TESTIMONY OF DAVID A. BALTO[1]
BEFORE THE FEDERAL TRADE COMMISSION
OFFICE OF POLICY PLANNING
PUBLIC WORKSHOP ON E-COMMERCE
October 10, 2002
Washington, D.C.

I appreciate this opportunity to participate in the Federal Trade Commission's Public Workshop on "Possible Anticompetitive Efforts to Restrict Competition on the Internet" and submit this statement. As a former government enforcement official and current private practitioner, I recognize the tremendous importance of antitrust enforcement to ensure that the full potential of electronic commerce is achieved free of both governmental and private restraints.

The promise of the world of electronic commerce is to create an environment where consumers can freely shop between various competitive alternatives. By reducing transaction costs and improving transparency, the Internet offers the potential of dramatically improving competition in various retail markets.

This Workshop appropriately has focused primarily on the activities of governmental entities to restrict electronic commerce. These activities, as documented in the testimony in this Workshop, create artificial barriers to the growth of electronic commerce with few, if any, countervailing competitive benefits. The Federal Trade Commission ("FTC") should be commended for its efforts in advocating against these restraints.

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1 David A. Balto is a partner with the law firm of White & Case LLP. His testimony and oral comments reflect his own views and do not necessarily reflect the views of White & Case, any of its partners or clients. For a more detailed discussion of many of the issues addressed in my testimony, see David A. Balto, *Emerging Antitrust Issues in Electronic Commerce*, Journal of Public Policy and Marketing (Fall 2000) and David A. Balto, *Building a Stronger Foundation: Recent Trends in Vertical Restraint Enforcement*, Antitrust Report (October 2001). Mr. Balto thanks his colleague Seth Garfield for his assistance in the preparation of this testimony.

Private restraints, however, can be as egregious — albeit not as durable — as governmental restraints. Any antitrust practitioner or economic historian knows that as new market forces arise, those "traditional" competitors often respond to the threat by trying to create barriers to thwart those new entrants. Antitrust is filled with the stories of commercial upheavals, particularly in retailing, where antitrust enforcement has prevented private parties either individually or collectively from erecting artificial barriers that would otherwise stifle or delay the emergence of new forms of commerce.

One might hope that private efforts to stifle the development of e-commerce would be relatively rare and that such practices would not have a significant competitive effect. But recent studies, such as the testimony provided by the Progressive Policy Institute ("PPI") at this Workshop, suggest that channel conflict — that is, conflict between traditional and Internet retailers — appears to be inhibiting the growth of electronic commerce. As PPI has observed, "In a survey of fifty consumer goods manufacturers by Forrester Research, 66% indicated that conflict with retail channels was the biggest issue they faced in their online sales strategy."[2] PPI itself had found that producers in many industries have delayed or scrapped plans to sell online due to fear of retailer retaliation.

As I describe below, the FTC should also address both horizontal and vertical restraints that may dampen the growth of Internet commerce by denying essential inputs or raising the costs of inputs for Internet retailers. If such restrictions are allowed to continue, the Internet may ultimately become the high-priced alternative to traditional sales channels and the promise of electronic commerce may not be fulfilled.

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2 Robert D. Atkinson, *Revenge of the Disintermediated*, Progressive Policy Institute (January 2001).

Horizontal Restraints. The most typical horizontal restraint fact pattern involves a group of traditional retailers acting to boycott a new form of competition. In a classic case from 1966, the Supreme Court held that a group boycott of discount automobile dealers in the Los Angeles area, orchestrated by full-price dealers and acquiesced in by General Motors, was a clear violation of Section 1 of the Sherman Act.[3] The full-price dealers complained to General Motors that discount dealers were purchasing their product by buying it from full-price dealers. The Justice Department successfully challenged this arrangement as an illegal horizontal boycott.

There are many other instances where traditional retailers have collectively attempted to force manufacturers to stop dealing with innovative competitors. When these new kinds of competition emerge, one of the first things incumbents may do is to attempt to deny necessary inputs to the innovators by organizing a boycott. Traditional retailers, afraid of losing sales to a competitor selling over the Internet, may pressure manufacturers to deny product (or offer product only on disadvantageous terms) to the Internet seller by threatening a boycott. These types of boycotts may raise serious competitive problems. As the Supreme Court has explained, firms may violate the antitrust laws when they jointly seek to "disadvantage competitors" by "cut[ting] off access to a supply, facility, or market necessary to enable the boycotted firm to compete."[4]

Indeed, the FTC brought such a boycott case in *Fair Allocation System*.[5] This case involved a group of twenty-five Chrysler dealers in the northwest United States who were losing sales to another dealer who sold at low prices over the Internet. The innovative dealer offered

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3 *United States v. General Motors Corp*., 384 U.S. 127 (1966).

4 *Northwest Wholesale* Stationers *v. Pacific Stationery & Printing Co*., 472 U.S. 284, 294 (1985).

5 *Fair Allocation System, Inc.,* C-3832 (Oct. 31, 1998) (consent order).

low, no-haggle pricing and was among the first dealers nationwide to sell automobiles over the Internet. The Internet enabled the dealer to reach customers over a wide geographic area in eastern Washington, Idaho and western Montana.

One can imagine the significant substantial competitive impact of this new Internet retailer. Consumers in rural areas in the northwest United States traditionally had to travel significant distances to purchase cars. Search costs were obviously very substantial. This Internet retailer greatly expanded the competitive alternatives for these rural consumers.

To counteract this competitive threat, the traditional full-price Chrysler dealers established an association known as "Fair Allocation System" and threatened to refuse to sell certain Chrysler models and limit the warranty service they would provide for particular customers unless Chrysler limited the allocation of vehicles to the Internet sellers. Chrysler traditionally allocated vehicles based on each dealer's total sales. The FAS members wanted Chrysler to allocate vehicles on the basis of the expected number of sales from a dealer's local area, which would have reduced substantially the number of cars available to Internet sellers who sold to a more diverse group of consumers. The FTC successfully challenged this agreement as an illegal boycott.

Vertical Restraints. The Commission's efforts should not stop at simple horizontal action. Vertical restraints, including resale price maintenance, can themselves stifle the growth of electronic commerce. Two of the cases brought during the Clinton Administration provide important guidance about the type of vertical restraints that may pose competitive problems.

In the first case, *In re Toys-R-Us*, the FTC sued Toys-R-Us for entering into vertical agreements and facilitating a horizontal conspiracy by denying access to the supply of certain popular toys to warehouse club stores such as Costco.[6] In the past, Toys-R-Us had responded to new competition from discounters such as Wal-Mart and Target by lowering prices and improving in-store presentations. When the warehouse clubs entered the market, however, the Commission alleged that Toys-R-Us, the nation's largest toy retailer and the inventor of the toy store category killer, pressured toy manufacturers to deny popular toys to price clubs or to sell them only at less favorable terms than it was giving. The Commission alleged, and ultimately found, that Toys-R-Us entered into illegal vertical relationships with manufacturers to deny warehouse clubs products that were important to their ability to compete. The Commission also alleged that Toys-R-Us orchestrated a horizontal agreement among manufacturers to deny these products to warehouse clubs. The Commission ultimately held that both the horizontal and vertical agreements were illegal, and that decision was affirmed by the Seventh Circuit.

In the compact disc cases, the Commission challenged the use of a minimum-advertised price ("MAP") program by the major record distributors in the United States as illegal vertical price fixing.[7] The Commission alleged that the music distributors had stiffened their MAP program to restrict the ability of "category killer stores" such as Best Buy and Circuit City to market recordings through aggressive discounting, often below the manufacturers suggested resale prices.

Like many areas of retailing, the prerecorded music industry had faced a revolution in the early 1990s with the emergence of category-killer stores such as Best Buy and Circuit City.

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6 *In re Toys 'R Us, Inc.*, 126 F.T.C. 415, 600-17 (1998), *aff'd*, 221 F.3d 928 (7th Cir. 2000).

7 *See In re Sony Music Entertainment, Inc.; In re Time Warner, Inc.; In re BMG Music; In re Universal Music & Video Distribution Corp.; and In re Capitol Records, Inc.*, Docket Nos. C-3971, C-3972, C-3973, C-3974, and C-3975, (consent agreements accepted for public comment on May 10, 2000) at http://www.ftc.gov/os/2000/09/musicstatement.htm.

These category-killer retailers sell at low margins, engage in regular advertising (typically in weekend newspaper circulars) and often sell products such as CDs as loss leaders in order to bring customers into their stores. Traditional retailers did not welcome the emergence of the new competitors or their aggressive pricing policies. The traditional retailers pressured the manufacturers to impose MAP programs for their cooperative advertising and when those programs were not sufficiently effective in deterring price discounting by the category-killer stores, the traditional retailers pressured the distributors to tighten those policies. The revised MAP programs, characterized as "MAP with teeth," "broadly restricted in-store advertising and promotion" including virtually every means of communicating the price of the product to the consumer other than the small price tag on the CD. By broadly restricting advertising, including all in-store displays and signs, the MAP policies effectively precluded most retailers from communicating prices below minimum suggested prices to their customers and without the ability to advertise lower prices, prices increased. The Commission found that these MAP policies were illegal under the rule of reason in large part because all the major record distributors had established them.

What is important is the relevance of this CD decision on future resale price maintenance enforcement. Resale price maintenance and similar restrictions may be efficient particularly to the extent they enable firms to provide services that may enhance output. And in the CD decision, the traditional retailers argued that the MAP restrictions were necessary to protect their margins so they could offer a greater level of service. The record did not support these theoretical justifications, however. The category-killer stores offered at least the same level of service and offered an even broader range of products. Instead, the Commission concluded that the policies had been adopted both to protect the traditional retailer and distributors' margins.

Unfortunately, most of the jurisprudence on resale price maintenance does not examine the real economic impact of RPM, but rather focuses on the less informative question of whether there is an agreement between a manufacturer and a retailer. Thus, there is relatively little guidance on how to evaluate the economic consequences of resale price maintenance (an issue that enforcement officials must consider, if only to evaluate the potential for consumer injury as a guide to prosecutorial discretion).

The Internet poses different economic issues than traditional retailing does and thus more careful evaluation of resale price maintenance is important. Consider free-riding, frequently offered as an important justification for a manufacturer's use of resale price maintenance. Manufacturers used to worry that mail-order houses would free-ride on the investments that conventional retailers made in showrooms. That may still be true in some cases, and the Internet vendor may take orders from people who have examined the product in their local store first. But now, increasingly, the reverse may also be true. As electronic sales sites become larger and more complete, shoppers may and often do go there first for product information and product reviews and then purchase from the local store for more prompt delivery. In this case, the traditional brick-and-mortar stores are free-riding on other firms' websites. Accordingly, the free-riding concept needs to be scrutinized carefully.

At the same time, not all Internet retailers are like Amazon.com, and many smaller e-commerce retailers may do a less than adequate job supporting high-technology products. These e-commerce retailers may provide insufficient or no on-site customer support, service and marketing for products they sell. In turn, this lack of support may degrade the reputation of the manufacturer and its product and places a tremendous burden on that manufacturer to compensate for the e-commerce retailers inadequacies. Faced with inadequate support and service, customers who purchase products from these Internet retailers contact the manufacturer, who is compelled to absorb the support and service costs that otherwise should have been covered by the Internet retailer to salvage brand reputation. Because these problems arise frequently, under the law, manufacturers must feel empowered -- within limits -- to unilaterally take action to maintain their reputations and profitability.

Carlton and Chevalier have begun to examine in greater depth these free-riding questions. They find, for high-service goods such as perfume and DVD appliances, there may be significant free-riding concerns for Internet vendors.[1] Free-riding needs to be carefully examined. As the courts have held, if a traditional retailer can be compensated for the service they provide, then there is no free-riding problem. Carlton and Chevalier suggest that free riding is more of a concern for traditional retailers than Internet retailers, because it is easier to compensate Internet retailers since the services Internet retailers provide (information services) are easier to observe and less variable than services provided by brick and mortar retailers. In some instances, those arguments may have validity but I would be hesitant to adopt them as a general rule.

Consider the evaluation of the free-riding arguments in *Toys-R-Us* where the Commission examined the justifications behind restrictions imposed by Toys-R-Us. Toys-R-Us argued that the restrictions were justified because consumers would go to Toys-R-Us, which guaranteed a full-year complete selection of toys, to examine the toys and comparison shop. Toys-R-Us also did extensive advertising of new toys. Toys-R-Us was concerned that warehouse clubs would free ride on these information services.

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1 Dennis W. Carlton and Judith A. Chevalier, *Free Riding and Sales Strategies for the Internet*, NBER Working Paper No. 8067 (NBER and University of Chicago, Jan. 2001).

The Commission found that there were several less restrictive alternatives to address the free-riding problem. In this case, Toys-R-Us was fully compensated by the manufacturers for these services. On a more theoretical level there may be other alternatives for addressing free-riding. The FTC posed three theoretical alternatives in the *Toys-R-Us* decision. First, a consumer could pay separately for services that are provided. Second, a group of dealers, which do not supply a service, may pay full-service dealers roughly the amount that the first group benefits from the service. A third technique for compensating traditional retailers for their investment in services would be for the manufacturer to pay the high-service retailers an amount roughly equal to their investment. The manufacturer might do this because it might decide that different types of retailers are important to its long-term market success and it prefers to keep both types of dealers.

In examining claims of free-riding, empiricism must triumph over theory. Not all products require substantial levels of service. Free-riding is most often a problem for manufacturers and distributors of expensive, complex goods. In other areas, the Commission should scrutinize critically whether free-riding justifies certain types of vertical restraints. It should evaluate the potential for the type of less restrictive alternatives identified by the Commission in *Toys-R-Us.* In many instances, traditional retailers may be compensated by manufacturers for the services provided.

Guidance. Finally, the Commission can enhance the growth of electronic commerce by providing guidance in important areas of the law that, while left muddled, may deter firms from entering into efficient distribution arrangements. For example, the law on cooperative advertising programs is ambiguous about the extent that manufacturers can restrict price advertising on Internet retailers' websites. Can a manufacturer restrict price advertising throughout a website? Can a manufacturer prevent an Internet retailer from offering the consumer to call the retailer to search out even lower prices?[9]

In addition, the Commission could clarify some of the more significant Robinson-Patman Act questions that affect manufacturers dealing with both Internet and traditional bricks-and-mortar retailers. For example, the Commission could update the *Fred Meyer Guides* in order to provide new guidance about the applicability of Sections 2(d) and 2(e) of the Robinson-Patman Act to Internet commerce.[10] Because of the unique characteristics of Internet retailers, some of the *Fred Meyer Guides* may unduly restrict the ability of manufacturers to provide incentives to this channel, ultimately to the detriment of consumers.

For instance, in my experience, suppliers encounter difficulties with the issue of how to accommodate the "functional availability" restrictions set forth in Section 240.10 of the Guides. If, for example, a manufacturer wanted to encourage an Internet strategy, it might provide e-commerce retailers with an extra discount if they provide a tutorial for the product line for prospective customers. Of course, under the *Guides*, such discounts must be made available on proportionally equal terms to all competing resellers, and if that discount is not functionally available, alternatives must be offered to such resellers. Thus, while an Internet retailer could easily implement a tutorial to all prospective customers by simply providing a streaming video link on their website, bricks-and-mortar retailers may not be able to provide a similar tutorial. Thus, manufactures wonder whether they can offer such a discount to Internet retailers, or

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[9] These issues are described in greater detail in David A. Balto, *Building a Stronger Foundation: Recent Trends in Vertical Restraint Enforcement*, Antitrust Report (October 2001).

[10] *See* FTC Guides for Advertising Allowances and Other Merchandising Payments and Services, 16 C.F.R. § 240 (1990).

whether they would have to offer additional advertising funds to the bricks-and-mortar counterparts in order to make such a discount "functionally available."

More generally, practitioners have wondered whether the Commission considers Internet and bricks-and-mortar retailers competitive for purposes of the Act. For example, if an Internet retailer assumes higher distribution costs than a bricks-and-mortar retailer, can a supplier argue that a functional discount is warranted to compensate the Internet dealer for either the supplier's savings or the dealer's costs? Could a seller argue that a functional discount might be permitted if an e-commerce retailer also actually performs the functions of an entity at a different level of the distribution chain, e.g., functions of a wholesaler, by relieving its suppliers of risk, investment and costs? Clarity on these issues would foster greater investment and more stability for e-commerce participants.

Conclusion. I commend the FTC for convening this Workshop to highlight the potential burdens placed on Internet retailers by both unnecessary state regulations and private restraints. I look forward to the Commission taking an active stance in trying to eliminate barriers — both governmental and private — to unleash the true potential of retailing on the Internet.