Resale Price Maintenance with and without Free-riding

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The Questions

For a pure monopolist :

Positive Questions:

- Why might a simple contract, without restraints, <u>fail</u> to coordinate the incentives of a retailer with the interests of a manufacturer?

- How might RPM resolve the incentive conflict?

Normative Questions:

- Are there implementable tests that distinguish between efficient and inefficient uses of RPM?

Dissent in Leegin

"Petitioner and some amici have also presented us with newer studies that show that resale price maintenance sometimes brings consumer benefits. Overstreet 119.129 (describing numerous case studies). But the proponents of a per se rule have always conceded as much. What is remarkable about the majority's arguments is that nothing in this respect is new. .. The one arguable exception consists of the majority's claim that, even absent free riding, resale price maintenance 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.. Ante, at 12. I cannot count this as an exception, however, because 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." 551 U. S. _____ (2007) 15 **BREYER, J.,** dissenting [underscore added]

Why might a simple price contract fail?

- <u>Starting point</u>: if retail demand depended only on price, it would not.   E.g. two retailers competing…

- <u>Recognize</u>: in reality retailers do much more:
  - Sales effort, enthusiasm
  - Establish a pleasant shopping environment
  - Point-of-sale information
  - Provide time-efficient shopping: adequate sales staff in number and training
  - Organize inventory
  - Post-sales service

- These instruments are all means of competing / attracting demand.

Why might a simple price contract fail?

- But Justice Breyer's question: in attracting buyers, why do retailers not <u>automatically</u> adopt the "right" mix of various instruments: price, sales effort, etc?

- Useful lemma: the price system alone, without restraints, elicits maximum profits only if the retailer is <u>"unbiased"</u> in its mix of price and any other instrument.

- Maximum profits can be achieved only if retailer adopts exactly the strategy that a monopolist would dictate in a complete contract (e.g. "enthusiasm: 8.437 on a scale of 1 to 10").

Why might a simple price contract fail?

- Think of simplest theory:
  - monopolist sells to retailers, who set P and "service".
  - Demand at any retailer depends upon (P, service) at all retailers.
  - Monopolist's interest is in maximizing total profits for system.

- Let ε_P and ε_S be elasticities of demand with respect to price and service.

- Elasticities of demand can be measured at firm level or market level.

- Simple price contract fails …

Why might a simple contract fail?

whenever

$$\varepsilon_P \ / \ \varepsilon_S$$

differs between the individual retailer and the manufacturer / market as a whole

- Think of Dorfman-Steiner (1954) on optimal advertising (here "service expenditure"). For a firm with market power.

$$\textbf{service expenditure / revenue} \ = \ \varepsilon_S \ / \ \varepsilon_P$$

- If this differs between the individual retailer and the market... failure of price system to coordinate incentives.

Why might $\varepsilon_P / \varepsilon_S$ be greater for retailer than market?

$\varepsilon_P / \varepsilon_S$ greater for individual retailer ("bias towards price competition") if:

(1) Extend the classic free-riding on special services – to <u>any</u> positive externality on effort across retailers:

– Effort on quality certification

– Effort in post-sales service to maintain reputation for quality

positive externality → positive cross-elasticity of S in demand across retailers → ε_S <u>smaller</u> at retail level than market → failure…

(2) Mathewson-Winter (1984) (cross-elast of S = 0)

Why might retailers be biased towards competing on prices instead of "sales effort"?

(3) Consumer heterogeneity plus … correlation

- A fundamental problem: the manufacturer would like each retailer to design its strategy to attract consumers <u>into the market.</u>

- the retailer designs its strategy to attract consumers into the market <u>and</u> <u>away from other retailers</u>.

- Consumers who can be attracted away from other retailers respond to a different mix of instruments.

Why might retailers be biased towards competing on prices instead of "sales effort"?

- Source of incentive distortion: heterogeneity of consumers <u>plus</u> correlation across consumers between (1) willingness-to-search/travel and (2) tolerance-for-low-sales-effort.

- Retailers compete "on the wrong margin" <u>and</u> consumers on the wrong margin are relatively more responsive to low price → bias towards price competition

-- 3 simple, plausible examples "bias towards price competition", beyond "free-riding on special services"

How does RPM correct the bias?

RPM elicits greater retailer sales effort, at the cost of higher prices, in 3 ways:

1. If there is free-riding on special services, RPM prevents it;

2. RPM protects the retail margin (P – w) from getting squeezed by price competition → protects the retailer's marginal benefit from attracting demand.

3. (Klein-Murphy 1988): RPM protects the flow of rents to retailers. With costly monitoring of sales effort, especially quality of service, rents allow enforcement of contract through threat of termination and loss of rents.

The Welfare Economics

- I have argued that RPM can be explained as a response to a distortion (w.r.t. collective profit) in the mix of retail price and effort dimensions.

- Is this shift in this socially efficient or not?

  (and is that the right question….?)

- starting point (Spence 1976): a monopolist will spend $1 per unit raising quality/sales effort if the <u>marginal</u> consumers would value the increase at $1.25. But a social planner would want quality raised if the <u>average</u> buyer (including inframarginal) valued the increase at 1.25.

The Welfare Economics

- Monopoly quality may be too high or too low.
- Monopoly use of RPM to "shift the mix" <u>might</u> be welfare improving or … not.
- Required tests… inframarginal versus marginal tastes…? practical?
- **Step back:** we do not regulate direct choice of price versus advertising, price versus quality, and so on.
- Is this because we are 100% confident that a dominant firm will always choose the ideal mix of price and advertising or promotion? No.
- Why don't we intervene on the <u>possibility</u> that it might ↑ W?
- Policy position: a complete monopoly invokes RPM to elicit greater dimensions of sales effort. Intervention cannot reliably increase welfare.

Summary: RPM by a pure monopolist

- RPM plausibly used by a monopolist to shift the mix of price and non-price decisions at the retail level.

- Response to retailer incentive distortions due to: positive externalities, systematic differences between consumers on the inter-retailer margin versus product margin; or inventory incentive distortions.

- *Any* RPM use, outside of cartel facilitation, is consistent with the elicitation of greater sales effort.

- The right policy question is not: "is RPM efficient?"; but "are reliable tests available that identify inefficient use?" Key: allocation of burden

Application: The FTC Approach in *Nine West*

FTC POSITION: to avoid burden of proving precompetitive effects, the defendant must demonstrate the <u>absence</u> of <u>every</u> "*Leegin* factor":

(1) the use of RPM by many manufacturers with substantial aggregate share;

(2) that dealers, not the manufacturer, were the impetus for RPM

(3) that there is a dominant manufacturer or dealer with market power.

- **If the defendant fails to prove this first stage, it bears the burden of proving that RPM is pro-competitive / enhances total sales.**

CRITIQUE

- **Re (3): to meet burden, a pure monopolist would (often) need evidence on marginal versus average preferences.**
- **Re (1): Firms in the same market generally face similar conditions. If many use RPM then still bear the burden in the second stage. But absent collusion, commonality of business practice should → efficiency.**
- **Re (2): If dealers are the impetus, but the manufacturer is clearly "on board", then RPM maximizes total profits of both levels. The theory outlined here applies.**

Addendum: a closer look at assumptions

- **Assumes total wealth maximization:**
  - Ignores (O'Brien and Shaffer 1992)
- **Assumes single dimension of retailer effort and that RPM is enforced.**
- **Assumes "effort" chosen in response to contract**
  - In reality, low-service discount stores and up-market retailers are established as such already. The issue is <u>selection</u> of outlets, not just "effort" at outlets.
  - Similar logic applies
- **Assumes complete monopoly: e.g. ignores cartel issues.**
  - The point is: RPM policy at the two extremes of competition and monopoly upstream should be clear. Difficult cases in the middle: RPM as cartel facilitating device
- **Ignores multiproduct nature of retailer decisions.**