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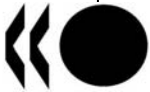

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ROUNDTABLE ON RESALE PRICE MAINTENANCE

-- Background note by the Secretariat --

This background note is submitted by the Secretariat to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 22-23 October 2008.

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RESALE PRICE MAINTENANCE

1. Introduction

1. The Competition Committee last held a roundtable on resale price maintenance ("RPM") in 1997, when it discussed the practice in the context of cultural and published products. Some important developments have taken place since then, and more are coming up in the near future. First, economists have continued to study and debate RPM and its effects, adding to the substantial literature that already existed in the mid-1990s. Second, the treatment of RPM as a per se antitrust violation in the United States has come to an end because the Supreme Court endorsed the rule of reason approach instead. Third, RPM continues to be a favourite target of enforcement agencies in many other OECD member countries, where it remains a per se offence. Consequently, there is now a significant policy divergence between the US and other member countries. Finally, the treatment of RPM in the European Union will likely be considered when the next revision of the Block Exemption on Vertical Agreements is drafted (the current one expires in 2010).

2. The predominant issue in the academic literature related to RPM has long been whether it should be unlawful per se or subject to the rule of reason.[1] For at least the past 20 years, a substantial majority of commentators has been arguing against the per se approach, yet it persists in nearly every OECD country.[2] There are some new voices on the other side of the argument, however, so this note takes a fresh look at the per se/rule of reason debate. A closely related and controversial topic is what a good rule of reason approach to RPM cases would look like. All of those subjects are addressed in Part 2 after an overview of the pros and cons of RPM from a consumer welfare perspective.

3. Part 3 examines RPM in practice by reviewing the approaches some countries use in RPM cases as well as a small selection of court decisions. Some of the countries in which RPM is unlawful per se have defended the idea of allowing it – and in at least one case even requiring it – in certain industries. Some of those exemptions have been withdrawn in recent years, providing an opportunity to compare how consumers fared with versus without RPM.

2. RPM in Economic Theory

2.1 What Is RPM?

4. The term "resale price maintenance" encompasses a number of price-related understandings between upstream and downstream firms. The most common variety involves a supplier agreeing with retailers that they will not charge customers less than a certain price for the supplier's product, leaving the

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1 The rule of reason approach is to examine the reasonableness of a firm's conduct in light of all the relevant facts and circumstances in each case.

2 *See, e.g.*, Denis Waelbroeck, "Vertical Agreements: 4 Years of Liberalisation by Regulation n. 2790/99 After 40 Years of Legal (Block) Regulation," in Hanns Ullrich (ed.), The Evolution of European Competition Law 85, 93 (2004) (citing S. Bishop & M. Walker, The Economics of EC Competition Law 167 (2002) and J. Tirole, The Theory of Industrial Organisation 188 (1988)).

retailers free to charge any price above that level ("minimum RPM"). Sometimes a specific price is mandated (the retailer must charge no more and no less than that price). Alternatively, the firms may agree to a price ceiling, leaving retailers free to charge any price below that level ("maximum RPM").[3] Unless stated otherwise, the term "RPM" in this Note refers to minimum RPM, as it is much more common than price-specific RPM and maximum RPM.

5. RPM requires resellers to comply with certain price conditions. In contrast, non-binding price recommendations by upstream firms are generally not considered to be RPM and are permitted. Even when upstream firms advertise recommended prices or print them directly on a product's packaging, that is typically not deemed to be RPM so long as the resellers remain free to charge whatever prices they wish.

2.2 The Pros and Cons of RPM

6. Manufacturers have imposed RPM for a wide variety of reasons. Some of them are pro-competitive and some are not. This section examines the objectives that manufacturers may aim to achieve with RPM. It also considers the associated welfare effects on consumers.

7. On the surface, it may seem like RPM is obviously harmful to consumers. After all, the essence of RPM is to keep retail prices higher than they would be otherwise. Continuing at this superficial level, RPM may also seem like a puzzling practice since it is ordinarily in a manufacturer's interest to minimise dealer profits, not enhance them. That is, a manufacturer should prefer the lowest possible retail prices because they will correspond to consumer demand that is as large as possible. Greater demand at the retail level translates into greater demand at the wholesale level. One would thus expect manufacturers to encourage low prices and competition among their distributors, and that is indeed what manufacturers usually do.

8. That reasoning, however, takes into account only price effects on demand. Other factors influence demand, too, and they do not necessarily correspond well with perfectly competitive retail prices. In fact, there are sometimes powerful reasons for manufacturers to limit competition among their resellers, and many of them are pro-competitive.

2.2.1 Welfare-Enhancing (or at least welfare-neutral) Uses and Effects

9. The most common arguments that RPM has pro-competitive effects revolve around the idea that RPM improves interbrand competition by enhancing distribution efficiency. It can do that by encouraging retailers to provide more of the pre-sale services that customers are willing to pay for in the form of higher prices for the relevant product. Those services could be things like attractive shopping environments, brochures, and attentive, knowledgeable salespeople, for instance. There are other potentially welfare-enhancing effects of RPM, as well, and they are also discussed in this section.

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[3] Many other variations are possible, such as those contained in guidelines issued by Japan's Fair Trade Commission: prices that must be within a fixed percentage discount from the manufacturer's suggested retail price; prices that must be in a specified range; prices that must be approved in advance by the manufacturer; and prices that must not be less than those charged by nearby stores. *See* JFTC, Guidelines Concerning Distribution Systems and Business Practices Under the Antimonopoly Act (11 July, 1991), Chapter 1, Section 2.(4); *see also* European Commission, Guidelines on Vertical Restrictions (2000/C 291/01) para. 47 (also mentioning agreements that fix the distribution margin and extending the definition of RPM to include cooperation achieved indirectly by means such as threats, intimidation, warnings, penalties, delays, suspensions of deliveries and terminations in connection with following – or not following – a given price level).

Encourage retailers to provide efficient pre-sale services.

10. By guaranteeing retailers a certain profit margin on each unit sold, manufacturers can better motivate the retailers to provide services that customers want or need. First, the margins guaranteed by RPM should allow retailers to afford to provide customers with more of such services. Thus, even though it prevents retailers from competing on the basis of price, RPM enhances their ability to engage in other types of competition. In fact, given that they cannot compete on price, they have to find other ways to attract customers if they are going to remain competitive with other dealers.[4] Furthermore, that competition will be directed not only toward rival brands, but toward other retailers who sell the same brand. In other words, RPM can boost both interbrand and intrabrand non-price competition. Theoretically, in competitive markets, the retailers' investment in that heightened non-price competition should increase to the point at which their extra revenues from RPM are entirely competed away.[5]

11. Second, if competition itself does not provide enough motivation for resellers to invest their enhanced profits from RPM in greater services, then the looming threat that the manufacturer could terminate them or dismantle the RPM program altogether may do so. That, in fact, is exactly what a rational manufacturer would do if the dealer is not providing adequate levels of service. Higher retail prices without greater service could be a desirable state of affairs for the retailer, but for the manufacturer it would be unquestionably harmful since sales would be driven down, not up, despite the fact that wholesale prices did not increase.

12. So how do the extra services engendered by RPM translate into greater consumer welfare? Some customers will buy the product if those extra services are provided but would not buy it if the services are not provided. If the higher demand due to the services promoted by RPM more than compensates for the dampening effect on demand due to the (presumed) higher retail price associated with RPM, then total demand and sales will rise and, typically, so will consumer welfare. This possibility is shown in Figure 1.[6]

13. In Figure 1, the pre-RPM equilibrium is at point d (Q_1, P_1). After RPM begins, the demand curve shifts outward in parallel fashion from D_1 to D_2 because greater services are assumed to increase the product's value to all consumers equally. (A different assumption will be made later.) Consumers are now willing to buy more of the product at any given price. Those extra services cost something to provide, however, so the supply curve moves higher, too (from S_1 to S_2). The new equilibrium is at point b (Q_2, P_2). Notice that the quantity sold has increased (Q_1 to Q_2) despite the fact that price has risen from P_1 to P_2.

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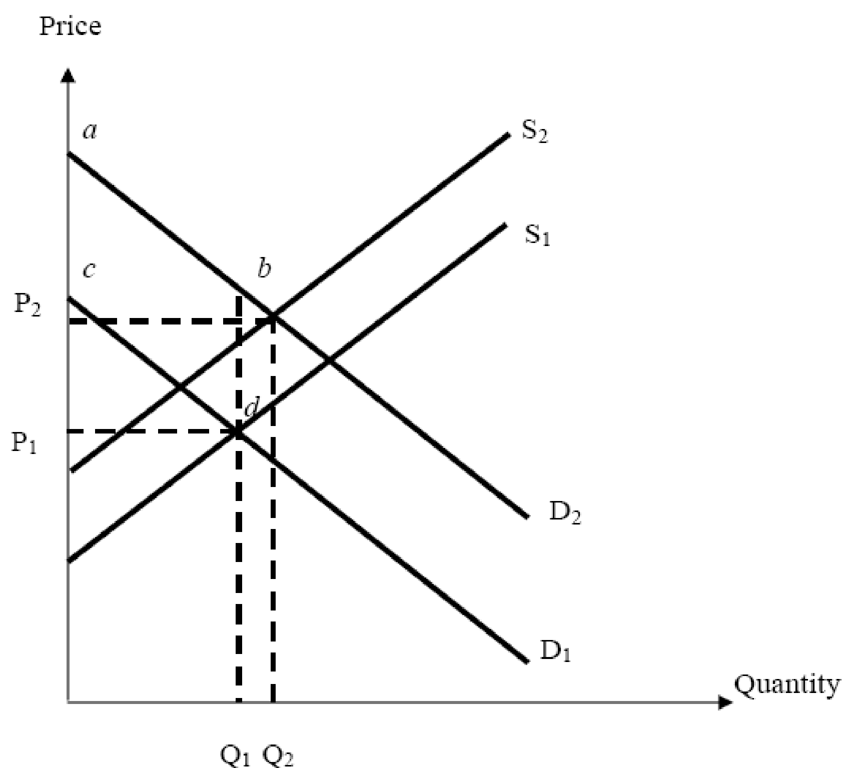
4 Mart Kneepkens, "Resale Price Maintenance: Economics Call for a More Balanced Approach," 28 European Competition Law Review 656, 658 (2007).

5 Richard Posner, Antitrust Law 173 (2d ed. 2001).

6 This diagram appears in Roger Blair, "The Demise of *Dr. Miles*: Some Troubling Consequences," 53 Antitrust Bulletin 133 (2008), 143.

Figure 1. Welfare-Enhancing RPM.



14. In Figure 1, the pre-RPM equilibrium is at point d (Q_1, P_1). After RPM begins, the demand curve shifts outward in parallel fashion from D_1 to D_2 because greater services are assumed to increase the product's value to all consumers equally. (A different assumption will be made later.) Consumers are now willing to buy more of the product at any given price. Those extra services cost something to provide, however, so the supply curve moves higher, too (from S_1 to S_2). The new equilibrium is at point b (Q_2, P_2). Notice that the quantity sold has increased (Q_1 to Q_2) despite the fact that price has risen from P_1 to P_2.

15. Under these conditions, consumer welfare (technically, consumer surplus) clearly increases because of RPM. Prior to RPM, it is represented by area cdP_1. After RPM, it becomes area abP_2.

Combat free riding.

16. RPM can also stimulate greater pre-sale services by discouraging free riding. Free riding occurs when customers benefit from pre-sale services offered by full-service retailers but then buy from discounters. The former bear the costs, but the latter get the revenue. If the problem is serious, full-service retailers will eventually curtail or even eliminate the affected services, which may result in an inefficient under-provision of such services in the market. Manufacturers will find it difficult to persuade retailers to offer the services unless free riding can be prevented. RPM does that by stopping discounters from discounting. Because all retailers have to charge the same price under RPM, customers will have no incentive to shop at one store and buy from another. With price competition and free riding no longer possible, retailers will (presumably) be more inclined to engage in non-price competition by offering more of the pre-sale services that could be free-ridden in the absence of RPM.

17. What types of services are included in that group? The most frequently mentioned include things like expert advice and information from trained specialists, product demonstrations, and consumer trials. Intuitively, the products that would seem most likely to be affected by free riding are differentiated, complex and feature-rich products. Certain consumer electronics items such as mobile smartphones and high-definition video cameras are good examples because they may sell better when a salesperson is available to explain their functionality and to highlight their advantages in comparison with competing products. The problem for full-service retailers is that they may not be the ones making the actual sales, as it is often fairly easy for consumers to find discounters who sell such products without providing sales advice.

18. The need for RPM's free-rider-killing effect has been exaggerated, according to some commentators. Areeda and Hovenkamp, for instance, state that unrestricted intrabrand competition does not cause much harmful free riding in a large number of situations. These include markets where "dealers provide no significant services (such as drugstores selling toothpaste), the services they do provide cannot be utilised by customers who patronise other dealers (luxurious ambience), the services are paid for separately (post-sale repair), the services provided are not brand specific . . . (high quality department store), the services can be provided efficiently by the manufacturer (advertising), or a sufficient number of customers patronise the dealers from whom they receive the service."[7] Scherer and Ross add that enhanced services are irrelevant for customers who already know what they want and how to use it, as well as for customers who are shopping for inexpensive items.[8]

19. But there is another service that is susceptible to free riding and it can apply to many types of products. It is known as "certification" or "signalling," and its wide applicability means that the free riding phenomenon may not be as limited as was once believed.[9] Certain retailers invest considerable resources in screening the products they carry, ensuring that only the most high-quality and/or stylish products appear on their sales floor. They may also cultivate a trustworthy and upscale reputation through spending on advertising, store furnishings, store locations, etc. Over time, customers may come to trust that retailer's product choices and automatically associate the brands and models it sells with excellence and prestige. In the absence of a strategy such as RPM, discounters could simply mimic the trusted retailer's inventory without having to invest any resources of their own in determining which products are the best or acquiring an upscale reputation themselves. Consumers could save money by doing their research at high-end stores but their buying at discount stores. RPM helps to preserve the certification effect by giving customers no reason to buy from discounters, thereby directing purchases back to the sellers who do the certifying.

20. Areeda and Hovenkamp remain unmoved by the certification theory. They contend that upscale dealers are unlikely to discontinue their certification services, which are not brand specific, just because they are being free ridden with respect to a few individual products.[10] This criticism is not especially

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[7] 8 Phillip Areeda & Herbert Hovenkamp, Antitrust Law ¶ 1601e, at 13 (2d ed. 2004); *see also* Kneepkens, *supra* n.4 at 657.

[8] F.M. Scherer & David Ross, Industrial Market Structure and Economic Performance 552 (3d ed. 1990). As the authors put it, "[t]he consumer who secures from her friendly local hardware store a ten-minute demonstration of a $1.79 potato peeler's merits and then makes a special trip to the discount house to buy one is a candidate for something other than center stage in the economic theory of shopping behavior." *Id*.

[9] Howard Marvel, "The Resale Price Maintenance Controversy: Beyond the Conventional Wisdom," 63 Antitrust Law Journal 59 (1994); Howard Marvel & Stephen McCafferty, "Resale Price Maintenance and Quality Certification," 15 Rand Journal of Economics 346 (1984); Thomas Overstreet, Resale Price Maintenance: Economic Theories and Empirical Evidence, USFTC Bureau of Economics Staff Report, pp. 56-62 (1983).

[10] Areeda & Hovenkamp, *supra* n.7 ¶ 1613d-g, at 156-165.

persuasive, though, because even if the certification services are not brand specific, the free riding is. In other words, dealers can easily put a stop to the free riding by refusing to continue carrying the affected products – and only those products. That is the result RPM would be intended to prevent. Furthermore, the rise of internet shopping has strengthened the certification hypothesis by making the process of shopping itself cheaper and easier. It is now more believable than ever that customers will shop for certain items in reputable, full-service stores and then go online to see if they can find the same items at a discount. In fact, customers undoubtedly do both types of shopping online at least occasionally.

21. Some manufacturers may make improbable claims about supposedly necessary services that are vulnerable to free riding. This is somewhat subjective territory, especially outside the context of any particular case, but a degree of scepticism seems appropriate for services like convenient hours, large store size, and pleasant salespersons. One may reasonably doubt that customers will actually shop at a full-service store during hours when a discounter is closed, for instance, but then go to the discounter when it opens to make the purchase.

Protect brand image: prevent dealers from using the product as a loss leader.

22. This argument is sometimes offered as a justification for limiting price competition among distributors. Essentially, it holds that when a manufacturer invests in giving its product an image of quality or sophistication, price reductions may actually reduce sales volume. It is rare, however, that demand can be raised by keeping prices high.

Manage demand uncertainty.

23. If demand for a product turns out to be unexpectedly low after retailers have bought a substantial supply of it, retail prices may decline dramatically as the dealers try to unload their stock. As a result, they will experience substantial losses. The higher the risk that demand may be low and prices will plummet, the less willing retailers will be to carry a product (or at least to carry enough of it should demand turn out to be normal or high). Furthermore, retailers tend to perceive a higher risk of that happening for new, unproven products. Because RPM assures retailers that prices will not decline even if demand is low, they may be more likely to carry a product that they otherwise would not have carried (or to place larger orders for it than they would have done otherwise). That, in turn, would benefit consumers because stores will be more likely to maintain adequate inventory levels.[11]

24. Those who are unfamiliar with this hypothesis may be wondering why RPM in the presence of low demand would give retailers any comfort at all. Wouldn't RPM in this situation simply mean that instead of liquidating all their inventory at rock-bottom prices, retailers would sell just a portion of it at the normal RPM price and receive nothing at all for the rest, since it would never be sold? Well, yes, it would, but the idea that retailers can rely on selling at least a portion of their inventory at the RPM price turns out to be the key point.

25. The demand uncertainty theory requires the classification of retailers into several groups, from discounters that always sell at low prices to high-end stores that always sell at high prices. When demand is low, only the discounters will be able to sell anything. Even if demand is high, competition among

[11] Raymond Deneckere, Howard Marvel & James Peck, "Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition," 87 American Economic Review 619 (1997); Raymond Deneckere, Howard Marvel & James Peck, "Demand Uncertainty, Inventories, and Resale Price Maintenance," 111 Quarterly Journal of Economics 885 (1996). Note that if retailers would have carried enough of the product to satisfy a high demand state even without RPM, then RPM may not enhance consumer welfare. Marvel, *supra* n. 9 at 75-76.

discounters is assumed to keep their prices low, but in either demand state the discounters have a relatively high probability of selling their stock. Upscale stores, however, will sell only when demand is high enough to support their high prices. There is a chance, therefore, that they may wind up selling nothing. Accordingly, they may be unwilling to carry sufficient quantities of the product to satisfy demand if it turns out to be high. RPM at least partially remedies that problem by making it more likely that each retailer – whether it is a discounter or not – that it will sell a portion of overall consumer demand even if that demand turns out to be low, and that it will do so at the high-margin RPM price. Consequently, on the whole, retailers will hold larger inventories under RPM because the higher exposure to losses involved in doing so is offset by the higher probability that they will earn higher profits on at least part of their stock. [12]

Encourage preferred treatment by multi-brand dealers.

26. This idea is simply that retailers will put extra effort into selling a product if its price is kept high. It works especially well when consumers need a dealer's advice on which product to buy. This behaviour has ambiguous effects on consumer welfare, though.

Promote entry

27. New companies, and even established companies who are introducing new products, sometimes find it difficult to convince distributors to carry those new items. Without a means of distribution those new products will not, of course, be able to enter the market. In addition to being more reluctant to carry new, unproven items because of the risk that demand for them will be low, distributors may also be averse to stocking new products even if they turn out to be popular with customers. The problem arises when distributors need to make substantial investments in advertising and promotion for the new products to be profitable. If those investments are made and the distributors begin to earn profits, other distributors who never made those investments may start to carry the same products and compete away the original distributors' profits. RPM is a means of increasing the likelihood that "pioneer" distributors will recoup their investments and earn compensation for the risk they bore because it prevents price competition. RPM therefore can ease the entry of new products and/or new competitors at the upstream level by helping to persuade distributors to accept the risk of carrying and investing in the success of new products. Note that RPM may promote entry at the distributor level, as well.

Eliminate double marginalisation

28. Manufacturers sometimes impose maximum RPM when both they and their resellers have some market power. Without maximum RPM in such situations, both the upstream and downstream firms will set prices that maximise their own profit. Those prices will tend to be higher than marginal cost since the firms have market power. The resulting "double mark-up" leads to a retail price above the level that would maximise the aggregate profits of the upstream and downstream firms together. More specifically, the downstream firm will make any price increase that raises its own profits, ignoring the fact that those increases decrease the quantity sold to consumers. That decline in quantity decreases the manufacturer's profits. Imposing maximum RPM enables the manufacturer to recalibrate retail pricing to avoid the profit loss associated with double marginalisation.

29. The use of maximum RPM to eliminate double marginalisation enhances consumer welfare. Maximum RPM prevents the uncoordinated exercise of market power when such power exists at both the

[12] RPM is not the only strategy that can motivate retailers to keep higher inventory levels. For example, manufacturers might also agree to buy back unsold goods. Presumably, if manufacturers choose RPM instead, it is because it is more efficient for some reason. Manufacturers should therefore be able to explain why that is the case.

wholesale and retail levels. That lack of coordination results in retail prices that are above the level that would maximise profits for the aggregate chain of production. By giving manufacturers control over retail prices, maximum RPM enables them to correct an externality that causes needless reductions in both the profits and the economic efficiency of both upstream and downstream firms. With maximum RPM, manufacturer can dictate a retail price that takes into account its effects on the whole chain of production.[13] Because correcting the double marginalisation externality lowers retail prices to (aggregate) profit maximising levels, economic efficiency improves and consumers benefit.

Prevent price gouging by dealers with market power.

30. This is different from the double marginalisation issue because downstream price gouging will be a concern to manufacturers regardless of whether they have market power themselves. When dealers have some localised market power, manufacturers may find it beneficial to impose maximum RPM to restrict the dealers' ability to charge supracompetitive retail prices. Such prices would not be in the best interests of either the manufacturer or consumers. Thus, for example, a manufacturer might impose maximum RPM when it has granted exclusive territories to its dealers.

2.2.2 Welfare-reducing Uses and Effects

31. Concerns that RPM may reduce welfare focus on its potential to facilitate collusive behaviour. That could happen at either the manufacturer or the reseller level. While both types of RPM schemes are vertical in form, they are horizontal in substance. Other potentially harmful effects are also discussed in this section.

Facilitate price fixing among dealers.

32. A cartel of retailers may want to instigate RPM because it can serve as both camouflage and an enforcement mechanism. Because RPM has the appearance of being imposed by manufacturers, it could help to disguise what is really a retailer-initiated cartel agreement. In addition, knowing that the manufacturer will punish retailers who cheat provides a level of confidence for all of the cartel members, especially in markets where they might find it difficult to do the punishing themselves.

33. The idea of a retailer cartel being enforced by a manufacturer should cause at least some intuitive consternation. Ordinarily, manufacturers want retail prices to be as low as possible so as to encourage consumer demand. More consumer demand means more demand at the wholesale level, which increases manufacturers' profits. Higher retail prices, in contrast, reduce consumer demand. That leads to lower manufacturing profits. Therefore, one of the last things we might expect a manufacturer to do is to help its retailers maintain artificially high prices. To do so, it would likely have to be coerced, which will require a sufficiently powerful group of retailers.

34. Moreover, there are a number of other reasons why we might expect retailer-induced RPM schemes to be uncommon. First, of course, is the fact that cartels themselves are considered to be criminal activities in some jurisdictions and can at least draw heavy fines in others. Second, market conditions do not always favour cartel formation. The well-known group of factors that affect the plausibility of a successful cartel in general (such as the number of firms in the market, the homogeneity of their products, the ease of entry, etc.) will make cartels too difficult to maintain in some markets, even with the assistance

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13 Minimum RPM cannot help in this situation because the double marginalisation problem causes reseller prices to be too high, not too low.

of RPM.[14] Third, retailers may be able to implement and monitor their cartel well enough without RPM, in which case they would not need it. Although that may not be a very comforting thought for enforcers, the point here is simply that it reduces the likelihood that RPM will be used to maintain a retailing cartel.

35. Finally, RPM will not work very well as a cartel device for retailers if they fail to persuade an adequate portion of manufacturers to implement it. If enough of the industry's capacity remains uncovered by RPM agreements, then consumers will simply switch to brands that are RPM-free. In general, however, the more market power any individual manufacturer has, the harder it will be for the retailers to coerce it. Conversely, markets with manufacturers that have little or no market power may present the retailers with easier targets, but there are likely to be more of them. Either way, conspiring retailers will sometimes face an uphill battle.

36. For all of those reasons, some commentators consider it improbable that RPM could ever serve as a facilitating device for a retailer cartel. In fact, Marvel has called that situation "clearly implausible."[15] As we will see in Part 3.3., however, it is likely that some enforcers consider the risk to be not only plausible, but substantial.

Facilitate price fixing among manufacturers.

37. RPM can be used as a facilitating device for manufacturer cartels, too. Retail prices, being more observable than wholesale prices, are easier to monitor. It is therefore easier to detect price deviations at the retail level than at the manufacturing level. Manufacturers, however, sell at the wholesale level. Therefore, if they form a cartel they will be concerned about the possibility of cheating on wholesale prices. By imposing RPM, they may be able not only to detect cheating more easily, but to deter it more effectively, as well.

38. This is why that strategy might work: Normally, members of a manufacturing cartel who wish to cheat would lower their wholesale prices. That would enable their retailers to reduce prices to end users, as well, which would increase demand at both the retail and wholesale levels. That demand increase is what the cheating manufacturers would count on to make their secret price cuts profitable. Meanwhile, the cheater could keep the true reason for the decline in retail prices hidden from other cartel members by attributing it to any of a variety of plausible reasons other than cheating. It could blame normal fluctuations in market prices, for example, which could be due to anything from variations in the retailer's overhead costs to localised changes in demand. But RPM prevents retailers from lowering their prices for any reason, including a decline in wholesale prices. Because retail prices must not change, neither will retail demand. Consequently, demand at the wholesale level cannot change, either. That would remove the manufacturers' incentive to make secret price cuts. With that temptation eliminated, the manufacturers' cartel would be more stable.

39. Marvel recently stated that, at least in the US, "[t]he number of cases in which RPM can plausibly be alleged to have facilitated a manufacturer cartel can be counted on one's fingers."[16] A number of factors may be responsible for that. To begin with, some of the same reasons that make retailer-induced RPM cartels less likely also militate against RPM as a device for manufacturing cartels. For example, manufacturing cartels are just as illegal as retailer cartels, market conditions can also be unfavourable for

[14] *See, e.g.*, OECD, Public Procurement, The Role of Competition Authorities in Promoting Competition, DAF/COMP(2007)34, Background Note at 21-23.

[15] Marvel, *supra* n. 9 at 59.

[16] Howard Marvel, "Resale Price Maintenance and the Rule of Reason," The Antitrust Source (June 2008), p. 1.

cartel formation in manufacturing markets, and manufacturers will not always need RPM to facilitate a cartel.

40. Another reason that RPM-facilitated manufacturers' cartels may be rare is that they have an inherent, destabilising characteristic. Both the incentive to gain market share at the other cartel members' expense and a means to do it will remain even if all cartel members have imposed RPM on their dealers. Even though a manufacturer is not likely to get away with cheating for long by lowering its wholesale price and letting its dealers pass those savings on to consumers, it still might benefit by lowering its wholesale price. Rather than expecting its dealers to pass that lower price on, though, the manufacturer could stimulate demand by allowing its dealers to continue pricing at the RPM level if they agree to engage in more intense non-price competition with the other cartel members' products.

41. A dealer that carried the products of several colluding manufacturers could, for example, begin to promote more heavily the brand on which it is receiving secret discounts. Sales people could push that brand harder than others, there might be more prominent in-store advertising, better positioning on shelves, etc. For this reason, RPM alone might not be enough to ensure the stability of a manufacturing cartel. It might be necessary to impose other vertical restraints, as well, such as exclusive dealing. But while that would partially alleviate the problem, it would not solve it entirely. Even if each dealer were permitted to carry the brand of only one of the colluding manufacturers, the manufacturers would still have an incentive to try to take sales away from their rivals by encouraging their own dealers to engage in greater non-price interbrand competition. Consequently, all of the potential gains from the cartel might be competed away.

42. This is a very plausible problem for manufacturing cartels.[17] After all, one of the main arguments in favour of RPM is that it can be effective in stimulating non-price competition by retailers. A manufacturer therefore might find it profitable to cut its wholesale price while technically adhering to its commitment to impose RPM, provided its dealers respond with the type and level of pre-sale services that take away enough sales from other cartel members to recoup the secret price cut. This strategy is likely to work best with products for which customers are relatively more responsive to extra pre-sale services. In contrast, uncomplicated, inexpensive, commodity goods that are sold widely and in many different types of stores will not be as susceptible to this kind of cheating. Therefore, we should expect to see a higher incidence of manufacturer-RPM cartels involving such products than of manufacturer-RPM cartels involving more complex or higher-profile products.

43. Finally, even if no cartel members cheat, another kind of destabilising force may make RPM-based cartels more trouble than they are worth to manufacturers, especially in markets where pre-sale services are not very important. The essence of the problem is that RPM will be an expensive way for the cartel to maintain discipline. Ordinarily, even if there is a cartel at the manufacturing level, retailers are free to choose the prices they wish to charge their customers. Some retailers will be more efficient than others and thus will have the ability to charge relatively low prices, which will probably result in a higher sales volume. That helps to offset the effect of the monopolistic input price set by the cartel, which is good for the manufacturers. RPM, however, inhibits the ability of the relatively efficient retailers to pass along cost savings to customers. Consequently, total industry sales are likely to decline, which hurts the manufacturers. If sales decline by enough, the cartel members may be worse off even though they are receiving a higher price per unit.[18]

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17 *See* Blair, *supra* n.6 at 137 n.16 (noting that RPM is unlikely to eliminate all cheating in manufacturing cartels because of the temptation manufacturers will still have to reward their dealers for greater non-price competition against other cartelists); *see also* Stanley Ornstein, "Resale Price Maintenance and Cartels," 30 Antitrust Bulletin 401, 406-08 (1985).

18 Ornstein, *supra* n.17 at 409.

44. So does all this mean that enforcers may as well not worry about RPM as a device for facilitating cartels? Certainly not. Even if cartel members do cheat, it will not necessarily happen often enough or to a large enough extent to make the cartels collapse. Meanwhile, there would be no guarantee that harm to consumers from the cartel's higher prices would be outweighed by the added services provided by the cheater(s). Furthermore, the sacrifice of relatively efficient retailers that can occur under RPM would be less pronounced in markets where consumers respond strongly to pre-sale services. The efficient retailers could use their cost advantage to fund such services rather than lowering their prices, thereby boosting demand (and the cartel's profits). Nevertheless, the sources of instability just described do provide some theoretical support for the view that RPM-facilitated manufacturing cartels are uncommon. Consequently, these observations tend to weaken the case for keeping RPM illegal per se.

RPM harms all consumers simply by raising prices

45. This is a flawed argument. Putting cartel-inspired RPM schemes aside, manufacturers implement RPM because it induces activity and effects to which consumers respond by buying more, not less, in spite of the resulting higher prices. In other words, RPM is a means of making customers in the aggregate better off, not worse off, as we saw in Part 2.2.1.1. Therefore, by itself, the fact that retail prices tend to rise because of RPM is not meaningful because such price increases will typically occur under RPM regardless of whether it is used to maintain a cartel or to encourage pro-competitive customer services.

46. Marvel adds that RPM is no different from certain other promotional investments that do not draw nearly as much scrutiny as RPM. Advertising, for example, can stimulate demand even though it also raises costs and (usually) prices. The same is true of investments in R&D.[19] Those strategies are rarely questioned, though.

47. Moreover, RPM does not have to result in a supra-competitive price. In fact, interbrand competition might prevent manufacturers from setting the retail price any higher than the competitive level.[20] In any event, manufacturers will rarely have a rational interest in padding resellers' profits by requiring them to charge supra-competitive prices to consumers.

RPM may benefit marginal consumers, but it harms inframarginal consumers

48. The price-raising debate does not end there, though. While acknowledging that RPM can stimulate pre-sale services, leading to increases in demand and consumer welfare, some commentators have pointed out that not all consumers share those benefits. Suppose that, instead of the demand shift depicted in Figure 1, the imposition of RPM caused a demand shift like the one in Figure 2.[21]

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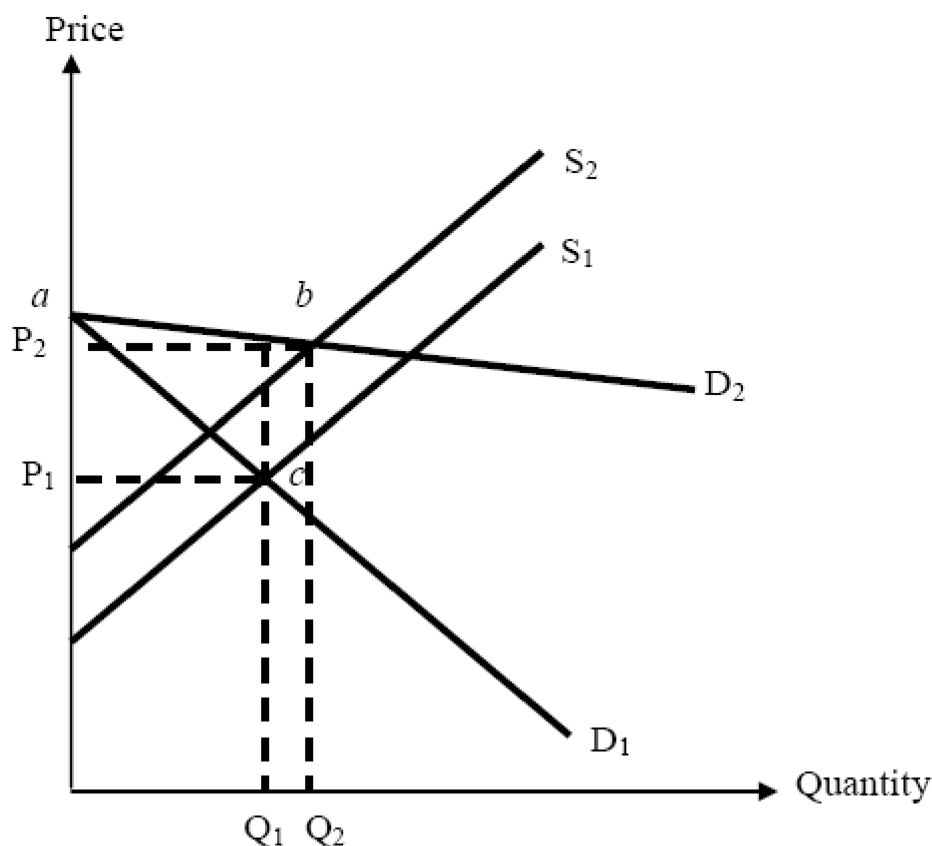
19 That is, at least until those investments result in actual innovation, which can reduce costs and prices.

20 This argument appears, for example, in William Baumol, et al., Amicus Brief in *Leegin Creative Leather Products v. PSKS, Inc.*, 2006 U.S. Briefs 480 (22 January 2007), p. 3. The "competitive" level, though, should take into account the cost of providing efficient pre-sale services.

21 Like Figure 1, Figure 2 appears in Blair, *supra* n.6 at 145. The ideas behind these diagrams were developed much earlier in F.M. Scherer, "The Economics of Vertical Restraints," 52 Antitrust Law Journal 687 (1983) and William Comanor, "Vertical Price Fixing, Market Restrictions and the New Antitrust Policy," 98 Harvard Law Review 990 (1985).

Figure 2. Welfare-Reducing RPM.



49. Why would the demand shift look like this instead of the way it looked in Figure 1? Comanor and Scherer's answer is that the customers who gain the most consumer surplus from a product are already likely to know about its positive qualities. They are also more likely to know how to use it already. Therefore, such infra-marginal consumers are harmed by the higher prices RPM tends to cause – regardless of any extra pre-sale services those prices stimulate – because most of those consumers would have bought the product anyway, even without the extra services. In contrast, the initially less informed, marginal consumers are the ones who buy substantially more because they are the ones who get most of the benefits from the extra services. "This is a plausible situation," Comanor and Scherer state, "as it is recognised that the consumers most likely to be influenced by additional pre-sale services are those 'who are indifferent between purchasing or not.'"[22]

50. In Figure 2, the pre-RPM equilibrium is at point c (Q_1, P_1). After RPM begins, the demand curve swings outward as if on a hinge, from D_1 to D_2, because greater services are assumed to increase the product's value to all consumers, but in varying degrees. Inframarginal customers (that is, customers who are on the part of D_1 that is above point c) value the additional pre-sale services relatively less while marginal customers (those on the part of D_1 that is below point c) value the services relatively more.

[22] William Comanor & F.M. Scherer, Amicus Brief in *Leegin Creative Leather Products v. PSKS, Inc.*, 2006 U.S. Briefs 480 (22 January 2007), p. 5 (quoting James Cooper, Luke Froeb, Daniel O'Brien & Michael Vita, "Vertical Restrictions and Antitrust Policy: What About the Evidence?" 1 Competition Policy International 45, 49, 51 (2005)).

Consumers are still willing to buy more of the product at any given price, but some consumers have a stronger response than others. Once again, the extra services induced by RPM have a cost, so the supply curve moves from S_1 to S_2. The new equilibrium is at point b (Q_2, P_2). This time, however, consumer surplus actually shrinks. Before RPM, it is represented by area acP_1. With RPM, it contracts to area abP_2.

51. Generally speaking, the larger the group of inframarginal customers is in comparison to marginal customers, the more likely it will be that the harm to their welfare will outweigh the increase in the marginal customers' welfare. In addition, the less price-sensitive inframarginal customers are, the more they may be harmed because manufacturers will be able to set higher prices without suffering so much of a loss in demand that overall profitability is reduced. Higher prices will, of course, also reduce the gains in consumer welfare experienced by the marginal customers. On the other hand, the more responsive customers are to greater services, the more the demand curve will shift and the more likely it will be that RPM will generate a net increase in consumer welfare.

52. Consequently, it is not clear that RPM always increases total consumer welfare even in situations where cartels do not initiate it, but rather it is being used strictly to boost demand. Figures 1 and 2 show that the net welfare consequences of RPM depend on how demand shifts – and on how much it shifts – in response to greater pre-sale services. As Blair points out, "[f]or all practical purposes . . . estimating the effect of RPM on consumer surplus while controlling for all other influences is problematic at best."[23] But Comanor and Scherer's point is a powerful one even if it must remain theoretical.[24] In any case, Figure 1 is purely theoretical, as well.

53. Still, the main point is that RPM *may* enhance total consumer welfare. Sometimes it does, and sometimes it does not. But the plain fact that RPM may reduce consumer welfare in some situations is, by itself, not a particularly strong basis for banning it in every situation.

RPM protects inefficient retailers by preventing efficient ones from competing on price

54. This argument is straightforward. By forcing all retailers to charge the same price, RPM prevents customers from benefitting from the lower prices that more efficient retailers would otherwise charge. Efficiency also suffers because retailers with higher cost structures are able to continue operating even though they would have been driven out of the market under more competitive conditions.

55. This concern is somewhat undermined by the points made in the previous section, though. While RPM may weaken price competition, the whole point of implementing it (aside from situations in which it serves as a cartel device) is to strengthen non-price competition. As a result, although it is true that inefficient retailers would have an easier time surviving with respect to pricing pressures under RPM, they would face more intense non-price competition from their rivals. Given that those rivals are more efficient, they would have higher profit margins with which to fund the pre-sale services they provide. That kind of competition could be just as effective in eliminating the inefficient retailers as low prices would have been. Furthermore, customers would benefit from those enhanced services even though they would be paying higher prices.

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23 Blair, *supra* n.6 at 146; *see also* Kneepkens, *supra* n.4 at 659 ("it may not be possible to determine whether the welfare loss for infra-marginal consumers is larger than the gain for marginal consumers").

24 Norbert Schulz recently devised an econometric model with certain assumptions that neither Comanor nor Scherer made, yet he still found that "[s]imple indications such as an increased demand due to higher service are found to provide neither a necessary nor a sufficient condition for RPM to enhance efficiency." Norbert Schulz, "Does the Service Argument Justify Resale Price Maintenance?" 163 Journal of Institutional and Theoretical Economics 236, 247 (2007).

Maximum RPM deters dealer services.

56. It has been said that maximum RPM should not be permitted because it may result in prices that are so low that retailers will be unable to provide the services that customers need or are willing to pay for.[25] This reasoning does not make sense, however, because if the prices were set so low as to bring about an inefficiently low level of dealer services, manufacturers would be foregoing some profit. They would therefore have an incentive to solve the problem themselves by raising the maximum price.

2.3 The Debate over Enforcement Approaches to RPM

57. Over the years, many economists have questioned the wisdom of making RPM illegal per se, arguing that it should be governed by the rule of reason instead. This section of the note first examines the general strengths and weaknesses of these two approaches. It then considers the arguments for and against applying each of them in the RPM context.

2.3.1 The Per Se Rule Versus the Rule of Reason: General Advantages and Disadvantages of Each

58. Under the approach that holds RPM to be illegal per se, whenever it can be shown that a manufacturer has agreed (or come to an understanding) with one or more resellers to control the price that the reseller(s) charge, a competition law violation will be presumed without any proof of anticompetitive effects.

59. The per se approach offers clarity, speed and savings in decision-making costs. There should be no doubt in anyone's mind about what is permitted and what is not under the per se approach. There is a reduced need for an agency or court to delve into intricate factual evidence and make judgments about it. Unfortunately, the per se approach is much like a sledgehammer: quick, relatively inexpensive, and predictable, but not very careful. The per se rule will condemn some conduct that is actually pro-competitive.

60. Under the rule of reason approach, competition authorities and courts strive to determine whether RPM in a particular case is likely to cause net harm to consumer welfare. All the facts and circumstances of each case may be taken into account, so simply showing that a vertical price agreement exists is insufficient. There must be some proof of competitive harm. Positive effects on consumer welfare from the RPM agreement will also be considered and weighed in some fashion against any negative effects that are shown.

61. The strength of the rule of reason is that it can take into account a great deal of information related to the conduct. Its weaknesses are that it can take a long time and a great deal of money to perform, it is often impossible to collect the necessary data or extremely difficult to interpret it correctly, and it is hard to predict what result the rule will yield in any particular case. It may wind up exonerating some conduct that should have been condemned, and vice-versa.

2.3.2 Which Approach Is Best for RPM?

62. One way to determine the answer to that question is to use the method adopted by the US Supreme Court, which presumes that the rule of reason will apply unless experience shows that the practice is always or almost always anticompetitive, in which case the practice will be deemed illegal per se. Another way is based on decision theory, which says that the best rule is the one for which the probability of error multiplied by the magnitude of harm caused by that error is lowest. There are solid reasons both in

[25] *See, e.g., Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

favour of and against each of those approaches, just as there are solid reasons for and against both the rule of reason and the per se rule themselves.

63. The US Supreme Court has held that "[t]here is a presumption in favour of a rule-of-reason standard; that departure from that standard must be justified by demonstrable economic effect, such as facilitation of cartelising, rather than formalistic distinctions; [and] that interbrand competition is the primary concern of the antitrust laws[.]"[26] Per se treatment is appropriate only for conduct that "almost always tends to restrict competition and reduce output"[27] or is, in other words, "manifestly anticompetitive."[28] All of those factors point in favour of a rule of reason approach toward both maximum and minimum RPM.

64. Indeed, those factors set up an especially strong case for applying the rule of reason to maximum RPM. In terms of the economics literature, it is widely agreed that maximum RPM comes nowhere near the category of "manifestly anticompetitive." Posner sums up what is now the conventional wisdom: "[U]nless the supplier is a monopsonist he cannot squeeze his dealers' margins below a competitive level; the attempt to do so would just drive the dealers into the arms of a competing supplier. A supplier might, however, fix a maximum resale price in order to prevent his dealers from exploiting a monopoly position. . . . It would do this not out of disinterested malice, but in its commercial self-interest."[29] The latter use of RPM would, as discussed earlier, be beneficial to consumers, as well. Of course, it is still possible that the maximum price might really serve as a signal for what is actually a de facto minimum price, which would certainly not be beneficial to consumers. That possibility alone, however, does not seem to be enough to warrant a per se prohibition of maximum RPM in light of the positive effects it may have.

65. Regarding minimum RPM, the Supreme Court's paradigm still favours the rule of reason. Economic theory indicates a number of possible negative effects on competition and welfare. But economic theory also indicates a number of pro-competitive effects. To sum up the conclusions of Part 2, theoretical work on RPM shows that it can facilitate cartels and/or raise prices. With respect to cartels, there is poor theoretical support for the conclusion that RPM frequently serves as a facilitating device. Concerning the fear that RPM causes price increases, it has been shown that such increases can strengthen interbrand competition by encouraging resellers to provide more pre-sale services that stimulate demand for a product. Therefore, the bottom line from the abstract perspective is that RPM does not go hand in hand with cartels and even if it does tend to cause prices to rise, one cannot conclude that there is necessarily a net anticompetitive effect.

66. As a group of eminent economists recently stated, "In the theoretical literature, it is essentially undisputed that minimum RPM can have pro-competitive effects and that under a variety of market conditions it is unlikely to have anticompetitive effects. . . . The position absent from the literature is that minimum RPM is most often, much less almost invariably, anticompetitive."[30] They concluded, therefore, that the economics literature provides no support for applying the per se rule. Some European

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26 *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 725 (1988).

27 *Id*. at 726-27.

28 *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 49-50 (1977).

29 *State Oil Co. v. Khan*, 93 F.3d 1358 (7th Cir. 1996), *reversed*, 522 U.S. 3 (1997). Posner wrote his decision (in which he followed but criticised then-binding Supreme Court precedent holding that maximum RPM was illegal per se) in the hope that it would be reversed.

30 Baumol, et al., *supra* n.20 at 16. Although the Comanor/Scherer point about inframarginal customers remains valid, even they do not view it as a reason to continue treating all RPM as per se illegal. *See* Comanor & Scherer, *supra* n.22 (endorsing a hybrid approach in which manufacturer-initiated RPM is subject to a rule of reason approach and retailer initiated RPM is illegal per se).

commentators agree: "[E]conomically speaking, the prohibition of resale price maintenance in European law is incomprehensible. . . . [A] general ban, in other words a prohibition per se, cannot optimise the market results from an economic point of view, because it means that all positive effects which are achievable through the application of price maintenance would be prohibited or only realisable in another way at greater cost."[31] "[T]he current per se ban on RPM should be relaxed, since RPM may have pro-competitive as well as anti-competitive effects."[32]

67. With respect to RPM's demonstrable effects, it seems to be generally accepted that RPM does raise prices.[33] Beyond that, the available empirical evidence is scant. There is not much of it, and much of what there is is decades old. But such as they are, the existing studies do not show that RPM almost always tends to restrict competition and reduce output. On the contrary, they point in the other direction. Perhaps most importantly, they indicate that RPM is not commonly used to facilitate cartels. That is a direct hit against a major argument for applying the per se rule. For example, one study found that only ten percent of the RPM cases brought by the USFTC between 1942 and 1983 concerned cartels.[34] Another study focused on the 153 reported RPM cases at the USFTC during the period 1976 to 1982. The author, Pauline Ippolito, found that cartels were alleged in only 5.9 percent of the cases. She concluded that there was little evidence to support the idea that collusion is a key motive for manufacturers when they impose RPM.[35] Looking at allegations in litigated cases is not necessarily the ideal approach, but these studies are among the very few that have been done so there is not much choice available.

68. Turning to the retailer cartel theory of RPM, there is some evidence – again decades old – indicating that dealers have occasionally been able to persuade manufacturers to impose RPM and play the role of a cartel enforcer. But the same study also found that in over 91 percent of the RPM cases for which information on the retail market structure was available, at least 100 retailers were in the relevant market. That fact suggested that widespread collusion among retailers was unlikely, leading to the conclusion that RPM probably was not motivated by colluding dealers in most cases.[36] Furthermore, Ippolito found that only about seven percent of the RPM cases in her sample involved allegations of dealer collusion. She therefore concluded that "this evidence suggests that, on the margin, a relaxation of the *per se* rule against RPM would primarily affect non-collusive uses of RPM."[37] Regardless of whether such evidence is viewed as merely inconclusive or as sufficient to establish that RPM does not have harmful economic effects overall, it cannot support application of the per se rule under the US Supreme Court's standards.

69. Another problem with using the per se rule is that it encourages companies to look for other ways to achieve the same or similar results. They may decide to use methods that are more harmful to

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[31] Rainer Olbrich & Carl-Christian Buhr, "Who Benefits from the Prohibition of Resale Price Maintenance in European Competition Law?" 26 European Competition Law Review 705, 712 (2005) (translating quotations from other authors).

[32] Kneepkens, *supra* n.4 at 656.

[33] *See, e.g.*, Areeda & Hovenkamp, *supra* n.7 ¶ 1604b, at 40.

[34] Stanley Ornstein, "Resale Price Maintenance and Cartels," 30 Antitrust Bulletin 401, 423 (1985).

[35] Pauline Ippolito, "Resale Price Maintenance: Empirical Evidence from Litigation," 34 Journal of Law & Economics 263, 281 (1991).

[36] Thomas Overstreet, Resale Price Maintenance: Economic Theories and Empirical Evidence, USFTC Bureau of Economics Staff Report, pp. 80, 133, 145 (1983) (survey of RPM cases litigated by the FTC between 1965 and 1982). For a critical view of the value of the Ippolito and Overstreet studies, see Richard Brunell, "Overruling *Dr. Miles*: The Supreme Trade Commission in Action," 52 Antitrust Bulletin 475, 508-511 (2007).

[37] Ippolito, *supra* n.35 at 282.

competition and/or less efficient than RPM unless those methods are per se illegal, too. For many years in the US, for example, the practice of granting exclusive territories to retailers was evaluated under the rule of reason while RPM was per se illegal. That, as many commentators noticed, was an odd antitrust policy. Exclusive territories eliminate *all* intrabrand competition within a given geographic market, whereas RPM eliminates only price-based intrabrand competition and allows several intrabrand rivals to exist within a given geographic market. The same inconsistency existed with respect to vertical integration and exclusive dealing, both of which could eliminate intrabrand competition entirely but are evaluated with the rule of reason. US antitrust policy finally came around to a consistent position on vertical restraints with 2007's Supreme Court decision *Leegin Creative Leather Products, Inc. v. PSKS, Inc.,* which swept RPM into the rule of reason fold.[38] This is not necessarily to say that the rule of reason approach is best, but only that there is some economic logic to the idea that vertical restraints should be treated in a symmetrical manner.[39]

70. Discussing *Leegin* at this point is anticlimactic. Not only is the outcome already well known, but we have already reviewed the main analytical underpinnings of the decision, for the Court considered most if not all of the same ideas that have been discussed in this paper. Nevertheless, *Leegin* is a landmark decision because it did with RPM what few other courts or parliaments have done. It is also a vital backdrop for any discussion of the merits of the per se approach versus the rule of reason approach to RPM.

71. In *Leegin*, a majority of the Supreme Court ruled that RPM is no longer subject to the per se rule in the US. Instead, RPM will be evaluated under the rule of reason. The facts are typical for an RPM case. Leegin, the defendant, supplied leather goods to retailers under an RPM program. Leegin argued that it imposed RPM to give its retailers the profit margins that were necessary for them to provide certain services to customers, and to protect its brand image and reputation from the harm that would be done to it by discounting. The plaintiff, a retailer, nevertheless sold Leegin's products at a discount. After the plaintiff refused to stop discounting, Leegin stopped supplying the plaintiff, who responded by filing an antitrust lawsuit alleging that Leegin's RPM program was illegal per se. The trial court, following then-valid precedent, refused to hear the testimony of Leegin's expert economist, who would have testified that Leegin's RPM policy had precompetitive effects. Such testimony would have been irrelevant under the per se rule. The jury eventually sided with the plaintiff and awarded damages.

72. On appeal, Leegin argued that the per se rule is inappropriate for RPM cases and that they should be governed by the rule of reason. The Supreme Court reviewed its standards for using the per se rule instead of the rule of reason, mentioned the results of the "few recent [empirical] studies documenting the competitive effects of resale price maintenance," and went over the main theoretical arguments both for and against RPM.[40] All of those factors have already been discussed above. Finding no support for the conclusions that RPM always or almost always tends to restrict competition and decrease output or that RPM is manifestly anticompetitive, the Court decided that the per se rule is indeed inappropriate.

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38 127 S. Ct. 2705 (2007). Maximum RPM had already been moved into the rule of reason category in *State Oil v. Khan*, 522 U.S. 3 (1997).

39 "[I]t is important to bring the law governing non-price and price restraints into congruence. From an economics perspective, vertical price and non-price restraints are substantially identical in effect. . . . [T]here is no justification for treating the two types of restrictions [differently] where sound economic analysis fails to support the distinction[.]" Baumol, et al., *supra* n.20 at at 3.

40 *Leegin*, 127 S. Ct. at 2715.

73. That would seem to be the end of the matter. There simply are not enough theoretical or empirical reasons to justify treating RPM as a per se violation. So it appears to be clear that the better approach is to use the rule of reason.

74. Or does it? Not everyone thinks so, and some of the dissidents' arguments merit attention.

75. Before examining those in detail, though, consider the broad objectives that should be achieved in selecting a rule for evaluating RPM. What general characteristics would an excellent policy toward RPM have? Given a certain level of abstraction, the features of a desirable approach to RPM are no different from the features of a desirable approach to the abuse of a dominant position. The latter have been identified in a previous Note as:

- *Accuracy* – the approach should be based on widely accepted economic principles and yield minimal costs from false positives and false negatives
- *Administrability* – it should be relatively easy to apply
- *Applicability* – the wider the scope of conduct the approach can cover well, the better
- *Consistency* – it should yield predictable results
- *Objectivity* – it should leave no room for subjective input from the decision-maker
- *Transparency* – the approach and its objectives should be understandable[41]

76. Keeping those characteristics in mind, consider one of Maurice Stucke's observations. He points out that the US Supreme Court's recent rejection of the per se rule for RPM looks puzzling from at least one vantage point.[42] While the Court reasoned that the per se rule might be responsible for increasing litigation costs by promoting "frivolous" suits,[43] it had also recently fretted over the high risk of inconsistent results by antitrust courts.[44] Yet that risk is, of course, much higher under the rule of reason than under the per se rule, and a considerable portion of the blame for that fact lies with the Court itself. Indeed, the Court's totality-of-economic-circumstances rule of reason has drawn criticism from many sources, again including the Court itself.[45] While progressively constricting the applicability of the per se rule to vertical restraints over the past century, the Court also enlarged the domain of a rule of reason approach that leaves much to be desired in terms of the six characteristics above.[46] Stucke argues, for

41 OECD, *Competition on the Merits*, DAF/COMP(2005)27 at 23.

42 Maurice Stucke*, Does the Rule of Reason Violate the Rule of Law?*, 42 University of California, Davis Law Review ___ (forthcoming May 2009), available at http://ssrn.com/abstract=1267359.

43 *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705, 2718 (2007).

44 *Credit Suisse Securities (USA) LLC v. Billing*, 127 S. Ct. 2383, 2395 (2007).

45 Stucke, *supra* note 42 (citing *Northern Pacific Railway Co. v. United States*, 356 U.S. 1, 5 (1958)).

46 This trajectory began in 1919 with *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919) (limiting per se treatment for RPM to cases in which there is an actual agreement between a manufacturer and a reseller to fix prices, as opposed to recommended prices, and permitting manufacturers to refuse to deal with resellers who don't follow the recommended prices) and continued through the years with decisions that applied the rule of reason instead of the per se rule, such as *White Motor Co. v. United States*, 372 U.S. 253 (1963) (exclusive territories), *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 57-59 (1977) (other vertical, non-price restraints), *State Oil Co. v. Khan*, 522 U.S. 3 (1997) (maximum RPM), and *Leegin*, 127 S. Ct. at 2712 (minimum RPM).

example, that the rule of reason provides little predictability to market participants. It also subjects litigants and courts to "sprawling, costly, and hugely time-consuming" litigation.[47]

77. In Stucke's view, *Leegin* is a trade-off in which the Supreme Court definitely sacrificed some intra-brand competition in exchange for a possibility of greater inter-brand competition.[48] While acknowledging that RPM often increases retail prices, the Court reasoned that "prices can be increased in the course of promoting pro-competitive effects."[49] But consumers pay more while waiting for these pro-competitive benefits, Stucke argues. Moreover, the more differentiated the brands are, the less significant inter-brand competition is relative to intra-brand competition.

78. Stucke's perspective on this aspect of the case could be criticised as an exaggeration. When reading the arguments in *Leegin* and the literature it cites regarding whether RPM is pro- or anti-competitive, one can lose sight of the fact that the issue in the case was not whether to take the major step of exonerating RPM altogether. Instead, the issue was whether to take the smaller step of moving RPM into the sphere of the rule of reason. Consequently, to say that the Court sacrificed one type of competition for another gives an impression of certainty that might be too strong. Whether such a sacrifice would be in consumers' best interests in a given case is what the rule of reason should (ideally) determine, taking into account factors such as the probability and magnitude of higher prices and the effects of brand differentiation. In any event, Stucke is right that the need to take such considerations into account adds to the unpredictability of the rule of reason, and his view that *Leegin* was a trade-off may well turn out to be accurate in practice.

79. Another critic, Richard Brunell, takes aim at the Court's logic with several arguments designed to establish that "abandoning the *per se* rule is bad policy and that the Court's policy analysis was woefully inadequate[.]"[50] Brunell does not take issue with the consensus view that RPM can be used to affect competition both positively and negatively. What he objects to, in the main, is the idea that RPM should be illegal per se only if it always or almost always tends to restrict competition and decrease output. That, in his view, is an overly simplistic test because it hinges on frequency alone. The correct test, he asserts, would take into account the probabilities and magnitudes of the harms and benefits that RPM could cause, as well as the cost of conducting the test. Stated another way, the best approach is the one that minimises the sum of the expected values of the costs of false positives, false negatives, and decisionmaking. The "almost or almost always anticompetitive" standard does not do that because it ignores the magnitude component of the expected values of false negatives and false positives. Instead, it considers only the probability component. Furthermore, it ignores the high administrative cost of using the rule of reason (and the relatively low administrative cost of using the per se rule).

80. Brunell's criticism does have some force. It is perfectly sensible to multiply the probabilities of harm and benefit to competition by their magnitudes, and to take into account the decisionmaking costs. But in the end, his attack fails under the weight of its implications. The root of the problem is that, as Brunell himself points out, there is insufficient data on the probabilities, harms, benefits, and decisionmaking costs to prove – using his decision theory method – that the rule of reason is superior to the per se rule for evaluating RPM. It is asking quite a lot to expect that there would be such data. Furthermore, there is also insufficient data to prove that the per se rule is superior to the rule of reason. Brunell's response to this data shortage is to default to the per se rule. At least we know that its administrative costs will be lower than the rule of reason's.

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47 *Twombly*, 127 S. Ct. 1955, 1967 n.6. (2007).

48 Stucke, *supra* note 42.

49 *Leegin*, 127 S. Ct. at 2718.

50 Brunell, *supra* n.36 at 476.

81. Brunell is right that we can be certain of that, but knowing how the administrative costs of the two tests compare is not enough to conduct the test he is proposing. Nevertheless, he defaults to a per se ban. But if per se illegality is the correct default rule when there is insufficient data to satisfy his test, then per se rules should be in force for virtually every area of competition law enforcement, as the problem of inadequate data is not unique to RPM. That would mean that, having finally arrived at the generally held view that economics-based approaches to enforcement are best, the competition community would find itself right back in a form-based world if it followed Brunell's reasoning.

82. Of course it is possible that if all the necessary data were available, Brunell's test would yield the result that a per se rule is superior to the rule of reason. But it is unclear why he is sure that the best per se rule would be a prohibition. What if the optimal policy is to make RPM per se *legal*? Brunell does not even address that outcome, but it is possible. At the very least, it would generate even more administrative cost savings than a per se ban, as there would be no need for any investigation or court proceedings whatsoever concerning RPM. Implementation could not be any easier, more predictable or more transparent.

83. Brunell does find a flaw in *Leegin* when he points out that the Court not only gave little guidance on what issues to consider under the rule of reason in RPM cases, but gave no guidance at all on how to evaluate arguments and evidence that a defendant's RPM program is pro-competitive. The decision is likewise silent regarding how important it is, if at all, to consider whether less restrictive alternatives were available. Finally, the decision contains no guidance on whether and how courts should weigh RPM's harms and benefits to competition against each other. That lack of direction only heightens the uncertainty inherent in the rule of reason, and Brunell predicts that as a result, public and private parties will be reluctant to bring RPM cases. In fact, he asserts, the legal status of RPM in the US under the rule of reason will probably become the same as non-price vertical restraints: de facto legal per se.[51] That, in turn, is likely to lead to greater boldness on the part of business – perhaps too much boldness.[52]

84. Some European commentators have voiced similar misgivings about the practical feasibility of a rule of reason approach to RPM, even though they are not necessarily in favour of the per se approach, either. Waelbroeck, for example, observes that "it is fair to say that there is no conclusive view today as to how to deal with resale price maintenance . . . . Taking into consideration that the economic criteria to assess [vertical] restraints 'are still either too crude or too costly to apply to allow for efficient rules and a structured rule of reason,' it is difficult to argue that fixed or minimum prices should not be [illegal per se]."[53] The fact that the US Department of Justice issued and then withdrew guidelines on vertical restraints lends some support to Waelbrock's point.[54]

51 *Id*. at 518 & n.188 (citing Douglas Ginsburg, "Vertical Restraints: De Facto Legality Under the Rule of Reason, 60 Antitrust Law Journal 67 (1991)).

52 That prediction inexplicably ignores a fact that Brunell points out immediately thereafter in his article: RPM is still unlawful under the laws of many U.S. states, and they will not necessarily follow *Leegin*. Brunell, *supra* n.36 at 518-19. But that, in any event, is an idiosyncrasy of the American legal system. Brunell's point could easily be pertinent some other jurisdiction if it adopted an approach like the one in *Leegin*.

53 Waelbroeck, *supra* n.2 at 98 (quoting R. Boscheck, "The EU Policy Reform on Vertical Restraints – An Economic Perspective," 23 World Competition 3, 22 (2000).

54 US Department of Justice, Vertical Restraints Guidelines (1985); (Anne Bingaman, Assistant Attorney General, "Antitrust Enforcement, Some Initial Thoughts and Actions," speech before the Antitrust Section of the American Bar Association (10 August, 1993) (withdrawing the Guidelines)).

85. Obviously, there can be differences between the world of ultimate truth (theoretical economics) and the world of practical realities, and the reality is that the rule of reason in practice has some drawbacks. This is not to say that the per se approach does not have its practical problems, as well – it does. As is so often the case in competition policy, there is no perfect solution to the question of how to treat RPM.

2.3.3 What Should A Rule of Reason Approach to RPM Look Like?

86. But if a jurisdiction does decide to adopt the rule of reason approach to RPM, as the US has just done, what would a sensible rule of reason approach be? Again, under this approach, the objective is to determine whether RPM is likely to have net anti-competitive effects in individual cases. Ideally, it will permit welfare-enhancing and welfare-neutral applications of RPM while disallowing those that reduce welfare. Based on the points made in Part 2, some factors that could be candidates for consideration under this approach are:

How much market power the defendant manufacturer has, if any

87. The less market power a manufacturer has, the less likely it is to harm competition by implementing an RPM program, provided it does so on its own, independent initiative (*i.e.*, it does not impose RPM to join a cartel of manufacturers or to facilitate a cartel of retailers). When a manufacturer has little or no market power, all else being equal, there will be more rivals, or at least stronger rivals, available to preserve interbrand price competition. A manufacturer that does have market power, though, might use RPM as device to raise entry barriers by cutting off distribution outlets for competing products. The manufacturer, in other words, could offer RPM as an enticement to retailers in exchange for their agreement not to sell rival goods.

The collective share of all manufacturers in the market who use RPM

88. This factor is easiest to evaluate when the defendant is a monopolist. In that situation, it clearly points in the direction of not permitting the RPM, as was just explained. The analysis becomes more difficult in oligopolistic markets where there are several defendants who have begun, or may begin, to engage in RPM one after the other as soon as one of them decides to do it, even though there may be no reason to believe they have actually agreed to do that. The other manufacturers might not initially want to use RPM, but could implement it anyway because they fear losing their distributors to the rival manufacturers who do use RPM. Interbrand price competition may suffer as a consequence. Therefore, if the manufacturing market is oligopolistic, it will be necessary to investigate the likelihood of this domino effect. An important factor in that inquiry will be how closely the firms have followed each other's behaviour in the past.

89. Furthermore, the higher this collective share, the more plausible the concern that RPM is being used to facilitate a cartel.[55] Widespread use of RPM in a market is a necessary, but not sufficient, condition for both manufacturer and retailer cartelisation schemes that rely on RPM. A large percentage of the market being covered by RPM agreements is consistent with a scenario in which manufacturers have agreed to fix their prices via RPM. Likewise, it is consistent with strong dealers coercing manufacturers into enforcing their retail-level cartel. One complication is that substantial RPM coverage is also consistent with strong, healthy interbrand competition in a market where unilaterally imposed RPM makes distribution more efficient.

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[55] In determining the portion of the market covered by RPM, vertically integrated firms should be counted as manufacturers who impose RPM. Areeda & Hovenkamp, *supra* n.7 ¶ 1606g6, at 96.

90. Finally, the more of a market that is operating under RPM, the more likely it is that consumers are being deprived of a meaningful choice.

Whether RPM was initiated by a manufacturer or dealer(s).

91. This should be a major consideration. When RPM is initiated by a manufacturer, horizontal collusion is much less likely to be the motive than when RPM is initiated by a dealer or a group of dealers. Furthermore, there is substantial support in the economics literature for the proposition that manufacturer-initiated RPM is welfare-enhancing. There seems to be little or no support of that kind, however, for retailer-initiated RPM.[56]

The standard checklist of general factors that affect the plausibility of a successful cartel

92. The more these factors point toward the likelihood that a cartel could be maintained in the market, the more of a concern RPM is, all else being equal.[57]

The reasons given by the defendant(s) for imposing RPM

93. Are they pro-competitive? Are they plausible? For example, is the defendant a new or small firm that is using RPM simply to help it establish (or re-establish) a foothold in the market?

How well the relevant product matches the profile of a product for which overall consumer welfare is likely to be enhanced by RPM

94. Markets with that profile include, for example, complex goods that need to be demonstrated or that otherwise require substantial sales assistance and customer education; goods likely to benefit substantially from certification by highly reputable retailers; and goods for which customers desire other services that can be free-ridden. The better the market matches this profile, the less likely it is that a cartel is responsible for the imposition of RPM. On the other hand, when RPM is imposed on goods for which extra pre-sale services are not likely to sway many customers, it becomes more likely that a cartel is behind it, especially if much of the market is covered by RPM.

Whether pre-sale services increased after RPM began (or, if no before-and-after comparison is possible, whether pre-sale services have increased during RPM)

95. Neither manufacturer cartels nor retailer cartels aim to increase profits by providing better service to customers. Instead, they increase profits by giving customers no other alternatives and raising prices. Pre-sale services are destabilising for cartels because colluders can offer more of them as a means of steering extra business to themselves while still technically complying with their commitment to charge a certain price. Therefore, one may expect cartel agreements not only to set price levels, but to impose some kind of restriction on services, as well. That suggests it is less likely that a cartel is present when services are significant and increasing in a market.[58]

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56 Comanor & Scherer, *supra* n.22 at 2; *see also* Richard Posner, Antitrust Law 177 (2d ed. 2001) (advocating the use of this factor in a rule of reason test for RPM).

57 *See, e.g.*, OECD, Public Procurement, The Role of Competition Authorities in Promoting Competition, DAF/COMP(2007)34, Background Note at 21-23.

58 Kneepkens, *supra* n.4 at 661.

Whether any other vertical restrictions, such as territorial restraints, are used in tandem with RPM

96. If they are, a manufacturer cartel – if there is one – would be more stable. It was mentioned above that RPM may have to be combined with other vertical restraints to combat cheating in manufacturer cartels. Even in the absence of a cartel, multiple vertical restraints can severely curtail intrabrand competition.[59]

How output changed in response to RPM

97. It has been proposed that welfare-reducing RPM can be distinguished from welfare-enhancing RPM by examining the practice's effect on output.[60] A decline in output after RPM is implemented suggests that a cartel is responsible. Cartels use RPM as a device to stifle competition and keep prices at supra-competitive levels, not to win more business by enhancing retail services. Higher prices with no additional services rarely stimulate demand; they are far more likely to bring about lower demand and lower output. Of course, it is also possible that output will decline simply because RPM was a failure, not because it is part of a cartel scheme. Customers' demand response to the additional services RPM promotes may be too small in comparison to the customers' response to the higher price. If so, that will cause demand and output to fall. When that happens, however, the manufacturer should be quite willing to discontinue its RPM program without any prompting from the legal system because it would be selling less without receiving a higher wholesale price.[61]

98. In contrast, RPM that is used to promote more efficient distribution (usually through greater pre-sale services) should increase output. In principle, therefore, a good rule of reason test is simple to design: If output shrinks when RPM is introduced then manufacturers should either voluntarily stop using it or face possible legal consequences; if output increases then RPM passes the test. Marvel acknowledges that applying the test to real cases would be difficult, mainly because before and after data will probably be unavailable. He therefore views the output test as a desirable component, not the entirety, of a rule of reason test for RPM.

99. Comanor and Scherer, however, have raised theoretical qualms about exonerating defendants based on increased output alone. They point out that, as illustrated in Figure 2 above, even if output expands after RPM is imposed, it is still possible for consumer welfare to decline. In fact, they contend that "[t]he assertion that output-expanding resale price maintenance enhances consumer welfare . . . should be recognised as a special case not applicable under plausible conditions."[62]

100. Taking their point into account, we might derive this guidance from the output test:

i. If output decreased then either RPM was a failure and rational manufacturers should voluntarily abandon it or RPM is the work of a cartel that fully intends to impose higher prices without providing greater services (though defendants should be given an opportunity to explain why they are maintaining a financially irrational program).

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59 *See* Robert Steiner, "The Nature of Vertical Restraints," 30 Antitrust Bulletin 143 (1985) (noting that RPM combined with exclusive dealing is particularly harmful to intrabrand competition).

60 This idea stems from various works by Robert Bork, including "A Reply to Professors Gould and Yamey," 76 Yale Law Journal 731 (1967) and "Resale Price Maintenance and Consumer Welfare," 77 Yale Law Journal 950 (1968), as well as Howard Marvel & Stephen McCafferty, "The Welfare Effects of Resale Price Maintenance," 28 Journal of Law & Economics 363 (1985).

61 Kneepkens, *supra* n.4 at 658 & n.9.

62 Comanor & Scherer, *supra* n.22 at 2.

ii. If output remained steady or increased then cartel explanations can be rejected, but the welfare implications are still indeterminate due to the Comanor/Scherer point.

The burden of proof

101. An important aspect of any rule of reason approach is where it places the burden of proof. Would RPM be given a presumption of lawfulness, forcing the plaintiff to establish its harmful effect on competition in every case? Or would RPM be presumed illegal unless the firms wishing to use it could demonstrate its net benefit to consumers? How that question is answered is probably the most important feature of the rule of reason in RPM cases because whoever bears the burden of proof is much less likely to prevail. In fact, Blair considers the assignment of the burden of proof to be a "dispositive" issue in RPM cases that are evaluated according to the rule of reason.[63]

102. Evidence will be hard to find in most industries because there will usually be no "before and after" data with which to determine RPM's actual effect on output and on customers. Furthermore, even in a market where there is before and after data on RPM, how can anyone prove that – all else being equal – RPM does or does not generate greater sales by promoting services like certification? All else will rarely, if ever, be equal. What if output declined but it would have declined even more if not for RPM? The challenge of sorting out RPM's effects from those of other forces is likely to be a formidable one.

103. Consequently, putting the burden on defendants to show that their RPM enhances efficiency may not turn out to be much different from per se illegality. Without any experience with which to compare their particular market with and without RPM, defendants' efficiency claims will be all too easy to reject as mere pretext. By the same token, putting the burden on governments and private plaintiffs to prove an anticompetitive effect may wind up closely resembling per se legality.

2.3.4 Short Cuts to the Full Rule of Reason Approach

104. Rather than performing a full evaluation of the facts and circumstances in each RPM case, the agency or court might adopt a modified approach that quickly eliminates cases in which it is especially unlikely that RPM is harming competition. This "safe harbour" approach has been used with a number of other types of conduct, such as mergers and non-price vertical restraints. A safe harbour, for example, might automatically allow the conduct in question if the defendant's market share does not exceed a certain level. Thresholds based on overall market concentration might also be used. At one time, market share-based approaches were used by both the EC and the US agencies for evaluating certain vertical restraints. The American agencies abandoned that method, though, and the EC's safe harbour expressly omits RPM.[64]

105. One objection to the use of market share-based safe harbours for RPM is that they are poorly suited to RPM instigated by retailers. More precisely, the objection is that retailer-initiated RPM is rarely

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[63] Blair, *supra* n.6 at 149.

[64] Commission Regulation (EC) 2790/99 (22 December 1999) para. 10; US Department of Justice, Vertical Restraints Guidelines (1985); *see also* (Anne Bingaman, Assistant Attorney General, "Antitrust Enforcement, Some Initial Thoughts and Actions," speech before the Antitrust Section of the American Bar Association (10 August, 1993) (withdrawing the Guidelines and noting that they "unduly elevate theory at the expense of factual analysis")). The EC's block exemption applies to firms with a market share below 30 percent, though the Commission may still impose regulatory restraints when parallel networks of similar vertical restraints collectively cover more than 50% of the relevant market. When those safe harbors do not apply, the EC uses a rule-of-reason approach. Under the former US guidelines, the vertical restraint would not be challenged if, among other things, the percentage of the overall market being supplied by firms that had adopted the practice was below 60 and the market share of the firm being challenged was below ten percent.

if ever justified; therefore, it should never be given a safe harbour. Market-share based thresholds, however, would do exactly that in cases where the thresholds are not exceeded, without any consideration of who was actually responsible for starting the RPM program.

106. Another approach offers the possibility of abbreviating the analysis in quite a different way. Instead of quickly identifying cases in which RPM will be allowed, this screen would speed matters up by imposing rebuttable presumptions of illegality in certain cases. It was suggested by Professors Comanor and Scherer in their amicus brief in the *Leegin* case. Although the Supreme Court chose not to adopt it, it is worth discussing. Their idea is this: When RPM is induced by manufacturers, use a rule of reason analysis. When RPM is induced by retailers, consider it to be unlawful unless the defendant(s) can prove that the RPM is not anticompetitive. This short cut, as far as it goes, has the advantages of being objective, predictable, easy to understand and easy to implement. (The analysis may not be very easy in the manufacturer-induced RPM cases, but Comanor and Scherer have a short cut for those, as well. It will be discussed shortly.)

107. In addition to their approach's objectivity, predictability, transparency and administrability, Scherer and Comanor add that it would also be accurate, correctly identifying the cases that deserve per se treatment. They emphasise that economic theory offers no support for the idea that reseller-initiated RPM enhances competition or consumer welfare. "In such circumstances," they add, "RPM and similar restraints lead to higher consumer prices with no demonstrated redeeming values, unless one subscribes to the notion that protecting small retailers is desirable in its own right."[65] To illustrate the significance of what is at stake, the authors note that when a legal loophole allowing retail pharmacies in the US to push for and benefit from RPM was closed, their profit margins slowly fell from an average of 40 percent to about 20 percent, translating into a savings for consumers and insurers of US$40 billion.[66] Note that the authors are referring to profit margins, not price levels. That blunts the pro-RPM argument that higher prices due to RPM were probably not detrimental to consumers, who allegedly would have benefited from the greater pre-sale services that RPM stimulated. At least, the figures do not suggest that the pharmacies were competing away their financial gains from RPM by spending them on greater investments in non-price competition.

108. What about Comanor and Scherer's plan for the cases in which manufacturers are the source of RPM? Their suggested short cut for those cases is based on the premise that RPM is most likely to harm consumers when it is used widely in the relevant market. "In such circumstances, consumer choice is restricted to goods bearing high distribution margins in the absence of possible lengthy and energy-guzzling shopping trips. And if under the umbrella of high margins, most retailers engage in substantial pre-sale promotion, their efforts will largely cancel each other out in the aggregate, leading to a high-price, high-margin, high promotional cost equilibrium with relatively little if any expansion of demand."[67] With that in mind, the authors suggest a structural approach in which the per se rule is invoked if the volume of resale-price-maintained sales in the relevant market exceeds a given threshold (they suggest 50 percent, or alternatively a Herfindahl-Hirschman Index above 1800) and the defendant's RPM sales add at least another given amount of volume (they suggest ten percent, or an HHI increase of at least 100). When both thresholds are exceeded there would be a presumption of illegality, which the defendant(s) could rebut by showing that RPM was needed to ensure that efficient services were provided by retailers, that the market definition was too narrow, that consumers actually had plenty of other (non-RPM) choices left, etc.

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65 Comanor & Scherer, *supra* n.22 at 8.

66 *Id*.

67 *Id*. at 9.

109. Although Comanor and Scherer do not specifically say so, one may presume that in manufacturer-induced RPM cases where at least one of the thresholds above is not met, their recommendation would be to apply a presumption of legality that could be rebutted by the plaintiff. Regardless of whether the structural thresholds are crossed, though, one party or the other will benefit from a presumption under the Comanor/Scherer approach, which is equivalent to assigning the burden of proof to the other party. Because carrying that burden is likely to be so difficult, this approach is indeed likely to result in significant judicial economy. Plaintiffs would be much less likely to bring cases with structural features that would not result in a presumption of illegality, and defendants would be much less likely to litigate cases in which that presumption applied. Whether that is a desirable outcome, given that in most cases it would probably come at the expense of ignoring the non-structural factors discussed in Part 2.3.3., is open to debate. Then again, the whole point of the approach is to be able to ignore those factors. They are the source of most of the uncertainty and subjectivity that would affect the rule of reason approach, making it slower and more expensive. The Comanor/Scherer approach is a calculated risk. It does not aim for a perfectly accurate outcome in every case, but for a compromise between efficiency and accuracy across all cases.

3. RPM in Practice: Approaches and Recent Events in a Selection of OECD Jurisdictions

3.1 European Union

110. In the EU, most restraints in agreements concerning supply and distribution are permitted unless there is market power. The 1999 block exemption regulation for vertical cooperation agreements recognises that parties may make such agreements to manage the distribution chain so as to improve efficiency. It also recognises that smaller-scale agreements are unlikely to affect competition either upstream or downstream. Therefore, the regulation applies a market share screen that exempts most agreements from Article 81 as long as they involve a supplier with a market share under 30 percent.[68]

111. When a vertical agreement involves a supplier with a share over 30 percent, there is still no presumption that the agreement is a violation of Article 81. But with increasing market power come increasing concerns that vertical agreements might impair competition by foreclosing other suppliers, raising barriers to entry or reducing interbrand competition and facilitating collusion. Therefore, a rule of reason standard applies.

112. Setting minimum resale prices, however, is a practice that remains prohibited regardless of market share. In effect, RPM is treated as a *per se* infringement, at least with respect to minimum prices.[69] Article 4(a) of the block exemption regulation excludes agreements that cause a "restriction of the buyer's ability to determine its sale price" from the regulation's purview. That leaves such agreements vulnerable to Article 81 (1) of the EC Treaty, which prohibits agreements that "directly or indirectly fix purchase or selling prices". Recommending a resale price or requiring resellers to respect a maximum resale price is sometimes permitted, though. Specifically, maximum RPM is allowed up to the 30 percent market share threshold, provided that the result is not a fixed or minimum sale price due to pressure or incentives from the supplier.[70] Beyond that market share level, the rule of reason applies, with most attention focused on

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68 Commission Regulation (EC) 2790/99 (22 December 1999).

69 Technically, even minimum RPM could be permitted if no appreciable effect on the market can be expected. In practice, however, European courts have never held that an RPM agreement fits that description. Kneepkens, *supra* n.4 at 656 n.3.

70 *See Volkswagen AG v Commission*, Court of First Instance Case T-208/01 (3 December 2003) (manufacturer who issued circulars and warnings to dealers urging them not to deviate from non-binding recommended resale prices was not liable for fixing prices); *but see* Commission decision *Nathan-*

how much (if any) market power the supplier has and on the market position of its competitors. Interestingly, some territorial restraints on resale are permitted, such as those that protect exclusive dealership systems, preserve functional distinctions between wholesalers and retailers or prevent resale of components leading to competition with the supplier.[71]

3.2 United States

113. The per se treatment of RPM died a slow death in the US. First declared to be unlawful in 1911, RPM's legal status followed a labyrinthine legal history at the federal level throughout the rest of the 20th century. The Supreme Court started chipping away at the contours of the per se rule against RPM as early as 1919. By the 1980s the complete removal of RPM from the per se rule's domain was inevitable. The Court finally made the change in 2007's *Leegin*.

114. The 1911 decision, *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, rested in part on the belief that RPM's effects were no different from those of horizontal price fixing among retailers.[72] Although from today's perspective it is easy to criticise the Court for drawing that parallel, it is not too difficult to excuse it, either. After all, nearly 50 years still had to pass before Lester Telser would explain why manufacturers impose RPM even though they do not benefit when retailers form cartels.[73]

115. The 1919 decision *United States v. Colgate & Co.* and a line of cases that interpreted it guaranteed manufacturers the right to announce suggested retail prices and to refuse to deal with resellers that do not follow those suggestions, provided the manufacturer acts unilaterally and any decision by a dealer to comply is an independent one.[74] In other words, RPM is not a violation unless there is an agreement, express or tacit, between the manufacturer and the cooperating dealers. *Colgate* was the beginning of the end for the per se rule's applicability to RPM in the US. In theory, at least, any manufacturer that wanted to skirt the per se ban could still impose RPM, in effect, as long as it avoided actual RPM agreements and was willing to terminate uncooperative resellers.[75] *Colgate* also set up an inconsistency in US antitrust policy toward RPM, for it meant that what a manufacturer was absolutely not permitted to achieve directly through RPM it might achieve indirectly through refusals to deal. Most if not all other jurisdictions, incidentally, have no exception like the *Colgate* doctrine. In the EU, for example, such indirect methods for achieving RPM-like results are specifically not tolerated.[76]

Bricolux, OJ[2001] L 54/1, paras. 86-90 (finding that setting maximum prices in conjunction with prohibiting discounts and rebates was equivalent to fixing resale prices).

71 OECD, European Commission – Peer Review of Competition Law and Policy (2005), p. 24.

72 *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911).

73 Lester Telser, "Why Should Manufacturers Want Fair Trade?" 3 Journal of Law & Economics 86 (1960).

74 250 U.S. 300 (1919).

75 In practice, the *Colgate* doctrine has not been altogether useful to businesses. *See* Frank Mathewson & Ralph Winter, "The Law and Economics of Resale Price Maintenance," 13 Review of Industrial Organization 57, 62 & n.11 (1998) (noting that during some of the doctrine's history it was considered that "the normal business relationship between a manufacturer and a retailer includes communication that precludes the doctrine").

76 *See* EC, Guidelines on Vertical Restraints ¶ 47, 2000 O.J. (C 291) 1, 11 (specifically banning RPM via indirect methods such as "threats, intimidation, warnings, penalties, delay or suspension of deliveries or contract terminations"); *see also* Waelbroeck, *supra* n.2 at 96 n.42 ("it is clear that there is no equivalent of the *Colgate* doctrine in EC Competition law").

116. Beginning in 1937, Congress passed certain laws that amended the Sherman Act to make RPM legal in many circumstances.[77] Those amendments were repealed in 1975. In the late 1970s and the 1980s, the Court narrowed the range of conduct covered by *Dr. Miles* and overturned the per se rule against vertical non-price restraints, replacing it with a rule of reason approach.[78] This created an awkward situation in which the Court was willing to take into account the possibility that vertical, non-price restraints on intrabrand competition can have positive welfare effects that outweigh the harm such restraints might do to interbrand competition. But vertical price restraints, which economists had been arguing could balance out the same way, were still illegal per se.

117. There was a partial resolution in 1997, when maximum RPM lost its status as a per se violation of the Sherman Act. Having been ruled illegal per se in a widely criticized 1968 decision,[79] maximum RPM was moved within the rule of reason's domain in *State Oil v. Khan* for the reasons discussed in Part 2.3.2.[80] Based on the outcomes so far, it appears that maximum RPM may as well have been made per se legal.[81]

118. In 2007's *Leegin*, the Court adopted the rule of reason for all vertical restraints. But in doing so, it might have replaced one convoluted approach with another one. The desirable features of a good rule of reason test have already been discussed. If *Leegin* had described such a test thoroughly and clearly, then the shift away from *per se* liability might have been less controversial. But it did not. The Court left it to lower courts to do the hard work of figuring out how to distinguish "good" RPM from "bad" RPM, cautioning them to "ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses."[82] One commentator has already declared that what the lower courts have been asked to do is something that cannot be done. "The implication of the economic analysis is plain: there is no way to conduct a rule of reason test that will resolve the issue of whether the promotional use of RPM is unreasonable."[83]

119. *Leegin* offers only three suggestions to lower courts regarding what factors to consider in future RPM cases. First, the number of manufacturers using RPM is relevant because the more of a market that is operating under RPM the easier it is to maintain a cartel and the more likely it is that consumers are being deprived of a meaningful choice. Second, whether RPM was initiated by manufacturers or resellers matters because when it is the latter, cartel facilitation is more likely to be the real motive behind the RPM.[84] Finally, the Court stated that lower courts should consider whether the manufacturer or retailer(s)

77 These laws were the Miller-Tydings Resale Price Maintenance Act (1937) and the McGuire Act (1952).

78 *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977); *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988).

79 *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

80 *State Oil v. Khan*, 522 U.S. 3 (1997).

81 *See, e.g., Mathias v. Daily News*, 152 F.Supp. 2d 465 (S.D.N.Y. 2001) (summary judgment against maximum RPM claim) (cited in Marvel, *supra* n.16 at 4).

82 *Leegin*, 127 S. Ct. at 2720.

83 Blair, *supra* n.6 at 150-51. Blair contends that the Court was well aware of the impossibility of its assignment. He therefore infers that the Court intended to confer de facto per se legality on RPM. *Id*.

84 The Court also reasoned that retailer-initiated RPM might serve to shield a dominant, inefficient retailer from more efficient or innovative competitors. While that is true with respect to price competition, the Court's reasoning breaks down when non-price competition is considered. A more efficient retailer would have higher profit margins and could use them to fund a greater level of service than the inefficient dominant retailer offers. It might also take market share by offering "free" goods together with the item

involved in the RPM agreement have market power. If the manufacturer has market power, then it might be using RPM essentially to bribe resellers not to carry competitors' products. The more market power a retailer has, the harder it is for a manufacturer to avoid its request for RPM by switching to other distributors.

120. Either more information than that should be considered in a rule of reason inquiry into RPM or some kind of short cut along the lines of the EU's or the ones suggested by Scherer and Comanor should be built into it. *Leegin* offers no clues about how much RPM coverage in a market is too much, how much market power is too much, or whether and how to use the output test. Let us see how one lower court fared recently when relying on *Leegin* for guidance.

121. In June 2008, a federal appeals court issued a decision that relied on *Leegin*. Plaintiff Toledo Mack Sales & Service, Inc. ("Toledo") was an authorised dealer of heavy-duty trucks supplied by defendant Mack Trucks, Inc. ("Mack"). Mack required its dealers to sign agreements giving each of them an area of responsibility ("AOR") – a geographic territory that the agreements did not describe as exclusive. In fact, Mack's stated policy is that its dealers are free to make sales wherever they wish. Acting on that policy, Toledo aggressively sought to sell Mack trucks throughout the US by undercutting other dealers' prices. Mack, however, warned Toledo to stop competing on price with other Mack dealers. Eventually, Mack terminated Toledo as an authorised dealer.[85]

122. Toledo then brought a lawsuit against Mack, alleging that Mack had violated Section 1 of the Sherman Act, among other things. At trial, Toledo introduced evidence that there was an unwritten, horizontal agreement among Mack dealers according to which dealers would not engage in price competition with each other. Toledo also submitted evidence that Mack had a vertical agreement with its dealers under which they were deterred from selling outside their own AORs (despite official policy). As part of that agreement, Mack announced that it would delay or deny wholesale price discounts to dealers who sold outside their AORs. Finally, Toledo introduced evidence indicating that Mack's vertical agreements with its dealers came about largely as a result of pressure from the dealers.

123. The district court granted judgment as a matter of law against Toledo's claim that Mack had violated Section 1 of the Sherman Act. "Judgment as a matter of law" means essentially that even if all the evidence presented at trial by a party is assumed to be true and every reasonable inference from it is drawn in that party's favour, the court still cannot grant judgment for that party because the evidence is legally insufficient. On appeal, therefore, the ultimate merit of Toledo's claim was not at stake; instead, the issue was only whether the claim was supported by evidence sufficient to allow it to go to a jury. The appellate court determined that it was and therefore reversed the district court's decision.

124. It requires a very broad definition of RPM to view Mack's agreement with its dealers as belonging in that category of conduct. The agreement said nothing at all about resale prices. Instead, it seems to be more aptly characterised as a territorial restriction. Nevertheless, the appellate court relied on *Leegin* for the principle that when "a vertical agreement setting minimum resale prices" is entered for the purpose of facilitating a horizontal cartel, the vertical agreement is evaluated under the rule of reason.[86] If that is an error by the appellate court, though, it could be considered an error without significance. Even if the vertical agreement had been characterised as a territorial restraint, after all, the rule of reason still would have been applicable.

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covered by RPM, thereby technically complying with the RPM policy but offering the customer a better deal nonetheless.

85 *Toledo Mack Sales & Service, Inc. v. Mack Trucks, Inc.*, 530 F.3d 204 (3d Cir. 2008).

86 *Id*. at 225 (quoting *Leegin*, 127 S. Ct. at 2717).

125. But in light of the factors that the appellate court considered in its rule of reason analysis and the fact that the court looked to *Leegin* for guidance, it is clear that the court have benefited from more thorough instructions in *Leegin* – if only they had been there. First, the appellate court listed four factors that, according to its own precedents, are relevant when evaluating restraints of trade under the rule of reason:

> (1) that the defendants contracted, combined or conspired among each other; (2) that the combination or conspiracy produced adverse, anti-competitive effects within the relevant product and geographic markets; (3) that the objects of and the conduct pursuant to that contract or conspiracy were illegal; and (4) that the plaintiffs were injured as a proximate result of that conspiracy.[87]

126. Those factors simply do not encompass enough information to enable a court to make an intelligent decision about whether a vertical restraint should be unlawful or not. In fact, they do not encompass *any* of the information necessary for such a decision. The first and fourth factors do not belong in the rule of reason analysis. The first one is, instead, a prerequisite for doing a rule of reason analysis in the first place. The fourth one concerns the narrow question of whether the particular party that brought the case is entitled to relief in the event that the defendant's conduct is deemed anti-competitive, not the larger question of whether the conduct harmed competition and consumers. The second and third factors, rather than shedding light on two crucial decisions that must be made, simply assume that those decisions have been made already. The whole point of going through the rule of reason process is to determine whether the restraint is anti-competitive and, ultimately, illegal. To say that those considerations are themselves part of the rule of reason analysis is to create a useless feedback loop.

127. Perhaps sensing that those four factors were not especially helpful, the court also mentioned two of the three factors identified by the Supreme Court in *Leegin*, the source of the restraint and whether the manufacturer or retailer has any market power. The court then discussed whether Toledo's evidence on each factor was sufficient to go to the jury.

128. The evidence was deemed easily strong enough regarding whether Mack and its dealers contracted, combined or conspired among each other and whether the source of the restraint was pressure by retailers. But the court then referred to precedent holding that the "adverse, anti-competitive effects" factor could be satisfied simply by showing that the defendant has market power. Toledo's expert had testified that Mack had power in two markets; therefore, for purposes of reviewing a judgement as a matter of law ruling, the appeals court was satisfied with Toledo's evidence on anticompetitive effects. The equation of market power with anticompetitive effect is especially troubling in an RPM context, given that the court stated that market power "is the ability to raise prices above those that would prevail in a competitive market."[88] While helpful as an indicator of market power in other situations, the use of this condition as a proxy for anti-competitive effects in RPM cases has the potential to be unjust for defendants and consumers alike. RPM does, after all, often raise prices even when it increases consumer welfare. Granted, it is true that in markets where RPM increases consumer welfare, the concept of a "competitive market" should take into account that the RPM price itself should probably be deemed competitive, and that should exonerate the defendant. But it is difficult to have confidence that courts will correctly identify such situations when the reason they are looking into that issue in the first place is to try to decide whether RPM is pro- or anti-competitive. This is another useless feedback loop.

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87 *Id*. (quoting *Rossi v. Standard Roofing, Inc.*, 156 F.3d 452, 465 (3d Cir. 1998)).

88 *Id*. at 226 (quoting *United States v. Brown University.*, 5 F.3d 658, 668 (3d Cir. 1993)).

129. *Leegin* could have done away with such problems for once and for all, but it did not. Given that even the courts of appeal are still having difficulty articulating a reasonable rule of reason, it is hard not to agree with Stucke's conclusion that the rule of reason provides little predictability to market participants.

3.3 United Kingdom

130. When the Competition Committee last held a roundtable on RPM in February 1997, two types of products were still exempt from the general ban on RPM in the UK: books and branded, over-the-counter (OTC) medicaments. Since then, both exemptions have been revoked. The book exemption was struck down in March 1997.[89] Four years later the Restrictive Practices Court eliminated the exemption for medicaments – a decision that had almost immediate effects on pricing. Within hours of the Court's decision, some supermarkets announced price cuts of 25 to 50 percent on leading brands of products such as painkillers, cough remedies and vitamins. Each percentage point off average prices was estimated to have saved consumers £16 million per year.[90]

131. Of more recent interest are two cases decided simultaneously by the Court of Appeal in 2006. The cases, joined because their facts and issues were so similar, involved agreements to fix the prices of replica football gear manufactured by Umbro Holdings Ltd and of toys and games manufactured by Hasbro UK Ltd. In each case, the Court affirmed decisions of the Competition Appeal Tribunal finding that the agreements had been made by a manufacturer and at least two retailers, that the agreements were both vertical and horizontal, and that they were unlawful.[91]

132. The football gear case primarily involved three retailers: JJB Sports, the largest sports retailer in the UK; Allsports, which was roughly half JJB's size; and Sports Soccer, a smaller discounter. Umbro, the manufacturer, had exclusive licences to produce the goods at issue: official England and Manchester United replica football gear. The driving forces behind the agreements in this case do not fit neatly into a pattern of either purely manufacturer-driven RPM or purely retailer-driven RPM. Instead, Umbro and the two larger, non-discounting retailers all wanted an agreement on minimum prices. Pressure flowed both from JJB and Allsports to Umbro and from Umbro to Sports Soccer.

133. The Competition Appeal Tribunal had found that JJB possessed both "considerable market power" due to its market share and "considerable bargaining power" due to the size of its orders from Umbro.[92] While it was true that Umbro had an exclusive licence to make the gear, which was considered essential for any sportswear dealer, it was also true that Umbro was dependent on JJB. In 2000, for example, the value of JJB's orders of Umbro-branded products was double the value of its orders of Umbro's replica gear. JJB "could have caused Umbro real difficulties by switching some or all of its branded product purchases to a rival such as Nike. Umbro therefore felt under pressure . . . to do whatever it could to assuage any commercial concerns expressed to it by JJB."[93] One of JJB's commercial concerns was putting a stop to Soccer Sports' discounting on replica gear. JJB therefore exerted pressure on Umbro to do something about it.

89 Michael Utton, "Books Are Not Different After All: Observations on the Formal Ending of the Net Book Agreement in the UK," 7 International Journal of the Economics of Business, 115 (2000).

90 OECD, Competition Law and Policy in 2001-2002 (Annual Report of the United Kingdom), available at www.oecd.org/dataoecd/33/29/2489084.pdf.

91 *Argos Ltd and another v Office of Fair Trading; JJB Sports plc v Office of Fair Trading*, Court of Appeal (Civil Division), [2006] EWCA Civ 1218.

92 *Id.*, para. 49.

93 *Id*.

134. There are a few other crucial facts. First, Allsports also exerted pressure on Umbro to put a stop to retail discounting. Second, several retailers including JJB and Allsports communicated with each other through Umbro, signalling that they would not price below a certain level so long as none of the others (including Soccer Sports) did, either. Third, in response to the pressure from JJB and Allsports, Umbro procured discounter Sports Soccer's grudging consent not to price below that same level by threatening it with supply cutbacks. But before agreeing, Sports Soccer demanded – and was given – assurances that the other retailers would not go below that price, either.[94]

135. Interestingly, Umbro was found to have been hostile to discounting even without pressure from JJB and Allsports. The company was interested in maintaining a high price in order to preserve its exclusive, authentic image with customers. Nevertheless, Umbro had not taken action unilaterally to curtail discounting; it was the pressure from JJB and Allsports that actually caused Umbro to threaten Sports Soccer.[95]

136. That such a fact pattern led to a finding in the OFT's favour is not unexpected, given that both vertical and horizontal price-fixing agreements are illegal per se in the UK. But the fact that a vertical price fixing agreement came about at least substantially as a consequence of applied pressure from retailers who had effectively agreed among themselves to fix prices is noteworthy. At the least, it casts some suspicion on the idea that RPM never facilitates retailer cartels.

137. It would be easier to dismiss the football gear case as an aberration were it not for the fact that it was accompanied by another case that involved very similar conduct. The toys and games case primarily involved two retailers, Argos and Littlewoods, which are the two major catalogue retailers in the UK. Hasbro is one of the country's largest manufacturers of toys and games. As in the football gear case, the price-fixing agreements at issue were found to be both vertical and horizontal.

138. Some retailers (it is not clear which ones) put pressure on Hasbro because they were not content with the margins they were earning on certain Hasbro products. Hasbro was fearful that its products would be de-listed (*i.e.*, that retailers would stop carrying its products) if it could not help the retailers increase their margins on its products. Again, it is not clear precisely where the pressure was coming from, but it is known that Argos and Littlewoods are both much larger companies than Hasbro in the UK, and that each of them carried more Hasbro products than just the particular ones at issue in this case.[96]

139. Hasbro responded to the retailers' concerns by designing a "pricing initiative" that aimed to persuade retailers to follow Hasbro's recommended retail prices. It knew that the initiative was unlikely to be successful unless Argos and Littlewoods both participated in it. It also knew that each of those two retailers was especially worried about undercutting by the other. Hasbro therefore assumed the role of a central coordinator, much like Umbro did with respect to its dealers, procuring agreements from Argos, Littlewoods, and other retailers that they would follow the recommended prices as long as the other retailers did. Hasbro also communicated reassurances to the participants as it obtained agreements from more retailers.[97]

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94 *Id.*, paras. 55-57, 92.

95 *Id.*, paras. 41, 58.

96 *Argos Limited & another v Office of Fair Trading*, Competition Appeal Tribunal [2005] CAT 13, para. 130.

97 Office of Fair Trading Case CP/0480-01, "Agreements Between Hasbro U.K. Ltd, Argos Ltd and Littlewoods Ltd Fixing the Price of Hasbro Toys and Games" (21 November 2003), paras. 42-55.

140. The Court of Appeal upheld the OFT's finding that there were unlawful bilateral, vertical agreements to fix prices between Argos and Hasbro, and between Littlewoods and Hasbro. It also upheld the finding that even though there was no evidence of direct communications between the two retailers, their respective agreements with Hasbro "were contingent on each other and . . . formed part of a pattern of continuous conduct with a common objective. The parallel bilateral agreements or concerted practices, thus linked, were to be read together as one agreement or concerted practice between the three companies."[98] In other words, Argos and Littlewoods could not escape liability for horizontal price fixing just because they used a middleman to collude with each other. They and their competitors had effectively formed a cartel that was facilitated by Hasbro's RPM program.

141. Those who downplay or deny outright the significance of retailer cartel-inspired RPM may view these two cases as merely nettlesome anomalies. For others who believe that such arrangements are not so rare, the cases offer an affirmation that doubts grounded purely in theory do not necessarily stop anticompetitive conduct from happening.

3.4 Germany

142. In Germany, as in a number of countries, the bookselling industry is exempted from the general ban on RPM that would otherwise apply.[99] In fact, RPM is actually required by law in the bookselling industry.[100] The official reason for this has little to do with traditional economics or competition policy. The act's self-described purpose is to protect books as a cultural asset by ensuring that a broad selection of books are available to customers through a large number of points of sale. Thus, policy aims related to cultural preservation have trumped policy aims related to competition.

143. Book publishers set the retail prices of their books, and the German Book Traders' Association oversees the enforcement of the RPM system. In setting the prices, publishers must take into account the contributions made by smaller booksellers toward the objective of supplying books on a broad basis, as well as the professional service they offer. Publishers are not permitted to supply non-traditional booksellers (*e.g.*, large supermarkets, variety stores) on better terms or at lower prices than they sell to traditional booksellers.

144. One of the concerns motivating this policy is that, without it, some retailers might engage in "cream skimming." Cream skimming in the context of the retail book market involves stocking only popular book titles and selling them at a discount rather than absorbing the expense of stocking a deep inventory of titles. This practice, it is feared, would take business away from traditional booksellers who rely on the profits from selling popular titles at full price to subsidise the cost of stocking less popular books, as well.[101] The non-discounting booksellers would supposedly be forced either to go out of business or to pursue the same strategy as the cream skimmers. Both outcomes leave the public with poorer access to all but the most popular books, dampening the level and diffusion of culture in society.

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98 *Argos Ltd and another v Office of Fair Trading; JJB Sports plc v Office of Fair Trading*, Court of Appeal (Civil Division), [2006] EWCA Civ 1218, para. 116.

99 France and South Korea, for example, have such exemptions in place.

100 Buchpreisbindungsgesetz (Book Resale Price Maintenance Act), amended 14 July 2006.

101 *See* Jürgen Backhaus & Reginald Hansen, "Resale Price Maintenance for Books in Germany and the European Union: A Legal and Economic Analysis," 8 Current Issues in Competition Theory and Policy 299 (2002) (arguing that were it not for such cross-subsidisation, the "end result would be a smaller number of highly successful products with the downside that the large diversity of products would suffer.").

145. In 1997, when the Committee last considered this topic, the Secretariat noted that the cream-skimming argument "seems to be belied by the experience in some countries where discounting of books is permitted."[102] The growth of national chains of medium-sized book shops advertising discounted best-sellers had been followed by the development of national chains of large-scale stores with extensive selections and services. Furthermore, although the internet was in a very early stage of development at that time, the background note observed that on-line booksellers raised the possibility "that all titles, even the most obscure, can be readily available to consumers without being carried in the local book shop. From this viewpoint, RPM, while it might be an aid to the preservation of particular merchants, could impede the development of new and more efficient distribution systems. Here, dealer-induced RPM could be seen as an attempt to prevent the emergence of new forms of competition."[103]

146. Today, some internet-based booksellers that sell to customers in Germany do carry a deep inventory of titles that any traditional book shop would be hard-pressed to match, and their development does not seem to have been impeded by RPM. That may be because direct, cross-border sales of German-language books to customers in Germany are specifically exempted from the law requiring RPM, thanks to a settlement agreement with the European Commission.[104] In any event, the success of large internet booksellers undermines the cream-skimming argument. Not only are they able to sell at lower prices but in some ways they offer significantly better service than traditional bookshops. The internet sellers have a very large selection of titles as well as a wealth of information about each book, including professional and amateur reviews and suggestions for further reading. In addition, some of them have begun to include listings for used books on the same page that describes the new copies that are for sale, enabling customers to save even more if they choose to do so. Finally, these virtual bookstores are accessible to anyone, anywhere – in big cities and villages alike – provided one has access to a computer and an internet connection.

147. Could the main result of the continuation of Germany's RPM system for books therefore be the preservation of a retailer cartel, rather than the preservation of German culture? Some academics insist this is not so. Backhaus and Hansen note that a cartel would raise prices above the competitive level and reduce output. They then state:

> As has become apparent by now, the [RPM] agreements result in fixed prices but not in an output reduction. In addition, the agreements do not result in a uniform price; the individual publishers remain free to set their prices at whichever level they desire, and they compete among each other with both prices and the quality of their product or better, product lines. Hence, speaking of a cartel overextends the appropriate meaning of the economic term and does not add to clarity. In conclusion, we note that the . . . agreements do not eliminate price competition, but that they do have a cultural effect in that through cross subsidisation cultural diversity is being supported. This diversity implies that some books, the trend-driven publications may be priced higher, but that a large number of books will also be priced lower than otherwise they would be. The overall price effect is not an increase, and ending the agreements would therefore not result automatically in a decrease of the overall book price levels.[105]

102 OECD, Resale Price Maintenance, OCDE/GD(97)229, p. 9.

103 *Id*.

104 Buchpreisbindungsgesetz, section 4; *Sammelbrevers und Einzelrevers*, [2002] 4 CMLR 1278.

105 Backhaus & Hansen, *supra* n.101.

148. This argument can be criticised on several grounds. First, it is not clear how the authors can be so confident that RPM has not resulted in output reduction. Because RPM has been in effect for a very long time in Germany's book industry, obtaining data for a before-and-after comparison would be rather difficult. Second, the point about publishers remaining free to set prices at whatever level they desire and to compete with each other is not very pertinent if the problem is a cartel at the retail level. Price competition *is* eliminated at that level (*i.e.*, the price that one retailer charges for a given book versus the price that some other retailer charges for the same book). Third, it is also unclear how the authors can be certain that the overall price effect of the RPM system is not an increase, but just a redistribution of revenues from some titles to others.

3.5 Norway

149. Some empirical insights about the effect of RPM in the book industry are available in a study just released by Norway, which curtailed its exemption for RPM in the bookselling industry a few years ago. In July 2008, the Norwegian Competition Authority issued a report on the effects of a 2005 agreement that substantially limited the RPM system that had governed sales of books in Norway since 1998. Whereas the old agreement had prevented anyone other than book clubs from discounting the retail price of new books, the new agreement extends that right to every retailer that sells books. Furthermore, the waiting period for new releases, during which no retailer may price below the RPM price, has been shortened from 24 to 16 months.[106]

150. The reform of Norway's RPM system for books could have gone much farther than it did. For example, there is still a waiting period during which full RPM remains in effect for new titles. In addition, even when that period ends, retailers are permitted to discount only up to 12,5 percent off the publisher's fixed price. That might lead one to wonder whether the new agreement could possibly make any difference, as the recommended prices could simply be raised by 12,5 percent to begin with, so as to nullify the effect of subsequent discounting.

151. As it turns out, however, even these measures have had noticeable and positive effects. The report's main findings are that the new agreement has not only led to greater output, but to a greater variety of book titles sold and to lower prices, as well.[107] During the years 2004 through 2007, the average price of books in Norway fell by about four percent even though the consumer price index had risen by about five percent. Meanwhile, the total number of books sold as well as the total number of titles sold each increased by about 30 percent.[108] Norway's experience with RPM for books therefore casts some doubt on the need for exemptions such as Germany's, even on purely "cultural" grounds. It also suggests that eliminating RPM altogether in these markets might be the best policy choice.

3.6 Switzerland

152. Switzerland's Competition Commission initially examined RPM in the Swiss books market in 1999, finding it to be unlawful. After an appeal, the Federal Supreme Court sent the case back to the Commission, asking it to consider whether fixed book prices could be justified on the basis of economic efficiency. After investigating whether RPM led to an increase in choice, variety or sales due to an

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106 The parties to these agreements were the Norwegian Booksellers Association and the Norwegian Publishers Association. Other aspects of their RPM system were eliminated, as well. For example, traditional booksellers no longer have the exclusive right to sell school books. For more details, see Norwegian Competition Authority, "The Development of Sales in the Book Industry 2004 to 2007," Report 1/2008 (July 2008).

107 *Id*. at 5.

108 *Id*. at 9.

increase in the number of retail outlets or better sales advice, the Commission concluded that such positive effects could not be proven. RPM in the book market was therefore considered an unlawful restraint.[109] This sets up an interesting conflict with Switzerland's neighbor, Germany. An important to bear in mind, however, is that under Swiss law the Competition Commission could not consider whether RPM was desirable on the grounds of cultural policy.[110]

4. Conclusion

153. Even though RPM reduces intrabrand price competition, it is not clear that it reduces consumer welfare. RPM does not always enhance consumer welfare, either, even if output increases. With such ambiguous welfare implications, it is not possible to know a priori whether RPM is generally helpful or harmful to consumers. Therefore, it cannot be deemed either purely pro-competitive or purely anti-competitive. That fact has led most commentators to oppose treating RPM as a per se violation.

154. The alternative – evaluating RPM under a rule of reason approach – is not altogether satisfactory, either. The rule of reason is more time-consuming, more expensive, and less predictable than the per se rule. Safe harbours and various other steps may be helpful, but the more they are used the greater the chance there is of arriving at erroneous outcomes in individual decisions.

155. The great majority of the theoretical pros and cons of RPM have been well-known for at least 20 years. What is needed is more empirical work on RPM. Yet Mathewson and Winter had already observed ten years ago that there was not a great deal of empirical evidence on RPM and their observation remains valid today.[111] There is a continuing need for further studies on the actual motivations for and effects of RPM.

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109 See Competition Commission, Annual Report 2005, available at www.weko.admin.ch/publikationen/index.html?lang=en&PHPSESSID=7530f7afcd2ca73b980d00dffdb2cd4f

110 Cartels Act (RPW 2005/2, p. 269 et seq.).

111 Mathewson & Winter, *supra* n.75 at 80.