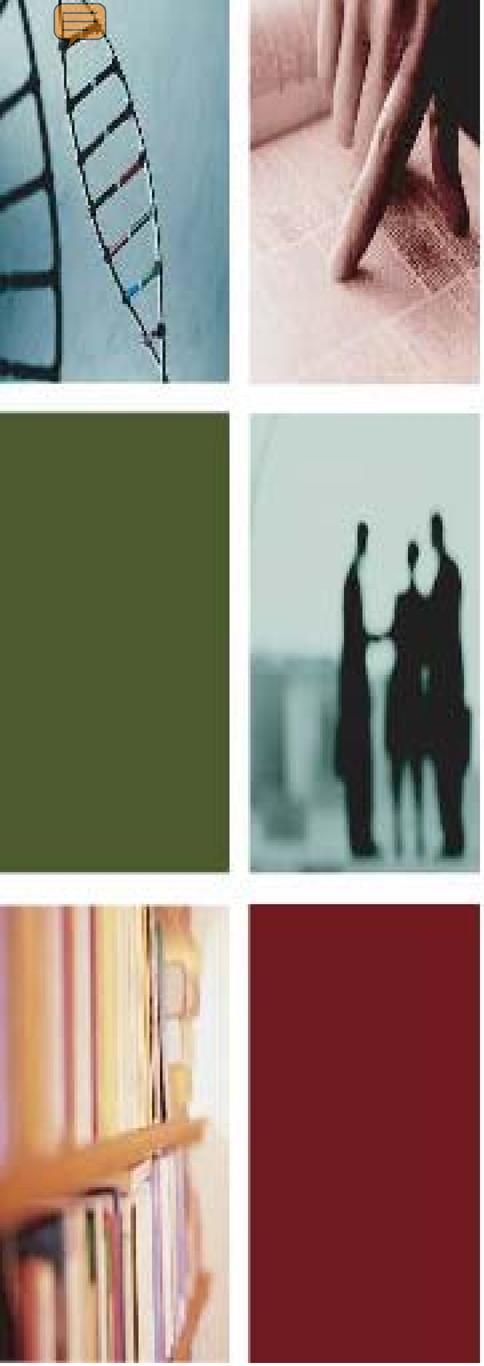

COMPETITIVE RESALE PRICE MAINTENANCE IN THE ABSENCE OF FREE-RIDING

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"Resale price maintenance can also increase interbrand competition by encouraging retailer services that would not be provided even absent free riding. It may be difficult and inefficient for a manufacturer to make and enforce a contract with a retailer specifying the different services the retailer must perform. Offering the retailer a guaranteed margin and threatening termination if it does not live up to expectations may be the most efficient way to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services." (*Leegin* at 2716.)

- summary of economic analysis in: Klein and Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J. L. & Econ. 265 (1988).

J. Breyer response:

"… I do not understand how, in the absence of free-riding (and assuming competitiveness), an established producer would need resale price maintenance. Why, on these assumptions, would a dealer not 'expand' its market share as best that dealer sees fit, obtaining appropriate payment from consumers in the process? There may be an answer to this question. But I have not seen it. And I do not think that we should place significant weight upon justifications that the parties do not explain with sufficient clarity for a generalist judge to understand." (J. Breyer dissent at 2733.)

Two Economic Questions

Question 1: Why do manufacturers compensate retailers to supply increased promotional services?

Question 2: Why is resale price maintenance an efficient way for manufacturers to compensate retailers for supplying increased promotional services?

Question 1: Why do manufacturers compensate retailers to supply increased promotional services?

The answer depends on the nature of the retailer promotional services at issue.

- prominent product display
- dedicated point-of-sale salesperson promotional efforts
- wide retail distribution

The Nature of Retailer Point-of-Sale Promotional Services Desired by the Manufacturer

1. manufacturer – specific promotional services
2. that are aimed primarily at marginal consumers
3. and are unlikely to have significant inter-retailer demand effects.

Question 1: Why do manufacturers compensate retailers to supply increased promotional services?

Translate into economics: Why is the manufacturer incentive for retailer supply of manufacturer-specific point-of-sale promotional services greater than the independent retailer incentive to supply such promotional services?

Answer to Question 1:

1. The manufacturer profit margin on incremental sales induced by retailer point-of-sale promotion often is substantially greater than the retailer profit margin on incremental sales.

2. The manufacturer's incremental sales increase often is greater than the retailer's sales increase from the supply of these promotional services.

In fact, when the retailer is a multi-brand retailer, retailer promotion of a particular manufacturer's products will come at least partially at the expense of the retailer's sales of other manufacturers' products. (The promotion "cannibalizes" retailer demand.)

To solve the incentive incompatibility that is likely to exist between the manufacturer and its retailers, manufacturers create distribution arrangements where retailers are compensated for providing increased promotion of their products.

The distribution arrangement between a manufacturer and its retailers involves three distinct aspects:

1. what increased promotional services the manufacturer desires its retailers to supply;
2. how the manufacturer compensates its retailers for their increased supply of promotional services; and
3. how the manufacturer assures retailer performance with regard to the increased promotional services it has purchased.

Aspect 1. desired promotional services consist of

- manufacturer-specific
- marginal consumer targeted services
- that generate incremental manufacturer sales

such as preferential display or point-of-sale salesperson promotional efforts

Aspect 3. Retailer performance is, in general, assured by manufacturer compensation of retailers for the desired increased promotional services and then self-enforced. Specifically, rather than court-enforcement, manufacturers merely terminate retailers that do not perform as expected.

- If the profit premium retailers earn from performing as the manufacturer expects is sufficient, the sanction associated with termination will assure retailer performance.

Question 2: Why is resale price maintenance an efficient way for manufacturers to compensate retailers for supplying increased promotional services?

Alternative payment mechanisms

a)	RPM:	$ / unit sales
b)	slotting fee:	$ / unit time
c)	per service:	$ / unit service

The efficiencies of RPM

- When the manufacturer pays retailers for increased promotion in relation to a retailer’s total sales, i.e., per unit sold, the increased profit margin on incremental sales provides retailers with an added incentive to supply the desired promotional services.
- RPM also provides a reasonable measure of compensation across retailers because the additional promotional services are likely to increase sales at every retailer by a particular percentage.

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Resale price maintenance, by increasing the retail margin, has the effect of supporting a larger retail distribution network.

- This is important when the promotional services that induce incremental sales are related to the number of retail outlets.
- For example, Leegin products were sold in 5,000 specialty outlets. The wide retail network produced significant point-of-sale promotional services that increased the demand for Leegin products.

Given this distribution arrangement, there are two primary forms of retailer non-performance.

1. A retailer does not supply the increased promotional services it has been compensated for.

2. A retailer engages in price discounting.

Price competition eliminates the “extra” retailer margin the manufacturer is using to compensate retailers for supplying additional promotional services.

- This will lead other retailers to stop carrying or promoting the manufacturer’s products, since it will no longer pay other retailers to devote valuable shelf space or salesperson efforts to the manufacturer’s products.
- The deterioration in the manufacturer’s retail network will decrease overall demand for the manufacturer’s products.

It is not that the price discounting retailer is free-riding on the promotional services provided by other retailers, but that the price discounting retailer is decreasing the incentive of other retailers to supply promotional services.

- Preservation of a manufacturer's wide retail network explains any examples of RPM
- This is distinct from the Marvel, et al. inventory theory of RPM, where the manufacturer desire for increased retail outlets is identified with the desire for increased inventories.

The economic role of RPM in inducing increased retailer promotional services is part of the normal competitive process.

RPM is commonly used in this way by both small and large firms without market power.

Effects on Consumers

Consumers benefit from this competitive process because competitive retailing implies that payments made from the manufacturer to retailers will be passed on to consumers in increased retail services and/or lower overall retailer prices.

Effects on Consumers

Some economists believe that we should focus on potential distribution effects across consumers from this competitive process, namely the fact that marginal consumers gain while infra-marginal consumers may lose.

However, such distribution effects across consumers are a pervasive part of the normal competitive process.

Micro-regulation of competitive market results to prevent such distribution effects is not the appropriate role of antitrust.

Conclusion

- This is a very broad-based procompetitive explanation for resale price maintenance.
- All that is necessary for it to be applicable is:
  1. a significant manufacturer profit margin on incremental sales, and
  2. a significant effect of retailer point-of-sale promotion on inducing manufacturer incremental sales.
- Because of its pervasiveness, it makes sense to require a demonstrable anticompetitive effect before prohibiting resale price maintenance.