An economic and legal discussion of minimum resale price maintenance

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By exerting pressure on or colluding with distributors, producers are often able to set a price below which their products cannot be sold. Jean Acheson examines the competing perspectives on minimum resale price maintenance and discovers that the issue is not as black-and-white as strict adherents competition policy would often have us believe.

Introduction

"Competition brings out the best in products and the worst in people"

David Sarnoff

Minimum resale price maintenance (RPM) is just one of many forms of vertical restraint analysed in competition policy. Opinion on vertical restraints is not unanimous: some believe they only harm competition when market power is sufficiently large; others condemn them outright as anti-competitive; still others such as those at the Chicago School of Economics justify them on efficiency grounds. This divide in economic theorists' opinions is mirrored in legal opinion too; RPM is treated as a 'hardcore restraint' in the EU and thus *per se* illegal in practice, whereas the USA recently adopted the 'rule of reason' in relation to its judgements.

RPM is defined as "the practice whereby an upstream firm (e.g. a manufacturer) specifies a minimum price to which a downstream firm (e.g. a retailer) is required to adhere in its sale efforts" (Kwoka & White, 1999: 364).[1] The treatment of RPM in both economic theory and legal practice will be examined. The empirical examples of *Leegin* (2007) and the Net Book Agreement (1994) will be used to highlight its handling in different legal jurisdictions. Finally, a conclusion will be drawn regarding RPM's overall welfare effects and its treatment in competition policy.

Getting from A to B

Drawing on the analytical framework prepared by Matthewson and Winter (1984) and utilised in Hay (1991), the following scenario is presented. There is a market for a particular manufactured good, where Sector A (manufacturing) makes the good and Sector B (retailing) distributes the good. Certain assumptions about the market are made: there is a one-to-one relationship between outputs in Sector A and Sector B; Sector A is a monopoly and Sector B has n identical firms; entry into B is determined by A (i.e. it can refuse to supply other retailer firms); and the only costs are fixed (F). Quantity demanded (q) is a function of the retail price (p_B), consumer services (S) and the number of firms (n). The profit functions for each sector are given below:

$$\pi_A = nq(p_B, S, n)(p_A - c_A) - F_A$$

$$\pi_B = p_B q(p_B, S, n) – q(c_B + p_A) - F_B$$

The manufacturer's profits π_A depend on the price charged by retailers, $p_{B.}$ Clearly, an incentive exists to initiate RPM, that is, by controlling p_B, Sector A would have greater power over its profit margin. Such behaviour distorts the market and can be viewed as anti-competitive. If it were the case that the firms in Sector B could all cooperate together, they too may wish to impose RPM (by coercing the manufacturer into setting up such an agreement). The motives of the two respective parties would be the same: greater control over their profit margins. Irrespective of which sector initiates it, the result for consumers is the same: the elimination of intrabrand price competition.

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[1] However, RPM does not necessarily originate at the upstream level; it can also be motivated by a dealers' cartel that forces the manufacturer to implement it, although this is empirically less likely.

The free-rider problem

Nonetheless, there are many arguments that legitimise the use of RPM. For instance, it is possible to justify RPM on efficiency grounds (Ornstein & Hanssens, 1987). The classic argument (and the one that signalled a change in attidudes to RPM in the 1960s) was that given by Telser (1960), an economist at the University of Chicago. In this influential paper, the author argues that certain goods require point-of-sale service, that is, retailer service should be seen as a valuable input into the sale of a good. It is often not easy to charge a separate fee for this service. For example, a consumer looking for information in a computer shop would not necessarily be willing to pay for it. This may tempt some retailers to operate as discount or online stores. These retailers are able to sell the product at a lower price than the retailer providing sales information (whose costs are higher due to staff training etc.). However, by this 'free-riding', they reduce the supply of the public good of sales information (Hewitt, 1997).

This phenomenon, the 'free-rider' problem, can be addressed by RPM. RPM eliminates price competition and provides the incentive to offer the services that the good requires. If a manufacturer implemented RPM for this reason, and a high level of retail service was indeed necessary to sell the product, then consumer welfare could conceivably be enhanced (Kwoka & White, 1999). Of course, consumers are heterogenous, and if, for example, an experienced user of the good is forced to pay a higher price that incorporates sales information they do not require, they will be worse off (Carlton & Perloff, 1999). There are other limitations to the 'free-rider' argument. Firstly, it can induce wasteful expenditure on advertising (Ornstein & Hanssens, 1987). In the past, RPM has often been used in the distribution of goods that do not require much sales information, for example, shoes and raincoats (Brennan, 2000). This suggests that the Telser (1960) argument is easily manipulated for anti-competitive ends; a manufacturer or retailer can claim that point-of-sale service is essential, but this may be a completely inaccurate portrayal of the good.

RPM can also play a role in quality certification of a good (Marvel & McCafferty, 1984). Such arguments are based upon the idea that some dealers can act as agents that certify the quality or respectability of a product, as well as the degree to which it is fashionable. By screening for low quality or unstylish goods, they build up a reputation that signals to the consumer, that the goods they sell are desirable. It is possible for a consumer to ascertain what constitutes a 'fashionable' good in one shop but buy it in a discount shop elsewhere. RPM blocks 'free-riding' on this intangible service (the dealer's reputation). By setting a minimum price and refusing to sell to low quality retailers, the manufacturer can induce high quality shops to sell the product. Once consumers associate quality with the higher price, this can offset the effect on demand of a higher retail price (Hay, 1991).

In industrial organisation, the manufacturer-retailer relationship is characterised as a principal-agent problem (Carlton & Perloff, 1999), as the manufacturer does not have full control over the retailer's actions. A manufacturer may desire a retailer to provide certain services (like sales information or quality assurance as discussed above) but a direct contract for these is difficult to enforce, just as detecting a breach of contract would be costly (Brennan, 2000). Using RPM, the manufacturer can demand a particular level of service from the retailer; the threat of termination of RPM (and the healthy retailer profit margin it brings) would act as an incentive to provide the other information services the manufacturer deems necessary to sell their product (Klein & Murphy, 1988).

Unless by the lawful judgement of their peers

The Sherman Act of 1890 is the legal means through which competition is investigated in the USA. It is a very general piece of legislation and, as such, open to wide and evolving interpretation (Kovacic & Shapiro, 2000). Throughout the 20th century, RPM was illegal in the USA. This rule was based on *Dr.Miles Medical Co. v. John D.Park & Sons. Co.* (220 U.S. 373 [1911]) where the Supreme Court deemed RPM illegal *per se.* This is an important definition for competition policy; by being illegal *per se* it is not necessary to prove the firm's actions have anti-competitive effects or to examine real market forces (Perry & Besanko, 1991). However, decisions on other restraints such as maximum RPM have recently evolved according to the 'rule of reason', that is, everything is judged on a case-by-case basis. In June 2007, this decision-making process was also applied to minimum RPM, overturning the almost century-long precedent set by *Dr.Miles*. In *Leegin Creative Leather Products, Inc. V. PSKS, Inc.*, 2007 WL 1835892 (June 28, 2007), Justice Kennedy delivered the following verdict:

> "Respected economic analysts, furthermore, conclude that vertical price restraints can have pro-competitive effects. We now hold that Dr. Miles should be overruled and that vertical price restraints are to be judged by the rule of reason."
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> (Supreme Court of the United States, 2007: 1).

There is still confusion as to the consequence of the *Leegin* decision, as it may be incompatible with state law in some cases, and it was only passed by a tight margin (five-to-four in favour). One possible use of *Leegin* could be in the music downloading industry, for example, if the most popular songs on an album were sold at a higher price through the RPM mechanism (Meigher & Evans, 2007). Consumers may gain more from having exactly what they want at a slightly higher price per unit, than from being forced to accept superfluous extras at an even greater overall price.

In contrast, the European Commission treats RPM as a 'hard-core' restraint that does not qualify for a block exemption from Article 81. Whilst it is not technically prohibited, in practice it is strongly discouraged, so as to create the sense of *per se* prohibition (Jones, 2009). Currently, the Commission is reviewing its policy toward vertical restraints – the current Block Exemption Regulation, which excludes minimum RPM, is due to run out in May 2010. It is possible that the *Leegin* decision will influence future European attitudes toward minimum RPM (Jones, 2009).

The USA and Europe do not just differ in their treatment of RPM. A more general view of competition law in both jurisdictions highlights an important difference: whilst USA antitrust law is concerned solely with maximising consumer welfare, European competition policy also aims to enhance the single market project. When this additional goal is considered, it seems unlikely that the position on RPM will change further.

What is stranger than fiction?

Each state also has national competition laws. In Ireland, price-fixing is deemed illegal under Section 4(1) of the Competition Amendment Act 2006[2]. In 1994, action was taken by the Competition Authority (CA) to abolish the Net Book Agreement[3]. This agreement between UK publishers and Irish retailers had been in place since 1957 (Hewitt, 1997). It involved over 400 UK publishers stipulating a minimum net price on books sold in Ireland (Hewitt, 1997). The CA found that the agreement displayed some features of a horizontal cartel (Massey, 1994). The Publishers' Association's (PA) defence rested on the following points: RPM protected specialist shops who would not be able to survive in a market that allowed discount shops (who could 'free-ride' on their specialist knowledge); and whilst the retail price of the most popular books may increase, this enabled less popular books to be distributed, that is, the products were cross subsidised.

The CA responded by stating that the Competition Act was there to protect competition and not competitors (such as small bookshops) and that the "cross-

[2]http://www.tca.ie/EnforcingCompetionLaw/CompetitionLaw/IrishCompetitionLaw/IrishCompetitionLaw.aspx

[3] Under Section 4 of the (older) Competition Act, 1991.

subsidisation" was a misallocation of resources, as consumers do not bear the true cost of the individual product. The PA also postulated that if book discounting were allowed, the risks to publishing would increase and fewer books would be published. However, the CA's counter argument has proven to be true: the rapid change in publishing technology has enabled greater publishing than before (Hewitt, 1997). Consumers have certainly benefited from the removal of RPM (consider anecdotal evidence like three-for-two offers, for example), and at an industry wide level, there has been no significant decline in the number of booksellers (Hewitt, 1997). This strongly suggests that RPM was anti-competitive and was hindering improvement in overall welfare.

Conclusion: the welfare of the people is the ultimate law

When looking at RPM, the most important thing to consider is its welfare effects. The first reaction to any form of price-fixing is that it must be bad for the market and the consumer. However, it is possible for the arguments in favour of RPM to lead to increases in overall welfare. That said, this is only persuasive when the good in question requires point-of-sale services or quality certification, or when there is a danger of 'free-riding' or when non-price competition is important to the consumer. The counter argument to RPM (and one which is just as, if not more, persuasive) is that it acts a proxy for a manufacturers' or dealers' cartel. This line of reasoning should be employed particularly when the good in question is homogenous and not that complex, as in the case of books discussed above.

Considering the uncertainties associated with both pro- and anti-RPM arguments, it can be concluded that its current legal treatment in the EU and the USA is the correct one. That is to say, *per se* illegality is not recommended in this area of competition law. The Commission, however, should take the upcoming opportunity to update the Block Exemption Regulations to signal that RPM is not *per se* illegal for a good reason: despite its dangers, it is possible for it to enhance welfare and its 'in practice' illegality should be reviewed. Such a signal need not imply that RPM will no longer be viewed critically for its potential welfare-decreasing effects. In the end, competition for market power and profits through RPM does not always bring out the best in products but nor does it unfailingly bring out the worst in competitors.

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