ASSOCIATION DES INDUSTRIES DE MARQUE
EUROPEAN BRANDS ASSOCIATION
EUROPÄISCHER MARKENVERBAND

# AIM® POSITION PAPER

# PARALLEL TRADE – CONSUMER BENEFIT OR CONSUMER LOSS ?

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# DRAFT Parallel trade – consumer benefit or consumer loss? version 8

## *Background*

### *Parallel trade and the exhaustion of trade mark rights*

Parallel trade is enabled by limiting (*exhausting*) the rights given by trade mark law. The EU follows the concept of *regional (EU-wide) exhaustion* whereby a company marketing a product in one member state cannot object on the grounds of trademark infringement to subsequent sales of that product in any other member state. This limitation is written into article 7 of the 1989 trademark directive 89/104/EEC.

The concept is tied to the free movement of goods in the single market. It was extended, under an EU agreement with certain EFTA countries, to Iceland, Norway and Liechtenstein. The concept of EU-wide exhaustion applies to all intellectual property rights which have been harmonised at EU level. This applies not just to trademarks but in other areas of intellectual property such as patents and copyright.

The concept of *global exhaustion*, to allow parallel trade from any country in the world, is being proposed by certain parties. Such a change would be a fundamental change in European intellectual property law. At the international level, there are no agreements on global exhaustion.

**Research** In early 1999 the Commission received a study it had commissioned from London-based economic consultant NERA and lawyers S.J. Berwin on the economic consequences of the introduction of global exhaustion in trademarks. The study showed that the effect on prices in all industry sectors was small (from 0% to 2% at most) whereas the transfer of profits from manufacturers to traders could be as high as 35%. This implies that parallel traders not consumers would be the main beneficiaries: parallel traders would free ride on manufacturers' investments, damaging long-term innovation and R&D.

### *EU law today allows brands to circulate freely in the EU*

In recent years case law in EU member states has confirmed the applicability of EU-wide exhaustion. In Case C-355-96 Silhouette v. Hartlauer the European Court of Justice affirmed in 1998 the single market intent of the EC Trade Mark Directive by ruling that the directive excludes a member state opting for international exhaustion. In the case C-352/96 Phytheron v. Bourdon, the Court ruled in 1997, that the origin of products was of no importance in determining the exhaustion rights of a trademark owner. In other words brands from third countries put onto the market by the owner in the EU can circulate freely *within* the EU. Today EU law allows fair and relevant free trade.

## *AIM's position*

**AIM supports EU-wide exhaustion** because this enables goods to circulate freely through the EU as one single market and because it offers consistent consumer protection within that market.

**NERA** has shown that parallel trade is not a consumer price issue. It is a manufacturer-trader issue. AIM does not believe that it is right to allow traders to free-ride on manufacturer's investment in innovation and brand support.

## *The parallel trade myths*

Parties who want to allow parallel trade from anywhere in the world make certain claims. These claims need to be questioned.

**Myth 1** "Parallel traders want to sell to consumers at special low prices"
**Reality** "Possible decrease in retail prices: 0%, 0.5%, 1% or 2%" NERA

Parallel traders want to maximise their own profits. They will sell goods at the highest market price they can.

> **Gillette – parallel goods at parallel prices**
> Since 1998 Gillette has conducted a comprehensive investigation, to date at 458 shops in the UK, into illegal parallel imports. Within its key findings were examples showing:
> - Parallel goods sold at the same price (after all retailers cannot charge two different prices)
> - Parallel goods had lot codes (useful for product safety recalls) removed
> - Parallel goods did not conform to EU labelling laws
> - Parallel goods evaded VAT payment
> - Parallel goods importers evaded obligations under the EU packaging waste laws
> - Parallel traders had in the past been sued for handling counterfeits
> - Middlemen scoop the profits. One US-based husband and wife team were responsible for £7,000,000 worth of Gillette imports over a three year period. They paid no EU taxes.
>
> **Source: Gillette**

When parallel goods are priced lower it may not last for long. It is typically a short-term opportunity to attract consumers inside the store.

**Myth 2** "Consumers are always happy with parallel goods"
**Reality** "Adverse effects on after-sales service, guarantees and product information" NERA

A consumer buying a brand in the EU has certain expectations. The consumer trusts the brand. It is a trust built-up over a long time. But parallel traded goods can give nasty surprises. The parallel trader will regard this as the consumer's problem.

**The expected product:** A brand is not a commodity. A successful brand may have formulation differences in order to deliver the same benefit to each local consumer.

> **Brands may be different to expected**
> - a brand of laundry detergent may be sold in 50 countries and will deliver the benefit of clean clothes but formulations for cold-water hand-washing are not the same as for front-loading automatic machines.
> - top-selling European brands of toothpaste in Indonesia taste of cloves not mint
> - face cream formulated for the humidity of the tropics offers little to the German consumer
> - a television for Asian terrestrial reception may not have the full band-width for European cable networks. If it did the Asian consumer would be paying for something they did not need.
> - motor lubrication oils are radically different for the Middle East and Sweden
> - excessive heat while shipping can ruin the taste and fizz of soft drinks
> - batteries may be near expiry by the time they reach Europe by parallel routes.
>
> **Source: AIM**

**The expected pack:** The same brand does not mean the exact same pack**.** Brand manufacturers in Europe ensure that their packaging conforms to European or national requirements such as labelling, re-usability and re-cyclability. The same brand sold outside

Europe may well be packaged differently because of local manufacture, access to re-cycling plants, humidity, or local demand for small pack-size. On-pack promotions may not be valid and consumers will be misled. Misunderstanding from foreign-language labelling may endanger the health of diabetics and allergy sufferers.

**The expected instructions:** A brand imported into the EU by a parallel trader may well contain instructions in non-EU languages. The consumer ends up either with instructions that are not understandable or no instructions at all if the trader decides to remove them. This flies in the face of the 1998 Council Resolution on operating instructions for technical consumer goods.

**The expected after-sales service:** For certain brands the consumer expects after-sales service, usually from the official distributor. Parallel traders almost never give after-sales service.

**Counterfeits** Channels of trade for parallel goods are ideal channels for counterfeits. Customs knowledge of regular shipping agents and ports helps distinguish counterfeits from originals. Parallel goods using different agents and ports cause confusion. Global exhaustion will increase the flow of counterfeits to European consumers.

> **Nike – counterfeits sold as the real thing**
> In August 1998 investigators for the sports wear company Nike in the UK found counterfeits goods on sale at a top UK retailer. The retailer thought it had bought a batch of parallel goods but there were counterfeits mixed in with them.
> **Source: Nike**

**Myth 3** “But the price differences are really big! ”
**Reality** “Taxes in the EU are higher than USA taxes” NERA

Simple comparisons of retail prices often forget the differences in taxes. “It costs €100 in New York but almost €140 in Brussels”.

> **Why US prices might seem to be lower**
> - US Sales Tax - on average 5% compared with the EU’s VAT rates of up to 25%
> - US Sales Tax is added at the point of purchase and is not shown on the price tag, unlike VAT
> - 13.5% import duty is paid on clothing by legitimate companies importing into the EU
>
> **Source: British Brands Group**

So, a €100 jacket actually costs a New Yorker just €105 but would cost €137 if lawfully parallel traded to Brussels (100+13.5%duty+21%VAT). No consumer benefit here.

Even the retailers agree that headline price comparisons are misleading:

> **“Outlandish basket comparisons”**
> “These inaccurate comparisons fail to take into account such factors as VAT, higher excise duties, higher fuel taxes resulting in higher transport costs and much higher property costs.”
> **Source: British Retail Consortium**

**Myth 4** ❝But these manufacturers are just making too much profit in the EU❞

**Reality** ❝Efficiency is best obtained through some form of price differentiation ❞

NERA in International Trade Law and Regulation

In an earlier study, NERA refuted the claim that differentiated pricing implies excess profit:

> "In fact, where sunk[1] costs are present, charging higher prices in some markets may perfectly feasibly be associated with normal recovery of sunk costs. Differential pricing simply reflects the fact that different proportions of the sunk costs are being recouped from unit sales in different markets."
>
> "Once it is accepted that it is desirable for the industry to generate a surplus over its variable costs of production, economic theory shows differential pricing ..to be the most efficient way of raising that surplus."
>
> [1] *Sunk* costs are the costs of innovation such as R&D and marketing
>
> NERA in International Trade Law and Regulation

**Myth 5** ❝All benefits are price benefits❞

**Reality** ❝Loss of profit as a result of parallel trading could lead to reduction in R&D expenditure❞ NERA

Supporters of parallel trade define consumer benefit as lower price. This is wrong for three reasons:

Firstly, remember myth one: parallel goods often sell at the same price.

Secondly, consumers want value for money (the balance between quality and price) not low price alone. Consumer value flows from innovation and R&D. For some products, parallel trade will erode the return on investment necessary to pay for R&D.

> **Parallel trade can threaten R&D**
>
> "Trade normally increases consumer welfare. However, the necessary conditions for this are violated in the case of parallel trade in pharmaceuticals. The lower prices in the exporting county reflect greater regulatory leverage, not superior economic efficiency, or lower real costs – indeed parallel trade adds cost of repackaging, re-transport etc. Moreover, savings accrue to middlemen rather than being passed on to the consumer."
>
> "As purchases of drugs, governments face a strong temptation to force prices down to marginal cost. But if every country pays prices only sufficient to cover their marginal costs – either through regulation or by *importing* low prices through parallel trade – then no one pays the common cost of R&D." **Source: Dr. Patricia Danzon, University of Pennsylvania**

Thirdly, the EU single market is about much more than low prices.

**Competition** Global exhaustion (allowing unrestrained parallel trade) could make sense once there is a global single market, global market access, global free circulation of goods, global consumer protection, global social protection, global environmental protection, and the global enforcement of all intellectual property rights. Applying global exhaustion in isolation would place EU industry at a disadvantage to its competitors.

**Environmental protection** There is the danger that the cost incentive leading to parallel trade is a result of less developed environmental legislation in the country of origin. The EU's packaging waste directive and environmental auditing all impose a financial cost on industry. EU-wide exhaustion is an effective way to enforce EU laws designed to protect the environment.

**Myth 6** ❝But countries like the US allow parallel trade don't they?❞

**Reality** ❝In principle the USA has national exhaustion❞ NERA

The USA has US-wide exhaustion of trade mark rights. Parallel goods may only be allowed if they come from an affiliate and are not materially different (i.e. no nasty surprises!).

> **How other countries control parallel trade**
>
> - In the US, the owner can stop imports if there are *material differences* in the goods. Formulation, fragrance, colour, calories, lot code removal, size, fill-volume, packaging, language, guarantees, labelling and instructions have all been used as grounds for *material differences*.
> - In the US, the trade mark owner can stop imports coming from an overseas subsidiary in which the owner only has a minority interest.
>
> **Source: NERA**

## *Consumer benefits of brands - why parallel trade threatens the benefits*

A brand is a signpost for consumers to certain benefits. Consumers must be able:

- to trust in the **value** of the brand,
- to know there is genuine **choice**,
- to have the **convenience** of wide-availability,
- to know the brand is **relevant** to their needs,
- to be **reassured** that the brand is reliable,
- to get the expected **satisfaction** from the purchase.

A parallel traded good may fail to deliver on all these benefits. It might appear to be good *value* but will it always be widely available? It will not be *relevant* to the consumer's needs if the instructions are missing. There is no *reassurance* when the brand seems different to the one expected. There is a loss of trust in the brand if there is no after-sales service. Finally, there is a loss of *satisfaction* when the brand fails to deliver on all its promises because it turns out different from expectation.

When parallel trade leads to consumer dissatisfaction, both the consumer and the brand owner lose out.

## *Conclusions*

**Parallel traders want to increase their profits not benefit consumers.** The status quo, that is free circulation within the EU, is compatible and supportive of the internal market. It assists manufacturers to best meet consumer needs in the most relevant way. It reinforces the bond of trust between brand owner and consumer. It assists fair and level competition.

## *AIM*

AIM is the European Brands Association. It represents the branded goods industries at European level on key issues which affect the ability of branded product manufacturers to market, to distribute and to sell their brands. AIM's membership comprises 19 European national associations and 50 corporate members most of which are active in the fast moving consumer goods industries in Europe.