THE ECONOMIC CONSEQUENCES OF THE CHOICE OF A REGIME OF EXHAUSTION IN THE AREA OF TRADEMARKS

Final Report for DGXV of the European Commission

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8 February 1999
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1. INTRODUCTION

1.1. Terms of Reference

This draft final report describes the results of a study into *The Economic Consequences of the Choice of a Regime of Exhaustion in the Area of Trademarks*, which has been commissioned by DGXV of the European Commission and undertaken by National Economic Research Associates (NERA). The main objective of the study is to examine the economic consequences for the European Union of alternative regimes for the exhaustion of trademark rights. NERA has carried out this study together with SJ Berwin, a leading London law firm with recognised expertise in intellectual property law and competition law, and with IFF Research, a market research firm with substantial experience of EU-wide business surveys.

Specifically the study is intended to analyse the effects of alternative exhaustion regimes on prices and trade volumes, product and market structures, consumers, and macro-economic indicators such as employment. It is explicitly not intended to provide definitive interpretations of the legislation that currently covers this subject or to investigate or comment on particular legal issues. However, it is necessary to summarise the main features of the current regime, both in the EEA and other countries, and this has necessitated some analysis and interpretation of the legal framework, including the identification of areas where there may be some uncertainties about the legal position and hence the actual nature of the current exhaustion regime operating in different countries.

The study is also not intended to develop economic arguments for or against particular points of view on the subject of international exhaustion, or to adjudicate on the case for or against the extension of an EEA exhaustion regime. We have, however, summarised what are in our view the essential economic arguments for and against international exhaustion, since this helps to set in context our assessment of the economic impact of possible changes to the exhaustion regime.

1.2. Methodology

The study is based in part on the use of market research to provide a basis for estimating how the different interested parties (including right holders and traders) might respond to changes in the trademark exhaustion regime. Economic analysis has been used to determine the most relevant questions for the market research exercise, to interpret the results and to extrapolate from the responses to estimate economic consequences. The questions were framed by the project team, including IFF and SJ Berwin, and took into account comments from DGXV.

We have focused our attention on ten sectors. It was clear that there was a limit to the number of sectors that could sensibly be covered in the study while still making the sample reasonably representative. Appendix A of this report sets out the basis for our selection of sectors; this was mainly based on their relative importance in relation to trademarks (ie

mainly consumer goods) and international trade. The selected sectors were confectionery; alcoholic drinks; soft drinks and mineral water; clothing; footwear and other leather goods; musical recordings; cosmetics and perfumes; domestic appliances; consumer electronics; and motor cars. In our view this selection provides a reasonable basis for identifying the economic factors that are important. It also covers a substantial part of total trade in consumer goods.

We also examined the economic characteristics of each sector in some depth, identifying the elements in each most relevant to trademarks and parallel trade.

1.2.1. Market Research Survey

The results of the survey provide one of the major items of empirical evidence for the study. As agreed with the Commission, four groups of interviewees were distinguished: trademark owners (including SMEs), importer/exporter associations (including some parallel traders), consumer organisations and SME organisations. For each of these groups a separate questionnaire was designed (see appendix B), and firms and other organisations across Member States of the EU were approached. In addition, a number of trademark holders with head offices in the USA and Japan were included in the survey.

Given the planned sample size for the survey, a target figure of 176, the number of countries (all EU countries) and the number of target groups (four) to be covered, there clearly had to be a limit to the number of sectors considered. Based on previous experience with this type of survey, we concluded that ten sectors were feasible but that this was the maximum number that could be considered while still making the survey reasonably representative. Even so not every country can or should be represented in every sector.

Interviews were carried out by telephone, but carefully structured questionnaires were faxed in advance to respondents on request so that they could prepare their answers and consult with colleagues as necessary. There were two main reasons for this choice of method. First, given the complexity of the subject matter, and the potentially time consuming nature of the questionnaire, this was felt to be necessary to guarantee an adequate response. Even with a telephone survey the response rate was low (less than 1 in 40), which proved to be a further vindication of this approach. Second, the nature of the questionnaire is such that the respondents benefit from guidance through the questions ("routing") as they consider alternative variations to the exhaustion regime; this complexity is intrinsic to the objectives of the study.

The questionnaires were successfully piloted, and the conduct of the survey led to 160 achieved responses, of which 137 could be considered complete. Anticipating some limitations to the survey, we collected additional information and views, not using the structured questionnaire. We therefore examined position papers and submissions prepared by other interested parties, including retailers and associations of trademark holders and parallel traders, to confirm and deepen our understanding of the commercial and economic issues involved.

These responses, from a further 33 interested parties, together with the questionnaire response 160, means that our analysis is based on a total of 193 responses in aggregate.

1.2.2. Analysis by sector

For each of the ten sectors, in addition to the survey results, we were able to gather statistical information from a variety of sources, on prices in different countries, output and employment, trade and profitability. The data sources vary, and are not always consistent, for a variety of reasons. We have taken note of ad hoc reports comparing the prices of individual products, as well as official statistics. In some cases differences in category definitions make comparison difficult. Overall we believe that it has been possible to build a reasonably comprehensive picture, at least at an aggregate level, of the susceptibility of each sector to parallel trade in trademarked goods. Observations on reliability and consistency that attach to the data sources must however qualify at least some of our conclusions.

After further qualitative evaluation of each sector, we have attempted to assess the size of the economic impacts of changes in trademark exhaustion regime. This has been based on some simplifying assumptions to produce broad brush estimates for the immediate short term impacts. Our analysis also indicates the potentially much greater importance of dynamic and longer term effects. The details of this economic analysis are set out in later chapters of this report.

1.3. Working Assumptions

In order to concentrate on the above objectives we have made a number of working assumptions (also specified in the Terms of Reference for this study), either based on the fundamental economics of trademarks, or simply in order to maintain a clear separation between the objectives of this study and other complex and related issues. The most important are the following:

- Trademark exhaustion regimes are particularly important to (branded) consumer goods. In this study we focus on this type of goods, rather than on, for example, industrial goods or services. Trade marking may be important for particular industrial goods, but concentration on consumer goods appears justified both in terms of economic fundamentals and the nature of parallel trade that actually occurs.
- The same exhaustion regime applies to all other relevant intellectual property rights (patent and copyrights) as to trademarks. If this were not to be so, then differences in regime might negate or modify the impact of changes in the trademark regime, but in ways which would be even more difficult to predict or analyse. To put this assumption in perspective, however, we have indicated for each of the selected sectors the extent to which the regimes for other IPRs might be important.
- The same exhaustion regime is applied in the same way by all Member States.

- Possible responses to changes in trademark (and consequently other intellectual property) exhaustion regimes are assumed to conform to competition law, both at national and Community level.
- Trademark law (and intellectual property law in general) is not misappropriated and is used in conformity with its essential function of identifying product origins.

It should be remembered that intellectual property rights other than trademarks are generally awarded for fundamentally different reasons. The results of the proposed analysis are therefore subject to two caveats:

- they are not readily extendable to cover the exhaustion of intellectual property rights other than trademarks which are granted for different reasons; and
- the effects of exhaustion as they apply to other intellectual property rights are not taken into account; it is likely that there are some such effects, but we have attempted to concentrate on alternative regimes of exhaustion for trademarks.

1.4. Structure of Report and Appendices

In this report we begin in Chapter 2 by describing the economic basis for an examination of trademarks, exhaustion regimes and parallel trade, and describe the legal position as it defines exhaustion regimes in the EU and other countries. This is followed in Chapter 3 by a description, in some detail, of the factors that need to be taken into account in assessing and measuring the potential impacts of the actual changes in exhaustion regime with which this study is concerned.

Chapter 4 summarises the findings of our survey of the opinions and estimates of the different interest groups, and this is followed in Chapter 5 by a summary of our sectoral assessments. Chapter 6 provides a summary and conclusions.

In addition, three appendices set out supporting material.

- Appendix A. The basis for our choice of sectors.
- Appendix B. The survey questionnaires.
- Appendix C. More detailed description of our assessment for the ten sectors

2. ECONOMIC RATIONALE AND LEGAL BACKGROUND

2.1. Economic Significance of Trademarks

The trademark system is designed to allow a manufacturer to mark its products in such a way that consumers can clearly identify the company that is the point of origin. In broad terms, a manufacturer can apply to register as its trademark any sign which can be represented graphically and which will distinguish its products from those of any other undertaking. Once a firm has registered a trademark, it has the legal right to prevent any other firm selling an identical product marked with that sign. Where trademark owners can show there is a risk of consumer confusion they can also prevent others using the mark on similar products. Consumers can associate a level of quality with the trademark on the basis of previous purchases or reputation, thus reducing search costs. Trademarks have an advertising function as well as serving as a symbol of quality.[1]

The use of trademarks, and the rights that they bring with them, is fundamental to ensuring that a wide range of products is available along with a choice of quality. It is often difficult for consumers to ascertain the quality of alternative brands of a good in a retail setting. In the absence of any reliable indication of the good quality of a product, the price the producer must charge to cover the costs of maintaining high quality is likely to deter sales, even though consumers might be happy to pay that price if they were assured of the quality of the product. Without trademarks low quality (cheap) products are thus likely to drive higher quality products from the market. Economists refer to such a situation as the problem of “lemons” (poor quality goods) following the pioneering work of Akerlof on the importance of sound information on quality in the second hand car market.[2]

The economic theory that Akerlof developed is most relevant to goods whose quality cannot be observed before consumption takes place. These are so-called 'experience goods'. The fundamental economic argument for trademarks is that they provide incentives for firms to produce high-quality products, even in the case of experience goods.[3]

To develop the argument further, suppose there are two types of firms: those providing low-quality and those providing high-quality experience goods. If before consumption consumers could not distinguish between low-quality and high-quality, and since they know that both types of goods are present in the market, they would not be prepared to pay the price that they would have been prepared to pay if they knew for sure the product was of high quality. It may not be financially viable to sell high-quality goods at this price. Only low-quality firms may be prepared to sell goods at the price consumers are prepared to pay.

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[1] With exclusive and expensive products, trademarks typically also have the function of signalling the consumer's perceived social status to others.

[2] Akerlof G. 1970 Quality Uncertainty and the Market Mechanism. Quarterly Journal of Economics 89:488-500

[3] See N. Economides (1998), New Palgrave: Trademarks.

The ultimate conclusion of this problem of 'adverse selection', may be that only low-quality goods are offered at the market (Akerlof's lemons' problem), and low quality drives out high quality.

A way out of this 'adverse selection' problem is to build a reputation as a high-quality goods provider. Advertising can serve as a means towards that goal. By spending a lot on advertising, a firm can credibly 'signal' to potential consumers that its product is of high-quality. If consumers were to find out after consuming the product that the quality was low, they would not buy again from that same firm. Only a firm selling high-quality goods would be able to recover its advertising expenditures.[4]

Trademarks are essential in this context. Trademarks prevent firms other than the trademark owner using or closely imitating the trademark. In this way over time they enable easy identification of the manufacturer and allow the manufacturer to benefit from a reputation for producing good quality items. For consumers, trademarks are a reliable source of information on the origin of the product. For firms, they protect advertising expenditures and make it possible to build a reputation.

Trademarks also allow firms to invest in advertising campaigns which, by generating a public image and public loyalty to a particular product, decrease the sensitivity of sales to the price charged and, in general, allow a higher price to be charged with less loss of sales than would otherwise take place, enabling a greater profit to be made. In the absence of trademark protection other firms could free ride on such an advertising campaign by offering an identical, or apparently identical product.

Besides providing an incentive to produce high-quality goods and to build brand image and reputation, trademarks also encourage the development of new products and of more product varieties, and thus establish more product differentiation in a market. Even though price competition is more relaxed between differentiated products, this could be offset by the added value as a result of a larger choice of product varieties for consumers and better matches between specific consumer needs and product features. Products can also be differentiated between countries. Investments in brand development in a local market (as opposed to investments in global branding) can take into account local preferences, culture, ability to pay and other relevant factors. This type of investment in local markets relies heavily on trademark rights and whether or not they include the right to control parallel imports. Strong trademark rights incorporating trade control rights more strongly encourage a trademark owner to expand and enter new markets.

Although we see the above economic arguments as strong and they are valid and well accepted by most economists, in practice trademark protected goods are not always of high-quality, and non-trademark protected goods may be of high quality. However, advertising

[4] This argument was developed in the seminal paper by P. Milgrom and J. Roberts (1986), 'Prices and Advertising Signals of Product Quality', Journal of Political Economy 94: 796-821.

campaigns and trademark protection is one important strategic option for successful marketing of high-quality goods.

Intellectual property rights other than trademarks are generally awarded for different reasons. Patents apply to single innovations and are designed to provide incentives to firms to invest in product and process innovation and thus encourage technological progress. In the absence of patent protection a firm would have a reduced ability to recover these costs. Copyright is designed to encourage creative activity by giving an individual or organisation the sole right benefit from reproduction of their work. These objectives of patent and copyright protection are clearly different from that of trademark protection and hence the current analysis would not be readily extendable to cover the exhaustion of intellectual property rights other than trademarks.

2.2. Parallel Trade

Parallel trade, sometimes referred to as the 'grey market', consists of trade in genuine trademark (or other intellectual property) protected goods that takes place without the consent of the trademark owner. Official channel goods reach the final consumer through the intermediaries and distribution networks that are designated by the trademark owner. Parallel traders acquire goods, typically without the consent of the trademark owner, from some layer of the authorised channel. This can either be directly from the manufacturer, from an intermediary (wholesaler or middleman) or from authorised retailers. Occasionally a trademark owner may give tacit consent to the disposal of some part of production through parallel traders.

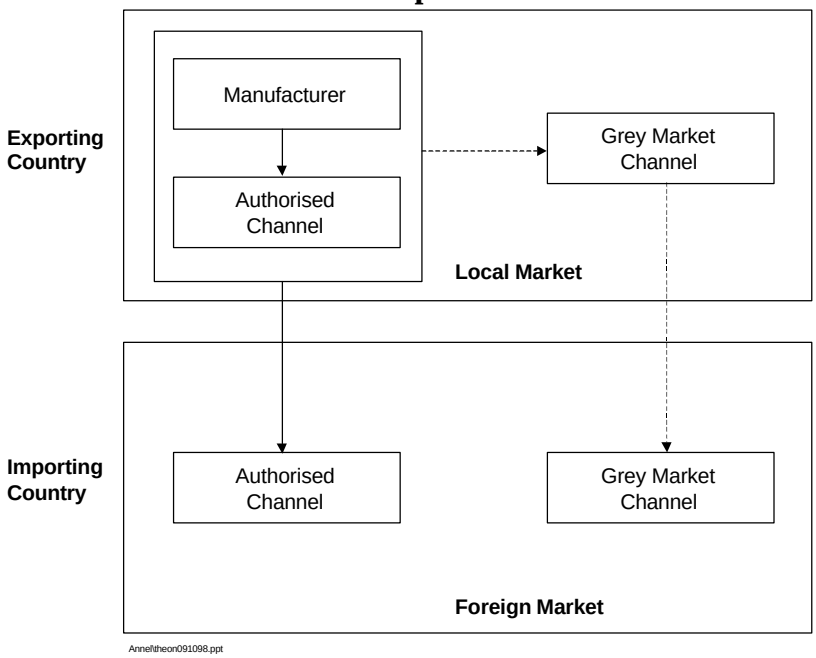
Parallel trade can take many forms and use many different channels and routes, which are not always very transparent. We have prepared some stylised examples[5]. These are purely for illustration, and ignore any rights the trademark holder may have to prevent these flows taking place.

Example 1 shows the situation where a manufacturer sells in his local (home) market through an authorised channel. The manufacturer also exports and uses an authorised dealer to distribute his product in the foreign market. At the same time a parallel trade flow takes place, from the local to the foreign country. This trade takes place parallel to the trade that goes through the authorised channels. In the home market a local grey market channel buys goods from the manufacturer or the authorised channel, without the consent of the trademark owner. The local grey market channel (wholesalers, intermediaries or retailers) then sells to a grey market channel in the foreign market. It is of course also possible that the foreign grey market channels buy directly in the manufacturer's home market without

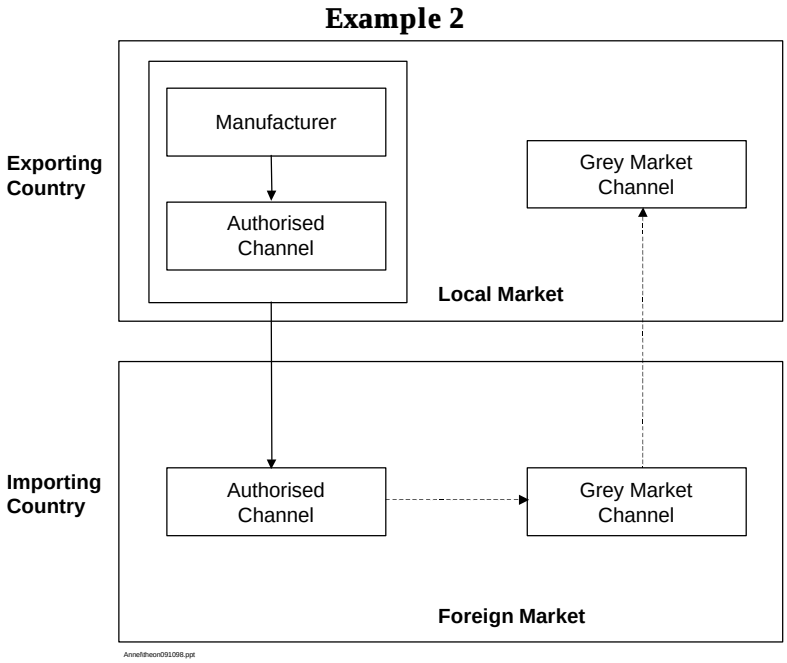
[5] These examples are based on Bucklin, L.P., Modelling the international gray market for public policy decisions, International Journal of Research in Marketing, 1993, 10: 387-405.

using a grey market intermediary. Example 1 would typically occur if prices in the local market are lower than in the foreign market.

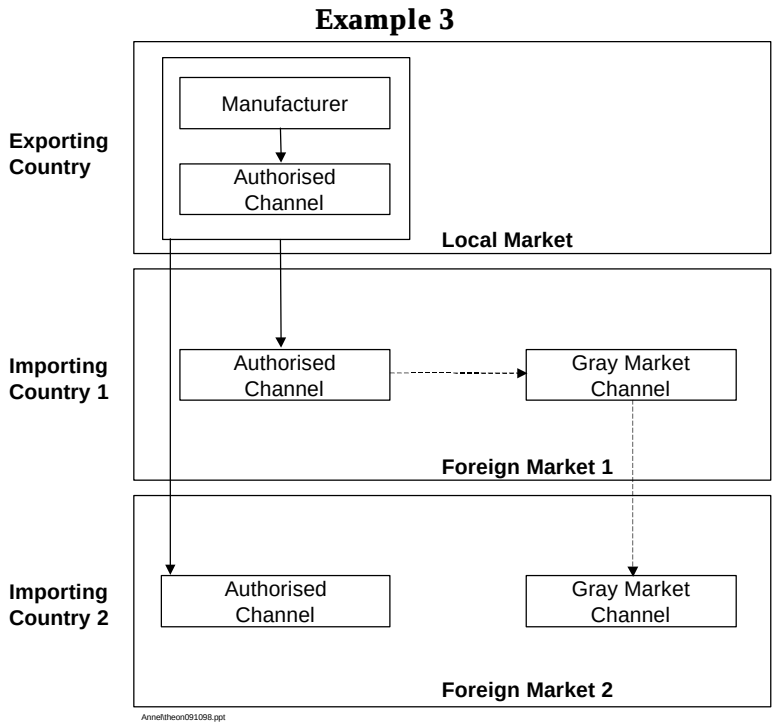
Example 1



Example 2 would typically occur if prices in the foreign market are lower than in the local market. A grey market channel buys from the authorised channel in the foreign market and sells to the grey market channel located in the country from which the products were exported in the first place.



Example 3 illustrates that parallel trade can be indirect and take place through third countries. The source country for the grey market channel in the second foreign country to which the manufacturer exports does not need to be the local manufacturer's market but may well be a country to which he exports (in this case the first foreign market). This situation could arise if the price in foreign market 1 is lower than in foreign market 2, while at the same time the local market is not a source market, for example, because prices are higher than in foreign market 1, or if more effective distribution controls are in place there.



All of these transactions could already take place[6] within the European Economic Area (EEA), as will be explained in section 2.3, if both exporting and importing countries are in the EEA.

There can be various often inter-related causes of parallel trade, including:

- Retail price differences (adjusted for transport costs broadly defined) between source and target country;
- Ex factory price differences (transport cost adjusted) between source and target country;
- Exchange rate changes between source and target country;
- High promotional expenditures by authorised channel in target country;
- Product quality differences between source and target country;
- Over-production in source country;
- Contractual terms (loose drafting) by manufacturer; and
- Failure to police contracts by manufacturer.

A difference in retail prices between two countries is a possible reason for parallel trade. However, a price difference alone is not a sufficient condition for it to take place. Parallel trade involves all kinds of transaction costs, ranging from transport costs associated with physically shipping of goods up to administration costs associated with crossing borders. In order to create an incentive for parallel trade, the retail price in the source country needs to be sufficiently lower than the retail price in the target country to offset these (transaction) costs.

Ex factory or wholesale price differences (after allowing for transaction costs) can also be a driver behind parallel trade, even when retail prices are identical in the source and target country. Parallel traders in this case can, for example, offer the goods at a lower retail price in the target country while having the same profit margin as the authorised distributors, which charge a higher retail price but pay higher wholesale prices.

Exchange rate changes can also be a reason behind parallel trade. They establish an indirect reason: the main driver remains relative international (wholesale or retail) prices. Exchange rate changes affect these relative prices.

Differences in promotional efforts between countries can be another parallel trade driver. High promotional expenditures can give rise to higher prices in the target country intended

[6] Notice that there are circumstances that apply to some sectors which offer rights to prevent certain types of resale.

to secure a return on the extra costs incurred. The parallel trader avoids these costs, eg by not giving as much pre-sales service. It can also be that, because of high promotional spending, the quality of the product in the target country is perceived to be higher, enabling a higher price to be charged than in the source country.

Quality differences between countries can also give rise to parallel trade. Lower quality goods (with the same trademark) may be exported from the low price source country and sold in the higher quality target country, making use of the price umbrella provided by the higher quality good.

For most parallel trade one can say that it will tend to result in lower profits for the trademark owner and/or authorised channels of distribution since part of the goods are sold at lower prices than would have happened in the absence of parallel trade. Some parallel trade, however, seems to be beneficial to the trademark owner. The last three bullet points from the above list of possible reasons differ because they might be in the interest of the trademark owner. If, for example, there is for some reason over-production in the source country, and the manufacturer would otherwise be left with an unsold stock, parallel trade may be a means to raise profits through additional sales. Another example is goods such as clothing which are subject to fashion waves. Previous season's clothing in one country can still yield useful revenues in other countries.

2.3. Trademark Exhaustion Regimes

The present regime in the EEA can be briefly described as follows: trademark rights are exhausted when the product is first placed on the EEA market by the owners of the trademark or with their consent. If such goods are then exported to another EEA country, the holder of the trademark cannot use it to prevent parallel importing of such goods. However, these rights can be used to stop parallel imports of goods from outside the EEA.

A unilateral extension would imply that the current EEA regime is extended to cover trade with third countries but only on a unilateral basis. This means that when a product is placed on a third country market by the owners of the trademark or with their consent, the holders cannot use their rights to prevent it being imported into the EEA. The regimes in third countries are assumed to be unchanged and therefore the legality of parallel exports of EEA goods to e.g. the USA and Japan would remain unchanged.

An extension of the current trademark exhaustion regime could also be reciprocal. In this case bilateral agreements with particular third countries (say, USA and Japan) are put in place. Trademark holders' rights cannot be used to prevent parallel imports from the USA and Japan to the EEA. Moreover, it also means that rights holders cannot prevent parallel exports to eg. Japan and the USA when the product has been put on the market in the EEA with their consent.

A third possibility is that of a multilateral agreement between all members of the World Trade Organisation - this is a more comprehensive version of the above reciprocal extension. Effectively the EEA (or in principle any other group) and other WTO members constitute a single market from the point of view of exhaustion. Once a good has been put on the market with the consent of the trademark owner, parallel imports can be made from any WTO country into the EEA and parallel exports can be made to any WTO country.

International exhaustion, especially on the basis of WTO membership, might be seen in the context of post-war negotiations to reduce tariffs and non-tariff barriers in order to gain the advantages of greater trade such as more specialisation, greater choice and more competition. Where there is not international exhaustion, a producer may prevent unauthorised imports of his goods from a low cost/price country in order to protect his high price domestic market. However, the arguments regarding parallel trade do differ from some of these usual arguments. The negotiators of the TRIPS[7] Agreement concluded with the words that "nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights". International exhaustion might also be viewed in the context of growing WTO interest in the interaction of trade and competition policy.

2.4. Economic Implications of Parallel Trade

The trademark regime has a number of economic implications. Some of these follow directly from the essential function of trademarks which is to allow the origin of a product to be identified easily and with certainty. Others, more incidental to this main function, are also likely to be significant and fall within the scope of the study. Economic implications are mainly determined by the extent to which parallel trade between countries is possible.

The scope for parallel trade is to a large extent determined by the rights that trademarks bring about. One possibility is that the trademark protection regime includes the right to prohibit any trade without consent of the trademark owner. In this case parallel trade can be prevented by the trademark owner. However, if trademark rights are 'exhausted' once trademark owners have put the goods on the market, they cannot use trademark rights to prevent trade without their consent. Where the exhaustion of trademark rights applies within a given area, the owner of a trademark right has no exclusive right over the resale of the product within that area. Section 2.3 has described the various trademark exhaustion regimes that will be the subject of this study.

Useful lessons about the implications of trademark exhaustion regimes can be learned from the economic analysis of "exclusive territories"[8]. If because of strong trademark rights no parallel trade was possible between countries, then the trademark owner would be able to

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[7] Trade Related Aspects of Intellectual Property Rights.

[8] The observation of similarity between exclusive territories and the absence of exhaustion of rights was made in Gallini and Hollis (1996), A contractual approach to the gray market, University of Toronto Working Paper.

have a distribution network with exclusive territories for national distributors. If parallel trade is possible, the trademark owner would face problems that are similar to a firm that cannot have a distribution system with exclusive territories. The main economic motives for having exclusive territories and restricting competition between distributors are to[9]:

- Price differentiate;
- Relax intra-brand competition;
- Prevent free-riding; and
- Prevent consumer confusion.

With a more extensive trademark exhaustion regime and consequently more opportunities for parallel trade, there is less scope for the trademark owner to undertake each of the above. It should be stressed here that whilst the analogy with exclusive territories is helpful in terms of assessing economic implications, trademark owners do not necessarily engage in these activities when parallel trade is not possible. However, the extent to which parallel trade is possible is a significant influence on the scope to do so.

Table 2.1
Implications of different scope for parallel trade

Scope for Parallel Trade	Scope for differentiating prices	Scope for relaxing intra-brand competition	Scope for free-riding	Scope for possible consumer confusion
High	Low	Low	High	High
Low	High	High	Low	Low

This study is concerned with legitimate trademarked goods flowing through unofficial channels and not with counterfeit or pirated goods per se. It is important that there should not be a blurring of the two. Among our selected sectors (see appendix A), CDs have been highlighted by industry interests as being particularly prone to pirating and with the technology now available copies are very hard to distinguish. Designer clothing, eg T shirts, is also commonly believed to be subject to this problem.

It is argued by the record industry that international exhaustion will lead to increased imports of pirated CDs into the EEA from, for example, Central and Eastern Europe. At present, any CD with an EEA trademark coming into the EEA from a third country source may be stopped for scrutiny by customs officials and both parallel imports and counterfeits may be prevented from entering circulation. The problem of distinguishing one from the

[9] See Gallini and Hollis, fn 8.

other does not arise. If parallel imports from third countries were legitimised, it is argued, there would be an increase in counterfeits because it is so difficult to identify them and because the industry would have less involvement in the monitoring process.[10]

There is no doubt that counterfeiting is a problem, especially for the record industry. However, although it does provide an argument against the extension of exhaustion, better enforcement by customs officials, possibly allied with higher penalties for offences, could mitigate these effects. When New Zealand introduced international exhaustion for copyright last year, penalties for infringements were increased from NZ$50,000 to NZ$150,000. The increased penalty was in recognition of the greater risk of piracy and to signal that reform did not mean that piracy was now condoned.[11]

In practice parallel traders typically refer to the first two factors (prices and competition) to justify parallel trade and to argue that the scope for parallel trade should increase. At the same time, trademark owners typically refer to the last two factors (free-riding and consumer confusion) to argue why the scope for parallel trade should be limited and why trademarks should bring about stronger rights. The argument that acting against counterfeits is complicated by parallel trade is also an argument typically used by trademark owners.

Each of these four factors is discussed in turn below.

2.4.1. Price differentiation

A trademark provides its holder with a form of property right; no other firms are allowed to supply a good marked with that particular distinguishing sign. Trademarks therefore allow firms to sustain prices at a higher level than would otherwise be the case, given competition from goods which may be very close substitutes but which do not bear the particular trademark. This allows returns on investments in activities such as advertising to be earned, but also weakens competition and creates the potential for the right holder to earn economic rents, ie. to earn profits that are higher than can normally be expected in a competitive market.

In the absence of any exhaustion of distribution rights, the holder of the trademark is better able to control the distribution of the products and can act as a price discriminating monopolist, thereby benefiting from charging different prices for the product in each market. Such a firm is likely to charge a high price in a market where consumers are relatively prosperous (or more generally where demand has features that allow for high

[10] In the UK, the record industry has a scheme whereby importers of parallel traded goods from third countries may seek the consent of the owner for goods to be brought into the EEA.

[11] "Parallel importing reforms: winners and losers" Chapman Tripp, New Zealand, 1998.

prices, such as less availability of substituting products) and a lower price where the price elasticity is high (eg because consumers have less money to spend or more substitutes are available).[12]

Where the exhaustion of distribution rights does apply, resale of the goods sold cheaply in one country into a country where they are sold at a higher price may become a profitable activity. In the absence of other barriers between markets, price differentials would then give rise to arbitrage opportunities. Parallel trade of this sort limits the extent to which price differentials can be sustained, and the larger the area over which exhaustion of trademark rights is applied the lower will be the value of a trademark to its owner.

To the extent that parallel traders can take advantage of arbitrage opportunities, extending the exhaustion of trademark rights across a wider area is likely to promote more uniform pricing within that area. Consumers in countries within an area that has relatively high prices, such as some of the EU Member States, may benefit from price falls. Conversely, it may involve price rises in some countries or, at the limit, product withdrawal from some markets (or not entering new markets that would otherwise have been served).

To the extent that prices do converge (assuming, for example, that other mechanisms do not reinforce market segmentation) the rents accruing to trademark holders will be smaller. In the short term, some consumers are likely to gain, at the expense of trademark holders, and others will lose. In particular, consumers in countries which currently enjoy low prices would be likely to be disadvantaged as firms reacted to the danger of those prices spreading to the major markets of the EU. In the longer term there may be a reduction in the availability of higher quality products because producers will have a reduced incentive to invest in quality. Further, there may be a poorer variety of goods because the reduction in rent from property rights will mean less money is available for R&D. Also, trademark owners would be less inclined to enter new markets with lower price levels if there is the possibility of arbitrage and of that lower price level becoming the prevalent price in other countries as well.

Trading intermediaries may also gain through the establishment of an unrestricted market. Any gains to consumers from parallel trade would be limited by the costs involved and by the margins appropriated by parallel traders.

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[12] For a theoretical discussion of the social welfare effects of price discrimination, see Schmalensee (1981), Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination, American Economic Review 71, Varian (1985), Price Discrimination and Social Welfare, American Economic Review 75, and Hausman and McKie-Mason (1988), Price Discrimination and Patent Policy, Rand Journal of Economics 19. Briefly, the conclusions are that social welfare under price discrimination can only increase if total output increases. However, if new markets open due to price discrimination, social welfare is likely to increase.

2.4.2. Intra-brand price competition

Since trademarks provide protection against close imitation by competitors, manufacturers of trademark protected goods are typically active in differentiated goods markets. Price competition in these markets is generally more relaxed than in homogeneous goods markets, where goods are, in the limit, perfect substitutes. Trademark owners are therefore subject to less intense inter-brand price competition.

Whether or not intra-brand competition (that is, competition between distributors or retailers of the same product) can be relaxed, to a large extent depends on the exhaustion regime and its consequences for the scope for parallel trade. If the exhaustion regime does not allow for parallel trade from country B to country A then distributors in country A do not face competition from distributors in country B. The exhaustion regime can thus relax intra-brand competition between distributors from different countries.[13] We note that the exhaustion regime alone cannot affect intra-brand competition within a country. Only some form of vertical control of distributors by the manufacturer can do that. Vertical control or vertical restraints are outside the scope of this study, except insofar as manufacturers respond to a change in exhaustion regime by strengthening vertical control, and insofar as the extent of vertical control affects the scope for increase in parallel trade. Less scope would be expected for parallel trade, the tighter the vertical relationships are. Vertical restraints are likely to affect the way that parallel imported goods are marketed. In the case of tight vertical restraints, it is more likely that parallel imported goods will be sold not through official outlets but through alternative retail establishments such as factory outlets. In the case of loose vertical restraints, official retailers are more likely to sell parallel imported goods without putting the long-term relationship with the manufacturer too much at stake.

2.4.3. Free riding

Manufacturers often encourage authorised dealers to make specific investments in goodwill. Goodwill can include a range of items including a reputation for a certain quality of product and service, brand awareness, pre-sale information and after-sales service. Goodwill can be created by investing in marketing, customer service, quality control and protection from counterfeits, to name a few possibilities. Authorised dealers typically incur these costs, which can be substantial. Grey traders may not need to incur these costs but still benefit from many of the goodwill investments made by the authorised channels. This may give them the opportunity to price above costs, but below the price set by the authorised dealer. The scope for this behaviour is influenced by the extent to which parallel trade is possible.

[13] See also Rey and Stiglitz (1995), The Role of Exclusive Territories in Producers' Competition, Rand Journal of Economics 36. They make the point that exclusive territories may also reduce inter-brand competition.

2.4.4. Consumer confusion

If products with the same brand name differ between countries, parallel trade risks causing confusion among consumers. The packaging of products can differ, eg the text on the label and instructions can be in a foreign language. Another possibility is that the physical characteristics are different. The taste of a particular soft drink, for example, may vary between countries depending on national preferences. Physical differences could also occur due to different local circumstances, such as climate. A car tyre, for example, that is to be used in the North of Sweden may require a different rubber substance to one to be used in the South of Spain. If products with an identical trademark differ between countries, parallel trade can give rise to consumer confusion and undermine the basic rationale for trademarks, that is to identify products and product characteristics on the basis of trademarks. Most problems are likely to be caused when the products comply to different safety, health and quality standards.

The reasons for having a common trademark for different products include economies of scale and scope in developing brands. As opposed to investments mainly to develop a brand in a local market, there are investments that aim at developing general knowledge of the brand targeted at consumers on a very broad geographical scale. These investments in general knowledge of a brand enable parallel trade in the first place. Parallel traders benefit from the knowledge of a particular brand and the associated reputation and image in target countries.

2.5. Trademark Exhaustion Law in the EU, USA and Japan

2.5.1. European Economic Area

2.5.1.1. Exhaustion of Rights within the EU

The starting point for understanding the principle of trademark exhaustion within the EEA is to be found in Articles 30 and 36 of the Treaty of Rome, governing the free movement of goods within the European Union ("EU").

Article 30 prohibits quantitative restrictions and other measures of similar effect on imports and trade between Member States.

Article 36 states that Article 30 does not preclude prohibitions or restrictions which are justified *inter alia* on the ground of protection of industrial or commercial property. Article 36 further provides that such prohibitions or restrictions must not constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States.

The European Court of Justice ("ECJ") has consistently held that where goods have been lawfully placed on the market within one Member State with the consent of the trademark owner, the presence of such consent deprives the trademark owner of the right to prevent importation of the goods into another Member State by invoking Article 36. In other words,

the ECJ has determined that the trademark right is "exhausted" on the first sale of the goods within the EU by the holder of the right or with his consent. The ECJ formulated the principle of exhaustion of rights to trademarks in *Centrafarm -v- Winthrop*[14] where the ECJ held that the Defendant could not use its Dutch trademark rights to prevent the importation of products lawfully bearing the mark which had previously been marketed in the UK. The ECJ held that Article 36 allows derogation from the free movement of goods provisions only where they are justified for safeguarding rights which constitute "the specific subject matter of the property", which is defined as:

> *"the guarantee that the owner of the trademark has the exclusive right to use that trademark for the purpose of putting products protected by the mark into circulation for the first time, and is therefore intended to protect him against competitors wishing to take advantage of the status and reputation of the trademark by selling products illegally bearing that trademark".*

The formulation of "specific subject matter" has since been refined by the ECJ in *CNL - SUCL -v- HAG AG*[15]. In this case, the ECJ observed that for a trademark to be able to fulfil its role, it must offer a guarantee that all goods bearing it have been produced under the control of a single undertaking which is accountable for their quality. Therefore, in order to determine the exact scope of the right exclusively conferred on the owner of the trademark, regard must be had to the essential function of the trademark:-

> *"which is to guarantee the identity of the origin of the marked product to the consumer or ultimate user by enabling him without any possibility of confusion to distinguish that product from products which have another origin".*

As noted above, a trademark proprietor can oppose further dealings in a product it has put on the market in one Member State of the EU if it has "legitimate" reasons to do so. Most of these cases have involved the repackaging of pharmaceutical products.

The leading case on repackaging is *Hoffman - La Roche -v- Centrafarm*[16]. In this case, the ECJ held that the essential function of a trademark is to enable the consumer, without any possibility of confusion, to distinguish the marked product from products which have a different origin. This "guarantee of origin" includes the guarantee that the products had not been interfered with by third parties in a way capable of adversely affecting the condition of the product. Accordingly, the trademark proprietor was justified in suing for infringement where his trademark was affixed without his consent by a third party.

However, the ECJ further held that a trademark owner cannot object to such repackaging if, (i) the trademark owner has adopted a marketing system tending artificially to partition the

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14 Case 16/74, [1974] ECR 1183

15 Case C-10/89, [1990] 1ECR 3711

16 Case 102/77, [1978] ECR 1129

market, (ii) where the repackaging did not adversely affect the product, (iii) where the trademark owner had prior notice of the repackaging and (iv) where the new packaging stated by whom the product had been packaged. This line of reasoning was affirmed in *Bristol - Myers Squibb -v- Paranova*[17].

The ECJ has also recently held in *Parfums Christian Dior -v- Evora*[18] that a reseller must not act unfairly in relation to the legitimate interest of the trademark owner by using advertising which affected the value of the mark by detracting from the luxury image of the goods. Therefore, disparaging or degrading marketing (particularly in the luxury goods market) may constitute "legitimate reasons" to oppose further dealings in a product in another Member State.

The principle of trademark exhaustion within the EU is embodied in the Trade Marks Directive[19] ("the Directive"). Article 7(1) of the Directive states:-

> *"The trademark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trademark by the proprietor or with his consent".*

Article 7(2) states:-

> *"paragraph 1 shall not apply where there exist legitimate reasons for the proprietor to oppose further commercialisation of the goods, especially where the condition of the goods is changed or impaired after they have been put on the market".*

Therefore, the Directive has codified the rules that have developed in interpreting the free movement of goods provisions in the Treaty of Rome.

2.5.1.2. International Exhaustion of Rights

Much more contentious in recent years has been the extent to which Member States within the EU are entitled to prevent the importation of products legitimately put on the market by the trademark owner outside the EU. Historically, there has been no consistency amongst Member States as to whether world-wide exhaustion should be excluded or not. In some jurisdictions, such as France, the courts have tended to allow trademark owners to rely on their trademark rights to prevent the importation of parallel imports from outside the EU. Conversely, the UK courts have been more willing to find, as a matter of fact, that trademark owners have impliedly consented to parallel imports from entering the UK from outside the EU where there are no express restrictions on the sale of the product into the UK nor any qualitative differences between the local product and the imported goods.

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17 Joined Cases C-427/93 C-429/93 and C-436/93, [1996] FSR 225

18 Case C-337/95, [1998] RPC 166

This inconsistency amongst Member States is inconsistent with the aims of the Directive which, whilst not intended to undertake a full scale approximation of trademark laws throughout the EU, has the express objective of harmonising national trademark laws within the EU which, "most directly affect the functioning of the internal market". It should be noted that the Directive does not harmonise all aspects of trademark law, but for the ones it harmonises, one can speak of total harmonisation. Clearly, in view of the principle of exhaustion of rights within the EU, so long as at least one EU Member State allows for the international exhaustion of trademark rights, the principle of international exhaustion would de facto apply throughout the Community. However, although Article 7 of the Directive codified the position on exhaustion between EU Member States, the Directive was silent on the issue of international exhaustion. This issue was considered in the *Silhouette* case.[20] In that case, *Silhouette*, an Austrian producer of high quality fashion spectacles, brought proceedings in Austria against an importer of sunglasses which *Silhouette* had authorised for sale only in Bulgaria and the former Soviet Union States.

In interpreting the Directive, the ECJ considers its scheme and purpose. In particular, it referred to the following recitals to the Directive:-

- The first recital, which recognises that trademark law within Member States contains disparities which may impede the free movement of goods and freedom to provide services and may distort competition within the common market. Accordingly, it notes that it is necessary, in view of the establishment and functioning of the internal market, to approximate the laws of Member States.
- The ninth recital, which emphasises that it is fundamental, in order to facilitate the free movement of goods and services, to ensure that registered trademarks enjoy the same protection under the legal systems of all Member States.

In light of these recitals, the ECJ held that the Directive must be construed as embodying a complete harmonisation of the rules relating to the rights conferred by a trademark. Therefore, Member States could not apply national rules providing for international exhaustion in respect of products put on the market outside the EEA under that mark by the proprietor or with his consent. To do so would be contrary to Article 7(1) of the Directive. The ECJ summarised the position as follows:-

> *"the Directive cannot be interpreted as leaving it open to the Member States to provide in their domestic law for exhaustion of rights conferred by a trademark in respect of products put on the market in non-Member countries.*
>
> *This, moreover, is the only interpretation which is fully capable of ensuring that the purpose of the Directive is achieved, namely to safeguard the functioning of the*

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[19] 89/104/EEC

[20] Case C-355/96, [1998] CEC 676

> *internal market. A situation in which some Member States could provide for international exhaustion while others provided for Community exhaustion only would inevitably give rise to barriers for the free movement of goods and the freedom to provide services".*

Therefore, the ECJ in *Silhouette* has made it clear that Member States as a matter of law cannot act unilaterally by allowing for the international exhaustion of trademark rights. There are, however, a number of other issues which are due to be considered by the ECJ. This finding by the ECJ does not mean (as some would believe) that the importation of trademarked goods into the EU from outside the EU can be blocked by the trademark owner. This is because an action for trademark infringement can be defeated if the trademark owner consented (whether expressly or by implication) to the importation as a matter of fact. The rule of consent will be considered by the ECJ in *Sebago -v- GB Unic*., where the Brussels Court of Appeal has asked the ECJ to clarify whether a trademark owner can oppose the sale of shoes imported from outside the EU when the trademark owner is selling identical products within the EU.

2.5.1.3. Extension to the EEA

Article 2 of Protocol 28 of the EEA Agreement extended the exhaustion provisions in the Treaty of Rome to the European Economic Area ("EEA") which includes the EFTA States (other than Switzerland, i.e., Norway, Iceland and Liechtenstein). However, EFTA States are free to decide whether or not to apply international exhaustion with regard to goods originating from outside the EEA.

In *Mag Instrument Inc. -v- California Trading Co.*[21] The EFTA Court held that articles made in the US and imported into Norway were not subject to the EEA's free movement of goods regime, but that it was for the EFTA States to decide individually whether or not to introduce the principle of international exhaustion. The Court stated that Protocol 28 requires the Contracting Parties to provide for exhaustion in line with Community Law. The Court noted that there was no case law which ruled out international exhaustion of rights, but, given that the purpose and scope of the EEA Agreement and the Treaty of Rome were different (the EEA Agreement created a free trade area not a Customs Union), the Court did not consider that the approach of the EU on international exhaustion needed to be followed in any event.

2.5.2. United States of America

The debate between European wide and international exhaustion of rights within the EEA has in many ways been reflected in the United States of America with its contrasting theories of "universality" and "territoriality". The universality theory is akin to the principle of

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[21] Case E-2/97, IIC No. 3/1998 at 316

international exhaustion and the theory of territoriality analogous to European wide exhaustion.

This conflict is reflected in US Statutory provisions governing parallel imports. Section 526 of the Tariff Act 1930 provides:-

> *"it shall be unlawful to import into the US any merchandise of foreign manufacture if such merchandise, or the label, sign, print, package, wrapper, or receptacle, bears a trademark owned by a citizen of, or by a corporation or association created or organised within, the US, and registered in the Patent Office".*

Section 526 would appear to allow US trademark owners to prevent the importation of products bearing its trademarks. However, US Customs regulations have limited the effect of Section 526. These regulations state that Section 526 will not apply where:-

1. Both the foreign and US trademarks are owned by the same person or business entity;
2. The foreign and domestic trademark or trade name owners are parent and subsidiary companies or are otherwise subject to common ownership or control.

These limitations were upheld in the Supreme Court's decision in *K-Mart Corp. -v- Kartier Inc.*[22].

Notwithstanding Section 526 and the Customs regulations, domestic trademark owners have also looked to Section 42 of the Lanham Act to protect themselves from parallel imports.

Section 42 states as follows:-

> *"no article of imported merchandise which shall copy or simulate the name of.... any domestic manufacture, or manufacturer, or trader..... or which shall copy or simulate a trademark registered in accordance with the provisions of this chapter or shall bear a name or mark calculated to induce the public to believe that the article is manufactured in the United States..... shall be admitted entry at the Custom House of the United States.....".*

In essence, Section 42 allows a trademark owner to prevent the importation of grey market goods where such goods are likely to confuse members of the public. In this regard, it is settled law that US trademark owners cannot use the Lanham Act to prohibit unauthorised imports of genuinely trademark goods which are identical to the goods which are sold in the United States. This is because there is no misrepresentation as to origin or quality.

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22 486 US 281 (1988)

In *Lever Bros -v- United States*[23], Lever US attempted to prevent the importation into the US of "Shield" branded soap which Lever UK had put onto the market in the United Kingdom. Lever relied on Section 42 of the Lanham Act claiming that its US customers were likely to be confused because the soaps were qualitatively different - the US soap had more lather, an antibacterial agent and a different scent. The Appeals Court ruled that the "affiliate exception" set out in the Customs regulations was limited by Section 42 of the Lanham Act and therefore Lever US could prevent the importation as the UK goods were "materially and physically" different from the authorised goods sold in the US.

In a further decision *Société des Produits Nestlé SA -v- Casa Helvitia Inc.*[24], the Appeal Court held that where material differences exist between goods sold simultaneously in the same market under the same name "a presumption of consumer confusion as a matter of law" automatically arises. That presumption can only be rebutted by a defendant showing "the differences are not of the kind that consumers, on average, would likely consider in purchasing the product".

2.5.2.1. Conclusion

In summary therefore, the ability of a trademark owner to prevent the importation of grey market goods into the United States will largely depend upon the extent to which there are material differences between the products or whether there is a corporate relationship between the US and foreign trademark owner.

Thus, whilst in principle the USA has national exhaustion, this can be overturned in specific instances eg if the parallel imports have been produced by an affiliate of the US trademark owner and if there is no material difference between the parallel import and US products such that confusion could not arise. These situations will often apply.

2.5.3. Japan

The Japanese legal perspective on the international exhaustion of intellectual property rights is a topical issue that is largely dominated by the recent Supreme Court decision in the Aluminium Wheels Case.[25]

2.5.3.1. The Aluminium Wheels Case

A German Company, BBS, held a patent for an aluminium wheel in both Germany and Japan. A Japanese company bought the wheels in Germany at a lower price, imported them into Japan and began re-selling them. BBS sued the Japanese company for infringement of

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23 877 F.2d 101 (DC Circuit 1989)

24 982 F.2d 633 (First Circuit 1992)

25 BBS Kraftverzeug Technik AG - v - Racimax Japan KK & Jap Auto Products KK (Heisei (1995) (o) No.1998 (July 1, 1997), affirming Heisei 6 (1994) (Ne) 3272 (March 23,1995))

its patent in Japan and, the Supreme Court ruled in favour of the Japanese Company. This effectively created a new precedent in Japanese Law on the doctrine of international exhaustion.

Although neither the High Court nor the Supreme Court guaranteed a doctrine of international exhaustion, the decision has been seen to reverse the previous law and provide for the exhaustion of intellectual property rights in relation to parallel imports. The Court stated that when a buyer purchased a product outside of Japan that person would naturally assume that it may import the product into Japan and use or re-sell it. The patent owner had received the benefit of its patent on the first sale of the product and should not be able to enforce its rights at a later date. To do so would be giving the patent owner a double benefit for the property right.

However, the decision was qualified by the following points and these should be noted as they are unusual to the doctrine of international exhaustion:

1. The patent owner could retain his property rights by a contractual agreement stating that the purchaser cannot import the goods into Japan (eg by a clause in a distribution/licensing agreement). However, apart from being potentially void under national anti-trust and competition laws, it would appear that such a contract would not be binding on any third party and therefore would be of little practical use. However, the combination of labelling products as being not for re-sale in Japan and restrictive contractual obligations could provide a degree of comfort to patent holders.
2. The Court said that if restrictions were somehow placed on the patent holder as to the price of its product, either by national price control or otherwise, then that patent holder's rights would not be deemed exhausted.

As a decision from the Supreme Court this decision is binding on all lower courts in Japan and can only be overruled by government legislation. Authors and academics on this topic consider that the doctrine (together with the exceptions set out) would extend to all intellectual property rights including trademarks and this seems a sensible conclusion to make. However, the consequences of the Aluminium Wheels Case are still unclear, although the Government is reportedly attempting to clarify the position by a circular being prepared by the Japanese customs who are themselves considering how best to deal with the impact and meaning of the Case.

2.5.3.2. Conclusion

Before the Aluminium Wheels Case holders of intellectual property rights in Japan were capable of preventing the importation of grey market goods from abroad. This issue was dealt with in the Aluminium Wheels Case and the Supreme Court of Japan found in favour of the parallel importer. As discussed above, the decision was qualified but, nonetheless, the case can be seen as a reversal in attitude by the Japanese courts and has, in effect, opened the

door for the concept of international exhaustion of intellectual property rights in Japan, ie it is likely to apply to trademarks as well as patents. The decision does not rely on any articles or provisions of Patent (or Trademark) Law.

2.6. Overview of Trademark and other IPR exhaustion regimes

The table below compares the position with regard to exhaustion across the range of intellectual property rights in the EEA and some other major trading countries.

Table 2.2
IPR Exhaustion Regimes*

Country/Region	Trademarks	Patents	Design
EU	Community Exhaustion	Community Exhaustion	Community Exhaustion
USA	National Exhaustion, where products are not from same corporate entity or there is a risk of "consumer confusion".	National Exhaustion	As patents ("design patent")
Japan	International Exhaustion, unless agreed by contract and goods marked to indicate this to third purchasers, or unless original sale subject to price regulation.	International Exhaustion, unless agreed by contract and goods marked to indicate this to third purchasers, or unless original sale subject to price regulation.	International Exhaustion, unless agreed by contract and goods marked to indicate this to third purchasers, or unless original sale subject to price regulation.
New Zealand	International Exhaustion, unless consent withheld.	International Exhaustion, unless consent withheld.	International Exhaustion, unless consent withheld.
Australia	International Exhaustion if the trademark applied with the consent of its Australian owner.	National Exhaustion, unless sold by the patent owner (not a licensee) without express restrictions.	International Exhaustion, unless consent withheld.

* ***NB: this table only provides a crude overview of exhaustion regimes; all regimes typically have important exceptions and are qualified by rules.***

The EEA

The EEA allows the Community wide exhaustion of intellectual property rights. In other words, once a product has been placed on the market by the intellectual property owner in one Member State, that same intellectual property owner cannot prevent the sale and marketing of that product in another Member State. There are limited exceptions to the rule of Community wide exhaustion.

The *Silhouette* decision confirmed that Member States are not entitled to introduce, of their own volition, national rules providing for the exhaustion of trademark rights. However, in cases where the IPR owner has expressly or impliedly consented to the importation and sale of the relevant product, it will not be able to prevent that product from being sold in the EEA even if it was imported from outside that area.

United States of America

The US position regarding trademarks has already been considered and a trademark proprietor in the US can only prevent imported trademark goods in certain limited circumstances, principally, where the imported product and the local product do not have a common origin and there is likelihood of consumer confusion between the two products (for example because of qualitative differences).

For patents, a geographical restriction prohibiting subsequent importation into the US will work to prevent a parallel import, so long as such a restriction is expressly stated at the time of sale or licence. Otherwise, it will presumed that the patent owner intended to part with (or exhaust) its rights in the patent. Designs are treated under patent law as "design patents" and the same rules apply as for patents.

Japan

It appears that Japan now has international exhaustion on patents as well as trademarks though restrictive contractual obligations and labelling "not for import into Japan" may provide some comfort for rights owners (also if original sale subject to price regulation eg medicine). The same appears to apply to designs.

New Zealand[26]

Section 8 of the Trade Marks Act 1953 gives the trademark proprietor the exclusive right to use its mark on the goods and services covered by the registration save that it can take no action where it has expressly or impliedly consented to the use of trademark by the third party. There is no authoritative case law on this point in New Zealand but it is likely that the New Zealand Courts will follow closely the position in Australia and possibly the United Kingdom.

The Patents Act 1953 does not define the extent of rights granted by the New Zealand patent but Syddall[27] believes that the Act offers little help to prevent parallel imports where the New Zealand patentee sold the patented product overseas and had not imposed any restrictions on subsequent sales of the patent. In the long term, Syddall did not hold much

[26] Based on communication from Ministry of Commerce New Zealand as interpreted by authors.

[27] T Syddall, "Parallel imports get go-ahead in New Zealand" Managing Intellectual Property October 1998.

hope that the New Zealand "would allow meaningful restrictions to come from either the New Zealand government patent law or trade mark law".

As for designs, the New Zealand Designs Act 1953 (Section 11) gives the registered proprietor of a New Zealand design the exclusive right to import articles made to the design but there is little further guidance. However, once again, it must be assumed that if the New Zealand owner of the registered design has consented (whether expressly or by indication) to the importation it will not be possible to prevent that product being sold in New Zealand.

Australia[28]

Section 123 Trade Marks Act 1995 states that "a person who uses a registered trade mark does not infringe that trade mark if it has been applied by or with the consent of the registered trade mark owner". The question is whether the mere putting of a trademark product on the market overseas by the Australian trade mark owner amounts to implied consent. The view of the Australian Courts is that if the trademarked product has been put on the overseas market by the Australian proprietor, the Australian trademark owner would be deemed to have consented to the importation into Australia.

It is an infringement of an Australian patent to import into Australia goods that are the subject of the patent where they were first put into circulation outside Australia by a foreign licensee. However, where the goods were put onto the market outside Australia by the Australian patentee there is no infringement of the Australian patent. Furthermore, if the patentee manufactures and sells the goods in an overseas jurisdiction subject to an express restriction not to import into Australia then, importation with knowledge of this restriction, would infringe the Australian patent.

The Australian Designs Act 1906 is similar to the position in New Zealand in that the owner of the registered design has the exclusive right to import articles made to that design. However, this must again be subject to exceptions where there has been implied or expressed consent to the importation.

[28] Based on communication from IP Australia as interpreted by authors.

3. OVERVIEW OF POTENTIAL ECONOMIC CONSEQUENCES OF EXTENDING EU TRADEMARK EXTENSION

3.1. Current Position

The present trademark exhaustion regime in the EEA was described in detail in Section 2.5.1. Briefly, trademark rights are exhausted when the product is first placed on the EEA market by the owners of the trademark or with their consent. If such goods are then exported to another EEA country, the holder of the trademark cannot use it to prevent such goods being parallel imported. Parallel imports within the EEA are legal. However, these rights can be used to stop goods being parallel imported from outside the EEA.

3.2. Possible Developments

3.2.1. Working assumptions for the study

The Terms of Reference set out a number of working assumptions for the study. They are as follows:

- the study is confined to the distribution rights on tangible goods. Trademarks are important for firms involved in producing services but the notion of trademark exhaustion is not relevant;
- goods may embody material covered by other forms of intellectual property rights as well as trademarks eg patents, copyright. These too involve the notion of exhaustion and could be used to reduce the impact of a change in the regime for trademarks. In order to clarify the impact of different regimes for trademarks, it is to be assumed that the changed trademark exhaustion regimes will apply to exhaustion of other property rights. Nevertheless, in order to get some impression of the impact that exercise of unchanged patent etc rights would have in the context of changed trademark exhaustion regimes, a question on this is included in the survey. This is done to put this working assumption into perspective. In particular in the in-depth sector analyses (see Appendices) we pay attention to this assumption and assess which other intellectual property rights besides trademarks may be used to prevent parallel trade.
- the changed exhaustion regime will apply to all states in the EEA;
- the response of companies to the change of regime will conform with competition policy at national and Community level eg with regard to vertical restraints;
- that trademarks will be used for their essential function to identify the origin of the product and not to attempt to segment markets as a means of counteracting the extension of the exhaustion principle eg through differentiated packaging.

3.2.2. The alternative forms of exhaustion to be examined

Through the survey and economic analysis, the study assesses the impact of two alternative regimes of exhaustion in comparison with the present situation and seeks general impressions of the impact of a third, internationally comprehensive, regime. Our examination of trade relations with third countries focuses heavily on the USA and Japan. As described in section 2.5, the current legal position on trademark exhaustion in the USA and Japan is not completely clear, although broadly speaking some degree of international exhaustion seems to apply. We will take this into account when analysing the impact of possible parallel exports from the EEA to the USA and Japan, as described in change of regime (2) below. We will seek to identify cases where additional parallel imports could occur under our assumptions.

The two main options to be examined are:

- change of exhaustion regime (1) - unilateral international exhaustion. The current EEA regime is extended to cover trade with third countries but only on a unilateral basis. This means that when a product is placed on a third country market by the owners of the trademark or with their consent, the holders cannot use their rights to prevent it being imported into the EEA. The regimes in third countries are assumed to be unchanged. It is assumed that parallel exports to the USA, for example, may or may not be legal depending on the circumstances whilst those to Japan though tending to be legal may not be in all cases (as noted in the previous chapter).

- change of exhaustion regime (2) - bilateral agreements with particular third countries (USA and Japan). In addition to the present case of exhaustion within the EEA, it is also assumed that exhaustion applies to trade with the USA and Japan on a reciprocal basis. Thus, trademark holders' rights cannot be used to prevent parallel imports from the USA and Japan. Moreover, it also means that rights holders cannot prevent parallel exports to Japan and the USA when the product has been put on the European market with their consent.

The third option is:

- a multilateral agreement between all members of the World Trade Organisation - this is a more comprehensive version of regime (2). Effectively the EEA and other WTO members constitute a single market from the point of view of exhaustion. Once a good has been put on the market with the consent of the trademark owner, parallel imports can be made from WTO any country into the EEA and parallel exports can be made to any WTO country.

On this third variant we consider only general impressions of how the effects would differ from those in regime (2).

3.3. Selected Sectors

NERA has selected the following ten sectors for this study:

- Footwear and leather goods;
- Musical recordings;
- Motorcars;
- Consumer electronics;
- Domestic appliances;
- Cosmetics and perfumes;
- Clothing;
- Soft drinks;
- Confectionery; and
- Alcohol.

A number of factors have influenced the choice and number of sectors to examine. They include pointers in the terms of reference, indications of some parallel trade activity in the EEA or elsewhere, importance in economic activity, belief that trademarks may be more important for consumers than for industrial purchasers, and limitations imposed by the scale of the survey. The sectoral definitions are those used in Panorama of EU Industry 1997[29] which contains a valuable range of statistics on a consistent basis and a lengthy description of the sectors. Comparison with statistics on applications by type of product for the new Community trademark is made difficult because of differing sectoral definitions; however, NERA's survey base broadly corresponds to sectors making up approaching half of applications for trademarks on goods. The European trademark data show applications from the USA as larger than those from individual EEA countries and far larger than those from Japan. NERA's sectors make up around a fifth of trade in manufactures but if capital goods, raw materials and semi-manufactures are excluded the ratio is about half.

Further, we exclude medicines because of the dominant influence of Government pricing and substantial importance of patent exhaustion. We are aware that parallel trade in this sector has been an important issue for the EC for many years. The subject has already been covered in numerous studies. The text box below presents a discussion of exhaustion in the pharmaceutical industry.

[29] Panorama of EU Industry 1997, Volumes 1 and 2, ECSC-EC-EAEC, Brussels, 1997.

Box 3.1
Exhaustion and the Research-Based Pharmaceutical Industry[30]

The impact of exhaustion of intellectual property rights may differ substantially in nature and size between different sectors of the economy. Our sectoral approach to the analysis captures some of these differences. However, the process of selection of our sectors, based on industries in which trademarks are likely to be of fundamental importance, may exclude many industries where intellectual property rights such as patents will be of greater importance. The conclusions from the sectors which we have studied can not readily be extended to other industries. To draw out some of the issues which may be relevant to exhaustion of intellectual property rights in other fields, this box briefly reviews issues relevant to exhaustion in the pharmaceutical industry.

Europe is the world's leading pharmaceutical producer, taking about 40 per cent of world pharmaceutical output, compared to the USA (30 per cent) and Japan (20 per cent). The value of pharmaceutical production in the member countries of EFPIA[31] reached ECU 93,500 million in 1996, when the EU pharmaceutical industry operated a balance of payments surplus of over ECU 9,000 million. In EFPIA countries, the pharmaceutical industry directly employed an estimated 520,000 people in 1996, including 80,000 employed in R&D.

A key characteristic of the research-based pharmaceutical industry is its reliance on patents. The process of turning a newly synthesised active substance into a marketable medicine takes an average of 12-13 years, covering laboratory research, trials in animals, clinical trials in humans and regulatory review. Only one or two of every 10,000 "candidate molecules" ever make it to the market. These facts make the cost of developing a new medicine, taking account of R&D failures, extremely large, estimated at around ECU 400 million. The patent system provides a limited period of marketing exclusivity, designed to allow innovators to charge prices above the current costs of production, and attempt to recoup the costs of development. In other words, the patent system provides incentives to innovate.

The value of a patent (and hence the power of incentives to innovate) is related to the area over which patent rights are exhausted. The narrower the area of exhaustion, the greater the value of a patent, since there is further scope to engage in price differentiation. Against this, enforcing wider areas of exhaustion creates pressure to reduce prices in some countries. Economic analysis[32] indicates that the most efficient way to recover the costs of innovation when products are sold in markets with different characteristics will be through some form of price discrimination. Although it is difficult to draw rigorous general conclusions regarding the desirability of differentiated prices compared to uniform pricing, there should

30 Data referred in this box are taken from EFPIA (1998) The Pharmaceutical Industry in Figures.

31 The European Federation of Pharmaceutical Industries' Associations. Members include all EU countries plus Norway and Switzerland.

32 The theory of Ramsey pricing.

be no presumption that moves towards uniform pricing in a set of countries will increase welfare across those countries.

A fact which further complicates the analysis of international exhaustion in the case of the pharmaceutical industry is the role of governments in the pricing and purchasing of medicines. For reasons including the fact that a significant proportion of spending on prescribed medicines is often met from public funds, governments play an active role in negotiating and regulating the price of medicines. Where pricing is regulated companies are unlikely to be able to raise prices, as a response to international exhaustion, so international exhaustion creates pressure, to at least some extent, for prices to converge on the lowest price allowed by any government within the exhaustion area. Such pressures are damaging to profitability and incentives to undertake R&D. Since they result, in the limit, in pressure to withdraw from markets they risk harming consumers in the short term as well as through damaging dynamic incentives.

Parallel trade of medicines within the EU has been an important topic for many years, and the European Court of Justice has delivered many judgements in the field, generally in favour of parallel traders. While direct estimates of the cost to industry of parallel trade are rare, the contradiction between free movement of goods and government pricing has been widely recognised. Commissioner Bangemann has led three round table meetings, and working groups including representatives of government and industry have met to seek solutions in this area. Tension of this nature will become more and more important, the greater the diversity between economies in an exhaustion area. Were exhaustion of patent rights extended to poorer countries, serious harm to industry profitability and R&D, and or the availability of in-patent medicines in poorer countries, would be risked.

The remaining of this chapter explains in general terms what factors determine the scope for (an increase in) parallel trade, and what the impact is likely to be. An analysis in more detail at the sector level is carried out in the sector appendices to this report. Section 5 presents a summary and overview of the results by sector.

3.4. Scope for Parallel Trade

3.4.1. Situations in which parallel trade is likely to take place

We have identified a number of situations which might be expected to lead to parallel trade flows. They are as follows:

- Ex factory price differences between countries: identical goods acquired in the low price country may be shipped through unofficial channels to be sold at or below the retail price in the country with high ex factory prices. Logic suggests that multi-nationals do not often make identical goods voluntarily in two countries with

significantly different costs of production though they make variants of a particular product under the same trademark eg to meet differing tastes (see below);

- Retail - or wholesale - price differences (consumer taxes excluded): goods are purchased in the low price country and shipped to take advantage of prices in the high price country. They may or may not have originated in the high price country;

- Exchange rate changes: a sharp appreciation of a country's exchange rate may lead to goods that are imported and are being sold at an unchanged price (in that country's currency) being diverted into unofficial channels to sell at a higher price;

- High promotional expenditures in official channels of sale: if before- or after-sales service costs of an imported product are high there may be opportunities to use unofficial sales channels to sell at a lower price through eg. less fully equipped facilities;

- Over-production: surplus output, eg. outmoded fashions, from an overseas supplier may be put on the market at a discount through unofficial channels. The trademark owner may prefer this more covert approach to selling at a discount through authorised distributors which might be seen as discrediting the brand;

- Loose drafting of or failure to police contractual terms: where goods are made under licence abroad by a firm but where the terms of the licence are not tight enough to prevent supplies' getting to parallel traders; or, through lack of control of suppliers total capacity, trademarked goods are made in quantities larger than agreed and the surplus flows into unofficial channels. Authorised dealers may behave opportunistically; and

- Product quality differences: goods with the same trademark may be made by a subsidiary in an overseas market for sale there but may be of lower quality (and therefore cost less to produce). These may find their way into unofficial channels to be sold in the country of the parent company.

Our questionnaire to a variety of interests is intended to cast some light on which situations are likely to be most important in practice.

3.4.2. Reasons for price differences between countries

Our survey examines reasons for international differences between prices. In principle we see some of the main reasons as being:

- Differences in local demand: prices will tend to be lower in country markets in which demand is more price responsive (ie price elastic) as a result of readily available close substitutes and higher where prices are less responsive due to there being fewer close substitutes. This is equivalent to the businessman's expression "what the market will bear". It presumes some ability to segment markets;

- Personal income differences: demand will tend to be more price-responsive in countries with lower incomes and prices therefore lower than in countries with higher incomes;
- Exchange rate differences: sharp movements can lead, initially at least, to differences in retail prices. If a country's exchange rate appreciates, the price of an identical good in other countries will become lower (in the same currency). This can reflect a number of factors including sluggishness in altering prices perhaps because consumers do not wish to see price volatility) and exporters "pricing to market";
- Differences in competitive conditions: where there are few dominant suppliers, prices will tend to be higher. This will be reinforced if consumers are not well informed and weakly organised;
- Differences in cost of production due to differences in efficiency. However, this raises questions about why a multi-national should produce in both countries if the difference is substantial; and
- Differences in levels of consumer taxation.

3.4.3. Price Differences between the EEA, USA and Japan

This study focuses closely on the consequences for parallel trade with the USA and Japan of changes in the regime of exhaustion. Other things being equal a change of regime could bring about significant flows of parallel imports if price differences between the EEA and the other two countries are sufficiently great to cover transport and other costs (including import duties). The USA is a generally low price country compared with the average level in the EU whilst Japan has relatively high prices. Thus (net) parallel trade might be expected to flow from the USA to the EEA and from the EEA to Japan. (The point of manufacture of the goods may target the same country or elsewhere.)

Price differences play an important part in the economic analysis and, while we are asking firms about their perceptions of price differences, an indication of this can also be gained from detailed (unpublished) OECD estimates of comparative dollar price levels in 1996 relating to products in NERA sectors. These are shown in Table 3.1. It should be noted that if allowance is made for changes in *average* consumer prices and exchange rates against the dollar between 1996 and the second quarter of 1998, EU prices (in dollars) have fallen by 10% and Japanese prices by 18%, whilst US prices have risen by 3%.

Table 3.1
Detailed provisional dollar price relatives in OECD 1996 (OECD = 100)

	EU 15	USA	Japan
Chocolate preps	102	74	162
Confectionery	123	75	187
Mineral water	106	61	221
Other soft drinks	116	71	208
Spirits and liqueurs	109	68	124
Wine (not fortified or sparkling)	93	116	205
Beer	85	88	230
Other wines and alcoholic beverages	98	80	110
Men's clothing	121	79	117
Ladies' clothing	119	70	176
Children's clothing	113	62	117
Infants' clothing	130	72	220
Men's footwear	118	67	259
Ladies' footwear	115	68	194
Children's footwear	130	83	86
Refrigerators etc	94	75	184
Washing mcs etc	99	101	126
Cookers, hobs, ovens	85	41	207
Heaters, air cond	138	51	216
Vacuum cleaners etc	143	79	162
Other major apps	106	51	177
Cars	122	88	91
Tyres, tubes, parts	120	80	107
Radio sets	113	93	104
TV sets, VCRs	145	75	111
Record players etc	151	89	85
Records, tapes, cass	111	82	108
Toiletries etc	94	99	141

Source: OECD

It is clear that prices are mostly much higher in Japan than in the EU (and the USA). The exceptions include cars and electronic consumer goods. In most types of goods, the US price is lower than that of the EU, often much lower. These are of course average relationships. The differences for individual brands may be greater or less, or even reversed.

However, these relative prices are inclusive of consumer taxes (VAT, sales taxes, excise duties) and some adjustments are necessary where tax-exclusive prices are more appropriate (eg as a driver of parallel trade). Sales taxes in the USA vary from state to state but may average around 4 per cent according to the US Embassy (in New York they are 8.25 per cent), standard VAT in Japan in 1996 was 3 per cent,[33] and in the EU around 18 per cent on average.

The importance of ascertaining consumer tax levels is increased by the fact that we are asking firms about relative retail prices inclusive of taxes. We have useful data on VAT rates and excise duties in EU and other OECD countries from a comprehensive OECD source.

More detailed price information at a less aggregated level is given in the sector analyses in the Appendix C.

3.4.4. Price differences between the EEA and the Transition Economies of Central and Eastern Europe

With personal incomes in the transition economies of central and eastern Europe (including the former Soviet Union) being a small fraction of levels in most of western Europe, EU firms may try to develop these export markets by selling at prices below cost but in excess of marginal cost. At prices covering full costs, sales might only be very small, ie the presumption is that consumption is highly price elastic. The goods may be made in the EEA or under some arrangement (licence or joint venture) in the transition economy.

Selling at low prices would raise the possibility of parallel imports back into the EEA if it were not for the fact that exhaustion does not apply to such trade and rights holders can act to prevent it. However with the probable accession to the EU of some of these countries in the early years of the next century, when incomes in central and eastern Europe are still likely to be relatively low (and price elasticities high) there could well be significant parallel imports unless transitional arrangements prevent them.

3.5. The Economic Consequences of More Parallel Trade

3.5.1. Expected immediate effects

Here we address in more general terms the issues for the EU listed in the Terms of Reference under regimes of

1. unilateral international exhaustion; and,
2. reciprocal exhaustion arrangements with the USA and Japan.

[33] Changed to 5 per cent in 1997.

Responses of manufacturers and authorised distributors to the impact are dealt with in the following section and not in this section, which deals only with the expected immediate impact. We now summarise the main expected immediate effects of introducing one or the other of these regimes on: trade volumes, domestic prices, product availability, market structure, consumers, business and border controls against counterfeit goods. Under each heading regime (1), which extends exhaustion in a unilateral way to the whole world, would generally have more impact than regime (2), which is confined to the USA and Japan.

Trade volumes**:**

1. The increase in parallel imports which may be either goods made in the EEA which have been exported and subsequently re-imported, or goods made in third countries that enter the EEA through unauthorised channels.

2. An increase in parallel imports (originating in the EEA but quite likely also in the USA, possibly even Japan, and even in other third countries if the trademark owner consents to marketing of the goods in the USA or Japan) could be accompanied by more parallel exports. At first sight parallel exports might be expected to go mainly to Japan but the initial difficulties of entering the Japanese market are well known. To some extent there would be original imports corresponding to any outflows. Otherwise they could be substitutes for exports through official channels. The scale of the parallel imports seems likely to be smaller than in (1). To what extent the USA and Japan might in practice act as channels for other third country sources of parallel imports is an empirical matter.

Domestic prices:

1. For most goods an increase in parallel imports seems likely to reduce average prices by increasing intra-brand competition, and because parallel imports might be sold at a discount. The extent to which this occurs must depend on a number of factors, including the scale of parallel imports and the cost structure of the industry. Small scale intermittent imports would produce localised effects and only for short periods.

2. In principle, the domestic price effects would be similar to those in (1) but presumably smaller. Domestic prices could also rise if trademark holders wish to protect themselves against parallel exports from the EU.

Product availability:

1. It is possible that the range of brands in the EU would be enlarged. It is more likely that there would be greater access to them through a wider range of outlets and the availability of discounted products.

2. Similar but on a smaller scale.

Market Structure:

1. The main effect is the gain of unofficial wholesalers and for certain goods retailers at the expense of authorised wholesalers and retailers.

2. A similar effect would be expected, albeit smaller.

Consumers:

1. To the extent that lower prices in the EU result there would be a rise in real personal incomes and a general benefit to consumers. This may, however, be less clear where parallel imports are discounted by dealers who may provide a lower level of service. This is probably more important when a more complex product is involved. This aspect is dealt with later. However, to the extent that price reduction is perceived to more than offset any loss of services, this still represents a gain. Some purchasers may feel they could do without what are seen as excessive accompanying services (gold-plating) built into the price. In the short term consumers may gain by free-riding on pre-sales service from authorised dealer, then purchasing from an unofficial outlet. There is a possibility that products bearing the same trademark as used domestically may differ in, for example, content, taste, nutrition description, language of instructions.[34]

2. Similar effects, smaller than in (1).

Business:

1. Trademark holder - sales direct to the domestic market would be substituted by parallel imports, but lower prices could mean that demand, and therefore output, would increase in volume (assuming spare capacity). If wholesale prices to the export market are less than those to the home market there could be a loss of profit at this stage but not otherwise. Loss of profit may also occur in distribution if any of this stage is owned by the manufacturer. Which is more likely depends on the factors driving parallel trade. Any consumer dissatisfaction with parallel imports is likely to harm the holder.

   Authorised wholesalers and retailers are likely to suffer a loss of profit, though if they lower their prices there would be some partial offsetting sales volume effect.

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[34] Although there was anecdotal evidence of injury to consumers in the USA in the 1980s, investigations by the Federal Trade Commission were unable to find significant evidence of a systematic problem. Several major retailing chains and wholesalers were providing their own substitute warranties and other services (JC Hilke, "Free trading or free-riding: an examination of the theories and available empirical evidence on gray market imports" World Competition vol 32 page 75)

The effect on SME trademark holders is not likely to differ in kind but they may be less likely to be exporters or to have goods produced overseas. However, for some SMEs exports are a high proportion of output. Many wholesalers and many both authorised and unofficial distributors (including parallel importers) are likely to be SMEs.

2. Trademark holder: apart from the likely smaller scale of parallel import effects, parallel exports through unauthorised channels can take place. Profits are more likely to be reduced if the holder is involved in distribution in the USA or Japan - which is quite likely if it is a large producer.

Authorised dealers in the EU are unlikely to be affected by increased parallel exports though, of course, they will be hit by parallel imports on a lesser scale than in (1). Unauthorised distributors in the EU will gain from parallel imports and perhaps also from parallel exports.

Employment effects

1. The effects on employment under the change in regime are complicated, and different factors may tend to increase or reduce employment. To the extent that EEA prices fall as a result of international exhaustion, EEA market volumes will increase. Hence, production and employment will increase in some locations. To the extent that the goods concerned are produced in the EEA, placed on the market in other countries, and parallel-reimported to the EEA, employment would tend to increase in the EEA. To the extent that parallel imported products are produced and marketed abroad and then parallel imported to the EEA, there would be no increase in EEA manufacturing employment. If these parallel imports displace direct route imports there would be little effect on EEA manufacturing employment. If parallel imports displace local production, manufacturing employment in the EEA would tend to fall.

Where our analysis makes quantitative estimates of the impact on employment we assume that the location of production remains unchanged, and accordingly employment rises in the original location of production. This implies that significant amounts of parallel trade will consist of parallel re-imports. Such assumptions are difficult to test and our analysis is likely to be very sensitive to them. Our quantitative estimates are hence subject to a significant range of uncertainty, both in terms of the direction and magnitude of the effects and should be regarded as indicative only.

Additionally, it should be noted that employment effects in retail and distribution have not been quantified. To some extent opening new distribution channels and retail outlets may tend to increase employment. However, falling employment in the (possibly more labour intensive) traditional retail sector may offset any such effects.

2. The effects would be similar but smaller in magnitude. To the extent that parallel exports occur the converse of the above analysis would apply, and if EEA production displaces production abroad, employment may tend to increase.

Border controls against counterfeit goods:

In general, distributors are likely to be very careful to avoid passing on counterfeit goods. However, a greater volume of parallel trade may lead to more counterfeits being landed and possibly more will slip through the customs checks if more resources are not employed on this task.

3.5.2. Potential longer term effects

The longer term effects of extending the trademark exhaustion are expected to be similar in the case of a unilateral and a reciprocal change. These longer term effects hold more generally for any increase in the scope for parallel trade.

For trademark owners, increased scope for parallel trade would lead to lower returns. In the longer term, this would inhibit investment in new brands, or in some cases might cause firms to retire existing products from the market. It may also mean that trademark owners are less willing to make investments in advertising and setting up distribution systems in new local markets, where circumstances are such that low prices can be charged (such as some Eastern European countries). These and other commercial responses of trademark owners are further discussed in section 3.6 below.

For consumers, lower investments in new brands in the longer term would tend to lead to reduced quality and variety of branded products. If owners are less prepared to invest in their trademarks, the benefits that trademarks bring, namely providing product information and signalling reputation, may also be reduced in the longer term. These longer term effects on consumers may offset the short term benefits of lower prices for some branded goods in some countries.

Distribution systems for branded goods could also change in the longer term. For some sectors "dual" distribution systems could emerge. An official system of authorised sales channels could be operating in parallel with a non-official system of non-traditional outlets including "factory outlets". The extent to which this is likely to happen depends amongst other factors on the tightness of vertical relationships in a sector. If a manufacturer has much control over the distribution chain and sales outlets in a potentially importing country and there is hardly any opportunity for these official channels to buy parallel imported products, we would expect non-traditional outlets to emerge. The impact on consumers is ambiguous. On the one hand, one could argue that consumers have more choice (they can either buy from the official or non-official outlet), while on the other hand, the image and reputation of the trademark could be adversely affected, which would harm all consumers in the longer term.

3.6. Potential Commercial Response of Trademark Holders and Others

Those questions asking trademark holder respondents (and others) how holders would react to additional parallel trade arising from changes in the regime of exhaustion are a crucial element of the survey. Respondents may already have had experience of parallel imports within the EEA and their reactions to these would provide a basis for responding to a new situation. In this section we outline the kinds of response that could be available and the limits set by Community and national competition law. Under regime (1) rights holders will need to respond only to additional parallel imports but under regime (2) they may need to respond to both additional parallel imports and parallel exports.

3.6.1. Responses on price and availability

The most direct response of a producer to the opening up of parallel imports is to reduce the price difference between domestic and foreign markets, or to withdraw from a market entirely. Some limitations on these approaches would be:

- Manufacturers may not legally have control of retail prices, as in the USA and the EU;
- There may be reluctance to lower prices in the high price market if the bulk of sales are made there (eg EEA in relation to the relatively low price USA);
- There may be reluctance to raise prices in a country which is regarded as a very important market (often the case for the USA). There would probably be reluctance to withdraw from a major market;
- Retail price differences may stem from factors such as a high level of retail promotion in one country rather than from differences in ex factory prices.

While the initial impact of parallel imports may be mainly on the authorised distributors, including retailers, it is very likely that these firms losing sales and under pressure to reduce prices will ask the trademark holder for a better deal thus putting pressure on the latter's profit margins.

3.6.2. Other strategic responses

There may be attempts to act more directly against the parallel traders and the goods they have sold. Alternatively some responses may arise because parallel traders are effectively free-riding on promotional services undertaken by the manufacturer or approved distributors. Reactions other than pricing moves could include:

- Cuts in after-sales services in connection with goods identified as parallel imports or more generally. Authorised dealers may not be prepared to repair goods that are

identifiably parallel imports. However, given an adequate demand new services could spring up. Identification of parallel imports may be difficult.

- Refusal to honour guarantees in connection with goods identified as parallel imports or to meet guarantees on less favourable terms. If this took place on a sufficient scale, alternative services could possibly arise depending on the nature of the product. The unauthorised retailer might be willing to bear this cost.
- Approach parallel traders to encourage them to change their behaviour. Occasionally, rightholders may be willing to supply parallel traders if they will use nominated (unofficial) outlets.
- Differentiate packaging by country market in order to make resale elsewhere more difficult. The product may be less attractive if the packaging is unfamiliar;
- Cuts in promotional expenditure by distributors to make it more commensurate with reduced sales through official channels. Promotional services here includes pre-sales service such as the advice given on complex appliances or the provision of facilities for listening to CDs before purchasing.
- Cuts in manufacturers' support for distributors' promotion activities;
- Set up selective distribution network and prohibit sales to unauthorised dealers;
- More rigorous enforcement of distributors' conditions on resale. Supplies could be cut off from firms thought to be selling to unauthorised dealers;
- Cut R&D and other means of product improvement. Loss of profit as a result of parallel trading could lead to reduction in R&D expenditure.

Clearly the scale of response by the holder will depend on the loss of profit. The same applies to authorised dealers.

Actions may apply either in the EEA market or overseas and to parallel imports or parallel exports.

However, some of these actions, eg cuts in promotional activity and reduction in expenditure on R&D, would weaken the future market position of the trademark holder and authorised dealers. Action of this kind would be a last resort in dealing with parallel trade. This might also be the case in refusing to honour guarantees or provide repair service for goods which are clearly parallel traded. Purchasers might not appreciate the distinction being made and the action could reduce consumer confidence and damage the brand image.

3.6.3. Legal limits to above responses

3.6.3.1. Preliminary

We would make three preliminary comments:-

1. In this study we are concerned with *international* exhaustion, not exhaustion *within* the EU. The parallel imports under consideration are:-

   - those from non-EEA countries to the EEA (on the basis that the EEA adopts the principle of international exhaustion): and
   - those from the EEA to non-EEA countries (in the event that other countries adopt the principle - on a reciprocal basis or otherwise).

   The main focus here is on the former, partly because this is something more within the control of the EEA and (more importantly) because it is likely to be more important commercially (the EEA being a relatively high price zone).

2. When looking at the EEA economy as a whole, and right holders in general, it is appropriate, in our view, to focus on areas where the law is likely to impose a significant limit in a significant number of situations. There may be situations where, because of the particular position of a right-holder (eg market share, attitude of the parties towards it etc.), that his attempts to check increases in parallel imports are restrained by regulatory considerations (such as the intervention of the European Commission). However, unless it is felt that such regulatory constraints are likely to be widespread, we take the view that it is not appropriate to analyse them in any detail in this study (this is a matter for consideration by individual right holders in the light of their own particular circumstances).
3. Contractual considerations may impose short term constraints on a right holder's ability to take some of the specified responses. However, these are unlikely to be relevant in the long term and are not considered further here.

3.6.3.2. The "Usual" Parallel Import Situation

The EU's Competition Law and Rules governing the free movement of goods have often limited action by right holders to prevent or restrict parallel imports between Member States of the EEA[35].

However, the current study is concerned with increases in parallel imports, not within the EEA, but between the EEA and elsewhere. In a sense the primary legal constraints on dealing with parallel imports under EU law are one stage removed from dealing with the

[35] The principle provisions/limits are the following:

* Article 85 of the EC Treaty which prohibits anti-competitive agreements which may affect trade between Member States of the EEA;
* Article 86 which prohibits abuses of a dominant position by companies;
* Article 30 which prohibits restrictions on trade between Member States of the EEA; and
* Article 36 which provides a limited range of exceptions to Article 30 (including provisions covering intellectual property of relevance to trademark right holders).

parallel imports in question. This means that they are likely to be relevant in fewer situations and, even where potentially relevant, to be a less effective break on right holders' activities in most situations.

3.6.3.3. Parallel Imports into the EEA

There may, however, be specific circumstances where actions by right holders to restrict parallel imports into the EEA from outside the EEA could have an effect on subsequent trade between Member States of the EEA with the result that the free movement of goods and competition provisions of the EU could be applicable. This possibility has recently been confirmed by the European Court in the Javico case[36] where the European Court held that a prohibition on export from a territory outside the EU could have an effect on competition within the EU and be liable to affect the pattern of trade between EU Member States (and thus infringe EU competition law). The Court suggested that this might be the case where the Community market in the products in question was 'characterised by an oligopolistic structure or by an appreciable difference between the prices charged for … product within the Community and those charged outside the Community'.

Of the potential actions by right holders to limit parallel imports into the EEA considered in the questionnaire and in this report the following might be relevant:-

(i) Withdraw from source country of parallel trade

Within the EEA refusing to supply a customer to prevent that customer (or customers of that customer) exporting to another Member State of the EEA, can often infringe Articles 85 and / or 86.

It is therefore conceivable that a refusal to supply customer(s) in non-EEA countries, with a view to preventing parallel imports into the EEA, could affect competition within the EEA and have a knock-on effect on trade between EEA Member States (and thus fall within the ambit of Articles 85 and 86). In our view, this will probably not be the usual situation, and, in any case, where a right holder withdraws completely from a particular source country (rather than penalising particular customers for exporting etc.), the prospect of EU competition law providing an effective restriction on the right holders response seems somewhat theoretical.

(ii) Alter Terms of Guarantee

Within the EEA, if a manufacturer offers a guarantee for his products, he cannot disown that guarantee solely because a customer seeks to invoke the guarantee in a Member State other than that for which the manufacturer intended the product.

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[36] *Javico v Yves Saint Laurent* of 28 April (see 306 / 96)

It is conceivable that withdrawing the benefit of a guarantee within the EEA in respect of products originally sold outside the EEA could be caught by EU competition provisions but, this would require an extension of current jurisprudence, which we think is probably unlikely.

(iii) Cut support for distributors

Within the EEA, selectively withdrawing support to distributors which export to other EEA Member States can be a clear infringement of EU competition law.

Where support is withdrawn from distributors outside the EEA who re-export to the EU (or otherwise permit this) this could also, in principle, be caught by these provisions - provided always that there is the requisite consequential impact on competition and inter-state trade within the EEA. In many cases this will not be demonstrated and, in any case, it will often be difficult to prove the necessary nexus between the withdrawal of support outside the EEA and the requisite intention or effect, on competition within the EEA.

(iv) Setting up selective distribution networks prohibiting sales to unauthorised dealers

Setting up selective distribution networks outside the EEA prohibiting sales to unauthorised dealers may reduce the risk of parallel imports into the EEA. In principle the competition laws of third countries may not permit such restrictions. However, the EEA's major trading partners generally have a more *liberal* attitude towards such "vertical restraints"[37] (eg Japan and the USA), and it seems unlikely to us that such laws would provide a significant legal limit in most situations.

(v) Vertical integration

Agreements between companies in the same corporate group will not fall for consideration under Article 85(1). This is provided that the group of companies constitutes a "single economic entity", within which the subsidiaries do not enjoy any freedom to determine their own conduct in the market. A trademark owner may therefore restructure a distribution network to include only subsidiaries, in which case, he may include in his agreements with those subsidiaries restrictions on onward sale. However, restrictive agreements with subsidiaries who do have freedom to determine their own conduct in the market will fall within the prohibition contained in Article 85(1), since the arrangement will not be treated as a single economic entity. (Contrast the two cases of Parker Pen v Commission and Viho Europe v Commission).

(vi) Approach parallel traders

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[37] Although the EU's approach is changing and in turn becoming more "liberal" (see the "Communication" on vertical restraints published in OJ C 365/3 of 26/11/98).

The general response that we describe as "approach to parallel traders" is somewhat open-ended. It could, however, involve unlawful means of coercion restricting such traders' ability to supply into the EEA market (eg discriminatory terms if a customer exports or permits exports to the EEA). Again, where there is the requisite knock-on effect on inter-state trade, such measures may be constrained by EU competition law.

3.6.3.4. Parallel Imports from the EEA to non-EEA Areas

In principle, the points considered at the section above could apply to constrain parallel imports from the EEA to non-EEA areas. This is primarily a matter for the competition laws of the third countries in question. Furthermore, the competition laws of non-EEA European countries are increasingly modelled on those of the EU itself (for example, Switzerland).

In addition, however, provisions restraining exports from the EEA to non-EEA areas can sometimes also be caught by EU competition law. This is essentially where there is a 'real likelihood' of the goods in question being re-imported into the EEA (see also the European Court's recent decision in Javico referred to in section 3.6.3.3 above).

One further point which we would add from an EU law perspective concerns selective distribution. A right holder might seek to establish a selective distribution network within the EEA prohibiting sales to unauthorised dealers. Under EU law, this will only be permitted for a relatively narrow range of products: eg where there are objective reasons for selling the products in question in a particular environment, where they require a particular expertise at the point of sale, or the need for after sales service etc. For example, such a system might be justified for certain electronic goods but not, for example, for records or clothing.

In 3.6.3.3 (iv) above we refer to the more liberal attitude towards vertical restraints of certain of the EEA's major trading partners. This approach is likely to be adopted within the EEA itself, following the model most recently set out in the Commission's communication on the application of the Community competition rules to vertical restraints. This more flexible approach will recognise that competition concerns only generally arise with vertical restraints where there is insufficient inter-brand competition, and therefore the market share of the supplier will be crucial to any analysis of whether restraints on onward selling fall within the prohibition contained in Article 85.

That said, at present it seems unlikely that the Commission will be prepared to extend the range of products for which it will accept the need for selective distribution (which will often have the practical effect of restricting access to the products by some of the more aggressive traders / discounters).

3.6.3.5. Consumer Protection and Safety Rules etc

Most developed economies have a complex network of rules designed to ensure that products are safe and otherwise to protect consumer interests. For example, Member States

are obliged to implement into their law minimum product safety standards by virtue of the Product Safety Directive. In addition, Member States have their own product safety and consumer protection regulations which set out minimum standards of protection. These minimum standards may include obligations to package products in a certain way, particularly with regard to providing warnings (for example, UK toy safety regulations).

However, there has been considerable effort to harmonise (or, at least, "approximate") the rules in this area within the EEA. Most rules of this sort are now derived from EU Directives.

Notwithstanding this, national rules in this area are still sometimes invoked against imports from other EEA countries (for example, by trademark owners against parallel imports).

As there has been considerably less harmonisation of rules in this area between the EEA and the rest of the world, there are many products which may have been put on markets outside the EEA which comply with the relevant rules in those countries but which, if imported into the EEA, would not meet the relevant requirements in the EEA. Accordingly, trademark owners may invoke this legislation to prevent such parallel imports following the adoption of the principle of international exhaustion for trademarks.

Similarly, they could invoke such safety/consumer protection legislation in third countries against parallel imports from the EEA to those countries.

Although not a legal limit, it is worth noting that technical standards (eg voltage) may also limit the extent to which parallel imports between the EEA and other parts of the world are practical.

4. SURVEYS OF TRADEMARK HOLDERS AND OTHER INTEREST GROUPS

4.1. Description of Scope and Method of Survey

Questionnaires, for the telephone survey that has been carried out by IFF Research, were designed for each of four interest groups identified by DG XV. These are:

- Trademark holders (SMEs and larger companies)
- Importer/exporter associations
- Consumer organisations
- SME organisations

The questionnaires share a common broad structure (see Appendix B for the complete questionnaires):

- Pricing under the current regime
- Parallel trade within the EEA under the current regime
- The effect of unilateral exhaustion
- The effect of multilateral exhaustion

Whilst intended primarily to shed light on the scale of parallel trade and the impact on and behaviour of the main players, it was also intended to provide quantitative information for our economic assessment.

Within this framework, questions were tailored to the different perspectives these groups might tend to have on the subject. However, it is possible to compare views on particular issues. Within each questionnaire, similar sets of questions were used for the two exhaustion regimes. Each question has multiple choice answers to facilitate computation of results, many including a scale of 1-5 to measure the impact of change or benefit etc. At the same time, opportunity was provided for responses outside those specified, for explanations and general views on exhaustion.

Draft questions were agreed with SJ Berwin and IFF and then with DGXV. In the meantime, IFF had been compiling lists of firms and other organisations.

IFF undertook the redrafting of the approved questionnaires in a more formal manner prior to their piloting. The piloting with nine organisations indicated that the drafting raised no problems and no large changes were made. There were, however, difficulties in obtaining

respondents but this was attributed mainly to the time of year when many people were on holiday.

The basic procedure was to approach by telephone (in the case of rights holders) a senior manager / director concerned with commercial matters so as to identify the correct person in the firm to address the questions. This was complicated by the mixture of legal and commercial issues although it was the latter to which the approach gave most prominence by focusing on "parallel trade". When agreement in principle was received to take part in an interview, the person concerned was sent a copy of a letter from DG XV seeking their co-operation and a note setting out the framework of the interview and very broad topics to be considered. This enabled the firm to make a more focused response. (In some cases, firms dropped out after receiving the background information.)

In practice, it proved difficult to arrange and complete interviews, not least among the rights holders. Representative organisations, as expected, often needed time to make a response even when they felt a response would be feasible. Table 4.1, below, shows the pattern of target responses by groups involving in total 176 firms and organisations. IFF managed to obtain 160 successfully screened respondents, having contacted over 5,500 organisations. However, of these 160 responses, 23 were partially completed, and 137 interviews were completed in full. This makes the response rate for completed interviews about 1 in 40 (137 out of over 5,500 contacts), which is very low.

Table 4.1
Target responses and achieved responses by IFF

Interest group	Target number of responses	IFF Achieved number of responses	IFF Achieved number of complete responses
Trademark holders	90	105	87
Consumer organisations	16	9	9
Importer / exporter associations	50	39	35
SME associations	20	7	6
Total	*176*	*160*	*137*

Source: NERA and IFF

The low response rate may be partly explained in terms of the inherent complexity of the issues. Participants obviously had most difficulty with the forward looking sections of the questionnaires, where they were asked to anticipate the effects of changes to the exhaustion regime. Even those responding registered a substantial number of "don't knows". It is also possible that the issues are only of major significance to a proportion of potential respondents.

In general, replies were provided for most questions and answers seemed sensible ie intuitively or otherwise credible. However, given the low response rates among some of the target groups, any numerical estimates from the survey must be treated with caution and

cannot be scaled up to give aggregate estimates. Nevertheless we believe that the contacts made do, in total, provide a reasonably representative selection of opinion on this issue.

Trademark holders also found it difficult to respond to questions on cost/price structures and these data are of limited value to an overall quantitative assessment of economic impacts.

4.2. Additional Programme

It became clear at a relatively early stage of the IFF survey programme that the response rate was low. In agreement with DGXV, NERA therefore decided to take into account a number of submissions and position papers sent spontaneously by interested groups. A number of interviews were also carried out by NERA, as well as a number of meetings with interested parties. The sole purpose of this additional programme was to improve our practical understanding of the issues that are relevant for this report. It has not been part of our task to conduct a consultation process, and there has been no general invitation to parties to give their opinion about the hypothetical changes we were investigating.

Table 4.2, below, lists the organisations we have been in contact with. The total number of responses through this route is 33. Together with the survey response of 160, the total number of responses of 193 comfortably exceeds the target number of 176.

Table 4.2
Responses in addition to the IFF survey programme

Organisation/person	Type of Response
1. Strategica AS (Swedish study on trademark exhaustion)	Meeting with NERA
2. Inventus AB (Swedish study on trademark exhaustion)	Meeting with NERA
3. UK Department of Trade and Industry (DTI)	Meeting with NERA
4. UK Patent Office	Meeting with NERA
5. Professor Paul Seabright	Written submission
6. Bureau Europeen des Unions de Consommateurs	Written submission
7. European Brands Association (AIM)	Written submission
8. European Brands Association (AIM)	Telephone interview by NERA
9. Union of Industrial and Employers' Confederation of Europe (UNICE)	Written submission
10. European Merchants Association (EMA)	Written submission
11. European Merchants Association (EMA)	Telephone interview by NERA
12. European Union of Small and Medium Sized Companies	Telephone interview by NERA
13. Feddersen et al /	Written submission
14. Parallel Traders Association (PTA)	Telephone interview by NERA
15. Parallel Traders Association (PTA)	Written submission
16. Foreign Trade Association (FTA)	Written submission
17. Association of Parallel Traders	Written submission
18. Verband Freier Deutscher Markenimporteure (VFDM)	Written submission
19. Large supermarket chain	Meeting with NERA
20. Interactive Software Federation Europe (ISFE)	Written submission
21. British Phonographic Industry (BPI)	Meeting with NERA
22. British Phonographic Industry (BPI)	Written submission
23. International Federation of the Phonographic Industry (IFPI)	Written submission
24. International Federation of the Phonographic Industry (IFPI	Meeting with NERA
25. Warner Music	Meeting with NERA
26. EMI	Written submission
27. BMG	Written submission
28. Musical Publishers' Association (MPA)	Written submission
29. British Independent Motor Trade Association (BIMTA)	Written submission
30. Federation of European Motorcyclists Association (FEMA)	Written submission
31. Auto Cardoen	Written submission
32. European Association of Independent Vehicle Traders (EAIVT)	Written submission
33. Belangenorganisatie voor Internationale Automobielhandel (Bovia)	Written submission

Source: NERA

The written submissions have been passed to DGXV. In the sections below, we have summarised the main arguments that have been mentioned in the written submissions, during telephone interviews and meetings, in favour of and against extending the trademark exhaustion regime. It should be emphasised that the following summaries of arguments received against and for extending exhaustion in 4.2.1 and 4.2.2 respectively are

based solely on submissions received, written or oral, from organisations and do not include material from the telephone survey carried out by IFF.

4.2.1. Summary of received arguments against extending of exhaustion

We have received submissions from the European employers' federation (UNICE), the European Brands Association (AIM), an independent economist, several national and international associations, and a major firm concerned with the music recording industry. The points made cover both arguments about the principles of exhaustion and the disputes over the facts that are relevant to the debate. They included the following.

- High brand reputation plays a crucial part in achieving non-price competitiveness. This reputation has to be both created and maintained by continuous investment in not only innovation, product improvement or line extension but also in communication with the market by advertising and other forms of promotion. Local markets need to be developed by investing in staff, material, advertising and promotion before a brand is established.

- Brands enable the consumer to make an informed choice benefiting from:

  - higher quality at competitive prices;
  - choice from brand diversity;
  - wide availability and ease of recognition of brand;
  - relevance to needs;
  - reassurance due to trust in brand reliability; and
  - satisfaction from purchase of and identification with the brand.

- The present regime is essential to protect EC competitiveness and innovation.
- International exhaustion would reduce the value of intellectual property rights and put European countries at a disadvantage against countries not applying international exhaustion. It should be opposed as long as there is no single world market with a uniform commercial, economic and legal framework.
- Where prices are lower than in the EU this may because there is not a level playing field on eg social taxes, environmental standards, advertising costs etc. Also, lower margins may be accepted in order to break into new markets.
- SMEs are especially at risk from parallel imports with adverse effects on R&D and future innovation.
- Brands ensure the consumer gets the product, packing and after-sales service expected. Brands change to meet new needs and differing national tastes.

- Parallel imports may confuse the consumer as a result of problems such as:

  - instructions may be in a foreign language;
  - lack of after-sales service;
  - deleted lot codes may prevent recalls;
  - quality, after-sales service and availability of guarantee may not meet customer expectations damaging the brand image and the trust between owner and consumer.

- Parallel imports, using different agents and ports, will confuse customs officials and make it more difficult to identify counterfeits, thus increasing the flow of the latter.
- As a rule of thumb, if inter-brand competition is reasonably strong, there is no economic case for preventing price discrimination. Competition authorities should be vigilant about developments that threaten to weaken such competition. But these particular and occasional dangers would not justify a general erosion of the institution of trade-mark protection.
- Retailers with investments in brands and with potential for expansion outside the EU may regret too hasty an attempt to overturn the Silhouette judgement.

The following points are made in one or more of a number of submissions connected with recorded music:

- The industry consists of a small number of vertically integrated major international record companies, many small specialised independents and own companies of famous artists. This is a high risk business involving seeking out and developing national talent with few artists making the grade.
- The parallel importer imports only the most successful albums, free rides on the risks and promotional investments of the rights holders and does not produce lower prices for the consumer.
- The right to prohibit parallel imports is an important property right. Without it, there would be severe negative effects on national and regional creative communities.
- To some extent the "majors" would be able to absorb this unfair competition but the impact on the independents would be severe. The strength of independents lies in developing new talents and trends and exploiting the relatively small number of successes through exclusive licensing and distribution agreements protected by strong importation rights. In the UK they focus on the home market (30 per cent of albums sold). Overseas selling is through licensing of unrelated companies or exporting through unrelated distributors and these revenues contribute to

overheads. Parallel imports of low-priced overseas sales (with low royalties earned) would displace domestic sales priced at full cost worsening an already precarious financial position (which for all record companies is threatened by the possibilities of the Internet) with knock-on effects on the development of creative talent.

- Consumers will not only not gain through lower prices from extending exhaustion, a further "Americanisation" of the industry and its output could be expected due to less innovation.

- Both copyright and trademark protection are important to the industry. Sound recordings benefit from copyright protection and CDs attract trademark rights. There is concern that any extension of trademark exhaustion will be matched by the same changes in other property rights.

- With new technology available, the industry faces severe counterfeiting problems from eg Eastern Europe and the Middle East. Trademark litigation is swifter and cheaper in bringing proceedings against pirates. The other benefit of trademarks as compared to copyright is that they are known to the customs authorities, the first line of defence against counterfeits. There is concern that whereas imports of all EEA trademarked CDs - parallel imports and counterfeits - are currently infringements, extension of exhaustion would require the separate identification of counterfeited CDs which is very difficult. Eastern Europe and the Middle East are markets being developed by record companies which often supply licensees at low prices.

4.2.2. Summary of received arguments in favour of extending exhaustion

Submissions were received from the Office of the Union of European Consumers, general and specialised (motor vehicle and motor cycle) associations of parallel traders and lawyers representing the interests of parallel traders. The main points included:

- Trademark legislation is intended to provide assurance of origin of a product and was not intended to be an instrument of market control and segmentation.

- Absence of international exhaustion on trademarked goods reduces the benefits to personal and industrial consumers of the lowering of barriers to trade through WTO.

- A number of myths have arisen in connection with parallel trade saying that consumers will suffer. There is little evidence that consumers suffer when parallel imports are permitted. This is certainly not so in the internal market. Points include.

    - It is not legitimate to make a connection between parallel traded goods and counterfeiting since goods are first placed on the market by the trademark owner or with his consent and sold through different channels at more affordable prices.

- The level of staff training is no different in retailers selling parallel imports from in official outlets.
- Supermarkets supplying discounted branded goods have strong records on customer care eg "no quibbles" money back guarantees were pioneered by them.
- Since discounted goods are the same quality goods, there is by and large little call for after sales care.
- Supermarket ambience may be different but many customers find this acceptable (and may be more at ease) when able to purchase a "luxury good" at reduced price.
- There is evidence of much reduced prices compared with official outlets thus widening access to lower income families and parents of young children pressing them to buy otherwise costly designer goods. There is also pressure on authorised outlet prices.

- The arrangements in favour of the trademark owner neglect developments in electronic commerce.
- USA and Japan have already partially implemented international exhaustion with no evidence of alleged ill effects of parallel trade such as poor service for consumers or lack of availability. International exhaustion has been applied in the past by a number of member states. Indeed, there are signs that the original intention was to include the principle of international exhaustion in the Trademark Directive.
- The difficulty in distinguishing between Community and non Community goods is being used by trademark holders to create a risk for independent traders of infringing trademark rights. The information on distributors that can be demanded from offenders is used to strengthen control over distribution systems. Retailers increasingly demand coverage of risk of litigation or contempt-of-court fines from wholesalers thus raising costs. The aim of the holders appears to be to raise the price of parallel traded products rather than to curb their volume per se.
- Manufacturers themselves are glad to use parallel traders when they wish to off-load excess supplies but do not wish authorised dealers to be associated with discounting.
- If parallel imports of motor cycles - mainly from third countries - are barred, then the independent sector of the trade is likely to be forced to close, consumer choice will be severely restricted and Japanese manufacturers will be able to enforce higher prices once again. A change of regime would preserve the gains that have been made. In this field, the argument of lack of after-sales service and guarantees associated by trademark owners with parallel traded goods is wide of the mark. The Association was established to ensure the consumer buys a motor cycle assembled by fully

trained mechanics, subject to all pre-delivery inspections and tests and with a guarantee equivalent to any motor cycle purchased from an official dealer.

- The retail price of some Japanese models has fallen by 30 per cent in Britain and Belgium as a direct result of parallel import competition. A similar condition exists in the Netherlands, Germany and Norway. The European Federation stresses that the present exhaustion regime severely restricts the choice and supply of goods resulting in higher prices. Official dealers have been known to turn to parallel traders to meet demand. It is considered that manufacturers must honour guarantees even if machines are bought through parallel traders.

- Parallel traders in cars open up a wider choice of vehicles which the franchised dealer does not make available in the EU or which are sold at high prices. Thus international exhaustion widens choice and encourages competition. Franchised dealers will perform more effectively if subject to competition. In one national association, all members of the association abide by a strict code of practice to offer an efficient network of service meeting sales and after-sales requirements, provision of efficient supply of spare parts, technical / diagnostic training, establishment of a customer complaints / arbitration service and co-operation with the DETR and Vehicle Inspectorate regarding vehicle fault recall campaigns and product liability. A UK firm says that guarantees are available from parallel traders regardless of exhaustion regime. A parallel trader from another EU country finances its own three year warranty for every new car sold, matching perfectly the offer from the manufacturer.

4.3. Summary of Responses by Target Groups

Below we have summarised the main results by interest group. The sections that follow after this overview provide more detail about responses to specific questions.

Main points, trademark owners:

- There were significant variations in the opinions of trademark holders, including in terms of current market situations, and the likely consequences of different exhaustion regimes.

- A range of strategic responses to parallel trade were suggested. On the whole, approaching parallel traders, or controlling the distribution chain were more popular responses than altering prices, reducing after-sales service or cutting R&D.

- Manufacturers overall believed that parallel traders, the transport sector and consumers were the clearest beneficiaries of parallel trade and that trademark holders, and official importer / exporters were the groups which lost out. In every case, however, there was some disagreement about whether a group benefited from parallel trade or not.

Main points, importers and exporters:

- Wider exhaustion is likely to lead to more parallel imports and (if reciprocal) more parallel exports.
- Gains to consumers should arise on prices and, perhaps, product availability but this could be offset to some extent by adverse effects on guarantees, after-sales service and information on the product.
- Manufacturers may be, if anything, losers but not strongly so. They are likely to react to curb the growth of parallel trade. It is unlikely, however, that action would be taken to reduce investment in product improvement.

Main points, consumer organisations:

- Consumer organisations believe that retail prices in Europe are higher than in the United States and Japan (for Japan, this view is not wholly consistent with the evidence of published statistics on retail prices). They identified differences in competition conditions as the major reason for differences in the price levels between Europe and the US. Differences in competition conditions, VAT/sales taxes and cost differences have been mentioned as the major reason for price differences between Europe and Japan.
- Although consumer organisations agreed that parallel trade is profitable for parallel traders and the transport sector and harmful to official importers and exporters, responses were not conclusive regarding whether manufacturers and retailers would gain or lose, with views depending on the exhaustion regime. The majority of consumer organisations are undecided as to whether final consumers gain or lose from a change of exhaustion regime.
- Consumer organisations identified domestic appliances, consumer electronics, clothing, footwear and motorcars as the major areas where parallel trade would increase if there is a change of exhaustion regime.

Main points, SME associations:

- On the basis of the responses that were achieved, only a small subset of the members of SME associations own trademarks. The key benefit of trademarks for SME members interviewed is to help maintain and create a reputation, rather than to affect the scope for parallel trade.
- Most SME associations interviewed do not have a clear view of the extent of current parallel trade (within the EEA). They generally expect a moderate increase in parallel trade for most of our sectors, and a more than moderate increase for only some specific sectors (CDs and videos, cosmetics and perfumes, clothing and alcohol), under a unilateral extension of the exhaustion regime. Under a reciprocal

change of regime, most SME associations interviewed tend to expect a moderate or less than moderate increase in parallel trade.

- SME associations tend to see price differences as the main driver behind parallel trade. As the main reason for current parallel trade, and for the moderate increases they expect in parallel trade volume after the hypothetical changes in exhaustion regime, they mention retail and ex factory price differences between source and target country. They also tend to expect manufacturers to react by lowering prices in high-price markets and by increasing prices in low-price markets.

The question numbers in the detailed summaries below refer to the questionnaires, which are included as appendix B to this report.

4.3.1. Trademark owners

4.3.1.1. The Sample

Q4 Eighty-seven responses were received from trademark owners, with thirty-nine responses from "large" rightholders and forty-nine responses from SMEs.[38] About forty per cent of the firms in the sample have turnover in excess of £10 million. Responses were received from firms based in a range of EU countries. Sixteen responses were received from firms based in the USA or Japan.

Responses were reasonably equally distributed between firms operating in each of the ten business sectors included in this study. However, only three responses were received from firms operating in the market for soft drinks / mineral water.

Q5,6 Firms in the current sample generate, on average, about two thirds of their turnover in the EEA, about ten per cent in the USA, and the remainder in other countries. Markets outside the EU were relatively more important for larger firms.

4.3.1.2. Pricing Under the Current Regime

Q8 Of those respondents who provided estimates in the case of the EEA, three of the firms claimed to be selling products at a loss and over half to be selling products at cost. On average the margin earned over costs was just under fifteen per cent. Respondents found it more difficult to assess ex-factory prices in other countries and the different sample base makes a simple comparison with the EEA averages misleading.

Q9 Responses suggested significant diversity in retail and distribution margins for EEA products, (with the ratio of retail price relative to cost estimated to range from 1 to

[38] SMEs defined as a firm with less than 250 employees.

over 5). On average, retail prices were said to be 140 per cent above current unit production costs.

Q10,11 Few respondents commented on reasons for international price differentials although explanations included differences in cost, demand, competition and sales taxes, and movements in exchange rates.

Q12 The division of the retail and distribution margin between intermediaries and retailers varied between firms, and in some cases retailers took the entire margin (presumably due to direct distribution). A broadly even split was the most common response.

4.3.1.3. Parallel Trade Within the EEA Under the Current Regime

Q13 The overall impression of respondents was that current parallel trade is limited, even within the EEA. Almost half of the respondents said they experienced no parallel trade, and over a quarter said that parallel imports represented less than 5 per cent of the market for their products, although the highest individual estimates were in excess of 20 per cent market share. In general, respondents believed parallel import penetration in their market to be higher than in their own product.

Q14 The most commonly cited explanations for parallel trade were price differentials (retail and / or ex-factory),[39] overproduction in source countries and exchange rate movements. High promotional expenditure and contractual issues were less commonly cited explanations. Explanations for the lack of parallel trade included product differentiation, Europe wide pricing and difficulties in traders obtaining supply.

Q15 For every interest group there was disagreement about both whether that group was advantaged or disadvantaged by parallel trade, as well as the size of the effect. The sectors can be ranked in terms of the average effect as follows (most advantaged first): parallel traders, the transport sector, final consumers, retailers, manufacturers, and official importers / exporters.

Q16 A wide variety of responses to parallel trade were cited, the most common being to: approach parallel traders and enact or enforce selective distribution and adjust prices (more often in high price markets). Cutting advertising and distributor support and enhancing product differentiation were less often cited. Acting on after sales service or guarantees, or enhancing product differentiation were even less frequent. Market withdrawal or reducing R&D were seen as very rare. When respondents were asked to rank actions in order of importance, the picture was similar.

[39] More commonly retail.

4.3.1.4. The Effect of Unilateral Exhaustion

Q17 Around a quarter of respondents expected no parallel imports to the EEA (in their product) and a third expected imports from the USA. This was less than from "other" countries in total. Most often the latter were in Asia, although only 5 per cent of respondents expected products to be parallel imported from Japan.

Q18,19 About a sixth of respondents said they would change prices in the EEA and a similar number (including some of the same firms) would change prices in a mix of other countries as a response to the regime. However, many did not wish to predict their responses. Respondents were generally unable to predict specific price changes.

Q19 Most respondents believed that there would be no retail price changes, although about a sixth expected changes in the EEA and small numbers foresaw changes in other countries.

Q20-23 EEA retail volumes were expected to rise or fall by various respondents - similar volumes were more commonly expected, and many respondents did not wish to comment. A few respondents expected increased US retail volumes; more commonly similar volumes were expected (or respondents did not reply). No consensus on the likely magnitude of changes emerged.

Q25 Of those companies expecting parallel imports, an average penetration of about 17 per cent of the market was expected (with significant variations).

Q26 Price differences (ex-factory and/or retail), overproduction in the source country, contractual inadequacies and high promotional expenditures were the main explanations for the expected parallel trade.

Q27,28 The effect of extra-EEA parallel trade on various interest groups was believed to be broadly similar to the effects of parallel trade within the EEA. Manufacturer reactions to parallel trade were similar in nature to their responses to parallel trade within the EEA. The main differences were that a greater variety of responses were suggested, that manufacturers seemed more inclined to lower prices in higher price markets and to withdraw from the source country for trade.

Q29 If other intellectual property rights were to remain unaltered, just over ten per cent would have offered different responses to the above questions. All of these respondents said this was because they could then use other IP rights to prevent parallel trade.

4.3.1.5. The Effect of Multilateral Exhaustion

Q30-32 About half of the respondents believed that the EEA would not experience parallel imports under this regime. Virtually all of the other respondents expected imports

from the USA, about half of which also expected imports from Japan. Fewer respondents expected parallel exports from the EEA.

Q33-36 Very few respondents were willing or able to predict likely price changes under the exhaustion regime.

Q37 Many respondents did not wish to answer these questions - respondents who did make specific predictions most often believed that retail volumes would remain about the same.

Q38 Few respondents predicted parallel import penetration rates, but for both the EEA and the USA estimates ranged from zero and below five per cent to over twenty per cent.

Q39,40 The main reasons cited for increased parallel trade were price differentials and over production in source countries.

Q41 The effect of parallel trade on different interest groups under the change of regime was viewed as being similar to previous situations. Groups were expected to benefit in the following order (most advantaged first): parallel traders, final consumers, transport sector, retailers, manufacturers, official importers / exporters.

Q42 In order of popularity, suggested reactions to parallel trade included establishing or tightening selective distribution networks, altering prices (most often in high but also frequently in low price markets), approaching parallel traders, altering guarantees or packaging, cutting R&D, advertising or distributor support, reducing after sales service, and withdrawal from the source country.

Q43 Most respondents' answers would have been unaffected were the basis for exhaustion of other intellectual property rights to remain unaltered.

Q44 Were international exhaustion of trademarks to be extended across all members of the WTO, about three quarters of respondents would have given similar replies. The remainder, were about equally divided between similar but stronger responses and qualitatively different responses.

4.3.2. Importers and Exporters

4.3.2.1. The Sample

Replies were received from 35 organisations, almost half of which came from Southern European countries and a fifth from Nordic countries (Sweden, Finland, Denmark). Most of the organisations were trade associations. The domestic appliance sector was not represented (although several predominantly consumer electronics associations respond to points on this sector) and three sectors had only one or two representative organisations.

The sectors with the most respondents are consumer electronics, motor cars, and confectionery. Organisations mainly confined their replies to their own sectors.

4.3.2.2. Pricing under the Current Regime

Q3 In about half of the 10 sectors EU prices were thought to be broadly similar to those in the USA (again in apparent contradiction to the evidence of published data). The sectors in which prices were seen to be higher were consumer electronics, domestic appliances and alcoholic beverages.

Prices in the EEA were higher than Japanese prices in consumer electronics and domestic appliances and lower in clothing and perhaps in footwear and alcoholic beverages.

Q4 The main reasons for differences in retail prices compared with the USA were tax differences (higher in EEA) and to a lesser extent differences in competitive conditions, cost differences and differences in the demand conditions.

Q5 Reasons for retail price differences compared with Japan were mentioned by a smaller number of respondents. Reasons mentioned most were differences in sales taxes, differences in competitive conditions and differences in costs.

4.3.2.3. Parallel Trade within the EEA under the Current Regime

Q6 The proportion of the total market in EU countries made up by parallel imports appeared to be less than 5 per cent in almost all sectors. The clothing sector was the main exception with a ratio of 6-10 per cent whilst for cosmetics and alcoholic beverages the ratio may be in a range of up to 10 per cent. There were some quite marked exceptions within sectors that suggested higher shares in some cases. There was a wide range of responses on alcoholic beverages.

Q 7 On reasons for parallel trade, by far the most frequently mentioned factors were retail (especially) and ex-factory price differences. Two or three organisations mentioned high promotional expenditures in the EEA, loose drafting of contractual terms, exchange rate changes, over-production in an EEA source country and failure to police contracts.

Q8 Not surprisingly, parallel traders were seen as gainers from current parallel trade. Manufacturers tended to be losers but not strongly so overall - there was a fair spread of views - as did official importers/exporters and retailers. Consumers and transport were thought to be generally neither gainers nor losers.

Q9,10 The price effect on consumers tended to be beneficial. The effect on product availability was broadly neutral - the intermittent nature of supplies was mentioned. Otherwise, the effects were seen as adverse - on after sales service, product

information, guarantees, packaging, product quality and development of new products.

4.3.2.4. The effect of Unilateral Exhaustion

Q11 The Southern and Nordic countries are the main influences on the outcome. Only two sectors did not indicate increases in parallel imports for their products - soft drinks and footwear. All clothing and CD groups expected rises in their sectors though numbers are small. Rather more than half the responses expected rises for confectionery, alcoholic beverages, motor cars and for cosmetics/perfume, and less than half for consumer electronics.

Q12 Most frequently mentioned reasons for the increase in parallel trade were differences in retail and ex factory prices followed by failure to police contracts and over production in the source country.

Q13 Parallel traders were clear gainers and transport tended to gain also. Manufacturers, official importers/exporters and consumers tended to be losers (but with a wide spread of replies) as did retailers.

Q 14 Expected reactions by manufacturers to increased parallel trade were (in descending order of frequency): lower prices in high price markets, varying packaging by market, withdrawal from source country of parallel trade, "approach parallel traders", cutting after-sales service, raising prices in low price markets, and cutting R&D or product quality improvement. Whereas eleven mentioned lowering prices, only four mentioned cutting R&D or product quality improvement.

4.3.2.5. The effect of Multilateral Exhaustion

Q15 Only soft drinks/mineral water was not mentioned as showing an increase but the responses in consumer electronics and confectionery were weak.

Q16 Only five specified factors were mentioned as reasons for the expected increase in parallel trade, with ex factory and retail prices receiving most mentions.

Q17 Replies were much as in question 13.

Q18 Mentioned 6-10 times were (in descending order): cutting support for distributors, set up selective distribution networks (SDNs), more rigorous enforcement of contractual relationships, varying packaging by country, cut support for distributors, lower prices in high price markets, and cuts in advertising expenditure. Cutting R&D was mentioned only twice.

Q19 Only about a third of organisations responded positively to the question on the effect on parallel **exports**. Sectoral organisations expected increases in motor cars,

consumer electronics, domestic appliances, cosmetics / perfumes, clothing, and confectionery. (domestic appliances -unrepresented- were mentioned by a consumer electronics respondent). Sectors not mentioning increases were CDs, footwear and other leather goods, alcoholic beverages and soft drinks / mineral water.

Q20 Reasons given for an increase in parallel exports were rather thin with some sectors having no explanations. Four of our specified factors were mentioned; retail and ex factory price differences, high promotional expenditures in USA / Japan and product quality differences.

Q21 Parallel traders and transport were gainers from parallel exports. Manufacturers were broadly neither gainers nor losers though slightly tending to gain (a fairly wide spread of replies). Official importers / exporters and retailers were losers. Final consumers were neither gainers nor losers.

Q22 Only a third of organisations replied to the question on the expected response by manufacturers to additional parallel exports, half of these coming from the Nordic group.

Mentioned 3-5 times were (in descending order) to: set up selective distribution networks, cut advertising expenditures, more rigorously enforce SDNs, lower prices in high price markets, and vary packaging. There was was no mention of cutting R&D.

Q23 Most said replies would have been much the same if exhaustion were to be based on the membership of WTO. A few said replies would have been the same in nature but stronger and a few said their replies would have been different in nature.

4.3.3. Consumer Organisations

We received responses from nine consumer organisations; three came from Ireland / United Kingdom, two from Spain / Greece / Portugal, one from a Nordic country, one from France, one from Germany / Austria, and one from USA / Japan.

4.3.3.1. Current Situation

Q1 All consumer organisations indicated that they believe that in most of the sectors investigated, retail prices in the United States are lower than in Europe, except in alcohol where one consumer organisation believes that prices in Europe are lower. Almost all organisations argue that Japanese retail prices are lower than European price levels, especially in the car industry, domestic appliances and consumer electronics industry. One UK / Ireland consumer organisation thinks that alcohol is more expensive in Japan than in Europe.

Q2 The major reason for differences in retail prices between the EEA and USA was identified as differences in competitive conditions.

Q3 The three major reasons for differences in retail prices between the EEA and Japan were identified as differences in competitive conditions, cost differences and differences in VAT / sales taxes.

4.3.3.2. Past Experience with Parallel Trade

Q4 Almost all consumer organisations believe that the proportion of market turnover made up by parallel imports is less than five per cent. Only one organisation from Germany / Austria believed that in most of the sectors under investigation, the proportion of the market taken by parallel trade is higher than 21 per cent.

Q5 Retail price differences, high promotional expenditures and product quality differences within the EEA and over-production in EEA source countries were identified as the major reasons for parallel trade by the organisation expecting significant penetration.

Q6 Consumer organisations agreed that parallel trade is profitable for parallel traders and the transport sector, and harms official importer / exporters and retailers, but responses were inconclusive as to whether manufacturers would gain or lose. The majority of consumer organisations were undecided as to whether final consumers would gain or lose from a change of exhaustion regime.

Q7 In analysing effects, consumer organisations expected parallel trade to have adverse effects on after sales services, guarantees and provisions of product information and beneficial effects on product availability and retail prices.

4.3.3.3. Change of Exhaustion Regime (1)

Q9 Consumer organisations expect an increase in parallel trade in the EEA especially in the areas of domestic appliances (mainly electrical), consumer electronics, motorcars, footwear and leather and clothing.

Q10 There was a similar response in all sectors. Ex factory price differences, retail price differences, failure to police contracts, loose drafting of contractual terms and over-production within the EEA were the major reasons for increases in parallel trade.

Q11 Most of the consumer organisations saw transport and parallel traders as the sectors who would benefit most from a change in regime. They were undecided whether official importers / exporters, final consumers and retailers would gain or lose.

Q12 Consumer organisations expect manufacturers to withdraw from source countries of parallel trade and to approach parallel traders in case of additional parallel trade.

4.3.3.4. Change of Exhaustion Regime (2)

Q13 Consumer organisations identified domestic appliances, consumer electronics, CDs and video discs, clothing and footwear as the main areas in which they would expect an increase in parallel imports in the EEA.

Q14 In the hypothetical scenario of a trademark exhaustion regime including EEA, America and Japan, most of the consumer organisations thought that ex factory price and retail price differences, failure to police contracts, product quality differences and the loose drafting of contractual terms would be the major reasons for the increase in parallel trade. This was so for all sectors.

Q15 The gainers from the change of regime were identified as parallel traders and the transport sector. The big losers, as identified by consumer groups, are the official importer/exporters. Again, consumer organisations were undecided as to whether the final consumer gains or loses from an extension of the exhaustion regime.

Q16 Consumer organisations expect manufacturers to react to parallel trade and to: approach parallel traders, alter terms of guarantees and enforce arrangements in their distribution networks more rigorously. The most likely overall reaction would be to set up selective distribution networks and prohibit sales to unauthorised dealers.

Q17 Consumer organisations are undecided as to whether parallel exports from the EEA would benefit consumers in their countries.

Q18 Almost all consumer organisations believe that the response to the questionnaire would have been much the same even if the trademark exhaustion area were to include all member states of the WTO in a multilateral change of regime.

4.3.4. SME associations

There were six responses, four from Nordic SME associations and two from UK/Irish SME associations.

4.3.4.1. Current situation and associations' profile

Q1 Two out of the six SME associations had a majority of retailers as members. None of the six SME associations had many (more than 30 per cent) wholesalers or manufacturers as members.

Q2 All associations indicated that trademarks are important to their members.

Q3 None of the SME associations quoted 'preventing parallel trade from outside the EEA' as a key benefit of trademarks for SMEs. Four out of six quoted as reason 'to

help create and maintain a reputation'. Two out of four gave their reasons as 'to prevent imitation of products' and 'to encourage advertising expenditure'.

Q4 Only a small proportion of the members of the interviewed associations (0-25 per cent) own trademarks in the EEA.

4.3.4.2. Parallel trade experience under the current regime

Q5 Most respondents (four out of six) did not know the current market shares of parallel imports in most of our selected sectors. Only for motorcars did interviewees seem to know more and two indicated that parallel imports accounted for less than 5 per cent while one indicated that the figure was in the 16-20 per cent range.

Q6 Five out of six indicated that parallel imports in their view were continuous rather than intermittent.

Q7,8 Although views are diverse, interviewees indicate that it is difficult to run a wholesale or retail business relying on parallel imports. There is a clear view that a good long-term relationship with official suppliers is essential.

Q9 When asked how official retailers and wholesalers are affected by current parallel trade, most respondents did not see significant effects (a low weight was given to the possible effects we indicated). A minor deviation from this general view was the effect of parallel imports as a cheaper source of supply, which was indicated by two respondents as significant.

Q10 Respondents thought ex factory price and retail price differences were the main reasons for parallel trade. Only a small number thought exchange rate changes were important, although some said that a mixture of reasons applied including exchange rate considerations.

Q11 Manufacturers, official importers/exporters and retailers are generally seen as losers from current parallel trade; some think that consumers gain, others that they lose; parallel traders and the transport sector are generally seen as gainers.

Q12 Three out of six associations believe SMEs reacted with a price increase in low-price markets or with a price decrease in high-price markets as a result of parallel trade within the EEA. Withdrawing from the source country, cutting after-sales service, setting up selective distribution networks and varying packaging by country are also generally thought to be responses.

4.3.4.3. Unilateral extension of exhaustion regime

Q13 Respondents generally expect a moderate increase in parallel trade after unilateral extension of the exhaustion regime; more than moderate increases are expected in CDs and videos, clothing, cosmetics / perfume and motorcars.

Q14 The main reason for the generally expected moderate increase is retail price differences.

Q15 A large majority of respondents expect retail prices to decrease as a result of a unilateral change.

Q16 A large majority of respondents also thinks wholesale prices will decrease as a result of the unilateral change.

Q17 The SME associations that were interviewed tend to see manufacturers and official importers / exporters as losers from current parallel trade. The Nordic respondents, in particular, see final consumers as gainers. Other gainers are considered to be parallel traders, retailers and the transport sector.

Q18 Only a small number of respondents has a view on the costs incurred by the parallel trader. Estimates run from about 8 per cent to about 20 per cent of the ex factory price.

Q19 Most respondents expect that manufacturers will lower prices in high price markets and cut after-sales services as a response to a unilateral change in exhaustion regime. Only a few expect that manufacturers will cut advertising expenditures or set up exclusive distribution networks.

4.3.4.4. Extension of exhaustion regime on a reciprocal basis with USA and Japan

Q20 Respondents generally tend to expect a moderate increase in parallel trade after change of regime (2) for most sectors. For consumer electronics, a more than moderate increase is expected, for soft drinks and alcohol a less than moderate increase.

Q21 As general reasons for the increase in parallel trade, respondents often mentioned ex factory price and retail price differences between EEA and US / Japan, and high promotional expenditures. Failure to police contracts is also mentioned relatively often. No clear distinction in responses between sectors seems to be present.

Q22 Most respondents expect that retail prices will be lower after change of regime (2). Some think retail prices will remain unchanged. This expectation is broadly the same for all sectors.

Q23 Very similar views were given about ex factory prices.

Q24 Manufacturers, official importers/exporters and retailers are seen as losers from extra parallel trade, the transport sector and parallel traders as gainers, and, although less clearly, the final consumers as also being gainers.

Q25 Respondents expected manufacturers' responses to be, in descending order: lower prices in high price markets, set up selective distribution networks, vary packaging by country market, alter terms of guarantees, cut support for distributors and vary packaging by country. Raising prices in low-price markets, withdrawal of markets, cut after-sales services and cut advertising expenditures were mentioned but only by a small minority.

Q26,27 Most respondents did not know whether there would be an increase in parallel exports as a result of change (2), but those who have a view tend to expect only a small increase for most sectors, the main reasons being ex factory and retail price differences. Some respondents expected a larger increase in parallel exports in motorcars and consumer electronics.

Q28,29 Although a majority did not know, the others expected retail prices and ex factory prices in the EEA to remain the same or go down as a result of parallel exports.

Q30 Respondents generally expected manufacturers to lose, official importers/exporters to be ambiguously affected, parallel traders to gain, final consumers to be ambiguously affected and the transport sector to gain, as a result of change of regime (2).

Q31 Expected responses by manufacturers are, in descending order of importance: lower prices in high price markets., alter terms of guarantees, cut support for distributors, set up selective distribution networks and vary packaging by country market. Remaining possible reactions, eg cutting advertising and R&D and other product improvement expenditures, were thought to be less important.

Q32 Most respondents would expect multilateral exhaustion to have an impact that was much the same in nature but stronger in effect.

4.3.5. Overview

The table below shows an overview of the survey results on the main points of interest.

Table. 4.3
Overview Preliminary Survey Results

Current Situation	Trademark Owners	Importers/Exporters	Consumer Organisations	SME Associations
Price differences between EEA and abroad	Some respondents found it difficult to assess non-EEA prices	EEA mainly similar to or higher than USA; and both higher and lower vis a vis Japan	EEA higher than the USA, similar or higher to Japan	-
Volume of parallel trade (% of market)	Limited in most cases, but with some exceptions	Less than 5% in almost all sectors	Majority thinks less than 5 %, one consumer organisation claims that in most sectors the proportion is larger than 21 %	Most respondents did not know, except for motorcars where estimates range from less than 5% to less than 20%
Gainers/losers from parallel trade	Parallel traders, the transport sector and consumers as main gainers. Trademark holders and official distributors as main losers	Parallel traders as gainers; manufacturers and official importers / exporters as possible losers; consumers and transport, broadly neutral	Gainers: transport sector, parallel traders; Losers: official importers and exporters; diverging opinions about others	Gainers: parallel traders, transport sector; Losers: manufacturers, official importers / exporters, retailers; position for final consumers unclear
Effects of parallel trade	Responses to parallel trade suggest adverse effects in terms of market withdrawal or reduced after-sales service would be limited	Beneficial on prices; effect neutral on availability; adverse on after-sales service, information, guarantees, packaging, product quality and new product development	Adverse effects on after sales services, guarantees, provision of product information; beneficial effects are in retail prices and product availability	Lower prices in high-price markets; higher prices in low-price markets

Unilateral Change of Exhaustion Regime	Trademark Owners	Importers/Exporters	Consumer Organisations	SME Assoications
Impact on parallel trade volume	A quarter of respondents expected no parallel trade. The others expected an average penetration rate of 17 per cent	Almost all sectors to show rise	Expect increase especially in consumer electronics and domestic appliances	Moderate increase in parallel trade in most sectors; more than moderate increase in CDs and videos, clothing, cosmetics / perfume and motorcars
Impact on prices	Small numbers of respondents expected price changes (mainly in ex-manufacturer prices), but many found it difficult to make specific predictions	-	-	Retail and wholesale price generally expected to decrease
Manufacturers' responses	A full range including approaching parallel traders, controlling the distribution chain, adjusting prices, and market withdrawal	Lower prices in high price markets, vary packaging by market and withdraw from source market were mentioned most	Withdraw from source country and approach parallel traders	Lower price in high-price markets and cut after-sales services

Reciprocal Change of Exhaustion Regime				
Impact on parallel trade volume	Similar	Almost all sectors to increase	Expect increase especially in consumer electronics and domestic appliances	Increase in parallel trade in many of selected sectors; expectation is affected by nationality of interviewees
Impact on prices	Similar	-	-	Retail and wholesale price generally expected to decrease
	Trademark Owners	**Importers/Exporters**	**Consumer Organisations**	**SME Associations**
Manufacturers' responses	Similar	Wide variety: cut support for distributors, set up and more rigorously enforce selective distribution networks prohibiting supply to unauthorised dealers, and vary packaging	Set up selective distribution networks prohibiting sales to unauthorised dealers	Most respondents expect manufacturers to lower prices in high-price markets
Multilateral Change of Exhaustion Regime	Most respondents would offer similar replies; A few would have offered stronger, or qualitatively different replies	Most said "much the same"	Responses to the questionnaire would be the same	Similar responses, impact stronger in effect

4.4. Survey Results by Main Headings

4.4.1. Prices and trade volumes

Prices: in general prices were seen to be the same in the EU as in the USA or higher whereas in Japan the position was seen to be more mixed. Parallel imports are seen to have beneficial effects on consumer prices.

Part of the reason for differences in prices between the EEA (in general) and other countries lies in consumer tax differences but other factors such as competitive and demand conditions and costs of production and sale also play a part.

Price (retail and wholesale) differences are the main factors leading to parallel trade and both regimes of exhaustion would lead to an increase in parallel imports, e.g. from South-East Asia, the USA and perhaps Japan though the possible scale is a matter of considerable uncertainty. Trademark holding companies expecting an increase in parallel imports had widely differing views but expected the increase would be smaller in the reciprocal case.

Currently, parallel imports may make up less than 5 per cent of the EEA market in the present regime, though a few organisations quoted much higher figures for their sectors.

An increase in parallel exports under the reciprocal regime was foreseen by a minority.

In the longer term, it appears likely that various kinds of action would be taken by the holders to attempt to reduce the flow of parallel imports.

It should be borne in mind that these increases in parallel imports and exports are not net effects on the real trade balance, at least in terms of volume. For example, products of a non-EEA firm with a trademark registered in the EEA may be diverted into unofficial channels to reach Europe and be at the expense of official imports. Again, products of a US-based firm exported to the EEA and re-exported to Japan by unofficial channels will be recorded on both sides of the European trade account.

4.4.2. Product availability

Consumer organisations believed that exhaustion leads to greater availability of products though importers/exporters thought the effect was on balance neutral. Expected action by holders to extend or tighten up selective distribution systems prohibiting sales to unauthorised dealers would have some offsetting effect after initial increases in parallel imports took place.

4.4.3. Market structure

There were often widely differing views on whether an interest group was likely to be a gainer or loser from parallel trade. Parallel traders themselves, especially, and transport

were seen as clear gainers from increased parallel trade. However, the view of the impact on consumers is not clear cut. Consumers were seen at best as slight gainers with a number of adverse effects offsetting price and, perhaps, availability gains. At the same time, manufacturers might be losers from increased parallel imports, but not necessarily strongly so. The position for retailers and official importers / exporters was broadly similar.

Action by manufacturers to tighten up on selective distribution would also eventually impact on structure.

4.4.4. Consumers

There was some perception, even amongst the consumer groups, that the benefits through lower prices and, perhaps, greater availability, would be accompanied by adverse effects on after sales services, guarantees and provision of product information. This helps to account for consumers not being seen as clear gainers from additional parallel imports. On the other hand, action by manufacturers to curb such services, while possible, is unlikely to be a first resort. (Rightholders did not envisage much price effect from increased parallel imports, though, for the most part, they found it difficult to judge what the effect on prices would be.)

At the same time there are signs that, in the longer run, manufacturers might be inclined to lower prices in high price markets, presumably including the EEA.

Regarding the ability of trademark owners to disown guarantees on parallel imports into the EEA when these goods have initially been sold outside the Area, it is conceivable that such action could be caught by EU competition provisions but this would require an extension of current jurisprudence, which seems unlikely to happen.

4.4.5. Businesses

As to effects on future product quality, cutting R&D and other expenditure to improve product quality seems to be an unlikely response to increased parallel trade.

Some indication of the expected effects on different business interests, in terms of whether they would be gainers or losers from increased parallel trade are set out above.

Holders found it difficult to judge what they would do about their prices and whether there would be any gain in retail sales. SME organisations, however, expect both retail and wholesale prices to be lower.

4.4.6. Relationship with third countries

There is general agreement that the impact of the unilateral regime would be greater than that of the reciprocal regime as specified. Most respondents said they would have given similar replies on the impact of a multilateral exhaustion regime based on WTO members.

4.4.7. Effect on border controls

The Community Regulation clearly empowers customs authorities to take action on counterfeit goods. In principle it is not clear that it would be more difficult. It is possible that counterfeiters would see wider exhaustion as an opportunity to try to sell more of their wares. However, parallel importers we have spoken to take great care to avoid becoming involved with such goods.

5. ASSESSMENT OF IMPACT OF CHANGES IN TRADEMARK EXHAUSTION REGIME AT SECTOR LEVEL

5.1. Introduction

This chapter provides an overview of the analysis of each for our ten selected sectors. The analysis at sector level is more extensively described in Appendix C.

The methodology we have followed in these in-depth sector studies includes several steps. Our first aim was to make a qualitative assessment of the scope for increase in parallel trade after changes in exhaustion regime. The inputs to this qualitative assessment include the survey results and written submissions to NERA by interested parties and interviews that were carried out in parallel with the survey programme (these submissions and interview have been briefly summarised in chapter 4). We have also used a wide range of public sources for information about our sectors.

The next step was to identify, on the basis of these information inputs and on the basis of economic analysis, factors that are likely to determine the scope for increase a parallel trade. These factors include:

- Price differences: where available (most sectors) we have collected price data at several levels of detail, including aggregated OECD data, sectoral data and data at individual product level. Being the main driver behind parallel trade, it is important to know how EEA price levels compare to outside countries, in particular the US.
- Transaction costs: for each sector we have aimed at identifying the costs that would be associated with parallel trade. Transport costs are an obvious transaction cost, but risk of damage, of quality deterioration and so on are possible transaction costs as well. If they are large, transaction costs can put a limit on the scope for parallel trade. In any case, parallel trade will only occur if there are net price differences, after taking into account transaction costs.
- Technical barriers: health, safety or quality standard regulations can act as technical barriers for parallel trade. We have identified, on the basis of public information, the extent to which these technical barriers are present in each of our sectors.
- Trade barriers: import duties and quotas can also act as barriers to parallel trade. We have indicated for each sector the size of the import duties for products imported from outside the EEA. Any price difference between EEA countries and other countries must at least make up for these import duties. In the EU tariffs form the main such trade barrier. As in the USA and Japan, the average level of tariffs on industrial goods is low and falling as a result of the Uruguay Round of trade negotiations but there are exceptions including consumer electronics, some kinds of footwear and clothing. Moreover the same goods coming in through official

channels would also be dutiable. EEA goods that are exported and then re-imported by parallel traders would pay import duty. Two of our sectors (footwear and electronic consumer goods) are to some extent subject to anti-dumping duties on goods from Asia. In addition to tariffs, clothing imports from NIEs and other developing countries are subject to quantitative restraints under the Multi-fibre Arrangement which does not end until 2005.

- Other IPRs: one of our working assumptions is that the exhaustion regime for trademarks is similar to that for other IPRs. To put this assumption in perspective, we have made an assessment of which IPRs besides trademarks are important in a sector. If these other IPRs do not undergo the same change in exhaustion regime, they could be used by the manufacturer to prevent parallel trade.

As a third step we have briefly described the vertical relationships that are present in a sector. As well as being of some relevance to the expected scope for increase in parallel trade, vertical relationships could determine the nature by which parallel imported goods are sold. The idea is that in the case of, for example, very tight vertical restraints, such as selective distribution systems, official retailers are less likely to sell parallel imported goods because suppliers would use their control as much as possible to prevent this. In the case of tight vertical restraints parallel imported goods are more likely to be sold (if parallel trade occurs at all in the first place) in "factory outlets", by which we mean less conventional settings eg supermarkets, warehouses. If, on the other hand, vertical restraints are weak, retailers would be able to sell parallel imported goods (perhaps in addition to officially imported goods), without the supplier having much control.

In addition to formal vertical relationships, we have also assessed to what extent mutual dependence between manufacturers and retailers is important for business. If parallel imports would endanger for a retailer a good long-term relationship with the manufacturer and this relationship is valuable, the likelihood of parallel imports by official retailers is smaller.

We have then continued by in the sector analyses by estimating the amount of parallel trade that currently occurs, within the EEA. This information gives an idea to what extent parallel trade within a sector is practically possible. If all factors seem favourable for parallel trade but in practice no or little parallel trade is taking place, this fact should be taken account of in the analysis.

Our next step of quantitative assessment is designed to be a way of setting the survey responses and other data into a simple overall framework. The quantitative assessment is based upon a number of simplified assumptions about the workings of markets, and judgement on the level which key parameters might take. Such judgements are based on survey responses and other analysis. The results should only be seen as indicative of the possible order of magnitude of effects.

The quantitative assessment is designed to provide a simplified overview of the magnitude of the economic impacts. It focuses on the short term (ie it does not generally focus on long run responses by interested parties) and first round effects (ie ignoring any macroeconomic feedback effects). Adjustment mechanisms within the economy may have feedback effects on variables such as inflation and employment which we do not attempt to quantify.

Important parameters which may need to be specified (for each exhaustion regime) include:

- the percentage of the total market which may be susceptible to parallel imports;
- parallel import penetration rates;
- the difference between ex-manufacturer prices in various countries;
- the discount secured by a consumer purchasing a parallel imported product;
- any effects on pricing strategy;
- the price elasticity of demand.

Important simplifying assumptions include that production is subject to constant returns to scale, and the division of production (between EEA and other markets) is unaffected by parallel trade. In general this assumption may be reasonable, since firms will always seek to produce in least cost locations, but where transport costs are important, and there are advantages in producing close to the site of first marketing it may become less realistic. The assumption also avoids possible differences between the susceptibility of European and other products to parallel trade (eg if they are differently positioned in the market).

These assumptions about the nature of the production process are important drivers of some of the results obtained through our analysis. For example, if market volume rises (which we assume to be the case where prices fall) then production must also rise. In a simple first round analysis employment can be assumed to rise equi-proportionately to the rise in production. The assumption that the location of production remains unchanged hence leads to a rise in manufacturing employment in the EU. These assumptions suggest that most of the parallel imports to the EU consist of parallel reimports. These estimates in particular should be regarded as indicative only, and significant uncertainty applies to both the magnitude and direction of employment effects. In particular, if local production is displaced by parallel imports which are manufactured abroad EU employment could fall.

Our assumptions about the differences between ex-manufacturer prices in different countries have been largely driven by data which have obtained on retail price differences. If (as seems plausible in at least some circumstances) price differentials are smaller at ex-manufacturer level, the impact on industry profitability would be likely to be smaller.

5.2. Footwear and Leather

5.2.1. Qualitative assessment

The table below summarises the factors that are likely to determine the scope for increase in parallel trade as a result of extending the current EEA trademark exhaustion regime. We have found evidence that prices differences between the EU, US and Japan can be relatively large, with the general pattern being the US is cheapest, followed by the EU and then Japan. The transaction costs, in this case the relatively low transport costs, also have the potential of increasing parallel trade flows. The absence of strong technical barriers would also encourage parallel trade.

Factors that would have the potential of discouraging parallel trade would be the presence of import duties, the vertical restraints that become increasingly tighter and the relatively small amount of parallel trade that takes currently place within the EEA, as found in our survey. The general conclusion therefore seems to be that the scope for extra parallel trade in footwear and leather goods is moderate overall. However, it may be greater in some segments of the market, eg trainers.

Table 5.1
Scope for increase in parallel trade in footwear and leather goods

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	++
Transaction cost	+
Technical barriers	+
Trade policy barriers	-
Vertical restraints / long-term relationship	-
Current parallel trade	-

Authors' assessment

Given the above conclusion, the consequences for trademark owners are likely to be small in general, but they may be larger in some cases. There may however be some pressure on the prices of officially routed products of the kind parallel traded, but also on the prices of close substitutes. But even in the cases where the scope for parallel trade seems more than moderate (eg trainers), we do not expect much reduction in IPR driven investments like advertising and promotion, and product development and design. The reason for this is that firms, in particular in sportswear, seem to put more focus on a global rather than local marketing strategy. The survey results also seem to suggest that a reduction in investments in these areas would be unlikely.

Regarding the consequences for consumers, again, given the moderate scope for increase in parallel trade, no large impact is to be expected for consumers. However, given that there may be some pressure on prices, consumers could benefit from this. Otherwise present

possible disadvantages, such as possibly less well-trained sales assistance, do not seem to be significant in this case. Also in the longer run, we do not expect consumers to be adversely affected through lower product development and design efforts.

As far as consequences of authorised dealers and retailers, if anything, they are likely to be disadvantaged. Given the increasingly tighter vertical agreements, non-traditional outlets are likely to sell the parallel imported goods.

5.2.2. Quantitative assessment

The table below shows the quantitative results of the analysis carried out in Appendix C.

Table 5.2
Overview Quantitative Assessment Footwear and Leather Goods *

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	For premium brands, parallel imports from the USA in the range of 5 - 15%; for other brands, from South East Asia in the range of 0 - 5%	For premium brands, parallel imports from the USA in the range of 5 - 15%.
Impact on retail prices	Average price reduction for premium brands of 2%; average reduction of 0.5% for others	Average price reduction for premium brands of 2%.
Impact on volumes	Increase in EEA volumes of 0.7%	Increase in EEA volumes of 0.2%
Impact on production	Increase in EU production of 0.5%	Increase in EU production of 0.2%
Impact on employment	See assumptions, increase of about 1,000 EU jobs	See assumptions, increase of about 250 EU jobs
Impact on profits	Potential reduction of 15%	Potential reduction of 3%
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.2.3. Summary

Despite the recent trend towards producing footwear in newly industrialised countries the EU retains a strong footwear and leather industry with a positive balance of trade. Trade is an important part of the economy of the sector with about a third of EU production being exported. Footwear is not a high technology sector and trademarks, together with design

rights in some cases are the dominant form of intellectual property. Trademarks play a crucial role in advertising and developing brands. Depending on data sources, shoes are more expensive in the EU than the USA, but cheaper than Japan. While price differentials are on average moderate, larger price differentials, sufficient to generate incentives to parallel trade are present for parallel trade. Transaction costs appear unlikely to form a significant barrier to parallel trade although import duties and quotas are present in the sector. Strengthening manufacturer control over the distribution system suggests that parallel imports would be likely to retail in independent environments.

Our analysis suggests that the sector is moderately susceptible to parallel trade. The consequences for trademark owners as a whole appear likely to be moderate, although individual trademark holders may be more strongly affected, and since parallel trade tends to reduce revenue without affecting costs, small effects on the market can affect profitability significantly. However, the global marketing of major footwear brands makes it unlikely that promotion would be much reduced. Consumers may benefit to some extent from lower prices, but authorised dealers and retailers would be disadvantaged.

5.3. Musical Recordings

5.3.1. Qualitative Assessment

Price differences between EEA countries and the US and some Asian countries suggest scope for an increase in parallel trade after change of regime. This scope may be more limited than appears to be the case at first sight because of the fact that part of the differences is due to different VAT and sales taxes.

Transaction costs, including transport but also risk of damage and quality deterioration, are likely to be small. Technical or trade barriers are absent, apart from some relatively low import duties. A possibly considerable barrier may become custom checks for counterfeits, which without doubt would intensified were the trademark exhaustion regime to be extended to outside the EEA.

Vertical restraints are, apart from the vertically integrated record companies, not expected to be so tight that they would prevent parallel trade. The need for a good long-term relationship between record companies and retailers may be more of an obstacle to increase in parallel trade. If an increase occurs, it is most likely that the categories of non-traditional retail outlets are selling them.

Finally the fact that current parallel trade is present within the EEA but does not take place in very large volumes indicates that not too much increase can be expected after a change in exhaustion regime.

Given the fact that copyright is the main IPR for record companies, if one assumes that the community copyright exhaustion regime remains intact, parallel trade can be stopped by

using copyright and no increase would occur at all. If, however, the working assumption is that all IPRs would be changed in a similar way, copyright cannot be used for that purpose.

All in all, there are a relatively large number of factors that seem to be conducive for parallel trade and a moderate to large increase is to be expected.

Table 5.3
Scope for increase in parallel trade in musical recordings

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	+
Transaction cost	++
Technical barriers	++
Customs counterfeit check	-
Vertical restraints / long-term relationship	-
Current parallel trade	++

Authors' assessment

5.3.2. Quantitative Assessment

Table 5.4
Overview Quantitative Assessment Musical Recordings*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	For new international releases, penetration rate in the range of 5 - 15%, mainly from the USA and South East Asia; overall 4% increase in parallel trade	For new international releases, penetration rate in the range of 5 - 15%, dominantly from the USA; overall 2% increase
Impact on retail prices	Average price reduction around 0.6%; price reduction for new pop releases about 15%	Average price reduction around 0.3%; price reduction for new pop releases about 15%
Impact on volumes	Increase of 0.3%	Increase of less than 0.2%
Impact on production	Increase of almost 0.3%	Increase of less than 0.2%
Impact on employment	See assumptions, increase of about 1,800 EU jobs	See assumptions, increase of about 900 EU jobs
Impact on profits	Potential reduction of 14%	Potential reduction of 7%
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.3.3. Summary

The world market for music recordings amounts to nearly ECU 30 billion, about 30 per cent of which is taken by the EU. The sector contains a mix of large multinational companies and smaller independent (generally local) firms. Although the industry relies more on copyright than trademarks, allowing parallel imports may make it more difficult to prevent counterfeiting. Prices are somewhat higher in many EU countries than in the USA, although the difference, after taking account of sales taxes is moderate, and not necessarily due to the absence of parallel imports. Technical barriers and transaction costs appear very low and parallel trade within the EU is an important factor for at least some releases. Vertical restraints are not sufficiently tight to prevent parallel trade, although retailers' desire to maintain good relationships with record companies may be a limiting factor.

Overall, our analysis suggests that a moderate to large increase in parallel trade in this sector could be expected if all IP rights were to be internationally exhausted concentrated in full price recordings of international pop music (especially recent releases). While consumers

may gain some benefit from discounting, producers would suffer a reduction of profitability, with incentives to invest in new acts being correspondingly reduced. If copyright were to maintain a community exhaustion regime, the effects would be **far** less pronounced.

5.4. Motorcars

5.4.1. Qualitative Assessment

The table below summarises the factors likely to determine the scope for an increase in parallel trade as a result of extending the current EEA trademark exhaustion regime. Our information on price differences suggests that EU prices (ex tax) are higher than those in Japan, especially following the greater depreciation of the yen since 1996 but possibly not greatly higher in general than in the USA though there may be individual exceptions to this eg 4 wheel-drive cars.

The end of the restraint on Japanese exports to the EU at the end of 1999 could increase sharply the level of competition in the market and bring down the level of prices but the extent is uncertain given the market structure. It is not apparent that there is in general much scope for parallel imports from the USA though individual models may be parallel traded. Similarly there may be scope for parallel exports to the USA of luxury European cars but we have no evidence for this. There were parallel exports of sports cars etc into the USA during the 1980s but the US real exchange rate was high at the time.

Transaction costs - transport - have the potential for increasing parallel trade and import duties are low.

While safety / technical standards are important it is not apparent that these are generally an important obstacle but independent dealers argue that this is the case as far as they are concerned under present rules (which the UK has proposals for changing).

The power of the suppliers in the European distribution system (all the leading international car makers are operating similar systems) and the vastly greater number of official dealers as compared with independents is a factor presently militating against parallel imports.

Table 5.5
Scope for increase in parallel trade in motor vehicles

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	+ (with Japan but depends on effect of ending trade restraint at end 1999)
Transaction cost	+
Technical barriers	- (type approval and emissions)
Trade policy barriers	++ (- before 2000 for Japanese cars)
Vertical restraints / long-term relationship	-
Current parallel trade	-

Authors' assessment

At present there appears to be a fairly modest level of parallel trade, very largely within the EEA. Whilst prices and trade barriers post 1999 may encourage parallel imports from Japan and there may be the possibility of imports of specialist cars from the USA, the present distribution system seems likely to keep growth to moderate proportions. However, this would add to pressure on profits that is likely to come from the liberalising of trade with Japan at the end of 1999. With a marked need for the EU producers to improve competitiveness (in cost and quality) against Japanese firms and more generally the bid for globalisation, it is difficult to see there being much reduction in IPR driven investments.

The survey suggests mainly countries other than the USA as sources of increased parallel imports under unilateral exhaustion. Under reciprocity, a minority see both the USA and Japan as sources but a majority think neither or do not know.

Manufacturers are likely to resort to other means of countering parallel imports before going down this road.

As far as the consequences for consumers are concerned, there could be moderate gains in prices which could spark matching action by suppliers through official dealers. Official dealers argue that buyers would face problems in terms of servicing, repairs and spare parts availability but it is not clear that this would be the case. Surveys in the UK by the Consumers' Association have suggested that the competence of franchised dealers is not clearly better than that of independents. Nor is it clear that franchised dealers would be able to reject requests for servicing or repairs under guarantee. It is also suggested by the official dealers that buyers of parallel imports run a safety risk.

Of course, the argument for the block exemption is precisely that franchised dealers will provide guarantee and other services in any location and more competently as a result of the protection given to them but it is argued that while the present position may strengthen inter brand competition, it may nevertheless be giving to much power to the suppliers.

Consumers are unlikely to find less investment in product quality for reasons given above.

Authorised dealers are likely to be disadvantaged by exhaustion. Given the grip of the suppliers on the network, independents are more likely to sell parallel imported cars.

5.4.2. Quantitative Assessment

Table 5.6
Overview Quantitative Assessment: Motor Vehicles*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	0-4.5% concentrated on family cars (say, 90% of the car market) and mostly from Japan. The low end of the range assumes price differences are substantially reduced after the end of the Japanese export restraint	0-4.5% concentrated on family cars (say, 90% of the car market) and mostly from Japan. The low end of the range assumes price differences are substantially reduced after the end of the Japanese export restraint
Impact on retail prices	Average reduction of 0-0.9%	Average reduction of 0-0.9%
Impact on volumes	Increase in EEA volumes of 0-0.3%	Increase in EEA volumes of 0-0.3%
Impact on production	Increase in EU production of 0-0.3%	Increase in EU production of 0-0.3%
Impact on employment	See assumptions, increase of about 0-3,000 EU jobs	See assumptions, increase of about 0-3,000 EU jobs
Impact on profits	Potential reduction of 0-16%	Potential reduction of 0-16%
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.4.3. Summary

Our analysis focuses on the market for motor cars, although we note that parallel importing of motor cycles into the UK from outside the EEA has been a major topic of recent debate. The motor industry is a net exporter and an important contributor to the EU economy, employing over a million people. Globalisation has enhanced concentration within the industry. The industry relies on trademarks to market company names and specific products and trademarks also help to encourage product development and design and R&D. Design rights are important in the industry and patents will also be important (albeit for components rather than "whole vehicles"). Prices tend to be higher in the EEA than in Japan, even after allowing (broadly) for sales taxes and they appear to be higher than in the USA on particular models. Technical barriers constitute significant factor in parallel importing, however, with both health and safety factors and technical standards (eg regarding emissions) potentially constraining trade. Strong ties between manufacturers and retailers may also constrain opportunities to undertake parallel trade.

Prices and trade barriers (after 1999) will encourage parallel imports from Japan after 1999 and low to moderate penetration could be expected. Consumers would benefit to some extent from lower prices but other considerations are also important – the current block exemption is provided precisely in order to encourage dealer investment in service, guarantees etc and it is unclear to what extent purchasers of parallel imports will enjoy such benefits. Active parallel traders in this field insist that they will do so.

5.5. Consumer Electronics

5.5.1. Qualitative Assessment

The table below summarises factors likely to determine the scope for increase in parallel trade as a result of extending the current EEA trademark exhaustion regime. We have seen that price differences between the EU and the USA, Japan and other E Asian countries can be large. Transaction costs, however, may not encourage parallel trade for bulky articles.

Factors that would tend to discourage parallel trade are technical standards, anti-dumping duties on products from mainland E Asian suppliers (not Japan) and the importance of vertical restraints and manufacturers / retailer relations.

The survey of rights holders does not suggest that any increase in parallel exports will be significant.

Given the above conclusions, the consequences for trademark holders may not be great. Of course, most of the major players are Japanese and Korean owned firms supplying the market from European or overseas plants. Using unofficial outlets, there may be some pressure on official prices and on prices of close substitutes but it could be mainly localised. Given the importance of brand and technical progress in achieving global competitiveness, we would not expect there to be a significant effect on IPR driven investments.

Regarding consumers, the survey results saw little or no gain for them except perhaps on prices. On the non price factors, the effects were seen as wholly adverse. While informed service and after-sales service, might be thought to be more important for these products, it is clear that consumers are willing to go to unofficial stores to purchase and that this is encouraged by improved product quality. Some consumers are prepared to have warehouse surroundings and possibly less well versed sales assistants in return for lower prices. We do not expect a larger scale of such activity would adversely affect the quality of products in the long run.

Authorised dealers are likely to suffer, as non traditional outlets seem more likely to sell parallel imports.

Table 5.7
Scope for increase in parallel trade in consumer electronics

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	++
Transaction cost	-/+ (depending on product)
Technical barriers	-
Trade policy barriers	- (mainland Asia subject to anti-dumping action)
Vertical restraints/long-term relationship	-
Current parallel trade	+

Authors' assessment

5.5.2. Quantitative Assessment

Table 5.8
Overview Quantitative Assessment: Consumer Electronics*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	10%	5%
Impact on retail prices	Average price reduction of 2%	Average price reduction of 1%
Impact on volumes	Increase in EEA volumes of 1.6%	Increase in EEA volumes of 0.8%
Impact on production	Increase in EU production of 0.9%	Increase in EU production of 0.4%
Impact on employment	See assumptions increase of about 3,100 EU jobs	See assumptions, increase of about1,400 EU jobs
Impact on profits	Potential reduction of 35%	Potential reduction of 17%
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.5.3. Summary

The consumer electronics industry is dominated by Japanese firms, who control almost their entire domestic market and export 33 per cent of production. The EEA is a net importer, although also maintains a substantial manufacturing base. Trademarks are likely to be the main relevant IP right (although components may be patentable, design may be of some importance, and copyright is relevant for computer games). Branding is an important element of marketing and trademarks also encourage product development and R&D. Prices in Europe tend to be substantially higher than those in the USA or Japan. Transaction costs of parallel trade may be important, for reasons including the fragility of products, and different technical standards present a further barrier to be overcome. The apparent

strength of manufacturer control over the distribution system makes it likely that parallel imports would be sold (at discounted prices) in non-standard outlets.

Our analysis and the survey results suggest that there may be substantial levels of parallel trade. Consumers could benefit in terms of discounted prices (and perhaps through dynamic effects on the prices of direct route products), but may lose out in terms of service quality. Official retailers are likely to be disadvantaged, and parallel trade appears to have the potential seriously to affect manufacturers' profitability, more so than in most sectors.

5.6. Domestic Appliances

5.6.1. Qualitative Assessment

The table below summarises the factors likely to determine the scope for an increase in parallel trade. We have found both that US prices tend to be significantly lower though not on washing machines and this seems likely to hold after allowing for exchange rate changes over the past two years. Japanese prices are rather higher than in the EU though, after allowing for exchange rate changes perhaps by only around 15% in the case of vacuum cleaners. It may be that transport costs could be a significant barrier in the case of cheaper models of white goods. Technical and safety standards could also be a problem for goods first sold on other markets. Trade policy measures do not appear to be a barrier.

Table 5.9
Scope for increase in parallel trade in domestic appliances

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	++
Transaction cost	- (for cheap models)
Technical barriers	-
Trade policy barriers	+
Vertical restraints / long-term relationship	-
Current parallel trade	-

Authors' assessment

While price differences may seem to encourage more parallel trade, including parallel exports to Japan, other factors seem mainly to discourage it. If it does increase, outlets are more likely to be outside the official network eg "warehouses" and hypermarkets. Given the aim of EU firms to achieve global competitiveness we do not believe they will cut either promotion or new product development.

Consumers should benefit to the extent that they are prepared sometimes to trade-off surroundings for lower prices. Greater reliability of machines will encourage this. We cannot believe that reputable hypermarkets would fail their customers on issues such as

guarantees and after-sales service. Nor do we think that new product development will suffer.

Authorised dealers are likely to be disadvantaged and would seek better terms from suppliers. The non-traditional outlets are likely to be the main sources of parallel goods.

There appears to be scope for parallel exports to Japan but entry to that market would be difficult and brand names perhaps not very familiar.

5.6.2. Quantitative Assessment

Table 5.10
Overview Quantitative Assessment: Domestic Appliances*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	8%	5%
Impact on retail prices	Average price reduction of 1.6%	Average price reduction of 1.0%
Impact on volumes	Increase in EEA volumes of 0.6%	Increase in EEA volumes of 0.4%
Impact on production	Increase in EU production of 0.5%	Increase in EU production of 0.3%
Impact on employment	See assumptions, increase of 1,300 EU jobs	See assumptions, increase of 850 EU jobs
Impact on profits	Potential reduction of 25% on *assumed* operating ratio	Potential reduction of 15% on *assumed* operating ratio
Impact on trade	Increased imports	Increased imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.6.3. Summary

The EU maintains positive balance of trade in this sector, although EU industry is relatively stronger in the non-electrical goods sector. Trademarks are of fundamental in this sector, where the quality of a product may not become evident for some years after purchasing, and they are used for advertising and for product development purposes. Use is also made of design rights. Pricing varies between appliances and after taking account of taxes the EEA has relatively cheap prices for refrigerators and washing machines. Prices for cookers and heaters are, however, substantially higher in the EU than the USA. Barriers to parallel trade include technical issues and product suitability issues.

Price differences appear likely to encourage parallel imports to the EEA for at least some products. We consider that parallel traded items will most likely be sold outside current

retail outlets eg in hypermarkets. Customers may benefit from trading quality of service against price, and there seems no reason to believe that such establishments would eg fail to honour guarantees.

5.7. Cosmetics and Perfumes

5.7.1. Qualitative Assessment

Taking into account the analysis of factors that are likely to affect parallel trade and the survey results, this section makes a qualitative assessment of the scope for increase in parallel trade if trademark exhaustion regimes would be extended. Where possible, it also assesses the changes that would take place in the cosmetics and perfumes sector as a result of more parallel trade.

First, the scope for extra parallel seems to be limited judged by average price differences between the EU and other (groups of) countries. There is some evidence that at the individual product level, prices of luxury cosmetics or perfumes for some European countries are higher than those in the US, but at the same time also higher than in other European countries. Japan seems to have the highest prices in general.

Next, there are some transaction costs involved in trade in cosmetics and perfumes, especially when transported over large distances and exposed the temperature changes. Although this would not necessarily limit the volume of parallel trade taking place, it would certainly not be in the consumers' interest if the quality of parallel imported goods from the USA or East Asia was of lower quality.

There are furthermore some technical barriers when importing cosmetics and perfumes from outside the EU into the EU. Goods would have to meet the requirements in the area of ingredient labelling, and manufacturing and health safety. This would of course not be a barrier if the products were exported from the EU in the first place (although in that case the above-mentioned transaction costs are likely to be high).

The presence of tight vertical agreements (selective distribution systems) and the importance of good long-term relationships between supplier and retailers imply that parallel imported goods in the premium-price luxury segment would probably be sold through retail outlets outside the officially selected outlets. This would not be in line with the luxury image of these products, which arguably require certain standards for retailers. For cosmetics and perfumes that are located towards the lower end of the product spectrum, vertical restraints are much less strict, and parallel imports could be sold through the regular outlets. But, as argued, not much parallel trade is expected in this segment of the market.

Finally, the relatively high estimate of parallel trade (around 13%) in the upper end of the market indicates that parallel trade, at least within the EEA, is well possible.

Table 5.11
Scope for increase in parallel trade in cosmetics and perfumes

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	+
Transaction cost	-
Technical barriers	-
Trade policy barriers	++
Vertical restraints / long-term relationship	-
Current parallel trade	++

Authors' assessment

5.7.2. Quantitative Assessment

Table 5.12
Overview Quantitative Assessment Cosmetics and Perfumes*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	For premium brand, penetration rate in the range of 5 - 15%, mainly from the USA; overall around 4% increase in parallel trade	For premium brand, penetration rate in the range of 5 - 15%, mainly from the USA; overall around 4% increase in parallel trade
Impact on retail prices	Average price reduction around 1.2%; price reduction for parallel imported premium brands about 30%	Average price reduction around 1.2%; price reduction for parallel imported premium brands about 30%
Impact on volumes	Negligible, because of low price elasticity (close to zero)	Negligible, because of low price elasticity (close to zero)
Impact on production	Negligible, because of low price elasticity (close to zero)	Negligible, because of low price elasticity (close to zero)
Impact on employment	Negligible, because of low price elasticity (close to zero)	Negligible, because of low price elasticity (close to zero)
Impact on profits	Potential reduction of 3%	Potential reduction of 3%
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.7.3. Summary

The EU is the largest producer of these products in the world, and maintains positive trade balance. Trademarks are the main IP right utilised by the industry, although design rights for items such as perfume containers may be relevant. The main use of trademarks is for branding and advertising, although they also serve product development and R&D purposes. Counterfeiting of premium priced fragrances is an issue for the sector. On average, the EEA and US seem to have similar prices for cosmetics and perfumes, while Japanese prices are higher. However, this picture is not necessarily representative of individual perfumes, especially at the high end of the market. Transport costs may be low, although some care for the condition of the product is required, and health and safety and product labelling are also a relevant factor. Premium products tend to be distributed through selective distribution, with very tight vertical restraints. Restraints are looser for other products.

Our analysis suggests relatively high parallel import penetration for premium products, which account for a significant proportion of the market by value. Consumers may benefit from lower retail prices for such products, and the direct effects on manufacturers may be limited, since ex-manufacturer prices in countries of export may not be significantly lower. These savings result from the avoiding the cost of retailing in a luxury setting and selling products through non-traditional outlets. Arguably, this might damage the luxury image of products in this sector. Little parallel trade in non-premium products is expected.

5.8. Clothing

5.8.1. Qualitative Assessment

The Table below summarises factors that are likely to determine the scope for increase in parallel trade as a result of extending the current EEA trademark exhaustion regime. We have found evidence of moderately higher prices on average in the EU compared with the USA and quite large differences for specific articles. Japanese prices tend to be higher than in the EU but the gap now appears to be modest. The transaction costs - transport - also have the potential of increasing parallel trade as would the absence of strong technical barriers. Current experience shows that there is scope for such activity at least in supermarkets and cut-price stores (see below).

Among factors that would tend to discourage parallel trade are moderately high import duties (more important for any developed country source, which seems not to be very likely - we assume that US brand names tend to be made in developing countries or Italy) and the MFA limiting exports from developing countries until 2005. Selective distribution networks and the generally close relationship between manufacturer and retailer seem to militate against use of these channels but supermarkets have shown the possibilities elsewhere albeit with a limited range of goods - shirts, tee shirts and jeans.

It would be surprising if they did not build on this given freedom to do so. Indeed they may expand the range of activities. In face of this, some department stores may wish to move in this direction in the longer run if thy cannot get better deals from the producers. Price effects would be less local and last longer.

Our survey of importers/exporters suggests an increase in parallel imports both under unilateral international exhaustion and quite possibly with reciprocal exhaustion but rightholders seem unclear about what would happen or may not expect an increase.

There are also some indications of an increase in parallel exports in our survey though to which market - USA or Japan - is unclear. Given the apparent narrowing of the price gap with Japan and problems of entry to the Japanese market this looks somewhat doubtful.

Table 5.13
Scope for increase in parallel trade in clothing

Potential determinants	Effect on scope (increasing +; decreasing -)
Price differences	+
Transaction cost	+
Technical barriers	+
Trade policy barriers	- - (developing country sources until 2005)
Vertical restraints/long-term relationship	-
Current parallel trade	+

Authors' assessment

While the consequences for trademark owners may not be very great overall, they could be more significant on a narrower front affecting particular sections of a business and some specialists eg in leisure wear.

Manufacturers will doubtless take action to prevent an increase in parallel trade by a variety of measures as indicated by our survey but we are doubtful whether reactions will be such as to reduce significantly IPR driven investments such as advertising and other forms of promotion, and product development and design since all are so important in an industry faced by strong competitive pressures, external and internal to the EEA.

Regarding the consequences for consumers, rightholders/importers/exporters, have acknowledged price gains for consumers but have asserted that that there may be adverse effects on eg guarantees, after-sales service, and product information. To our knowledge, there have been no complaints along these lines with regard to recent supermarket activity in the UK and we doubt that reputable firms (as have been involved in highly publicised cases) would behave in this way. Nor do we expect consumers to be hit by less investment in product quality - the only means by which developed economy producers can hope to compete with China and other developing country producers.

Authorised dealers are likely to be disadvantaged, at least initially. Manufacturers are likely to tighten vertical restraints and non traditional outlets are likely to take the lead in selling parallel imported goods.

5.8.2. Quantitative Assessment

Table 5.14
Overview Quantitative Assessment: Clothing*

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	10-20% in premium brands, say,1-2% overall	10-20% in premium brands, say 1-2% overall
Impact on retail prices	0.2-0.4%	0.2-0.4%
Impact on volumes	Increase in EEA volumes of around 0.1%	Increase in EEA volumes of around 0.1%
Impact on production	Increase in EU production of less than 0.1%	Increase in EU production of less than 0.1%
Impact on employment	See assumptions, increase of about 300-600 EU jobs	See assumptions, increase of about 300-600 EU jobs
Impact on profits	Potential reduction of 2.8-6.0 %	Potential reduction of 2.8-6.0 %
Impact on trade	Increase in imports	Increase in imports

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.8.3. Summary

The EU clothing industry has been facing fierce competition from developing countries, and has been in decline despite the protection afforded by the Multifibre agreement. Production tends to be a labour intensive process. Trademarks are the only IP right of substantial importance to the sector, predominantly through facilitating the advertising and branding of clothes. Trademarks may also facilitate the design of new products. Prices of clothes, especially premium brand names, are higher in the EU than in the USA, although consumer tax rates go some way towards explaining the difference. The main costs involved in parallel trade include a 13.8 per cent tariff, and quotas with regard to imports from certain countries. Relatively tight vertical restraints characterise the market for luxury clothes.

For the market as a whole, parallel imports may be very limited, although focussed in a small number of premium brands. These may retail in a range of establishments, probably at a discount to direct route products.

5.9. Soft drinks

5.9.1. Qualitative Assessment

The table below summarises the factors that are likely to determine the scope for additional parallel trade as a result of extending the current EEA trademark exhaustion regime.

The evidence described above regarding price differentials suggests that the EU may have higher prices for soft drinks than the USA, but lower prices than Japan. The evidence on prices of mineral water differs according to the source selected, so no clear conclusions can be drawn regarding prices in this area. The data from the EIU survey suggest that there is a wide range of prices for soft drinks within the EEA, and that while USA prices are similar to those at the lower end of the European range, the higher European prices may be the highest in the world. East Asian prices for soft drinks, if not mineral water, are generally low.

Transaction costs are likely to be very high for these products, since they are likely to have a very low value per unit weight. Transport, for other than a very short distance, would appear likely to have very high costs. On the other hand, technical barriers to parallel trade do not appear to be particularly strong.

Vertical integration of manufacturers into distribution and may tend to limit the scope for parallel imports to be sold by some of the larger retailers. The absence of any significant contact between smaller retailers and brand owners suggests that this is a more likely forum for the sale of parallel imports. Suggestions that parallel trade currently occurs within Europe, despite the barriers in terms of transaction costs may prove a positive influence on the amount of parallel trade which will occur.

Table 5.15
Scope for increased parallel imports to the EEA of soft drinks

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	+ +
Transaction cost	- - -
Technical barriers	+
Trade policy barriers	- (not mineral water)
Vertical restraints / long-term relationship	+
Current parallel trade	+

Authors' assessment

Overall, and taking account of all of these influences, our conclusion is that an extension of the exhaustion of trademark rights will have only minor implications for this sector. Transport costs appear likely to be sufficiently high seriously to constrain parallel imports of soft drinks to the EEA. While parallel trade does currently occur within the EEA, this can be in the face of significant price differentials and small distances (hence transport costs).

Realistically, only local countries, might be in a similar position, and hence able to act as a source for parallel imports to the EEA. Since we have been unable to study prices in Eastern Europe it is difficult to judge the potential significance of this flow. However, overall we judge that the additional parallel imports resulting from the change of regime will be low.

Price differentials may be such as to facilitate parallel exports from the EU to Japan. On the whole, we think that the various difficulties in exporting to Japan make it unlikely that such trade will occur to any significant extent. In any case, the USA would generally appear to be a more profitable source if such trade were to be undertaken.

5.9.2. Quantitative Assessment

The table below shows the quantitative results of the analysis carried out in Appendix C.

Table 5.16
Overview Quantitative Assessment Soft Drinks *

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	Market penetration of 0-5%, probably towards the lower end of the range.	Very low penetration
Impact on retail prices	Negligible	Negligible
Impact on volumes	Negligible	Negligible
Impact on production	A risk of a decline in EU production by up to 5% but probably less	Negligible
Impact on employment	See assumptions, risk of a decline by up to 4,500 manufacturing jobs, but probably less	Negligible
Impact on profits	Potential reduction of 15%	Negligible
Impact on trade	Increase in imports	Negligible

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.9.3. Summary

The market for soft drinks is dominated by domestic production, with both imports and exports being low by comparison with the market size. Trademarks appear to be the only IP right of substantial importance to the sector, which is characterised by a high degree of

consumer brand awareness. Trademarks are used for branding and advertising purposes rather than particularly to encourage product development or R&D. EU prices are substantially above prices in the USA, but below those in Japan. However, there is also striking variation in prices within Europe (and parallel trade). Given that transport costs are likely to be significant parallel trade between local countries appears likely to be of greater significance.

While there would be scope for some parallel imports in this sector, overall, the dispersion of prices within Europe, and the transport costs involved in undertaking trade from far afield mitigate against there being large increases in parallel imports from outside the EU. Since parallel imports would tend to mingle with direct route products, there is less likelihood than in most sectors of consumers benefiting from discounting.

5.10. Confectionery

5.10.1. Qualitative Assessment

The table below summarises the factors that are likely to determine the scope for additional parallel trade as a result of extending the current EEA trademark exhaustion regime.

The evidence described above regarding price differentials suggests that the EU may have higher prices for confectionery than the USA, but lower prices than Japan. Although the price differentials are smaller than some sectors, one should remember that the figures quoted represent the average price differentials. Certainly for products with differentials in excess of the average parallel imports to the EEA may well be possible.

Transaction costs are likely to be moderately high for these products, since some care in handling will be required and the "value to weight" ratio appears unlikely to be exceptionally high. to have a very low value per unit weight. Vertical integration appears likely to be relatively unimportant in this sector and suggestions that parallel trade currently occurs within Europe, despite the transactions costs involved, may prove a positive influence on the amount of parallel trade which will occur.

Table 5.17
Scope for increased parallel imports to the EEA of confectionery

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	+
Transaction cost	- -
Technical barriers	+
Trade policy barriers	-
Vertical restraints / long-term relationship	+
Current parallel trade	+

Authors' assessment

Overall, and taking account of all of these influences, our conclusion is that an extension of the exhaustion of trademark rights will lead to low to moderate parallel trade in this sector. Transport costs, coupled with less than extreme price differentials, appear likely to be sufficiently high to constrain parallel imports of confectionery to the EEA. On the other hand, transactions costs seem unlikely to cancel out price differentials completely, so a certain amount of parallel trade might be expected.

Price differentials may be such as to facilitate parallel exports from the EU to Japan. On the whole, we think that the various difficulties in exporting to Japan make it unlikely that such trade will occur to any significant extent. In any case, the USA would generally appear to be a more profitable source if such trade were to be undertaken.

5.10.2. Quantitative Assessment

The table below shows the quantitative results of the analysis carried out in Appendix C.

Table 5.18
Overview Quantitative Assessment Confectionery *

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	Market penetration of 0-10%, with about half being sourced in the USA and half elsewhere	Market penetration of 0-5%
Impact on retail prices	Average reduction of around 0.1% (no dynamic effect)	Average reduction of around 0.05% (no dynamic effect)
Impact on volumes	Very small increase (0.04%)	Small increase (0.02%)
Impact on production	Very small increase (0.04%)	Small increase (0.02%)
Impact on employment	Very small increase (around 70 jobs)	Very small increase
Impact on profits	Potential reduction of 15%	Potential reduction of 6%
Impact on trade	Increase in imports	Very small effect

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.10.3. Summary

The EU is the largest producer and consumer of confectionery in the world, and maintains a positive balance of trade in this sector. Trademarks appear to be the only IP right of substantial importance to the sector, where they are generally used for branding and

advertising purposes. However, they may also play a role in encouraging product development in a sector which has shown significant innovation (eg developing low calorie products) in response to changing market conditions. The EU tends to have higher prices than the USA, even after taking account of consumer taxes, and transaction costs and barriers to parallel trade seem to be no higher than moderate.

Moderate penetration rates for parallel trade, with source countries being the USA, and other countries (unilateral case only) might be expected. Retailers and intermediaries, rather than consumers, could be expected to benefit from higher margins, with manufacturers losing out in terms of profitability.

5.11. Alcoholic Drinks

5.11.1. Qualitative Assessment

The table below summarises the factors that are likely to determine the scope for additional parallel trade as a result of extending the current EEA trademark exhaustion regime.

The evidence described above regarding price differentials suggests that in terms of tax-inclusive retail prices the EU may have higher prices for spirits than the USA, but that even if such a differential does exist, it is explained by differences in alcohol and general sales taxes. For beer and wine the EU appears to have lower prices than the USA, and prices for all alcoholic beverages seem lower in the EU than in Japan. These factors suggest that, relative to many of the sectors which we study, price differentials will have a severely constraining influence on parallel imports to the EU. Nonetheless, this does not preclude the possibility that imports of individual products may be possible, or that imports from regions (such as Eastern Europe) for which we do not have price data could be feasible.

Transaction costs are likely to vary according to the product at issue. For beer, transaction costs are likely to be very high, unless the distances involved are very short. For quality wines and spirits this would be less of a constraint. The absence of strong technical barriers would also encourage parallel trade.

The vertical integration of manufacturers into distribution and in some cases in to retailing may tend to limit the scope for parallel trade. However, suggestions that parallel trade currently occurs, despite the barriers in terms of transaction costs and vertical relationships may prove a positive influence on the amount of parallel trade which will occur.

Table 5.19
Scope for increased parallel imports to the EEA of alcoholic drinks

Potential determinants	Effect on Scope (increasing +; decreasing -)
Price differences	- - -
Transaction cost	- -
Technical barriers	+
Trade policy barriers	-
Vertical restraints / long-term relationship	-
Current parallel trade	+

Authors' assessment

Overall, and taking account of all of these influences, our conclusion is that the circumstances in which an extension of the exhaustion of trademark rights will lead to parallel imports of alcoholic drinks to the EEA are rather limited. In most cases, the EEA already contains some of the lowest prices which we have identified, and hence parallel imports are very unlikely. There is a wide range of prices in the EEA, which suggests that imports to higher priced countries could be possible. However, where such differences are not explained by the influence of taxation, other European countries would appear to be the more logical source of supply for parallel traders.

Some imports could remain possible, such as imports from areas where we have not been able to study prices (eg Eastern Europe), or imports of (probably a small number of brands) whose pricing is unrepresentative of the general trends identified, but from the point of view of the market as a whole we judge that the additional parallel imports resulting from the change of regime will be small.

Price differentials may be such to facilitate parallel exports from the EU, especially for wine, with Japan being the most obvious target market. On the whole, we think that the various difficulties in exporting to Japan make it unlikely that such trade will occur to any significant extent.

5.11.2. Quantitative Assessment

The table below shows the quantitative results of the analysis carried out in Appendix C.

Table 5.20
Overview Quantitative Assessment Alcoholic Beverages *

Economic Variable	Unilateral Exhaustion	Reciprocal Exhaustion
Amount of parallel trade	Very low penetration	Very low penetration
Impact on retail prices	Negligible effect	Negligible effect
Impact on volumes	Negligible effect	Negligible effect
Impact on production	Negligible effect	Negligible effect
Impact on employment	Negligible effect	Negligible effect
Impact on profits	Negligible effect	Negligible effect
Impact on trade	Negligible effect	Negligible effect

** A number of assumptions have been made for this assessment; these assumptions can be found in the sector appendix*

5.11.3. Summary

This sector covers a range of products, including spirits, wine and beer. In each case the EU industry contributes a positive balance of trade. Trademarks are the main traditional intellectual property right although systems such as appellation controlée may put some limits on their need. Nonetheless, competition through branding remains an important part of the sector, perhaps more so for spirits and beer than for wine. Examination of price differences is complicated by the presence of tax rates, but after making a crude attempt to take account of such taxes we find that the EU tends to have relatively low prices for these products. Although for reasons of data availability, we have not had the opportunity to examine every potential source country, on the basis of the analysis we have undertaken, an appreciable level of parallel imports to the EU appears unlikely. Parallel exports could be possible, especially in the case of wine, and especially to Japan. Practical factors may limit the size of this trade, which we have not been able to quantify.

6. SUMMARY AND CONCLUSIONS

6.1. Basic Elements of Trademarks and Exhaustion Regimes

Trademarks fulfil two mutually dependent economic functions:

- they assist and protect the consumer in identifying the source of products and hence improving their ability to judge quality; and
- they provide a property right to the trademark holders, by limiting the rights of other parties to copy their products, specifically by prohibiting use of their trademark; this allows trademark holders to be rewarded for their investment in product development and product quality, and for their expenditure in creating brand image or "branding" of a product.

There is no dispute that trademarks are of fundamental importance in the market, and of particular importance for certain categories of consumer goods.

The rights conferred on holders by trademarks are, however, qualified by the principle of exhaustion. A decision to apply this principle means that once trademark holders have sold a product, then they cannot prohibit the subsequent re-sale of that product; their rights in respect of an individual item or consignment are "exhausted" by the act of selling it. In particular they cannot discourage re-sale by preventing use of the trademark.

Similar principles regarding exhaustion may be applied to other intellectual property rights (IPRs), such as copyright or patents. This report is concerned primarily with trademarks. Some goods may however be covered by more than one form of intellectual property protection, so that the patent and other regimes may also affect the outcome of changes made to the trademark regime.

The definition of an exhaustion regime is essentially a definition of the geographic area to which the principle of trademark exhaustion is deemed to apply. Thus the current exhaustion regime for the EEA relates to the territory of the Member States, so that trademark holders cannot legally prevent re-sale of products within the single market of the EEA, once those goods have been put on the market there. They *can* legally seek to prevent the re-sale within the EU of goods first sold outside the EEA; these latter are known as **parallel imports**.[40] This is the exhaustion regime implicit in the legal judgement in the recent Silhouette case, involving re-import of spectacle frames sold to a Bulgarian

[40] The terms parallel imports and parallel trade will also be used to describe any trade that reflects re-sale that occurs without the consent of the trademark owner; this may include parallel trade between countries within the EU. A parallel import into the EU could be manufactured there and re-imported, or made in a third country and imported through an unauthorised channel.

company.[41] In essence the court ruled that trademark rights are not exhausted by virtue of sale outside the EU.

The subject of this report is the examination of the potential economic effects of extension of the exhaustion regime beyond these boundaries, either unilaterally by the EU or on the basis of reciprocal/bilateral or multilateral agreements with other countries. This is sometimes described in general terms as a move towards **international exhaustion**. It may be noted that some countries already apply international exhaustion, at least to certain types of product. There has been some inconsistency in the past between EU member states, with some countries practising international exhaustion while others did not.

The exhaustion regimes that apply in other countries, such as the USA or Japan, affect the potential for **parallel exports** *from* the Community *to* those countries. Our report includes a brief description of the exhaustion regimes that currently apply in the EU/EEA, US and Japan. In some cases the regime is not clear cut, and an assessment of the legal position indicates an intermediate position with some degree of international exhaustion, applied only to IPRs relating to certain categories of product or on a case by case basis. Uncertainties regarding even the *current* legal position for some products adds to the uncertainties of assessing the economic impact of a change of regime.

6.2. Defining the Economic Issues

Parallel trade, ie parallel imports or parallel exports, arises primarily, but not necessarily exclusively, because of price differences that exist between different markets for a single product. Sometimes this may be due to relatively transient phenomena such as exchange rate movements, where parallel traders are able to react more quickly in trading than trademark holders or distributors can in altering selling prices. A more fundamental cause however is the likelihood that the trademark holder wishes, as a matter of commercial policy, to sell goods at different prices in different markets. This may reflect several different factors, including differences in production or distribution costs, differences in the ability or willingness of consumers to pay for the product, because of differences in wealth or tastes, and investment in "branding" for the local market.

From an economic point of view, there is nothing intrinsically bad about price discrimination. Some form of price discrimination is common and efficient in situations where fixed costs have to be covered, and as our brief description of related intellectual property issues in the pharmaceutical sector indicates, there may be significant benefits in terms of both economic efficiency and consumer welfare when firms are allowed to practise it. There can be no a priori presumption that prohibiting price discrimination in a particular case will result in prices in a particular market falling to the lowest of the different market

[41] Case C-355/96, [1998] CEC 676

prices. They may rise to higher levels, and the trademark holder may withdraw from the low price markets altogether.

A major dimension to the argument, therefore, surrounds the importance that should be attached, on the one hand, to the trademark holder's right to exploit the value of the intellectual property right constituted by the trademark and to discriminate in how the product is marketed, as against, on the other hand, the potential benefits that "freer trade" and parallel imports may induce in the form of increased intra-brand competition, with the consequence of lower consumer prices.

A second dimension is the question of how changes in the exhaustion regime might impact on the other fundamental role of trademarks, in protecting consumers by providing an assurance as to the origin and quality of a particular product. Consumers may for example be adversely affected by confusion over the origin and content of products which have the same trademark but have been produced to meet different national tastes, or to meet different technical requirements; or they may be affected by deterioration in quality in the course of transporting the goods, or by an adverse impact of a change in trademark regime in weakening the controls against counterfeit goods.

6.2.1. The case for maintaining the protection of trademark rights, and limiting the geographical extent of the exhaustion regime

Arguments for limiting exhaustion to the EEA derive from the belief that this provides a higher economic reward to firms that invest in the quality or style of their products, and that this incentive is necessary in order to maintain the range of products and the quality of goods and associated service that EU consumers expect. International exhaustion would make it more difficult for EU firms to sell at a lower price outside the Community or for non-EU firms (which intend to use EU licensees) to sell at a higher price in the Community, and therefore have one or more of the following negative economic consequences:

- lower returns to the trademark holder; this would over time inhibit investment in new brands, or in some cases might cause the firm to retire existing products from the market, or to reduce the quality of goods and the provision of associated services; this would be contrary to the long term interests of consumers in tending to reduce quality and choice;
- specifically trademark holders may not be willing to make the investment in "branding" necessary in order to bring a particular existing brand to a local EU market;
- higher prices in markets outside the EEA, and the possible withdrawal from the market of products which the citizens of those countries value; and
- if firms exit from lower margin markets to prevent parallel trade, prices in EEA markets may even rise because fixed costs can no longer be spread over a larger volume of sales.

These arguments parallel those that can be made for other intellectual property rights, and assert that the best outcomes will occur when holders are allowed more freedom to exploit their rights, in this case predominantly through price discrimination between different national markets, and any associated measures (limiting supplies to more price sensitive markets, discouraging re-export, and others) that they see as necessary to sustain that strategy. Freedom to exploit the intellectual property right, without exhaustion, increases the incentives to innovate and develop new brands.

To counter the argument that trademark owners are exercising monopoly power, the proponents of maintaining the status quo would argue that there is generally substantial inter-brand competition, and that concerns about the possible abuse of monopoly power are more properly addressed through competition law rather than through further limiting the rights of trademark owners.

The second set of arguments in favour of limiting the geographical scope of exhaustion to the EEA is based on the view that a move towards international exhaustion would tend to disadvantage consumers by weakening the effectiveness of trademarks in assuring quality, identifying origin and protecting the consumer. There are several ways in which this could happen, although the relevance of each is likely to vary from sector to sector and from product to product. Relevant factors vary from product to product but include the following.

- Products tailored to different national markets, and correspondingly different needs, may be of different quality, composition or style, but bear the same trademark; this is potentially so for confectionery and soft drinks, for fashion goods, and for consumer appliances.
- Parallel imports also represent a weakening of the ability of the trademark holder to control the distribution chain and the conditions under which products are sold; this may result in a reduction in the quality of the product supplied and in the retail and after sales service associated with it; for some products such as vehicles this could be an important factor.
- Parallel imports may make it more difficult to enforce common technical or safety standards within the EU, with corresponding risks to consumers; again this may be of importance for particular products.

Harmonisation within the EU is intended to create a single market, so that these considerations are less important within the existing exhaustion regime. International exhaustion, however, would create these problems.

Proponents of a more limited exhaustion regime may argue that the future economic development of advanced economies relies heavily on sectors and products with a substantial content of intellectual property. Affording proper protection to the owners of

those rights, such as trademarks, and maintaining incentives, are likely to be vital for the economic future of the EU.

Finally, the absence of a barrier to parallel imports may reduce ability to detect and prevent counterfeit imports; this may be directly damaging to consumers and further undermines the financial returns to trademark holders; this has been identified as of particular importance to musical recordings.

6.2.2. The case for international exhaustion

The economic case for extending to international exhaustion is simply stated and rests on the proposition that this will deliver lower prices to consumers. The case is that trademark holders, or their authorised distributors, are in some cases exercising a degree of monopoly power in a particular brand. Parallel imports provide additional competition that reduces prices to the consumer, by reducing the ability of the trademark holder to exploit its position (in that brand) and to set higher prices in some markets than in others, *and* by increasing competition in the distribution of the product.

Proponents of this argument emphasise that the fundamental function of a trademarks regime is the protection of the consumer, not the assignment to the trademark holder of further rights that create elements of monopoly in the market for the product, and add further value to the property rights associated with ownership of the brand. International exhaustion, it may be argued, is consistent with the general trend towards liberalisation in international trade. In some sectors retail trends such as purchasing over the internet, or other "personal imports", will make it increasingly difficult to sustain the existing regime.

As for the arguments that this would result in a loss of protection for consumers, it may be argued that parallel importers, or the retailers of parallel imports, would have exactly the same incentives to offer good service as authorised distributors. Many will do so to safeguard their own reputation as retailers. Further consumers might be prepared to forego the benefits of certain services in exchange for a lower price, rather than being forced to purchase at a particular combination of price and service. Technical and safety standards can also be seen as a barrier to the incidence of parallel imports, which will in practice limit their feasibility for many products, rather than as being protections put at risk from a change in regime.

Finally it can be argued that counterfeiting problems should be attacked directly, perhaps by improving detection and effective deterrence, rather than by inhibiting legitimate competitive activity.

6.2.3. The differences between unilateral, bilateral and multilateral extensions to international exhaustion

The effects of any extension to international exhaustion would depend on:

- the other countries that are included in the extension; the prices at which trademarked goods are sold in each country determines the likely scope for parallel trade that arises from an extension to include that country within the exhaustion regime; and
- whether the extension is unilateral, or whether it is made as part of a deal in which the other country agrees to extend its own exhaustion regime to include the EEA; the effect of this reciprocal arrangement is to allow parallel exports from the EEA and this may happen in cases where the prices of trademarked goods are generally lower in the EEA.

There are clearly many possible combinations that would constitute an extension to international exhaustion. We have confined our examination to a limited number of possibilities, concentrating on the US and Japan as major trading partners, and on the options of unilateral change, bilateral change, and change as part of a general multilateral agreement on international exhaustion.

In this context we note from our description of the legal position in other countries that some other countries (notably the US and Japan) already practise some degree of international exhaustion.

One should not assume a priori that reciprocal or multilateral agreements are more advantageous for individual EU firms, or for EU trademark holders collectively, than is unilateral change. EU trademark holders who would be disadvantaged by parallel imports *to* the EU may also hold trademark rights in other countries and might be disadvantaged by parallel exports *from* the EU. Similarly it will not necessarily be true that reciprocal or multilateral extensions are better for the EU economy as a whole than is unilateral extension.

With reciprocally or multilaterally agreed moves to international exhaustion, net changes in parallel imports and exports would depend mainly on the relative prices in different countries for a range of trademarked products. Extension of international exhaustion to countries such as the USA, where (post-tax) retail prices and probably (pre-tax) wholesale prices are generally lower, might, in the absence of other factors, be more likely to lead to increased parallel imports. Extension to countries such as Japan, where retail prices are generally higher, might, again in the absence of other factors, tend to favour parallel exports. The actual direction of flow may however vary from sector to sector or product to product. Current practice of at least partial application of international exhaustion in some other countries would tend to reduce the likelihood of any significant change in the level of parallel exports.

6.3. Factors influencing an assessment of the economic impact

This report does not adjudicate between these conflicting points of view. Instead it explores the economic impacts of extending the exhaustion regime. To do this we have focused on

ten sectors in which trademarks are important, and which we believe cover a substantial proportion of international trade (and the potential for parallel trade) in consumer goods. The sectors are footwear and leather goods, musical recordings, motor cars, consumer electronics, domestic appliances, cosmetics and perfumes, clothing, soft drinks, confectionery and alcoholic drinks.

Our survey has attempted to collect views on the economic consequences of change and includes the perspective of trademark holders, import/export associations, consumer organisations and associations of small and medium size enterprises across the EU.

The immediate economic consequences that would flow from a change in trademark regime can be put into perspective by the following observations.

- Exhaustion regimes across the world may be of secondary importance in determining the location of production; much of the trademarked footwear and clothing sold under the trademark regimes of the EU or the US is for example sourced from South East Asia.
- Trademark holders within the EU include large numbers of US and Japanese firms whose perspective on the international exhaustion issue is likely to be broadly similar to that of EU firms, but whose earnings will ultimately accrue to US or Japanese investors. The converse will be true for trademark holders in the US or Japan.
- Increases in parallel imports of previously exported goods (so-called re-imports) are not net effects on the trade balance; nor are parallel imports that displace imports arriving by authorised channels.
- The fact that the EU is a large market will tend to dampen the potential for major price reductions on individual products; thus it is unlikely in any circumstances that Bulgarian parallel imports would determine the general level of prices for spectacle frames. Trademark holders will tend to sustain sales in larger and more profitable markets, abandoning if necessary those that are smaller and more price sensitive.

Nevertheless international exhaustion could have a significant impact on some sectors, and for particular firms or products in any sector. This could alter radically business strategies for these firms, leading to re-location of the firm's marketing or production base for example, and causing the firm to alter its pricing, marketing, product development and distribution strategies.

Our analysis shows that the consequences of change are complex, and may vary considerably both between sectors, and between products within a sector. In our analysis we have attempted to identify those factors that are likely to be important for different sectors. We have also made an uncomplicated assessment of the immediate economic

impact, using simplifying assumptions and approximate judgements about the scope for parallel imports and the extent of their price effects.

In the long run however these effects are likely to be much less important than the dynamic effects of any change, as trademark holders and others react to any new regime. Dynamic effects may offset and reduce any immediate effects, as trademark holders find new commercial strategies which maintain their existing position (eg through exploiting other intellectual property protections). Or they may cause much more fundamental shifts in business strategy.

In the following sections we summarise the factors that will influence the scope for parallel trade, and the potential consequences of a change in the exhaustion regime.

6.3.1. Current EU impact of parallel trade

A significant item of evidence is the extent of parallel trade that currently takes place within the EEA. The effects of extension to international exhaustion are likely to be similar in nature, although not necessarily in extent, to those that occurred in the evolution of a single market.

The tables below summarise the picture that emerges for the sectors that we have examined. The first covers price differences currently observed for branded products within the EU. The second summarises the impressions gained from our survey and from other sources about the current extent of parallel imports.

Table 6.1
Price differences currently observed for branded goods, within the EU

Sector	Price differences	Comment
Footwear and leather goods	Intermediate / large	e.g. Nike trainers or Timberland boots
Musical recordings	Intermediate	International full-price pop CDs
Motorcars	Large	Across most models
Consumer electronics	Large	Based on aggregated data (EIU data)
Domestic appliances	Large	Based on aggregated data (EIU data)
Cosmetics and perfumes	Large	e.g. CK 200 ml Eau de Toilette
Clothing	Intermediate	-
Soft drinks	Intermediate / large	-
Confectionery	Intermediate	-
Alcoholic drinks	Large	But mainly due to tax differences

Source: see Appendix C of this report for the various sources

Table 6.2
Extent of current parallel trade within the EU

Sector	Assessment	Comment
Footwear and leather goods	Small	< 5%
Musical recordings	Large	Overall 5 to 10%; some releases up to 20%
Motorcars	Small	Estimates of up to 5%
Consumer electronics	Small	Around 5%
Domestic appliances	Small	< 5%
Cosmetics and perfumes	Large	Around 13% for upper end of market
Clothing	Intermediate	Survey mentions range 5 to 10%
Soft drinks	Intermediate	Between 0 and 15% of market (survey)
Confectionery	Small / intermediate	< 10 %
Alcoholic drinks	Small	< 5%

It is clear that the existing regime has not eliminated the potential for major retail price differences within the EU, nor has it eliminated parallel trade. Some of the observed price differences may of course reflect factors such as exchange rate movements or differences in transport and distribution costs, taxes, and retail margins, as well as price discrimination by the trademark holder. As a side remark regarding parallel trade within the EU: one would expect the introduction of the Euro as a single currency to be significant in its impact on price differences within the EU, increasing transparency within the single market and eliminating or reducing the effect of exchange rate fluctuations.

6.3.2. The relative importance of intellectual property rights

The effect of a change in regime will also be influenced by how important trademarks and other intellectual property rights (IPRs) are for particular sectors. The following tables indicate our assessment of the relative importance of different intellectual property rights, and the extent to which investment is driven by the IPR related needs of branding and advertising, product development and research and development.

The potential for parallel trade may be reduced by the ability to continue to use the protections afforded by copyright or other IPRs besides trademarks. The adverse effect on profits, and potentially on the availability of products to consumers, is likely to be higher where IPR driven investments are the most important.

Table 6.3
Relative importance of different Intellectual Property Rights

Sector	Trademark	Copyright	Design	Patent
Footwear and leather goods	High	Low	High	Low
Musical recordings	High	High	Low	Low
Motorcars	High	Low	High	Only for components
Consumer electronics	High	Generally low	Medium / high	Only for components
Domestic appliances	High	Low	Medium / high	Only for components
Cosmetics and perfumes	High	Low	Medium / high	Low / medium
Clothing	High	Low	Low	Low
Soft drinks	High	Low	Low	Low
Confectionery	High	Low	Low	Low
Alcoholic drinks	High	Low	Low	Low

Table 6.4
Relative importance of IPR driven investment

Sector	Branding / Advertising	Product development and design	Research and Development
Footwear and leather goods	High	Intermediate / high	Low
Musical recordings	Intermediate	High	Low
Motorcars	High	High	Intermediate
Consumer electronics	High	High	Intermediate / high
Domestic appliances	High	Intermediate / high	Low
Cosmetics and perfumes	Very high	High	Intermediate / high
Clothing	High	Intermediate	Low
Soft drinks	High	Low	Low
Confectionery	High	Intermediate	Low
Alcoholic drinks	High	Low / intermediate	Low

Trademarks are clearly the most important form of intellectual property protection for the sectors we have examined, with the exception of musical recordings, where copyright is for obvious reasons also of great importance. Even for musical recordings, trademark holders tend to regard trademarks as important because trademark rights are often easier to enforce. Design protection is also fairly important in a number of sectors. Overall the availability of other forms of intellectual property protection would appear to offer only limited comfort, even if these operated with different and more restricted exhaustion regimes. For analytical convenience we make the working assumption that trademarks are the dominant form of protection, and that possibly different regimes for the other forms of protection will not alter the effects we describe.

In the context of intellectual property protection, counterfeiting is also an important issue affecting products in some of the sectors we have examined. As a subject it is not part of this study, but it has been noted by trademark holders that allowing parallel imports would in practice weaken a number of the defences against counterfeiting and piracy, particularly for goods originating from outside the EEA. While this is likely to be a significant issue for a number of products (including fine fragrances and trainers), it is clear that it is of particular commercial importance for the musical recordings sector, both because of the prevalence of piracy and its economic impact on earnings from copyright.

Investment in branding and advertising is high for at least some firms in all the ten sectors we have examined, with investment in product development and design also of substantial importance in most cases. This emphasises the importance of branding in those markets for which trademarks are most important.

6.3.3. Barriers to parallel trade created by transport costs, and other transaction costs

Parallel trade may also be rendered more difficult by factors such as the cost of transport (in relation to potential price differences), and other potential barriers to trade such as health and safety legislation, technical standards and labelling differences. Our assessment of the significance of these factors, which create what we refer to as transaction costs, for the ten sectors is as follows.

Table 6.5
Obstacles and transaction costs

Sector	Transport	Health/safety	Labelling	Technical
Footwear and leather goods	Low	Not present	Low	Not present
Musical recordings	Low	Not present	Not present	Not present
Motorcars	High	High	Not present	High
Consumer electronics	High	Intermediate / High	Intermediate / High	Intermediate / High
Domestic appliances	High	High	Intermediate	Intermediate
Cosmetics and perfumes	Low	Intermediate	Intermediate	Not present
Clothing	Low	Not present	Low	Not present
Soft drinks	High	Low	Intermediate / Low	Low
Confectionery	Intermediate	Low	Low / Intermediate	Low
Alcoholic drinks	Mixed	Low	Low / Intermediate	Low

This suggests that transaction costs are of most importance in respect of motor cars, consumer electronics and domestic appliances. They are relatively unimportant, and therefore will not constitute a significant obstacle to parallel trade, for footwear and leather goods, musical recordings, clothing, confectionery and for spirits and fine wine.

6.3.4. Trade Barriers

Formal trade barriers, including import duties and import quotas, are also significant. Import duties imposed on parallel trades will reduce the impact of price differentials between countries for a particular product. Import restrictions may eliminate parallel trade altogether.

For the sectors we have examined, trade barriers are most likely to be important for motor cars.

Table 6.6
Trade barriers

Sector	Import duties	Anti-dumping action	Import quota
Footwear and leather goods	From 3.5% to 17%	Certain footwear from some South-east Asian countries	Not present, except China
Musical recordings	3.5%	Not present	Not present
Motorcars	2.5%	Low - not used	High - Japanese made cars
Consumer electronics	4%	East-Asian countries for TV sets	Not present
Domestic appliances	Low	Not present	Not present
Cosmetics and perfumes	Free to 6.5%	Not present	Not present
Clothing	Mostly 13.8%		Quotas on trade with developing countries
Soft drinks	Relatively high	Not present	Not present
Confectionery	9.5% plus agricultural components	Not present	Not present
Alcoholic drinks	9% for beer; various for wine	Not present	Not present

6.3.5. The importance of vertical relationships

Table 6.7
Vertical relationships within sector

Sector	Vertical restraints	Relative importance long-term relationship
Footwear and leather goods	Becoming tighter	Intermediate
Musical recordings	Intermediate	High
Motorcars	High	High
Consumer electronics	High	High
Domestic appliances	High	High
Cosmetics and perfumes	High	High
Clothing	High	High
Soft drinks	Mixed	Mixed
Confectionery	Low	Low
Alcoholic drinks	Intermediate/slackening	Intermediate

Relationships between trademark holders and manufacturers and retailers are particularly important because their nature will affect the ability of trademark holders to maintain price discrimination while limiting the impact of parallel trade. The nature of these relationships varies widely between sectors, but appears to be relatively weak in soft drinks and confectionery.

The reaction of trademark holders to a change in exhaustion regime may well include efforts to tighten their control over the vertical chain through to distribution and retail. In our assessment we assume that such responses are always compatible with current competition law. However possible responses, and the further responses of the competition authorities in monitoring and controlling them, together with the prospective removal of a number of block exemptions (eg motor vehicles), constitute a further uncertainty.

6.3.6. Responses to the Survey

Our survey indicated that parallel traders and the transport sector are generally seen as the gainers from parallel trade, and official importers/exporters and manufacturers as the losers. More surprising is that the effect on retailers and on consumers was largely seen as neutral, or there were divergent views. This was so even among consumer organisations. This appears to reflect perceptions that price reductions could be offset by adverse effects on after-sales service, guarantees, product information and other aspects of service quality.

The survey also obtained the views of the different interest groups on the likely response of trademark owners to unilateral and reciprocal exhaustion. There was general agreement that there would be a response to curb an increase in parallel trade, though the importance of measures cited varied between interest groups and between the postulated exhaustion regimes.

Trademark owners emphasised "approaching parallel traders" and enacting or enforcing selective distribution networks as general responses to parallel trade, including current intra EEA trade. With unilateral exhaustion, price adjustment and withdrawal from the source market were mentioned frequently. With reciprocal exhaustion, selective distribution networks and price adjustment were again most often mentioned. Cutting R&D or other forms of product improvement did not rank high among responses.

6.3.7. Relative prices

Relative retail prices are the probably the most important single indicator in determining the potential scope for parallel trade. The table below indicates relative prices (including taxes) for a variety of products corresponding to the ten sectors. Generally prices are significantly lower in the US, with the exception of cosmetics and perfumes and some alcoholic drinks. Prices are generally higher in Japan, except for motor cars and consumer electronics.

Table 6.8
Dollar price relatives in OECD 1996 (retail prices including tax)

	Ratio US : EU	Ratio Japan : EU
Men's footwear	0.57	2.19
Ladies' footwear	0.59	1.69
Children's footwear	0.64	0.67
Records, tapes cassettes	0.74	0.97
Motor cars	0.72	0.75
Tyres, tubes, parts	0.67	0.89
Radio sets	0.82	0.92
TVs, VCRs	0.52	0.77
Record players etc	0.59	0.56
Refrigerators	0.80	1.96
Washing machines	1.02	1.27
Cookers	0.48	2.44
Heaters and air cond	0.37	1.57
Vacuum cleaners	0.55	1.13
Toiletries	1.05	1.50
Men's clothing	0.65	0.97
Ladies' clothing	0.59	1.48
Children's clothing	0.55	1.04
Infants' clothing	0.55	1.69
Mineral water	0.59	2.17
Other soft drinks	0.61	1.79
Chocolate preparations	0.73	1.59
Confectionery	0.61	1.52
Spirits and liqueurs	0.62	1.14
Wine	1.25	2.20
Beer	1.04	2.71
Other	0.82	1.12

Source: OECD; NERA Analysis; These ratios are in retail prices including VAT and other taxes. Generally speaking, taxes in the EU are higher than USA taxes. Price differences, excluding taxes, between the EU and the USA are smaller (so the USA : EU ratio will be closer to 1 in most cases). The Japan EU ratio is much less affected when excluding taxes.

6.3.8. Overall assessment of factors affecting parallel trade

Overall our assessment of the scope for parallel trade can be summarised as follows

Table 6.9
Qualitative assessment: scope for increase in parallel trade

Sector	Price differences	Transaction costs	Technical barriers	Trade policy	Vertical constraints	Current parallel trade	Overall scope
Footwear and leather goods	++	+	+	-	-	-	+
Musical recordings	+	++	++	-	-	++	++
Motorcars	+	+	-	++	-	-	+
Consumer electronics	++	-/+	-	-	-	+	+
Domestic appliances	++	-	-	+	-	-	+
Cosmetics and perfumes	+	-	-	++	-	++	++
Clothing	+	+	+	--	-	+	+
Soft drinks	++	---	+	-	+	+	+
Confectionery	+	--	+	-	+	+	+
Alcoholic drinks	---	--	+	-	-	+	-

++ and + indicate strong and moderate positive influence tending to promote parallel trade; - - and - indicate negative influences tending to reduce parallel trade; blank denotes neutral effect

6.4. Summary for the Ten Sectors

6.4.1. Footwear and leather goods

Despite the recent trend towards producing footwear in newly industrialised countries the EU retains a strong footwear and leather industry with a positive balance of trade. Trade is an important part of the economy of the sector with about a third of EU production being exported. Footwear is not a high technology sector and trademarks, together with design rights in some cases are the dominant form of intellectual property. Trademarks play a crucial role in advertising and developing brands. Depending on data sources, shoes are more expensive in the EU than the USA, but cheaper than Japan. While price differentials are on average moderate, larger price differentials, sufficient to generate incentives to parallel trade are present. Transaction costs appear unlikely to form a significant barrier to parallel trade although import duties and quotas are present in the sector. Strengthening manufacturer control over the distribution system suggests that parallel imports would be likely to retail in non-traditional outlets.

Our analysis suggests that the sector is moderately susceptible to parallel trade. The consequences for trademark owners as a whole appear likely to be moderate, although individual trademark holders may be more strongly affected, and since parallel trade tends to reduce revenue without affecting costs, small effects on the market can affect EU profitability significantly. However, to the extent that major footwear brands use global marketing (as opposed to local marketing by region or country), it is less likely that

promotion would be much reduced. Consumers may benefit to some extent from lower prices, but authorised dealers and retailers would be disadvantaged.

6.4.2. Musical Recordings

The world market for music recordings amounts to nearly ECU 30 billion, of which the EU accounts for about 30 per cent. The sector contains a mix of large multinational companies and smaller independent (generally local) firms. Although the industry relies more on copyright than trademarks, allowing parallel imports may make it more difficult to prevent counterfeiting. Prices are somewhat higher in many EU countries than in the USA, although the difference, after taking account of sales taxes is moderate, and not necessarily due to the absence of parallel imports (that is, in the presence of parallel trade price differentials would be likely to remain). Technical barriers and transaction costs appear very low and parallel trade within the EU is an important factor for at least some releases. Vertical restraints are not sufficiently tight to prevent parallel trade, although retailers' desire to maintain good relationships with record companies may be a limiting factor.

Overall, our analysis suggests that a moderate to large increase in parallel trade in this sector could be expected if all IP rights were to be internationally exhausted. The effect would be concentrated in full price recordings of international pop music (especially recent releases). While consumers may gain some benefit from discounting, producers would suffer a reduction of profitability, with incentives to invest in new acts being correspondingly reduced. If copyright were to maintain a Community exhaustion regime, the effects would be **far** less pronounced.

6.4.3. Motor Vehicles

Our analysis focuses on the market for motor cars, although we note that the parallel importing of motor cycles into the UK from outside the EEA has been a major topic of recent debate. The motor vehicle industry (assembly) is a net exporter and an important contributor to the EU economy, employing over a million people. Globalisation has enhanced concentration within the industry. The industry relies on trademarks to market company names and specific products and trademarks also help to encourage product development and design and R&D. Design rights are important in the industry and patents will also be important (albeit for components rather than "whole vehicles"). Prices tend to be higher in the EEA than in Japan, even after allowing (broadly) for sales taxes and they appear to be higher than in the USA on particular models. Technical barriers constitute a significant factor in parallel importing, however, with both health and safety factors and emissions standards potentially constraining trade. Strong ties between manufacturers and retailers may also constrain opportunities to undertake parallel trade.

Prices and the dismantling of trade barriers will encourage parallel imports from Japan after 1999 and low to moderate penetration could be expected. Consumers would benefit to some extent from lower prices but other considerations are also important – the current block exemption within the EEA is provided precisely in order to encourage dealer investment in

service, guarantees etc and it is unclear to what extent purchasers of parallel imports will enjoy such benefits.

6.4.4. Consumer Electronics

The consumer electronics industry is supplied predominantly by Japanese firms, who control almost their entire domestic market, and exports 33 per cent of production. The EEA is a net importer, although it also maintains a substantial manufacturing base. Trademarks are likely to be the main relevant IP right (although components may be patentable, design may be of some importance, and copyright is relevant for computer games). Branding is an important element of marketing and trademarks also encourage product development and R&D. Prices in Europe tend to be substantially higher than those in the USA or Japan. Transaction costs of parallel trade may be important, for reasons including the fragility of products, and different technical standards present a further barrier to be overcome. The apparent strength of manufacturer control over the distribution system makes it likely that parallel imports would be sold (at discounted prices) in non-standard outlets.

Our analysis and the survey results suggest that there may be a moderate level of parallel trade. Consumers could benefit in terms of discounted prices (and perhaps through dynamic effects on the prices of direct route products), but may lose out in terms of service quality. Official retailers are likely to be disadvantaged, and parallel trade appears to have the potential seriously to affect manufacturers' profitability, more so than in most sectors.

6.4.5. Domestic Appliances

The EU maintains positive balance of trade in this sector, although EU industry is relatively stronger in the non-electrical goods sub-sector. Trademarks are of fundamental importance in this sector, where the quality of a product may not become evident for some years after purchasing, and they are used for advertising and for product development purposes. Use is also made of design rights. Pricing varies between appliances and after taking account of taxes the EEA has relatively low prices for washing machines compared with the USA. Prices for most other appliances are, however, substantially higher than in the USA. Prices in the EEA are generally lower than in Japan. Barriers to parallel trade include technical issues and product suitability issues.

Price differences appear likely to encourage parallel imports to the EEA for at least some products. We consider that parallel traded items will most likely be sold outside current retail outlets eg in hypermarkets. Customers may benefit from trading quality of service against price, and there seems no reason to believe that such establishments would eg fail to honour guarantees. We would expect that in most cases and under certain conditions, guarantees are the responsibility mainly of manufacturers rather than retailers.

6.4.6. Cosmetics and Perfumes

The EU is the largest producer of these products in the world, and maintains a positive trade balance. Trademarks are the main IP right utilised by the industry, although design rights for items such as perfume containers may be relevant. The main use of trademarks is for branding and advertising, although they also serve product development and R&D purposes. Counterfeiting of premium priced fragrances is an issue for the sector. On average, the EEA and US seem to have similar prices for cosmetics and perfumes, while Japanese prices are higher. However, this picture is not necessarily representative of individual perfumes, especially at the high end of the market. Transport costs may be low, although some care for the condition of the product is required, and health and safety and product labelling are also a relevant factor. Premium products tend to be distributed through selective distribution, with very tight vertical restraints. Restraints are looser for other products.

Our analysis suggests relatively high parallel import penetration for premium products, which account for a significant proportion of the market by value. Consumers may benefit from lower retail prices for such products, and the direct effects on manufacturers may be limited, since ex-manufacturer prices in countries of export may not be significantly lower. These savings result from avoiding the cost of retailing in a luxury setting and selling products through non-traditional outlets. This might damage the luxury image of products in this sector. Little parallel trade in non-premium products is expected.

6.4.7. Clothing

The EU clothing industry has been facing fierce competition from developing countries, and has been in decline despite the protection afforded by the Multi Fibre Agreement. Production tends to be a labour intensive process. Trademarks are the only IP right of substantial importance to the sector, predominantly through facilitating the advertising and branding of clothes. Trademarks may also facilitate the design of new products. Prices of clothes, especially premium brand names, are higher in the EU than in the USA, although consumer tax rates go some way towards explaining the difference. The main costs involved in parallel trade include a 13.8 per cent tariff, and quotas with regard to imports from NIEs and certain developing countries. Relatively tight vertical restraints characterise the market for luxury clothes.

For the market as a whole, parallel imports may be very limited, although focussed in a small number of premium brands. These may retail in a range of establishments, probably at a discount to direct route products.

6.4.8. Soft Drinks

The market for soft drinks is dominated by domestic production, with both imports and exports being low by comparison with the market size. Trademarks appear to be the only IP right of substantial importance to the sector, which is characterised by a high degree of

consumer brand awareness. Trademarks are used for branding and advertising purposes rather than particularly to encourage product development or R&D. EU prices are substantially above prices in the USA, but below those in Japan. However, there is also striking variation in prices within Europe (and parallel trade). Given that transport costs are likely to be significant parallel trade between nearby countries appears likely to be of greater significance.

While there would be scope for some parallel imports in this sector, overall, the dispersion of prices within Europe, and the transport costs involved in undertaking trade from far afield mitigate against there being large increases in parallel imports from outside the EU. Since parallel imports would tend to mingle with direct route products, there is less likelihood than in most sectors of consumers benefiting from discounting.

6.4.9. Confectionery

The EU is the largest producer and consumer of confectionery in the world, and maintains a positive balance of trade in this sector. Trademarks appear to be the only IP right of substantial importance to the sector, where they are generally used for branding and advertising purposes. However, they may also play a role in encouraging product development in a sector which has shown significant innovation (eg developing low calorie products) in response to changing market conditions. The EU tends to have higher prices than the USA, even after taking account of consumer taxes, and transaction costs and barriers to parallel trade seem to be no higher than moderate.

Moderate penetration rates for parallel trade, with source countries being the USA, and other countries (unilateral case only) might be expected. Retailers and intermediaries, rather than consumers, could be expected to benefit from higher margins, with manufacturers losing out in terms of profitability.

6.4.10. Alcoholic Drinks

This sector covers a range of products, including spirits, wine and beer. In each case the EU industry contributes a positive balance of trade. Trademarks are the main traditional intellectual property right although systems such as appellation controlée may put some limits on their need. Nonetheless, competition through branding remains an important part of the sector, perhaps more so for spirits and beer than for wine. Examination of price differences is complicated by the presence of substantially differing tax rates, but after making a crude attempt to take account of such taxes we find that the EU tends to have relatively low prices for these products. Although for reasons of data availability, we have not had the opportunity to examine every potential source country, on the basis of the analysis we have undertaken, an appreciable level of parallel importing to the EU appears unlikely. Parallel exports could be possible, especially in the case of wine, and especially to Japan. Practical factors may limit the size of this trade, which we have not been able to quantify.

6.5. Quantifying the Effects

6.5.1. Defining scenarios of unilateral and international exhaustion

For the purpose of illustrating the economic impact of changes in regime, we have chosen two scenarios, of unilateral extension to an international exhaustion regime, and bilateral extension.

Scenario 1. Unilateral extension. By unilateral extension we mean simply that the EEA operates an international exhaustion regime regardless of what other countries choose to do. This means that parallel imports are permitted from all other countries. In this scenario one would expect an increase in parallel imports but no change in parallel exports.

Scenario 2. Bilateral extension. In this case it is assumed that the EU exhaustion regime is extended to cover the US and Japan only, but with reciprocal arrangements which would tend to increase parallel exports to the US and Japanese markets.

Our assessments indicate that under Scenario 1, with unilateral exhaustion, the main source of parallel imports would tend to be from the countries of South East Asia and from the USA. They also suggest that the scope for parallel exports is generally likely to be small whatever regimes are in place in other countries; parallel exports to South East Asia or the US are unlikely since prices there tend to be lower; there is in principle potential for parallel exports to Japan, but other factors are likely to militate against this.

It follows that the difference between the two scenarios reflects mainly the fact that in Scenario 2 parallel imports are largely confined to those likely to take place from the US. It also follows from the relatively low potential for parallel exports that the case of full multilateral international exhaustion would tend to approximate to Scenario 1 in its broad economic impacts. For any particular product, of course, this or other alternative combinations might have distinctive effects.

6.5.2. Short term and long term effects

Any effort to quantify the impact of changes to the exhaustion regime, under either of the above scenarios, must distinguish between potential short term (say one to two years) and long term effects, as parties respond in more fundamental ways.

In the short term, the economic consequences can be summarised as follows. Extending the exhaustion regime will tend to increase parallel imports. This will tend to reduce retail prices to a greater or lesser degree, which we have attempted to estimate, typically on the basis of the survey data, knowledge of existing price differentials and a number of approximate judgements and estimates. The effect on prices can be translated, using previously estimated price elasticities, into an increase in volume, and hence into an increase in employment to produce the additional sector output. The change in employment is assumed to be pro rata to the change in volume. There may also be effects on supplier

industries which we do not estimate. The effect on sectoral profits is driven mainly by the estimated price reduction in relation to profit margins. For a given price change, the effect on profit is higher when margins are already low.

Implicit in this analysis are a large number of assumptions. We have not quantified net changes in employment in retail and distribution. In reality of course one should expect some losses of jobs in official retail outlets for a product, but a corresponding increase in jobs in "unofficial" outlets. More generally, our estimates of the effects on production and employment should be regarded as indicative only. Significant uncertainty surrounds the magnitude and direction of these effects, in particular with regard to whether parallel imports will be parallel reimports, will displace direct route imports, or will displace European production.

The short term effects, even in aggregate, appear small in macro-economic terms. This reflects the analysis of the numerous factors, described earlier and in the main body of the report, which will tend to reduce the impact that might in principle be expected from allowing parallel imports in markets where very large price divergences can be observed.

However, the longer term dynamic consequences of a change in regime are likely to be both more important and more difficult to predict. They are most likely in sectors where there is a significant short term effect on profits. The need to restore profits may affect the location of production as well as pricing, product and distribution strategies, with consequent economic impacts.

The potential scale of these effects can be evaluated by looking at the macro-economic contribution of the sectors where we have estimated a moderate or large impact on profits in the short term. The impacts may affect all firms in a sector, or individual firms only but with a large impact. A selective impact on some firms may have disproportionate consequences for the sector as a whole.

Table 6.10
Quantitative assessment I: Unilateral change of exhaustion regime

Sector	PI penetration	Decrease in retail prices	Increased EU production	Increased EU employment[42]	Potential impact on profits in EU
Footwear and leather goods	Moderate (around 5%)	Small (< 1%)	Very small (>0.5%)	Very small (<0.5% or 400 jobs)	Medium reduction (about 15 %)
Musical recordings	Moderate (around 4%)	Small (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 1,800 jobs)	Medium reduction (about 14%)
Motorcars	Moderate (< 5%)	Small (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 3,000 jobs)	Medium reduction (about 16%)
Consumer electronics	Medium (10%), most goods affected	Moderate (around 2%)	Small (< 1.0%)	Small (< 1.0% or 3,100 jobs)	Large reduction (about 35%)
Domestic appliances	Medium (8%), most goods are affected	Moderate (< 2.0%)	Small (< 1.0%)	Small (< 1.0% or 1,300 jobs)	Large reduction (about 25%)
Cosmetics and perfumes	Moderate (< 5%)	Small (< 1.5%)	Negligible	Negligible	Small reduction (about 3%)
Clothing	Small (about 1.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 450 jobs)	Small reduction (less than 5%)
Soft drinks	Small (0 to 5%)	Negligible	Very small	Negligible	Medium reduction (around 15%)
Confectionery	Moderate (around 5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small	Medium reduction (around 15%)
Alcoholic drinks	Negligible	Negligible	Negligible	Negligible	Negligible

[42] Indicative and subject to significant uncertainty for reasons described in the text.

Table 6.11
Quantitative assessment II: Reciprocal change of exhaustion regime

Sector	PI penetration	Decrease in retail prices in sector	Increase in EU production	Increase in EU employment[43]	Impact on profits in EU
Footwear and leather goods	Small (c. 1%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 150 jobs)	Small reduction (about 3 %)
Musical recordings	Small (around 2%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 900 jobs)	Moderate reduction (about 7%)
Motorcars	Moderate (around 5%)	Small reduction (< 1%)	Very small (< 0.5%)	Very small (< 0.5% or 3,000 jobs)	Medium reduction (about 16%)
Consumer electronics	Small (around 5%)	Small (around 1%)	Very small (< 0.5%)	Very small (< 0.5% or 1,400 jobs)	Medium reduction (about 19%)
Domestic appliances	Small (around 5%)	Small (around 1%)	Very small (< 0.5%)	Very small (< 0.5% or 1,100 jobs)	Medium reduction (about 15%)
Cosmetics and perfumes	Moderate (< 5%)	Small (< 1.5%)	Negligible	Negligible)	Small reduction (about 3%)
Clothing	Small (around 1.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5% or 450 jobs)	Small reduction (< 5%)
Soft drinks	Negligible	Negligible	Negligible s	Negligible	Negligible
Confectionery	Small (around 2%)	Very small (< 0.5%)	Very small (< 0.5%)	Very small (< 0.5%)	Small reduction (around 6%)
Alcoholic drinks	Negligible	Negligible	Negligible	Negligible	Negligible

[43] Indicative and subject to significant uncertainty for reasons described in the text.

APPENDIX A. CHOICE OF SECTORS

A.1. Basis for Choice of Sectors

The Terms of Reference indicate that the study will "examine in broad terms, on a sector-by-sector basis" the present regime of exhaustion and effects of the choice of regime. Our choice of sectors was governed by the following factors:

- The Terms of Reference also state that "a sector which should receive special attention is the consumer goods sector [including] products like textiles, shoes, cars, CDs and video discs etc";
- Discussions with SJ Berwin that suggested it might be preferable to concentrate on consumer goods - industrial purchasers are likely to make a more informed choice when buying than personal consumers. Consumers seem more likely to be dependent on the trademark as an indicator of quality. This is not to suggest that parallel trade is absent in industrial purchases;
- The discussions with SJ Berwin also suggested that as far as possible we should avoid the complexities of the market for CAP products. Further, we should exclude medicines because of the dominant influence of Government pricing and substantial importance of **patent** exhaustion. We are well aware that parallel trade in this sector has been an important issue for the EC for many years. The subject has already been covered in numerous studies;
- Opinions we have seen on products involved in parallel trade in the EEA;[44]
- Indications that trademarks are important in terms of numbers of applications;
- Reasonable significance in EU trade with third countries;
- A balance had to be struck between adequate coverage within each sector and wider sectoral coverage needed to draw conclusions for the EU economy. Discussion with IFF suggested that the maximum number of sectors that could effectively be covered given the size of the sample was probably about 10;

Our selection has focused on sectors rather than on specific products. These sectors and some of their main economic data are reviewed in "Panorama of EU Industry 97"[45]. We expect firms to concentrate their responses on their main trademark-protected product group and the full survey results are intended to provide indicators of change in the sector in response to choices of regime.

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[44] eg summary of report by the European Merchants' Association, Gorinchem, Netherlands, July 1997

[45] European Commission 1997

NERA's choice of sectors (as defined in Panorama of EU Industry 97 - using NACE Revision 1 industrial classification) for the market research survey and subsequent economic analysis was as follows:

- Cocoa and sugar confectionery (and ice cream) NACE 15.84, 15.52;
- Alcohol including:
  - Brewing and malting NACE 15.96;
  - Alcohol and spirits NACE 15.91, 15.92;
  - Wines, spirits etc NACE 15.93, 15.94;
- Soft drinks and mineral waters NACE 15.98;
- Clothing NACE 18;
- Footwear (but also to include other leather goods) NACE 19.3;
- Manufacture of CDs, video discs etc NACE 22.31, 22.32;
- Soaps, perfumes, detergents and toiletries NACE 24.5;
- Domestic (mainly electrical) appliances NACE 29.7;
- Consumer electronics NACE 32.3;
- Motor cars (part of motor vehicles NACE 34.1, 34.2).

The great convenience of these sectors used in Panorama is that they are very fully described and accompanied by consistent production, trade and other statistics. CD and video disc manufacture, however, is part of a broader sector including publishing whilst motor cars are part of motor vehicles. A narrower sectoral focus seemed more appropriate in both cases eg motor vehicles includes commercial vehicles which are capital goods. However, estimates of effects on e.g. employment will be over stated by using broader data. (It also includes motor cycles which could also be relevant but which we will not cover.) A narrower focus than the Panorama sectors requires access to the highly detailed Europrom statistics on production and trade in the EU countries.

A.2. Data on Significance of Trademarks by Sector

The best guide we have to the sectoral pattern of trademarks in the EU are the statistics covering applications for the new European Community trademark.

The sectoral classification used for trademarks - the Nice Agreement - unfortunately does not correspond closely to the NACE industrial classification. In particular, class 9 which has by far the largest number of applications, covers a wide range of scientific and other

electrical equipment. All told, there are 42 classes, of which 8 are services. The leading classes (excluding services) are shown in table A.1.

Table A.1
Product shares in applications for EU trademarks 1996-7

Class	Products	% of total
9	Scientific, nautical and surveying and electrical apparatus inc wireless	12
16	Paper and paper articles	7
25	Clothing inc footwear	6
5	Pharmaceuticals etc	4
3	Cleaning preparations, soaps, perfumes	3
7	Machinery	3
30	Coffee, tea, sugar, rice etc	3
28	Games etc	3
1	Chemical products used in industry, science etc	3
18	Leather, skins, umbrellas etc	3
29	Meat, fish, game and products	2
11	Installations for lighting, heating and cooking	2
12	Vehicles	2
6	Un-wrought and part wrought common metals	2
10	Medical etc instruments	2
20	Furniture and other wooden articles	2
32	Beer, mineral and aerated waters etc	2
21	Small domestic utensils and containers (exc cutlery)	2
33	Wines, spirits and liqueurs	2

Source: Statistics of Community Trademarks, OHIM 1998

A comparison of these rankings with those for registrations in the UK (1996) showed the top five manufactures were identical. Of the next seven, six were the same but ordered differently.

Bearing in mind, our exclusion of CAP products, industrial goods and pharmaceuticals, our chosen sectors generally rank fairly high in the table. We do not include a sector within class 16 - paper and paper articles - but a very important product in this class is books and we judge copyright to be much more important as an IP issue here than trademarks.

We have aligned our chosen sectors with these rankings (not including services). The result is shown in table A.2.

Table A.2
NERA sectors and class ranking in EU trademark applications 1996-7

NERA sector	Trademark class(es)	Ranking
Cosmetics, perfumes	Cleaning preparations	5
Consumer electronics	Scientific and electrical apparatus	1
Domestic appliances	Scientific and electrical apparatus;	1
	Installations for lighting, heating and cooking	12
Motor cars	Vehicles	13
Clothing	Clothing inc footwear	3
Footwear and other leather goods	Clothing inc footwear; leather etc	3, 10
Soft drinks and mineral water	Beer, mineral etc waters	17
Alcohol	Beer, mineral etc waters	17,
	Alcoholic beverages exc beer	19
Sugar and chocolate confectionery	Coffee, tea, cocoa, sugar etc	7
CDs, video discs etc	Scientific and electrical apparatus	1

Source: Statistics of Community Trademarks OHIM 1998

The classes of which our chosen sectors are part make up 34 per cent of total applications and 46 per cent of trademark applications for goods only.

A.3. Trademarks and Country of Application

In general we would expect to find some broad link between the size of product markets and the extent of trademark registrations. Trademark holders in a particular country will be resident national and overseas firms wishing to protect their products sold in the market and overseas firms supplying the market from abroad

Taking 1996 and 1997 together (the first two years of operation) the leading applicants for the new European Community trademark were as shown in table A.3.

Table A.3
Leading applicants for EU trademarks 1996-7

Country	Percentage of total	Number 000
USA	29	20.5
Germany	17	11.6
UK	13	9.4
Italy	6	4.3
Spain	6	4.3
France	5	3.5
Japan	3	2.1
Netherlands	3	2.0

Source: OHIM

The importance of EU registration for US firms is clear and could well underestimate their importance. Larger firms with regional offices in Europe may make some applications classified to the country in which the office is located. Applications from Japan, on the other hand, are much less important.

It should not be inferred that the above ratios necessarily reflect relative magnitudes of trademark registration within the EU countries as can be seen in table A.4. For example, the level in France and Spain in 1995 was higher than in Germany and the UK.

Table A.4
Country totals and shares of applications for registration of trademarks percentage 1995

	Total	Domestic	Other EEA Countries	USA	Japan
	No.	%	%	%	%
Austria	7,400	58	17	18	2
Benelux	24,900	75	9	11	2
Denmark	10,100	34	43	15	1
Finland	8,500	22	41	17	2
France	83,500	68	19	7	1
Germany	48,200	80	7	9	2
Greece	11,100	45	34	13	1
Ireland	7,300	12	55	22	2
Norway	8,200	26	46	18	1
Portugal	15,700	24	49	12	1
Spain	65,500	87	4	6	1
UK	58,100	54	22	15	2
Japan	179,700	89	5	6	-
USA	188,800	87	6	-	1

Source: WIPO

Table 3.4 shows the magnitude of applications for trademark registrations in a number of EEA countries, the USA and Japan. The number of applications in France is notably large (cf the small number of applications for European Community trademarks). Among the larger countries, the UK is notable for the relatively low share of domestic registrations. EEA company applications are dominant in all EEA countries whereas they have only a small share of applications in the USA and Japan. Nevertheless, the EEA share is rather larger than the Japanese share in the USA and not very different from the US share in Japan. As in applications for European Community trademarks, Japan appears to be a small player. It may be that there is a pronounced tendency for Japanese multi-nationals to apply through their regional offices for both national and Community trademarks.

Examination of non resident applications for registration in a number of EEA countries shows, overall, the USA consistently the largest, followed usually by Germany, and then UK and France. Japan mostly did not rank in the top four non resident applicants.

A.4. Significance of Sectors in Relation to Volumes of International Trade

We can also identify the value of EU external trade involved in each of our chosen sectors and its importance relative to total external trade in manufacturers. The trade data are on the NACE basis.

Table A.5
EU 15 Trade in the NERA sectors in 1995

NERA sector	Extra EU exports	Extra EU imports
Cocoa and sugar confectionery	2,569	679
Alcohol - of which		
Brewing and malting	1,607	133
Alcohol and spirits	4,039	401
Wines and liqueurs	860	65
Soft drinks and mineral waters	520	39
Clothing	7,695	20,461
Footwear	4,880	5,157
Soaps, perfumes, detergents	5,032	1,109
Domestic appliances	4,738	2,717
Consumer electronics	16,328	28,872
Motor vehicles	38,530	16,298
CDs video discs	n.a.	n.a.
Total of sectors (1) EXC CDs	96,798	75,931
Total trade	572,840	545,130
Total mfrs(2)	496,624	381,179
Ratio (1) / (2) EXC CDs	19.5%	19.9%

Sources: Panorama of EU Industry 97, EC and Eurostatistics 3/98, Eurostat

For convenience, trade in manufacturers was defined according to the Standard International Trade Classification (sections 5+6+7+8).

Much trade is in capital goods and raw and semi-manufactured goods. These make up approaching 60 per cent of trade in both directions. Thus our chosen sectors make up about half the remainder. At this stage we do not have the value of trade in CDs etc. On the other hand, motor vehicle exports include commercial vehicles as well as cars (and motor cycles). Figures for cars will be substituted later.

It will be appreciated that there is not necessarily a close connection between the volume of trade and parallel imports that could arise from, say, international exhaustion vis a vis third countries. The extent of price differences between the EU and other countries (allowing for transport etc costs) and the extent of production abroad in factories owned by trademark holders and (especially) under licence are also important considerations.

A.5. Summary

A number of factors have influenced the choice and number of sectors to examine. They include pointers in the terms of reference, indications of some parallel trade activity in the

EEA or elsewhere, importance in economic activity, belief that trademarks may be more important for consumers than for industrial purchasers, and limitations imposed by the scale of the survey. The sectoral definitions are those used in Panorama of EU Industry 1997 which contains a valuable range of statistics on a consistent basis and a lengthy description of the sectors. Comparison with statistics on applications by type of product for the new Community trademark is made difficult because of differing sectoral definitions; however, NERA's survey base broadly corresponds to sectors making up approaching half of applications for trademarks on goods. The European trademark data show applications from the USA as larger than those from individual EEA countries and far larger than those from Japan. NERA's sectors make up around a fifth of trade in manufactures but if capital goods, raw materials and semi manufactures are excluded the ratio is about half.