

DISTRIBUTION AGREEMENTS IN THE DIGITAL ECONOMY – A COMPETITION LAW'S PERSPECTIVE

Sarah Legner

Law School, EBS University of Business and Law, Gustav-Stresemann-Ring 3, 65189 Wiesbaden, Germany

Abstract

New market players and novel forms of vertical restraints of competition have emerged in the digital economy. With the rise of intermediary platforms, the distribution of functions and power structures in sales have shifted. A clear differentiation between horizontal and vertical restraints has become more difficult. Further, novel forms of vertical restraints of competition, including restrictions on online selling and price parity clauses, have appeared. This paper presents the challenges these developments pose for the evaluation of distribution agreements under European competition law and explains their economic background. It assesses the solutions the European legislator provides in the recently adopted Vertical Block Exemption Regulation from June 2022.

Keywords: *distribution agreements, cartel prohibition, digital economy, e-commerce, intermediation services, restrictions on online selling, price parity clauses*

1. INTRODUCTION

In Europe, the digital economy has experienced steady growth in recent years. Today, the European Union is one of the largest e-commerce markets in the world. The percentage of people that have ordered goods or services via the Internet has grown annually [1]. The rapid development affects both consumers and businesses. Digitalisation has changed the production and sales conditions. Internet sales offer important advantages. These include lowering transaction costs and increasing reach. Market information is also more accessible, for example through price comparison services and search engines [2]. Notwithstanding this, new threats to competition have arisen. As a result of greater transparency, coordination and control tend to be easier. Novel forms of vertical restraints of competition are being observed. New market players have entered the scene with intermediary services [3]. Against this backdrop, this article aims to address crucial challenges for upholding free competition in the e-commerce sector. It seeks to evaluate the direction European policy is heading towards, especially by assessing the solutions presented in the revised Vertical Block Exemption Regulation from June 2022 [4].

The paper first provides an overview of the evaluation of distribution agreements under the cartel prohibition laid down in Article 101 of the Treaty on the Functioning of the European Union. It explains the function and the structure of the Vertical Block Exemption Regulation. Second, it discusses challenges posed by modern technology in e-commerce. Third, new business models are considered, focusing on intermediation services and dual distribution. Finally, new forms of vertical restraints on competition are presented. These include restrictions on online selling, dual pricing as well as price parity clauses. This paper discusses difficulties in assessing these restraints under competition law and offers solutions by reviewing the approaches in the revised Vertical Block Exemption Regulation. The paper ends with conclusions.

2. DISTRIBUTION AGREEMENTS IN THE CONTEXT OF THE EUROPEAN CARTEL PROHIBITION

2.1. Ambivalent nature of distribution agreements

Distribution agreements may violate the cartel prohibition laid down in Article 101 of the Treaty on the Functioning of the European Union (hereinafter referred to as “TFEU”). Agreements between

undertakings which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market are prohibited and void. Article 101 TFEU applies equally to horizontal and vertical agreements. While horizontal restraints refer to collusion between competing companies, vertical restraints of competition are based on agreements between firms at different levels of the economy [5]. Resale price maintenance, exclusive distribution, export bans, and non-compete obligations are common examples of vertical restraints.

The competitive nature of vertical agreements has long been ambivalent. Although the cartel prohibition does not differ between horizontal and vertical agreements, the conditions under which they restrict competition are in fact different. In broad terms, vertical agreements tend to be less anti-competitive. An individual vertical agreement regularly restricts the competitive freedom of action of only one company at a time [6]. In addition, distribution agreements may potentially generate efficiencies [7]. They can contribute to the solving of vertical and horizontal externalities [5]. In particular, double marginalisation can be avoided. The problem behind double marginalisation is that when both supplier and retailer add mark-ups to their costs, this "double mark-up" leads to inflated market prices [5]. This is because each company, when determining its price markup, does not adjust what impact its decision has on the profit of the other company. For example, when setting the purchase price, the retailer takes into account that a price increase may result in a decrease in the quantity sold. However, he does not consider that the decrease in volume reduces the producer's profits [8]. Furthermore, distributions agreements can make it easier for distributors to enter new markets [5]. If the supplier grants the distributor territorial protection, it will be easier for him to recoup its investment. Restrictions on online sales in form of dual pricing may also help eliminate free riders. They may ensure that retailers continue to operate their cost-intensive brick-and-mortar stores alongside online retailing [9]. Without price maintenance, retailers could try to entice away customers who have sought advice from competitors in local stores by offering more favourable prices in online retail.

However, distribution agreements can also lead to market foreclosure by raising barriers to entry [5]. This mainly depends on the market power of the involved undertakings [10]. If a powerful manufacturer bundles a substantial proportion of demand through exclusive purchasing obligations, new competitors will find it difficult to enter the market [11]. This diminishes inter-brand competition, i.e., competition between products of other manufacturers. Furthermore, distribution agreements can facilitate collusion amongst competing retailers or competing suppliers and give rise to horizontal concerns [5]. Softening of competition is also possible. Incentives for aggressive behaviour may be prevented by restrictions on intra-brand competition, for example by resale price maintenance. A manufacturer that imposes price restrictions tends to reduce competition between retailers of the same brand [7] [12]. Such restrictions may also lead to a reduction of inter-brand competition [13]. This is especially true when price maintenance is used to mask a cartel at the manufacturer level.

2.2. Assessment under Article 101 TFEU

Although vertical agreements fall in the scope of the cartel prohibition, the European courts and the European Commission take the ambivalent character of vertical restraints into account in their competitive assessment. Their evaluation is based on the goals of antitrust law. While the initial focus was on protecting the freedom of the competitive process, European antitrust practice also recognizes consumer welfare as an additional goal by now [14]. Consumer welfare is increased by lowering prices. In static terms, this can be visualized by the concept of consumer surplus, which is measured by the difference between the consumer's willingness to pay and the price she actually paid. In the long term, consumers also benefit from research and development, for instance if it leads to a higher quality or greater variety of products and services.

The goal of consumer welfare becomes particularly clear in the context of the exemption requirements laid down in Article 101(3) TFEU since they are related to an effects-based analysis. Agreements may be exempted from the ban if they contribute to improving the production or distribution of goods or to promoting technical or economic progress. Importantly, consumers must be allowed a fair share of the resulting benefit. Finally, the agreement must not impose unnecessary restrictions or aim to eliminate competition for a substantial part of the products concerned. Rather than exemptions being granted on a case-by-case basis, they are usually covered by the Block Exemption Regulations. Block Exemption

Regulations substantiate the undefined legal concepts in Article 101(3) TFEU. For distribution agreements the exemption conditions are specified in the Vertical Block Exemption Regulation (hereinafter referred to as "VBER") [4]. It intends to create a "safe harbour" for companies by establishing binding rules for agreements where pro-competitive effects typically outweigh restrictive effects. This is practical for the companies involved since the burden of proof lies upon them, and the Commission usually sets high standards. Within the scope of the Vertical Block Exemption Regulation, restrictions of competition in vertical supply relationships are in principle exempted from the ban on cartels, unless they are among the particularly severe restrictions listed in the regulation, see Article 2(1) VBER. If neither party's market share exceeds 30% (Article 3 VBER), vertical agreements, which do not contain any hardcore restrictions (Article 4 VBER) or excluded restrictions (Article 5 VBER), benefit from an exemption. Agreements which do not satisfy the VBER conditions may still be compatible with Article 101(1) TFEU, but these agreements require individual assessment under Article 101(3) TFEU. In addition, the European Commission has issued Vertical Guidelines [5]. They aim to help companies self-assess whether their agreements are covered by the VBER or may qualify for an individual exemption pursuant to Article 101(3) TFEU. They contain guiding principles as well as important examples of hardcore restrictions and excluded restrictions. Both the VBER and the related Vertical Guidelines have been amended in June 2022 [4] [5]. The previous version of the VBER from 2010 [15] did not yet take particularities in the digital economy into account. As will be described later, it was no longer suitable for conveying legal certainty under changed economic conditions.

Besides the mentioned goals of freedom of competition and of consumer welfare, the Vertical Block Exemption Regulation (the outdated as well as the current version) exemplifies that the ban on cartels aims to realize a unified internal market [16]. This is why European courts and the Commission have also been concerned with a reduction of intra-brand competition. Exports bans or territorial protection primarily only effect competition between retailers of products of the same brand. However, they may divide the European single market. Consequently, resale price maintenance is rated a non-exempt hardcore restriction pursuant to Article 4(a) VBER.

3. NEW TECHNOLOGY IN THE E-COMMERCE SECTOR

Assessing distribution agreements in the e-commerce sector under the European cartel prohibition faces several difficulties. One arises from the increased use of modern technology for communication and monitoring. Especially computer programs and algorithms are increasingly used for price coordination in the distribution chain [2]. This also applies to resale price maintenance, which is prohibited as a hardcore restriction according to Article 4(a) VBER. A price monitoring software is used to observe retailers' price setting, such as in the Pioneer case of the European Commission [17]: An electronics company used software to control the online prices of its retailers. It was able to intervene quickly when sales prices declined. By using the price monitoring software to find out who was the retailer responsible for lowering prices and who was only following that retailer by adjusting prices, the company was able to target the responsible retailer. This prevented price erosion in the entire retail sector.

Nevertheless, the mere use of software does not affect the basic concepts of vertical restraints of competition and the VBER. In this respect there is no need to adapt the antitrust rules. In the new Vertical Guidelines from June 2022, the European Commission clarifies that the bare use of a price control software does not breach antitrust law but can facilitate the implementation of prohibited agreements and increase their anticompetitive effects [5]. A different assessment may be required concerning the use of algorithms that independently adjust prices. In this regard it may indeed be questionable whether there is a prohibited agreement or a concerted practice at all. However, this primarily concerns the concept of prohibited conduct and not the assessment of vertical restraints. This paper therefore does not go into this in detail.

4. NEW BUSINESS MODELS IN THE E-COMMERCE SECTOR

4.1. Online intermediation services

Another challenge is the new role of online intermediation platforms such as online marketplaces or booking portals in distribution channels. Online intermediation services have gained significant economic and social importance over the last years. Platforms are generally neutral intermediaries that coordinate external transfers of products and services between platform users [5]. Platform markets are typically two-sided. They bring at least two user groups together and enable interactions between them. For instance, on the one hand, a service provider for the mediation of travel services turns to the potential travellers who demand travel services, and on the other hand to the providers of travel services, e.g., airlines, hotels, who place these services in the system. In this context, there is often a one sided cost distribution. The group of travellers may be able to use the travel portal free of charge, while the group of providers bears the costs and profit of the portal operator. Indirect network effects are characteristic for intermediation platforms. They occur when the benefit of a platform for at least one user group depends on the presence and size of the other user group. [18]. These network effects give platforms enormous market power. While several providers may compete in the beginning, the balance will often tip in favour of one provider, as it is ultimately more advantageous for all users to find all other users on one platform, at least if multiple presences do not seem practicable.

The concepts developed for vertical agreements in the stationary environment do not easily fit the business models of online platforms. This also applies to the legal framework of the outdated version of the VBER which was built on classic two- or three-tier distribution systems. The platform operator cannot be clearly assigned to the role of "supplier" or to that of "buyer". The distribution of tasks in online sales is different. Platforms take on functions that lie at the interface between production and sales [19]. Nevertheless, the level at which platform operators are placed in the distribution chain determines whether agreements they have concluded with other companies qualify as vertical agreements. In addition, some platform operators have a hybrid function. They do not only offer intermediary services online but also act as retailers themselves by offering products or services through their own platform [20]. Hybrid platforms may use their position as intermediaries to determine the conditions of resale at the merchant level [5].

In the revised version of the VBER from June 2022 the European legislator provides for meaningful solutions. Article 1(1)(d) VBER states that a provider of online intermediation services is categorised as supplier in respect to those services while a firm that offers or sells goods or services via online intermediation services is categorised as a buyer in respect to those online intermediation services. Hence, the regulation now recognizes that agreements for the provision of online intermediary services are vertical agreements and can in principle benefit from the exemption under the VBER. Accordingly, the following must be considered when examining whether an agreement with platform operators is exempt from the cartel prohibition. For the exemption laid down in Article 1(1) of the VBER to apply to vertical agreements between intermediary services and providers, the double market share threshold of Article 3 of the VBER must be met. The intermediary platform must also not hold a market share of more than 30% of the relevant market in order to fall within the scope of the VBER. In view of the multi-sided structure of platform markets, market delineation and the subsequent calculation of market shares however regularly cause difficulties [21]. In this respect, the application of the new rules will remain subject to uncertainties. In addition, the vertical agreements that a platform operator concludes with its merchants must neither contain hardcore restrictions nor exempted restrictions. In this respect, the new hardcore restriction for online trading in Article 4(e) of the VBER, and the new provisions on broad (Article 5(1)(e) VBER) and narrow (Article 6 VBER) price parity clauses will come into play. They will be addressed below.

Excluded from the exemption are providers of online intermediation services if they have a hybrid function, see Article 2(6) VBER. This includes platform operators who are themselves active as retailers, i.e., they compete with their retailers for their customers at the same time. In contrast to classic constellations of dual distribution, the platform operator does not compete at the downstream market level regarding products that it has supplied at the upstream market level [19] [20]. Rather, it provides intermediary services at the upstream market level. The exclusion of hybrid platforms seems convincing

since they create risks of horizontal collusion. Due to their enormous market power on the upstream market, platform operators may leverage their dominance into the downstream market.

4.2. Dual distribution

In the e-commerce sector other manufacturers who are not hybrid platforms also sell their products directly to end customers. This is referred to as dual distribution. As a result, manufacturers can be in a competitive relationship with their retailers at the downstream level of the market. Already the outdated version of the VBER clarified that this does not prevent the application of the regulation, provided that the distributors do not act as competitors of the supplier at the upstream level of the market. However, since direct sales by manufacturers are steadily increasing, it can no longer be assumed that restrictions on competition between direct-selling manufacturers and distributors have only minor impact on market activity [1]. In online distribution it has become easier for manufacturers to reach end customers directly [22]. In addition, digitalisation is expanding the possibilities for exchanging information. Distributors can use information systems to provide manufacturers with timely and detailed information, for example on sales volumes and prices. In the Commission's sector inquiry into e-commerce, 64% of the manufacturers responding stated that they had opened their own online store within the last 10 years [1]. Given this change, it is doubtful whether the Commission's view expressed in the 2010 Vertical Guidelines that "in general any potential impact on the competitive relationship between the manufacturer and retailer at the retail level is of lesser importance than the potential impact of the vertical supply agreement on competition in general at the manufacturing or retail level" [23] can fully persist.

It is therefore to be welcomed that, in June 2022, the European Commission has adopted new rules for dual distribution. In general, dual distribution remains exempted from Article 101 TFEU. In principle, it is harmless if a supplier competes with its customers on the downstream market, provided that the customer is not itself in competition with the supplier at the upstream market. However, certain aspects of dual distribution will no longer be exempted under the new VBER, but must instead be assessed individually under Article 101(3) TFEU. This refers to the exchange of information that is either not directly related to the implementation of the vertical agreement or is not necessary to improve the production or distribution, see Article 2(5) VBER. Nevertheless, the exchange of information in dual distribution scenarios remains largely group-exempt. The Commission's draft of 2021 was even stricter in this respect. In the first place, the Commission had proposed to exempt information exchanges between suppliers and distributors in a dual distribution only up to a combined downstream market share of 10% [24]. In addition, the hybrid platforms already discussed are excluded from the scope of the VBER.

5. NOVEL VERTICAL RESTRAINTS OF COMPETITION IN THE E-COMMERCE SECTOR

5.1. Restrictions on online selling

Online sales restrictions were not explicitly mentioned in the previous version of the VBER. However, according to the Commission's final report on its sector inquiry into online retailing, restrictions on online distribution are the second most common restriction [1]. In the recent years, case law regularly addressed the assessment of online distribution restrictions. In the Coty case, the European Court of Justice had to decide how Article 4(c) of the outdated version of the VBER was to be interpreted with regard to third-party platform bans [25]. Article 4(c) prohibited the restriction of active or passive sales to end users by members of a selective distribution system operating at the retail level of trade. Coty was a manufacturer of luxury cosmetics and perfumes. It distributed these by means of selective distribution. Coty barred its distributors from selling the contract goods on third-party platforms but permitted them to sell them in their own online stores. One member of the selective distribution system sold Coty products on Amazon. A German Court asked the European Court of Justice by way of preliminary ruling: Does the ban on selling goods on third-party platforms restrict passive sales? [25] The European Court of Justice held that the agreement did not restrict passive sales and therefore did not violate the ban on cartels. It argued that only a specific kind of Internet sale would be restricted, but not all Internet sales. To eliminate the Internet as a distribution channel would indeed be a prohibited

hardcore restriction according to the Pierre Fabre ruling [26]. In the Coty case, customers could still find the products in the retailers' own online stores. In the aftermaths of this decision, there was much discussion as to whether platform bans are also permissible in the sale of non-luxury goods.

Since June 2022 the Block Exemption Regulation provides for solutions. It now contains a new hardcore restriction dealing explicitly with online retailing. Pursuant to Article 4(e) VBER vertical agreements which have as their object the prevention of the effective use of the Internet by the buyer or its customers to sell the contract goods or services are not block exempted. This is without prejudice to the possibility of imposing other restrictions of online sales on the buyer; or restrictions of online advertising that do not have the object of preventing the use of an entire online advertising channel. Through this prohibition, the VBER contributes to the single market: If traders cannot sell via the Internet, this makes it more difficult for them to reach customers in other member states.

In this way, the legislator has reflected views expressed by case law. Among other things, Article 4(e) VBER prohibits vertical agreements aimed at preventing the buyer from using one or more entire online advertising channels such as search engines or price comparison services [5]. Regarding search engines, the Commission had already cleared such agreements to be violative of competition law in the Guess case of 2018 [27]. The same applies to preventing the buyers from establishing their own online stores and the mentioned Pierre Fabre ruling. In line with the decision of the European Court of Justice in the Coty case, marketplace bans will continue to be compatible with the cartel prohibition. In fact, the new VBER also exempts third-party platform prohibitions when the distributed product is a non-luxury good. In the past, several national courts had declared similar agreements that prohibiting the use of price comparison engines is anti-competitive, holding the view that the Coty ruling only applied to the distribution of luxury goods [28].

5.2. Dual pricing

The reconciliation of dual pricing with the ban on cartels has long been highly controversial. The issue is whether a manufacturer is allowed to differentiate between goods sold in stationary distribution and those offered on the Internet when setting its prices. It may be in the manufacturer's interest to promote brick-and-mortar distribution to incentivize dealers to maintain their local stores. They can do this by charging a lower price for products that are resold in stationary trade. While the Commission recognized the interest, it had limited the supplier's ability to do so in the past to giving fixed amounts to dealers as subsidies. Dual pricing was not exempt from Article 101 TFEU. It was the Commission's view that the pricing strategy restricted passive distribution over the Internet. This was hardly convincing since the harm to competition from dual pricing is actually no different than when a merchant offers fixed amounts as subsidies [29] [30].

With adapting the VBER, the Commission has made a welcomed paradigm shift. It has removed dual pricing from the list of hardcore restrictions. In broad terms, suppliers can now offer the same buyer different wholesale prices for products sold online than for products sold offline. The Commission states that the evidence gathered indicates that online sales "have developed into a well-functioning sales channel that no longer requires special protection relative to offline sales channels" [31]. From now on, suppliers may set different wholesale prices for online and offline sales, as this may incentivise or reward an appropriate level of investments [5]. The difference in the wholesale prices must be proportionate to the differences in costs or investments between the online and offline distribution channels. However, the parties are not required to perform complex cost calculations or provide detailed cost information to demonstrate this [31].

5.3. Price parity clauses

Price parity clauses prohibit providers from offering their services at lower prices on other sales channels. Prohibitions that limit distribution to all available distribution channels are referred to as broad price parity clauses. In contrast, narrow price parity clauses are characterized by the fact that providers are prohibited from offering more favourable conditions on their own (online) sales channels, in particular on their own websites. With such agreements, platforms aim to secure their position as the most favourable providers. According to the Commission's findings in its sector inquiry, platform operators frequently use price parity clauses [1].

While broad price parity clauses were largely unanimously declared to be in breach of antitrust law [20], the courts and competition authorities in European member states initially disagreed on narrow price parity clauses [32]. In the Booking case, the German Cartel Office had declared a narrow price parity clause to be contrary to antitrust law in 2016 [33]. The German Federal Supreme Court ruled the same way in 2021 [34]. The hotel booking portal Booking enables hotel customers to make direct bookings. It was reported that from July 2015, the general terms and conditions included a narrow price parity clause. Hotels were reportedly prohibited from offering their rooms on their own websites at better conditions than on the platform. The German Federal Supreme Court held that the narrow best price clause restricted competition in offering hotel rooms. It was of the opinion that the platform operators deprived hotels of the possibility of passing on the saved agency commission in the form of price reductions and thereby attracting customers [34]. However, national competition authorities in other member states, for instance in France and in Italy, decided not to take action against narrow price parity clauses [35]. They held the view that narrow price parity clauses did not restrict competition but were instead necessary to ensure the platform's business model. The clauses could prevent hotels from free riding on the platform's investments.

The European Commission has reflected the concerns with price parity clauses in the revision process of the VBER. From now on, wide price parity clauses are in breach of European antitrust law. Article 5(1)(d) VBER states that any direct or indirect obligation in vertical agreements causing a buyer of online intermediation services not to offer, sell or resell goods or services to end users under more favourable conditions via competing online intermediation services are not group-exempt. This is convincing because such clauses may prevent other platform operators from entering the market. The legislator has also addressed narrow price parity clauses. Pursuant to Article 6 VBER the European Commission has the power to withdraw the benefit of the VBER where it finds in any particular case that a vertical agreement to which the exemption provided for in Article 2 of this Regulation applies nevertheless has effects which are incompatible with Article 101(3) of the Treaty. As an example of such effects narrow price parity clauses ("agreements that restrict buyers of the online intermediation services from offering, selling or reselling goods or services to end users under more favourable conditions on their direct sales channels") are explicitly mentioned in the regulation. It is the Commission's view that such clauses may cause harm to competition where the relevant market for the supply of online intermediation services is highly concentrated and competition between the providers of such services is restricted by the cumulative effect of parallel networks of comparable price parity clauses. Although the Commission has taken a less strict approach than the German Federal Supreme Court by including narrow price parity clauses in the exemption under Article 1(1) VBER, there is a risk of violation of antitrust law.

The structure of the revised VBER reflects correctly that narrow price parity clauses don't pose the same dangers to competition and consumer welfare in principle as broad price parity clauses. Narrow best price clauses may weaken intra-brand competition, i.e., the price competition for accommodation services on different distribution channels. Yet this may only harm consumer welfare if inter-brand competition is weak. Narrow price parity clauses are likely to not benefit consumer welfare on concentrated markets. Free-riding, which could cause hotels to use the platform only to attract interested customers to their own website, may then only occur to a negligible extent.

6. CONCLUSIONS

With the revision of the Vertical Block Exemption Regulation the European Commission has taken bold steps to incorporate digital business models and new vertical restraints of competition in the e-commerce sector in European antitrust law. With the integration of online intermediation platforms, European competition law reflects the changed distribution of tasks and power relations in the e-commerce sector. The exclusion of hybrid platforms from the VBER illustrates that the distinction between vertical and horizontal restraints of competition also shapes the competitive assessment in the digital economy. With restrictions on online selling and price parity clauses the Commission included distribution agreements with high practical relevance. Although there remains scope for a simplification, it can be expected that the new regulations will increase legal certainty and help undertakings assess the competitive nature of

their agreements. It will be interesting to observe how the European Commission and the competition authorities in the European member states will apply and interpret the new rules.

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