

38 Art.3(5)(b) of Reg.1400/2002.

39 Art.3(3) of Reg.1400/2002.

40 Art.3(6) of Reg.1400/2002.

41 See Case C-10/86 *VAG France SA v Etablissements Magne SA* (1986) E.C.R. 4071; [1988] 4 C.M.L.R. 98, ECJ.

42 See Automotive Sector Group at Houthoff Buruma and Liedekerke Wolters Waelbroeck Kirkpartick, n.8 above, at p.254.

However, it appears that at the present stage car-makers, with very few exceptions, are opting for the qualitative and quantitative selective distribution system.⁴³ The stated reason for this popular choice is that the exclusive distribution system (the other option) does not allow car-makers to control the qualitative requirements of their dealers. In fact, if car-makers can impose qualitative requirements on their exclusive dealers, they cannot prevent them from selling to independent dealers that are not required to adhere to these requirements.

This means that, choosing the qualitative⁴⁴ selective distribution system, car-makers can still be able to decide who is going to sell their products and by that refuse to sell to retailers like internet operators or supermarkets.⁴⁵ Moreover, whereas the exemption of other vertical restraints is subject to a market share threshold, there is no such limit for pure qualitative selective distribution.⁴⁶ However, if it is proven that access to the retail market, or competition therein, is significantly restricted by the cumulative effect of parallel networks of similar vertical restrictions, such as qualitative selection provisions, the Commission may decide to withdraw the benefit of Regulation 1400/2002.⁴⁷

The policy approach of the European Commission as regards qualitative selection distribution is in line with the principle set out by the European Court of Justice stating that selective distribution systems normally fall

outside Art.81(1), provided that some conditions are satisfied.⁴⁸ However, the same Court has recognised that there may be a restriction of competition where the existence of a number of such systems does not leave any room for other forms of distribution.⁴⁹ Underlying this there is the belief that even if vertical restrictions, individually taken, can be seen as efficiency enhancing means by which to organise vertical relations between undertakings, their cumulative foreclosure effect could hinder innovation of distribution formats.⁵⁰ Thus, whereas according to the Court, selective distribution, individually taken, either lacks anti-competitive effects (qualitative) or normally has a positive effect on static efficiency, in the sense that they might achieve economies in the form of the saving of transaction or distribution costs (quantitative), the wide spread employment of these restrictions could prevent the emerging of new forms of retailing and by that hinder dynamic efficiency.

From the point of view of antitrust policy, the above mentioned situation would seem to require a trade-off between static and dynamic efficiency, and this is what the UK Competition Commission has proposed to do.⁵¹ In an inquiry which stemmed originally from consumer complaints about high retail prices for cars in the UK, the Competition Commission had come to the conclusion that innovative formats of retailing, in particular supermarkets and internet based retailers, had been prevented from accessing the car distribution market essentially because every manufacturer in the sector operated the same quantitative and qualitative distribution system exempted by Regulation 1475/95. “To enable suppliers to impose their own desired standards could hinder or prevent the evolution of retailing in line with consumer preferences and deter entry by retailers with new ideas, such as the development of virtual dealerships based on use of the internet”.⁵² In view of the fact that the UK Competition Authority considered

43 *ibid.* at p.257. Under the new rules, as we have seen above, car-makers cannot cumulate selective with exclusive vertical restrictions. This means that if, e.g. suppliers want to opt for the selective distribution system, they cannot grant their dealers exclusive territories or customers’ groups.

44 Car-makers can also restrict the number of dealers belonging to the selective distribution network by imposing quantitative selection criteria, see Reg.1400/2002, Art.1(1)(g). Car-makers may limit the number of dealers, appointing one dealer meeting a qualitative selection for each territory, but these dealers are not protected from competition from other selective dealers, who may actively sell to consumers in that territory.

45 However, qualitative criteria such as for example to design retail space according to supplier directives should not be applied in a discriminatory manner, see Reg.1400/2002, Art.1(1)(h).

46 Reg.1400/2002, Art.3(1). “Genuine” qualitative selection criteria do not directly limit the number of distributors, see Art.1(1)(h). Combining qualitative and quantitative selection criteria, car-makers are subject to a 40 per cent market share threshold.

47 Art.6(1)(a) of Reg.1400/2002. The first recognition of the possible negative cumulative effect of vertical restrictions goes back to Case 23/67 *Brasserie de Haecht v Wilkin* [1967] E.C.R. 525; [1968] C.M.L.R. 26. It was recognised that the existence of many parallel networks of similar exclusive purchasing agreements can have the effect of closing-off competing manufacturers. The Court expressed the opinion that if most of the retailers on a market are tied to a specific manufacturer, it can be difficult for other manufacturers to enter the same market because the tied outlets are no longer available to the potential entrants. For this reasoning within the general competition policy on vertical restraints see the Guidelines, as n.2 above, paras 142–146.

48 See judgments in Case 26/76 *Metro v Commission (No.1)* [1977] E.C.R. 1875; [1978] 2 C.M.L.R. 1, paras 20 and 21 and in Case 31/80 *L’Oréal v PVBA* [1980] E.C.R. 3775; [1981] 2 C.M.L.R. 235, paras 15 and 16. According to the Court, having regard to the nature of the product concerned, the selective distribution system should be necessary to preserve the product’s quality and ensure its proper use. Moreover, the criteria must be objective and of a qualitative nature, laid down uniformly for all potential resellers, not applied in a discriminatory manner and not exceeding what is necessary,

49 Case 74/84 *Metro v Commission (No.2)* [1986] E.C.R. 3021; [1987] 1 C.M.L.R. 118.

50 The cumulative effect hinders in this case not so much—or not only—price competition at the distribution level, but limits the diversity of distribution formats and by that affects the quality of the offers available to consumers.

51 See UK Competition Commission, *New Cars, A Report*, n.9 above.

52 *ibid.* para.2.403.

that the reduction in the transaction and distribution costs achieved thanks to the selective distribution systems operated by car manufacturers were not extremely significant,⁵³ whereas the effects on innovation were deemed very serious,⁵⁴ the conclusion was that selective distribution of the qualitative and quantitative kind in the car sector operated against the public interest.⁵⁵ The policy recommendation was, therefore, that suppliers should have been prohibited from entering into agreements with retailers which included obligations relating to standards of presentation and facilities,⁵⁶ training, test drives and information systems,⁵⁷ advertising,⁵⁸ that is to withhold supplies on the reason that the retailer does not fulfil certain qualitative criteria.⁵⁹

The EU Commission took a different view, as we have seen above. But the fact that the vast majority of carmakers are in the progress of adopting a qualitative selective system, and by that potentially exclude innovative retailers, poses perhaps again the question, if the UK Competition Commission's solution would not have been more appropriate. In order to answer that question, though, one should inquire about the effective link between the lack of innovation and the wide-spread use of the possibility to select one's dealers. In other words, is the main reason why there was no innovation at the retail level to be seen in the cumulative effect of this vertical restriction or there might be other—and perhaps at least as serious—reasons?

If the positive and negative effects of selective distribution, as well as other vertical restraints, on static efficiency have been the subject of extensive studies, the effects on dynamic—or evolutionary—competition are much less clear. Moreover, mainstream theorising on organisation focuses on management cost reduction as the main reason of economic organisation,⁶⁰ by that

normally neglecting the dynamic perspective on the role of transaction relations in learning and innovation.⁶¹ The issue here is to try to understand *how* retail innovations emerge and which role vertical restrictions like selective distribution—and their cumulative effect—could have in the process. The question is then also about the possible impact of selective distribution on the process by which innovation of retailing emerges. In a way, what will follow could be seen as a further reflection on the possible significance of dynamic competition studies for antitrust policy.⁶²

3. The nature and the working of the innovation process at the distribution level

On the dynamics of innovation in general

Economic theorising on innovation enquires how innovations emerge, and by that the economic system develops. For a long time innovation research had pictured economic actors as perfectly rational (“all-knowing”) beings for which innovation was just a matter of a suitable research budget. Instead, recent research, starting from a more realistic picture of economic actors, considers their capabilities and their ability to imagine and learn to play a key role in the innovation process.⁶³ Thus, it is the economic agent's creativity, fuelled by his knowledge, to be seen as the source of variety that allows for the generation of novel experiments.⁶⁴

Which among the novelties brought about by different economic agents is bound to prevail depends on the mechanisms and criteria by which they are selected. Selection criteria determine in other words the kind of

53 In particular, the UK Competition Commission does not find that, given the circumstances of the UK retail car market, the free rider argument could justify the application of vertical restraints, *ibid.* para.2.209–2.300.

54 *ibid.* para.2.304.

55 *ibid.* para.2.309.

56 *ibid.* para.2.404.

57 *ibid.* para.2.408.

58 *ibid.* para.2.410.

59 See also para.2.403, “We take the view that it is for retailers to decide on standards of presentation and facilities according to their own judgments as to what is required for commercial success. To enable suppliers to impose their own desired standards could hinder or prevent the evolution of retailing in line with consumer preferences and deter entry by retailers with new ideas, such as the development of virtual dealerships based on use of the internet. We believe that to allow such developments would be likely to lead to significant reductions in distribution costs”.

60 For an overview of the impact of these studies on antitrust policy see P.W. Dobson and M. Waterson, *Vertical Restraints and Competition Policy*, Office of Fair Trading Research Paper 12, 1996.

61 Innovation is not incorporated into the analysis of economic organisation essentially because of its enormous complexity, see O. Williamson, *The Economic Institutions of Capitalism* (New York Free Press, 1985), p.141. The body of literature we will refer to in the following can thus be seen as a dynamic alternative to the main stream economics of organisation with its central focus on the impact of vertical restraints on the efficient allocation of resources.

62 For some recent contributions see J. Ellig (Ed.), *Dynamic Competition and Public Policy* (Cambridge University Press, 2001).

63 See E.S. Andersen, *Evolutionary Economics: Post-Schumpeterian Contributions* (London, 1996), for a broad review of this literature.

64 Characteristic for the entrepreneur's task is on one side the bringing about of completely new resources, that is new ways of satisfying the needs of other economic agents (such as a new technological standard), but, more often, of new combinations of resources necessary to produce a certain good, thus breaking the routines firms have fashioned to make use of resources. In doing this, either he is able to generate new ideas, or he is at least able to see new business opportunities resulting from ideas coming from outside the organisation, and gone unperceived by others.

activities to engage in, the kind of resources to acquire and the relations to establish. The relevant aspect here is the recognition that what works and what does not, and what works better than what, must be learned through actual experience and actual competition.⁶⁵

The feedback mechanism of the competition process by which innovations are generated and selected is the emergence of profits and losses according to the relative performance of the firm. Profitability is seen as the reliable indicator of which are the better alternatives and consequently of where, in the general interest, resources should be placed. The innovative firm gains profits above average for having found out before others did what the “reality” is (preferences, technological possibilities, resources and their combinations). The sanction for the less innovative firms, that is for firms using knowledge which is obsolete, is the transfer of resources from them, in the form of losses. The constant threat of incurring losses stimulates exertion. In this respect, the profit/loss feedback also has the motivational effect of keeping firms up to the work, enforcing their ability to predict and plan.⁶⁶

The last but nonetheless crucial part of the innovation process comprises the reaction by the firms which have experienced the “pecuniary external effects of competition”.⁶⁷ This reaction is very important first of all as a method by which it comes to the diffusion of the new knowledge acquired via the process of selection by way of imitation. Given the opportunity, firms react competing in activities for which resources are most easily imitated.⁶⁸ The second possibility of reaction for the other firms is being creative themselves, even if it is only in the way one imitates, thus stimulating further developments.

65 This is not basically different for technological innovations. Technological solutions always reach beyond the range of options that are perfectly understood, or which can be reliably tested, and in that sense are somewhat blind.

66 Of course, superior profits may at times be undeserved, merely due to a run of luck, or because of the fact that consumers, possessing fallible knowledge, have made wrong decisions; these events could also have long lasting consequences because of a “rolling snowball mechanism” or “network effects”, see Giovanni and Dosi and R.R. Nelson, “An Introduction to Evolutionary Theories in Economics” [1994] *Journal of Evolutionary Economics*, pp. 153–172, at p.167 *et seq.*

67 M.E. Streit and G. Wegner, “Wissensmangel, Wissenserwerb und Wettbewerbsfolgen—Transaktionskosten aus evolutorischer Sicht” [1989] *ORDO* 183, p. 195.

68 The possible impediments to the imitation of resources are the object of study within the so called resource based theory of the firm, see for an in-depth analysis K.R. Conner, “A Historical Comparison of Resource-Based Theory and Five Schools of Thought Within Industrial Organisation Economics: Do We Have a New Theory of the Firm?” [1991] 17 *Journal of Management*, pp.121–154.

The innovation of retail formats: horizontal and vertical dimensions

The process of innovation we dealt with so far implicitly considers a single market. Firms come up with different hypotheses (products, services) about the best way to satisfy end users’ needs and the end users concerned choose among these offers, thus rewarding or penalizing firms according to their relative performance. By way of the profits/losses feedback, knowledge is diffused and firms motivated to try out new hypotheses. Now, when more than one firm is involved in the production and distribution of a single good—as is indeed normally the case—the activities performed by different economic subjects are sort of “bundled together” into the product or service offered to consumers (end users). Interrelated organisations, in other words, are involved in creating and delivering products and services to end users.

The mechanism by which it comes to a specific bundle of activities, and to many different bundles being offered in the same market can be described as basically the same trial and error process we have seen above.⁶⁹ Hence to concentrate only on the end part of the chain, producers select among the distribution services offered by heterogeneous retailers,⁷⁰ and retailers choose among the differentiated products available in the upstream market. Both producers and retailers are thus at the same time selectors and objects of selection. In this respect, retailers are often compared to *gatekeepers*, since they decide which products consumers will be able to choose from.⁷¹ The bundle (product plus retail service) is then offered to the consumers, who decide about its attractiveness relative to competing offers. In the course of this process, novelties are generated both at the production (new, differentiated products) and at the distribution (new, differentiated retail services) level, and reciprocally selected.⁷²

It is by this very mechanism of variation and selection,

69 For a detailed explanation of the working of evolutionary competition processes when more than one market is involved see W. Kerber, “Evolutionäre Wettbewerbsprozesse über mehrere Wirtschaftsstufen: Das Beispiel Industrie—Handel—Konsumenten” [1991] *ORDO* Bd. 42, pp.325–349.

70 That retailers do not conform to the picture of homogenous resellers divulged, among others, by the Chicago School is a fact hardly disputed in the more recent economic literature, see P.W. Dobson and M. Waterson, *Vertical Restraints and Competition Policy*, n.60 above p.13.

71 See London Economics, *Competition in Retailing*, Office of Fair Trading Research Paper No.13, 1997, p.31.

72 There is indeed a growing number of industrial marketing studies devoted to explaining the evolution of distribution formats in terms of market dynamics, see J. Narus and J. Anderson, “Rethinking Distribution—Adaptive Channels” [1996] *Harvard Business Review*, pp.112–120; A. Dubois, L.-E. Gadde and L.G. Mattsson, “Activity Structures in Distribution: A Framework for Analysing Efficiency” in Ghauri, P. (Ed.), *Advances in International Marketing* (JAI Press, Cambridge, 1999), Vol.9,

therefore, that novelties in retailing emerge and are selected in the market, both by the producers and the consumers. Essential for the efficient functioning of this innovation generating mechanism is, as we have seen above, that the feedback mechanism works properly. Thus retailers should be rewarded, both by the producers and the consumers, if their innovation format is better than the other ones being operated; retailers employing less innovative formats should suffer an economic loss, and this stimulates their reaction, either by imitation or by bringing about something new.

But innovations in retailing very often are not just new, better ways of performing one's function relative to direct competitors: they are better ways of combining producers/retailers resources. Retailers may overtake functions previously exercised by producers as in the case of products branding, or producers' functions previously exercised by retailers, an example here may be shelf replenishing. Changes in the relationship with the producers can best be thought of, in this respect, as an experimental search and learning process to discover possibilities for improvements in efficiency through a better bundling of their respective resources. More generally, it is the process of integration and disintegration itself that can be thought of in these terms.⁷³

Thus, thanks to vertical arrangements between manufacturers and retailers, alternative ways of combining their respective resources can be tried out and better, more efficient combinations discovered. The parties can for example find out that it is better, more efficient, if it is the distributor that explains to the consumers the intrinsic characteristics of the product and the distribution format is modified accordingly. In this respect, innovations in retailing can have either a horizontal or a vertical dimension, depending on whether they result in a direct improvement of the distributor's performance relative to his competitors or in a better combination of his resources with the manufacturers'.⁷⁴

There is indeed a very considerable and rapidly growing literature on the importance of vertical relations as a way for discovering better ways of bundling firms' resources.⁷⁵ The starting point is the belief that

what activities a firm engages in and how it distributes activities between itself and outside partners depends on considerations concerning its survival in the market. Central to this approach is the understanding that very important for survival in dynamic competition is the firm's concentration on its core competencies. These are commonly depicted as firm's specific combinations of complementary⁷⁶ resources drawing on the same capabilities,⁷⁷ which underpin its productive activity. Firms then have to fall back on other institutions like vertical arrangements to get access to complementary assets of the firms which draw on different capabilities and reach a qualitative co-ordination of their activities. Organisational arrangements must thus be devised to provide for the future availability of products complementary to its own, highly specific to the requirements of the firm (not general in demand).⁷⁸

Summing up, innovations in retailing emerge as the result of competition processes involving more than one market along a vertical chain. Retailers try to improve their performance relative to their direct competitors by changing their business formats, that is by modifying the level and quality of retail service, and producers and consumers choose among them according to their needs (preferences). In this respect, innovations of distribution formats emerge because of the existence of competition among retailers, both in their capacity of buyers and of

76 Two activities are complementary when the marginal benefit of being able to change one activity is larger the higher the frequency of change of the other activity.

77 G.B. Richardson, "The Organisation of Industry" [1972] *Economic Journal*, Vol.82, p.883, at p.888, refers to capabilities as to knowledge, expertise and skill.

78 Vertical arrangements can go even a step further. Not only do they allow for qualitative co-ordination and, through the continuous interaction of the parties, for the discovery of better combinations of resources, but they might even be the means by which genuinely new resources are discovered. Many authors explain the generation of much of modern technology by pointing to the existence of vertical arrangements allowing for the discovery of new combinations of resources or new resources. It is in fact increasingly the case that technological innovations do not stem from a single firm, but are the results of a work accomplished by several firms placed at different stages of the "innovation pipeline", which combining their resources (technologies, capabilities) have been able to create and implement novelties, that is new combinations of resources or genuinely new resources. On the other hand, radical innovations could be facilitated by active central direction because of the need to control for the strong interdependencies which characterise complex problems, see L. Marengo, "Decentralisation and Market Mechanisms in Collective Problem-Solving" DRUID's Summer Conference, 2000, p.4. In more general terms, this leads one to view "the generation of capabilities as dependent on the division of labour in the generation and exploitation of knowledge and on the particular methods for co-ordinating the division of labour", see R. Coombs and S. Metcalfe, *Distributed Capabilities and the Governance of the Firm*, CRIC Discussion Paper No.16. Centre for Research on Innovation and Competition (CRIC), University of Manchester, UK, 1998, p.14.

pp.43-62; A. Nyberg, *Innovation in Distribution Channels. An Evolutionary Approach* (EFI, Stockholm, 1998).

73 See V. Mahnke, "The Process of Vertical Dis-Integration: An Evolutionary Perspective on Outsourcing" [2000] *Working Paper Series, Department of Industrial Economics & Strategy, Copenhagen Business School*, p.8.

74 Of course, an innovation in retailing can have both dimensions, as when a distributor is able to improve his "horizontal" performance relative to his competitors just because he recognises synergies with the manufacturer's resources gone unperceived by others.

75 Reference is made here again to researches stemming out of the resource based theory of the firm, see n.68 above.

sellers. But we have also seen that innovations in retailing can be the result of vertical arrangements between manufacturers and distributors thanks to which new combinations of resources are discovered.

On the whole, there can be many reasons why the process of innovation of distribution forms does not work properly. High concentration on the retail market could be one of the reasons,⁷⁹ as well as rigidities in the capacity of retailers to bring about novelties, due, for example, to routine dependency in response to very uncertain environments.⁸⁰ In the following we will try to enquire the specific role selective distribution could have, that is to verify, elaborating on current literature, the impact of these vertical restraints on the process by which innovations emerge and diffuse throughout the system.

4. On the possible effects of selective distribution arrangements on the innovation process at the distribution level

We have seen in the previous section that the process by which innovation of distribution formats emerge can be considered as one of the competitive processes taking place on the market. Thanks to it, new, specific knowledge is created about the best way to satisfy consumers⁸¹ and manufacturers' needs. In the following we will try to enquire about the possible role that selective distribution arrangements of a qualitative kind could play in the process: do they foster or hinder this competitive process by which new, better, distribution formats are discovered?

What emerges from the economic literature on innovation is that there can be *dynamic* reasons to introduce vertical restrictions. First of all, attention has been

devoted to the fact that a key element of innovation creating arrangements (that is research and development projects) is to have a cognitive distance that fosters learning between the parties, without hindering communication. Condition for this is that parties invest in mutual understanding for crossing "cognitive distance", but at the same time keep distant enough so that from their relation something new can emerge.⁸² Learning to acquire the suitable cognitive distance requires some time and closeness, so that, for example, exclusivities might be necessary. Market-like incentives might in fact produce destructive effects on the learning and co-operation activities which determine the firm's long term performance.

Moreover, innovation might also need some stabilising circumstances.⁸³ For example, in very innovative environments vertical restrictions like exclusive distribution (distributor is assigned exclusivity over a geographical area or over a particular class of consumers or goods) can mean an important reduction in vulnerability. They provide a degree of stability, foresight, which favours planning—a firm bringing about a new distribution format will expect it in due course to be superseded, but know that it will take time to displace it.

A similar explanation points to the fact that vertical restraints can also protect against knowledge leakage. They provide for private firm knowledge not to be exposed to too rapid obsolescence. This protection becomes relatively more important when competitors are likely to command requisite "absorptive capacity" that makes imitation a viable competitive threat. Instead, it is of minor relevance due to a rapid obsolescence of capabilities in a world of radical speed of change, because, in that case, the specific knowledge is obsolete by the time that it reaches a competitor and can be embodied in products or retail services and brought to the market.⁸⁴

For what concerns in particular qualitative selection arrangements, a dynamic explanation can be presented in the following terms. The innovation of one's performance often requires changes in complementary resources which are under the control of economic agents belonging to different stages of production. The problem can be also formulated in terms of the necessity of an innovation to fit into a "context of use" in order for it to be efficiently exploited, that is, specific systems of use,

79 See W. Kerber, "Evolutionäre Wettbewerbsprozesse über mehrere Wirtschaftsstufen", n.69 above; W. Kerber and N.J. Saam, "Competition as a Test of Hypotheses: Simulation of Knowledge-Generating Market Processes" [2001] *Journal of Artificial Societies and Social Simulation*, Vol.4, No.3.

80 The more uncertain the environment, the more firms tend to engage in activities in which they are already competent, thus exploiting past knowledge for successive refinements rather than venturing in risky exploration. In the economic literature, this is known as the problem of "path dependency".

81 In this respect, the retailers' role is very important. Being normally closer to consumers than the manufacturers, they can find out circumstances of time and space that, possibly, would not have been found otherwise. See for the understanding of competition as a discovery process F.A. von Hayek, "Economics and Knowledge" [1937] *Economica* 4, pp.33–54 and, by the same author, "Der Wettbewerb als Entdeckungsverfahren", in *Freiburger Studien* (Tübingen 1969, Mohr).

82 B. Nooteboom, *Learning and Innovation in Organisations and Economics* (Oxford University Press, Oxford, 2000), p.72.

83 G.B. Richardson, "Evolution, Structure and Strategy" paper produced for the Druid's Nelson and Winter Conference, 2001, p.11.

84 See B. Nooteboom, "Innovation and Inter-Firm Linkages: New Implications for Policy" [1999] *Research Policy*, 28: 793–805 with reference to product innovation.

production and distribution need to be developed for the purpose.⁸⁵ Thus, some changes in a product's characteristics, for example, might require retailers of that product to modify the way they perform their activities. Changes must be co-ordinated between different economic agents, implying dynamic transaction costs of informing and persuading suppliers to cooperate in changing their activities.⁸⁶ These costs can be high, especially when the environment is very turbulent. In this case, *vertical leadership*, implying vertical restraints like obligations for the retailers to conform to the supplier's *changing* market image, could help keeping these costs low.

Even more important, perhaps, is that *selection as such* is vital for the good functioning of the competition process. In this respect, producers should be able to pick out what they think is the most suitable distribution service among the ones offered by different retailers, and by that stimulate dynamic competition at the retail level.⁸⁷

One could argue, though, that leaving retailers free to decide how to sell manufacturers' goods, that is totally banning qualitative vertical restraints, is the right solution if the goal is the promotion of innovation in the retail sector.⁸⁸ In that case, it would be totally for the consumers to decide if they like a distribution format or not. On the other side, as we have seen above, innovation in retailing very often is not only about discovering and fulfilling consumers' needs, but about finding new, better ways of combining producers' and retailers' capabilities (resources).⁸⁹ For this competition process to work, suppliers should be able to exercise their subjective choice as to which retailers they decide to supply.

If the freedom by the manufacturer to decide to whom to sell its goods is a key element assuring the functioning of the competition process by which innovations in retailing emerge, the same does not seem to apply to the obligation on the side of the selected retailer not to sell to unauthorised retailers. The fact that selected dealers are not allowed to sell new cars to unauthorised resellers could exercise a major constraint on their growth

potential and therefore on their capacity to act innovatively on the retail market.⁹⁰ The possibility for unauthorised dealers to be supplied by members of the official manufacturer's network would also encourage experimenting of independent retail services, from which the carmakers will be able to choose in the future. The sale to unauthorised dealers should nevertheless provide that they comply with minimum "technical" standards, such as for example regarding cars' safety,⁹¹ that is standards which are different, objective (and much less demanding) than the qualitative criteria which inform manufacturer's choice of the members of its own retail network.

In this respect, the requirements set out by the Court of Justice⁹² that:

- the selective distribution system should be necessary to preserve the product's quality and ensure its proper use;
- the criteria must be objective and of a qualitative nature, laid down uniformly for all potential resellers;
- the criteria should not be applied in a discriminatory manner; and
- should not exceed what is necessary

appear problematic from an evolutionary perspective. For once, the Court's requirements seem to be too stringent as applied to the manufacturer—dealer relationship (the carmaker should be able to choose whoever he *thinks* to be suitable for the purpose) and too broad as applied to the authorised dealers—not authorised dealers relationship (only the obligation to comply with minimum, technical standards seems appropriate).

Summing up, we have seen that there could be dynamic explanations of vertical restraints, that is explanations pointing at their positive effects on the process by which innovations emerge. This applies in particular to the restriction of the carmakers' supplies only to approved dealers. We have also seen that, in order to stimulate the innovation process at the retail level, it could be advisable that authorised dealers be free to sell also to unauthorised retailers, provided that

85 See B. Nooteboom, "Uncertainty, Cognitive Distance and Discovery" in *Uncertainty in Economic Decision Making: Ambiguity, Mental Models and Institutions* (K. Nielsen ed., 2002, Cheltenham: Edward Elgar).

86 R. Langlois and P. Robertson, *Firms, Markets and Economic Change* (Routledge, London, 1995), p.35.

87 Also the binding of sale with service could seem to make economic sense, because of cross-fertilisation of knowledge between selling and repairing.

88 See above, at pp.174 *et seq.*

89 See above, at p.177.

90 Approved dealers should also in principle be kept free to experiment their own ideas, also when what they intend to do varies from carmaker's official line, as long as this does not prejudice the interests of the network as a whole.

91 Comprising *inter alia* a basic mechanical knowledge.

92 See n.48 above.

these last resellers comply with minimum, strictly technical requirements.

5. On the complexity of the dynamic assessment of vertical restraints

So far, we have considered qualitative selective distribution obligations in a sort of *vacuum*, that is separate from other vertical restrictions the same distribution arrangement may provide for. But an in-depth antitrust assessment should consider the entire “bundle” of obligations at once. In fact, a combination of vertical restraints could be more—or less—problematic than each vertical restraint individually taken.⁹³ Other vertical restraints may in fact also have an impact on the competition process by which new forms of retailing emerge. For example, full-line forcing can restrict entry by undertakings which wish to specialise in more limited product ranges, whereas quantity forcing can prevent entry by small-scale retailers, who may happen to be more innovative than established resellers.

Moreover, as we have seen above, essential for the efficient functioning of this innovation generating mechanism is that the feedback mechanism works properly. The profits/losses feedback is very important so that parties (firms) can realise which hypotheses are the better ones (information function)⁹⁴ and also get motivated/forced to produce better ones (motivation function). It follows that in order for the innovation process to work, it is very important that suppliers, and not only consumers, are able to choose between different distribution formats, because in this way they reward retailers for their innovative efforts. Retailers should be rewarded both by the producers and the consumers, if their innovation format is better than the other ones being operated; retailers employing less innovative formats should suffer an economic loss, and this stimulates their reaction, either by imitation or by bringing about something new. Accordingly, suppliers should not be prohibited from entering into agreements that give retailers an advantage because they provide peculiar, innovative services, for example facilitating the suppliers’ tasks and reducing their costs. An inappropriate application of the discrimination prohibitions, that are part of most antitrust legislations, could therefore run

the risk of hindering the good functioning of the sanction/reward mechanism.⁹⁵

At least as important is that undertakings wishing to try out their ideas on the market are able to find sufficient undertakings in the upstream market at least *willing to consider* the supply of goods, possibly not discontinuing the supply to more traditional formats. At the stage of experimentation, existing linkages between economic agents can in fact provide obstacles for firms willing to try out new combinations of resources, and less incentives to do so. So when most of the manufacturers are tied to specific retailers, the innovating distributor can find it very difficult to experiment his idea of new resource combinations. This would seem to speak *against* long time contracts between manufacturers and distributors, and *in favour* of relatively easy rules for termination of existing contracts. In light of this, the obligation contained in the Regulation that a supplier who wishes to terminate a dealer agreement must give detailed, objective,⁹⁶ and transparent reasons in writing could appear too strict. Besides, if distributors are truly *selected* in view of their own, already existing qualifications, the sunk costs arguments in favour of dealers’ protection could become less relevant.⁹⁷

Also, an appropriate assessment of vertical restraints from a dynamic or evolutionary perspective should comprise the analysis of the impact of vertical restrictions on the competition process on the upstream market, that is, in our case, the carmakers’ market. Thus, for instance, full-range forcing, that is the obligation by the dealer to push all sorts of models without being able to choose among carmaker’s products, could have both a negative and a positive impact on products’ innovation. On the one side, in fact, it could be argued that, because of full-range forcing, carmakers are protected by their dealers’ direct pressures to provide for the best possible products and that consumers’ are not objectively informed by the dealer about the best models available. On the other side, the supplier, given the substantial costs and risks involved in developing and

93 See also Guidelines, n.2 above, at para.119(6).

94 Since an entire bundle of hypotheses is tested at the same time, it can be difficult for the firm to know exactly which performance was especially good or successful.

95 See W. Kerber, “Evolutionäre Wettbewerbsprozesse über mehrere Wirtschaftsstufen”, n.69 above, p.336.

96 The question as to whether or not it is necessary to reorganise the network should be broadly considered a subjective one, because it may depend on reasons that the manufacturer might not be able to explain, pertaining to his intuitive assessment of a competitive situation or of specific dealer’s characteristics.

97 Moreover, if the supplier cannot expect the retailer to invest much in his undertaking, this would mean that the supplier will be forced to select the retailer that, by its nature, without major investments, provides the service the manufacturer is looking for.

manufacturing new models, could need guaranteed outlets for its products, otherwise he would be less innovative.

From what we have just seen, some more general reflections about antitrust law could now be formulated. As it is well known, the economic theories by which this body of law is informed pay a great attention to the negative impact of economic agents' decisions on the allocation of present resources, but fail to realise how such decisions could influence the process by which innovation is generated. Surprisingly, though, relatively few efforts have been put into trying to re-orient competition policy so as to embrace a more dynamic perspective.⁹⁸ The fact that the functioning of competition as a discovery procedure is very complex, and only partly understood, has certainly been influential in keeping endeavours in this direction scarce. Recent economic theorising on innovation could well give decisive impulses to its long-awaited process of "modernisation" of antitrust law.

In particular, elaborating on the more recent economic literature on innovation and related studies, we have seen that, on the one side, economic agents facing the important task of bringing about new ideas face problems that not even the transaction costs framework is able to capture. Not being able to grasp, because of its static stance, innovation based co-ordination problems, antitrust policy could run the serious risk of ending up prohibiting practices which are instead beneficial for competition.⁹⁹ On the other side, vertical restraints could hamper dynamic competition processes in ways that the static analysis is unable to reveal. Therefore, it seems appropriate to conclude that the dynamic—or evolutionary—appraisal of vertical restraints, in spite of its undeniable complicated nature, should deserve a central role in antitrust law.

6. Conclusions

Despite the complexity of the required assessment of vertical restrictions in evolutionary terms, and the unli-

keness of clear cut policy solutions,¹ it appears that the dynamic appraisal of vertical restraints should play a major role in antitrust analysis. At least, it should come to complement the more static assessment that results from the EU Commission general policy approach on vertical restraints. From what we have seen above, the following indications for competition policy in the EU car sector could follow.

The innovation of retail formats has been presented as the result of a complex process, involving more than one stage of the production and distribution chain. It involves three basic steps, that is the experimentation of new ideas, their selection, and the provision of a reward/sanction mechanism fostering innovation and/or imitation. For this process to work in a satisfactory way, all of these steps are equally important. Thus, for example, selection without real choice, because of the homogeneity of the options available, does not produce actual innovation.

From the above consideration, we have been able to draw the following conclusions.

First, the carmakers' freedom to select the retailers whom to sell cars has appeared very important in order to stimulate the competition process by which new retail formats emerge. This freedom should not be subject to any third party's (as for instance a Court's) assessment as to the appropriateness of the choice given the nature of the product or the carmakers' overall marketing policy. This should include the possibility by the manufacturer to price retailers differently, according to the specific service they are able to provide.

Secondly, and conversely, because of the need to assure the heterogeneity of the offers available, there are reasons to consider the authorised dealers' obligation not to sell to unauthorised retailers problematic from an evolutionary point of view.

Finally, we have noticed that existing linkages can be an obstacle to the process of experimentation of new ideas, and therefore short term contracts and not too burdensome termination rules should be encouraged.

⁹⁸ See H. Arndt, *Schöpferischer Wettbewerb und klassenlose Gesellschaft* (Berlin, 1952); E. Hoppmann, *Wirtschaftsordnung und Wettbewerb* (Baden-Baden, 1988) and W. Kerber, *Evolutionäre Marktprozesse und Nachfragemacht* (Baden-Baden, 1989), for some important exceptions.

⁹⁹ See T.M. Jorde and D.J. Teece, *Antitrust Policy and Innovation: Taking Account of Performance Competition and Competitor Co-operation* [1991] *Journal of Institutional and Theoretical Economics* 147, pp.118–144.

¹ This could offer an opportunity to meditate anew on Friedrich A. von Hayek's well-known assertion that "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design", in *The Fatal Conceit: The Errors of Socialism* (W.W. Bartley III ed. 1988, Chicago: University of Chicago Press).