Resale price maintenance: Explaining the controversy, and small steps towards a more nuanced policy

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RESALE PRICE MAINTENANCE: EXPLAINING THE CONTROVERSY, AND SMALL STEPS TOWARDS A MORE NUANCED POLICY

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INTRODUCTION AND CONCLUSIONS

Over recent years, there have been important divergences of thinking between (some) economists and (some) lawyers about the appropriate treatment of Resale Price Maintenance (RPM) under competition law.[2] In the US, these divergences were brought into focus by the *Leegin* case, in which the Supreme Court concluded that RPM should no longer be viewed as *per se* illegal under US antitrust law.[3] In the EU, the debate has been precipitated by

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[2] This paper uses the term RPM to encompass both fixed price RPM or minimum RPM, and both are covered by the arguments made throughout. It is not intended that the paper covers maximum RPM, which is typically viewed as unlikely to be anticompetitive.

[3] *Leegin Creative Products, Inc v PSKS, Inc,* Supreme Court of the United States, 28 June 2007.

the Commission's review of its vertical restraints block exemption and guidance.[4]

In Part 1 of this paper, we set out why we consider that the legal framework in the EU (despite its best intentions) amplifies what are in reality relatively small differences in thinking around RPM. Primarily, this is because it asks economists, in the name of legal certainty, to draw a false dichotomy between agreements and practices which are harmful and those which are beneficial. For practices like naked price fixing, it is relatively easy for economists to agree on an answer. It is harder, however, for practices like RPM which can give rise to serious anticompetitive harm, but can also be indispensable for important and valuable efficiency benefits. This is discussed in Section 2, which provides a summary of the economic literature on RPM, and also emphasises the need for further empirical research in this area.

Within the current legal framework, we conclude that there is not yet, in our view, sufficient evidence to justify moving

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[4] See European Commission (2009) "Draft Commission Regulation on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices" available at http://ec.europa.eu/competition/consultations/2009_vertical_agreements/draft_regulation_en.pdf , and European Commission (2009) "Draft Commission Notice - Guidelines on Vertical Restraints" available at http://ec.europa.eu/competition/consultations/2009_vertical_agreements/draft_regulation_en.pdf

RPM out of the EU's ‘presumed illegality’ or ‘object’ box and into a case by case assessment ‘effect’ box. However, it is clear that this will sometimes involve presuming illegality of RPM arrangements which in fact either do not restrict competition or, if they do, are nevertheless justified by their efficiency benefits. We would therefore have significant reservations about a legal framework which went beyond ‘presumed illegality’, for example making RPM '*de facto* illegal' (because the presumption cannot in practice be rebutted), or '*per se* illegal' as in the US pre-*Leegin*.

Based on this thinking, we set out in Section 3 a few small steps that might be taken towards a slightly more nuanced approach to assessing RPM, within a 'presumed illegality' framework, without sacrificing too much of the beneficial legal certainty that the current approach brings.

First, we argue that it is important to ensure that any presumption of illegality is truly rebuttable, and we provide some thoughts as to how this might work. This includes the requirement that the authority should set out at least one plausible ‘theory of harm’ that is consistent with the known facts.

Second, we suggest that a series of screens might usefully be adopted for considering whether there is likely to be a credible theory of harm in any particular case of RPM, and for prioritising cases on this basis. We provide our initial thinking on what such a series of screens might look like, while recognising that there is room for further thinking in this area, and that further developments in the economic literature may be required before a definitive view can be taken on the appropriate screens.

Third, while the use of screens for prioritisation of RPM cases may have an impact in the EU, we recognise that a prioritisation approach may not be effective in a system, such as the US, where much enforcement of competition law is via cases brought by private litigants. We therefore suggest that there may be some potential to use screens of this sort to help define a legal standard. Under this approach, if the screens are failed, this would be taken to demonstrate that there is no credible theory of harm associated with a particular case of RPM. In such circumstances, the presumption of illegality could be rebutted. Such an approach would have similarities to the sorts of screens that are commonly applied in the EU in Article 82 abuse of dominance cases.

These various steps require varying degrees of further work, with the third being the controversial and raising the most significant issues. However, we believe they all have potential to substantially ameliorate our current reservations, while preserving legal clarity and a position where RPM will, for the most part, remain unlawful. Such steps would also have the benefit of avoiding cases – arguably such as *Leegin* – where there is no clear credible theory of harm, and which have the potential to bring the competition system into disrepute by making it appear out of touch with reality.

1. LEGAL AND ECONOMIC BACKGROUND: THE ROOT OF DISAGREEMENT

From an economic standpoint, competition law must be about ensuring competitive markets, which generate benefits for consumers, as well as driving productivity. As such, a key objective of any system of competition law should be to prevent firms from:

- engaging in practices and signing agreements which appreciably prevent, restrict, or distort competition,
- such that there is detriment to consumers that is not counter-balanced by efficiency benefits (which in turn can only be achieved through such practices or agreements).

The wording of EC competition law on agreements (Article 101[5]) is in line with this economic thinking. The first of the above bullets corresponds precisely to Article 101(1) of the EC Treaty, which prevents agreements or concerted practices which *"have as their object or effect the prevention, restriction or*

[5] Previously Art 81 of the Treaty establishing the European Community, now Art 101 of the Treaty on the Functioning of the European Union See Official Journal of the European Union, C 115/372, 9.5.2008.

distortion of competition within the common market".[6] The second bullet corresponds, more approximately, to Article 101(3) of the EC Treaty, which disapplies Article 101(1) where the agreement or practice in question *"contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not impose on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives".*[7]

So far, so good. Difficulties arise, however, from the way in which the law is implemented in practice. On its face, the law seems to suggest the need to review every agreement or practice on a case by case basis, to assess whether there is an anticompetitive object or effect and, if so, to assess whether this is counter-balanced by efficiency benefits. In terms of practical application of the law, however, it is argued that there is a need for far greater legal certainty than this suggests.

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[6] Consolidated version of the Treaty on the Functioning of the European Union - Part Three: Union Policies And Internal Actions - Title VII: Common Rules On Competition, Taxation And Approximation Of Laws - Chapter 1: Rules on competition - Section 1: Rules applying to undertakings - Article 101 (ex Article 81 TEC) (2008/C 115/01)

[7] See Supranote 6.

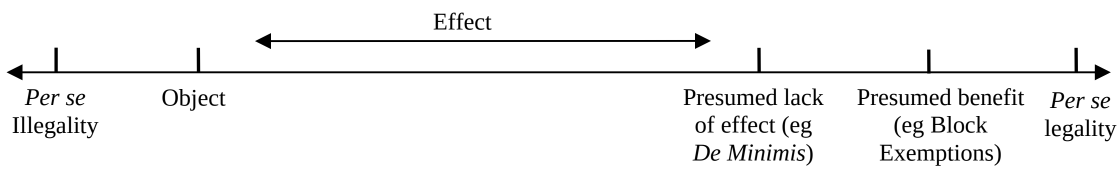
There are two key reasons for this. Firstly, a case by case approach places a high burden on firms, who are not in position to carry out this sort of economic analysis for each and every one of their agreements, and there is a consequent risk that firms simply avoid engaging in particular agreements or practices, even where these would be beneficial. This would clearly be detrimental to both competition and economic efficiency. Secondly, and conversely, a case by case approach places a high burden on competition authorities and private plaintiffs in bringing antitrust actions, which could lead to too little enforcement and therefore insufficient deterrence of anticompetitive behaviour. Such concerns are especially significant for less mature regimes or smaller, less well resourced authorities. Again, this would be detrimental to a competitive economy.

Creating legal certainty around the law on agreements

For this reason, there have been moves - on both sides of the Atlantic - to put certain types of agreement and practice into particular ‘boxes’, removing the need for case by case analysis of the likely harmful effects of such practices.[8] The

[8] The European Court of Justice recently confirmed the principle that in "object cases" harmful effects can be presumed rather than needing to be proved, since practices in the object box are by their very nature regarded as harmful. [T-Mobile Netherlands BV and others v NMa, Case C-8/08, judgment of 4 June 2009.] It is worth noting that even in

following figure sets out some of the most common 'boxes' that have been used, along a spectrum which runs from 'definitely illegal' to 'definitely legal'.



On the left hand side of the spectrum, '*per se* illegality' is a box that is used in the US, but not the EU.[9] An agreement which falls into this '*per se* illegality' box is definitely unlawful. There is no potential for rebutting the presumption of anticompetitive harm, nor is there any potential for showing that the agreement has efficiency benefits that might counter-balance any harm. Price-fixing is the classic '*per se* illegal' agreement.[10] The *Leegin* case was essentially about whether RPM, which had historically also been '*per se* illegal' should be taken out of this box.[11]

object cases parties may adduce evidence to meet the exemption criteria under Article 101(3), though the burden of proof is on them to prove the criteria are satisfied [Matra Hachette v Commission, Case T-17/93 [1994] ECR II-595, para 85.]

[9] See Peeperkorn, L. "Resale Price Maintenance and its Alleged Efficiencies" (2008) 4 European Competition Journal 201, 212.

[10] Ibid.

[11] Leegin Creative Products, Inc v PSKS, Inc, Supranote 3.

In the EU, the distinction is instead between ‘object’ and ‘effect’ infringements. Practices that are anticompetitive by ‘object’ are presumed anticompetitive.[12] For these cases, a competition authority is not required to provide any real economic (or other) evidence of likely anticompetitive harm. It is sufficient to demonstrate that the practice fits into the 'object' box and hence is illegal. However, the ‘object’ box differs from the US ‘per se illegality’ box in two ways – at least theoretically. Firstly, the presumption of anticompetitive harm is, while strong, nevertheless in theory rebuttable, if compelling evidence is adduced that the agreement could not have been expected to have an anticompetitive effect. Secondly, an object infringement can still, in theory, be exempted from Article 101(1) if it meets all of the conditions under Article 101(3).[13]

In reality, and as we will expand upon in the policy section, the extent to which the ‘object’ box differs from ‘*per se* illegality’ depends on the extent to which competition

[12] See Commission notice of 13 October 2000: Guidelines on vertical restraints [COM(2000/C 291/01) - Official Journal C 291 of 13.10.2000].

[13] Specifically that the agreement creates efficiency benefits, that a fair share of these benefits pass to consumers, that the restrictions are indispensable and that there is no elimination of competition. See Supranote 6.

authorities and courts are open to accepting rebuttal arguments under 101(1) or efficiency arguments under 101(3). Should such arguments be dismissed without due consideration, then we believe that there would be little in practice to differentiate these US and EU approaches.

At the other end of the spectrum, there is a variety of boxes under which an agreement or practice may be judged (likely to be) legal. Some practices are simply '*per se* legal', on the basis of being viewed as unlikely to have an anticompetitive object or effect.[14] Other agreements and practices are considered so unlikely to restrict competition appreciably that they are classed in a 'presumed lack of effect' box. The EU *De Minimis* doctrine is a good example of this.[15] Likewise, for particular

[14] So, for example, selective distribution is considered *per se* legal in the EU, so long as the criteria used for selecting distributors are purely qualitative and objective.

[15] The Commission's "Notice on Agreements of Minor Importance" [OJ [1997] C 372/13, [1998] CMLR 192] sets out market share thresholds under which all agreements (other than those which fall in the object box) are presumed lawful. Again, this presumption can theoretically be rebutted. The current market share thresholds, which relate to the aggregate market shares held by all of the participating undertakings, are 5% for horizontal agreements and 10% for vertical agreements. Another good example is the Commission's guidance that buying groups are unlikely to be found unlawful if the parties to the agreement have a combined market share of below 15% on the purchasing market(s) as well as a combined market share of below 15% on the selling market(s)

types of agreement and particular market share thresholds, it can be presumed that, even if there is anticompetitive harm, this is counter-balanced by efficiency benefits'. The various EU Block Exemptions are good examples of these.[16]

These various boxes clearly have the potential to provide a fair degree of legal certainty. The appropriate box, if any, for a particular agreement or practice will effectively depend on how likely it is the agreement or practice in question would be found illegal if a careful case-specific effects analysis were carried out. For example:

- for practices such as naked price fixing, we would expect it to be fairly rare that case by case analysis would find the practice legal, and as such, it is appropriate to put such agreements into the 'object' (or even 'per se illegality') box;
- for practices such as exclusive distribution by a firm without significant market power, or agreements between

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(see the Commission's "Notice on Horizontal Cooperation Agreements" [OJ [2001] 2001/C3/02].

[16] It is worth noting that Block Exemptions provide more legal certainty than a simple 'rebuttable presumption'. If an agreement is covered by the criteria in a Block Exemption, then the benefit of the block exemption has to be explicitly removed before that agreement can be found unlawful, and firms are not liable for retrospective breach (that is, for their behaviour prior to the removal of the exemption).

firms with small market shares, where harm is either unlikely or is likely to be counter-balanced by efficiency benefits, the high likelihood that they would be found legal on a case by case analysis means that it is appropriate to place them in one of the boxes on the right hand side of the figure above.

Agreements that don't fall into any of these boxes continue to require a full 'case by case' 'effects' analysis. The EU does provide some further guidance, within its various guidelines, as to the circumstances under which it might expect to find particular agreements or practices lawful or unlawful.[17] Beyond this, however, there has been relatively little work done on 'screens' which might help firms and regulators in deciding - under an 'effects' analysis - whether or not a particular agreement is lawful or unlawful.

Comparison with Article 102

It is interesting to contrast this situation with Article 102 of the EC Treaty,[18] the EU law relating to abuse of a dominant position. Under Article 102, practices are not

[17] See Supranote 12

[18] Consolidated version of the Treaty on the Functioning of the European Union - Part Three: Union Policies And Internal Actions - Title Vii: Common Rules On Competition, Taxation And Approximation Of Laws - Chapter 1: Rules on competition - Section 1: Rules applying to undertakings - Article 102 (ex Article 82 TEC)

classified into ‘boxes’ in quite the same way as under Article 101. There is no general doctrine that certain conduct is by its very nature regarded as being injurious to the proper functioning of normal competition.[19] Indeed, it could be argued that all Article 102 practices are assessed on an 'effect' basis. However within this ‘effect’ category, the approach taken is fairly nuanced. The Courts and the Commission have, over time, established 'screens' which help them to determine both whether the practice can be presumed pro or anticompetitive, and what proof is needed to change this presumption.[20] For example, firms have no duty to deal (that is, a refusal to supply a new customer is assumed not to be anticompetitive) unless there exist certain 'exceptional circumstances', specifically that the product is indispensable for competition, the refusal eliminates competition, and there is no clear objective justification.[21]

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[19] There is no analog in Article 102 case law to the general concept of the ‘object box’ saying that likely harmful effects can be presumed in relation to certain types of conduct. It follows that the Commission/ NCAs must make an assessment of likely harmful effects as part of each Article 102 case.

[20] For example loyalty rebates granted in return for exclusive purchasing. [Michelin v Commission, Case C-62/86 [1991] ECR I-3359] Or predatory pricing where pricing below AVC is presumed to be abusive. [AKZO v Commission, Case T-203/01 [2003] ECR II-4071].

[21] It is worth noting that the Commission’s recent guidance on enforcement priorities under Article 102 provides additional screens – in particular price-cost based screens – which arguably go beyond

Another contrast with Article 102 is also worth bringing out. In theory, an agreement or practice which falls within the ‘effect’ box under Article 81 is not presumed lawful or unlawful, absent a full effects analysis. Nevertheless it is our opinion, based on our experience of working at an enforcing agency, that practices or agreements which fall into the ‘effect’ box are often viewed as ‘more or less’ legal. Or at the very least, there seems to be an expectation that firms will consider that the competition authority or private plaintiff will face an uphill struggle in proving, on a full effects analysis basis, why an agreement or practice is likely to be anticompetitive and should therefore be found illegal. If so, we should not be surprised to observe firms deciding to wear the litigation risk and engage in the behaviour.[22]

(although are consistent with) current case precedent. However, these are (theoretically) intended to set enforcement priorities rather than legal standards. See European Commission, "Guidance on the Commission's enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings", [C(2009) 864].

[22] In reality, the extent to which this last point concern is valid is linked to the standard of proof required by Courts in order to show anticompetitive effect. If this standard of proof is set too high, then it will be more rational for firms to engage in anticompetitive behaviour, since the risk of effective litigation is low. This suggests less difference between the ‘effect’ box and ‘per se legality’ than might have been expected. Such a situation arguably in

Under Article 102, by contrast, there is certainly no presumption that all behaviour of dominant firms is 'more or less' lawful, absent an examination of the 'screens'. This perception has been reinforced by the extremely high fines which the Commission has imposed in abuse cases in recent years.[23]

Implications for RPM

Let us now turn (belatedly) to RPM. Based on the above, the key question from a legal perspective is whether it is appropriate to put RPM in one or other of the above boxes. To assess this, the core question would seem to be as follows: how often would RPM, if assessed on a case by case basis, be found to be illegal (that is, found to be anticompetitive and without countervailing efficiency benefits)? If the answer is 'usually' or 'very often', then the approach described above suggests that RPM should be put into the 'object' box.

The only problem with this 'core' question is that economists dread being asked it, because they find it exceptionally hard to answer. The difficulty is that, as will be

turn increases the pressure to put into the 'object' box agreements and practices which are fairly (but maybe not very) likely to be harmful.

[23] See for example the fine of EUR 497,196,304 imposed by the EU Commission on Microsoft Corporation (Case COMP/C-3/37.792 Microsoft), or the fine of EUR 1.06 billion to Intel (Case COMP/C-3 /37.990 - Intel).

discussed below, from an economic perspective RPM sits rather awkwardly on the spectrum in the figure above. Yes, for sure, it can be anticompetitive. But it can also give rise to important efficiency benefits, and in some cases will be indispensable for achieving those efficiency benefits. Many economists would agree that RPM is, if anything, slightly closer to the left hand side of the above figure than the right hand side.[24] But we believe that most economists would agree that its precise position in any given case will depend on market circumstances, and certainly that it is not squarely on the left hand side, holding hands with naked price fixing or dancing around with bid rigging.

Faced with having to choose whether RPM is mostly harmful or mostly beneficial, some economists (such as us) will veer towards the left hand side of the spectrum, and plump for RPM being an 'object' infringement. Others cannot stomach the fact that this approach has the implication of presuming unlawful, on the one hand, agreements that could not possibly have an anticompetitive effect and, on the other hand, agreements that

[24] See for example "Rey, P., and T. Vergé, "Economics of Vertical Restraints," in P. Buccirossi, ed., Handbook of Antitrust Economics, Cambridge, MA: MIT Press, 2008, pp. 353–391. And also G. Shaffer, "Slotting Allowances and Resale Price Maintenance: A Comparison of Facilitating Practices" (1991) 22 *Rand Journal of Economics* 120,136.

have real efficiency benefits. These economists plump for RPM being an ‘effect’ infringement.

What is interesting is that there is not necessarily a great deal of difference between the views of these two sets of economists. Rather, they are making different choices from what seems - from an economic perspective - an unappetising menu of options. Relatively small differences in view are therefore by the legal framework with which economists are presented.

2. INTRODUCTION TO THE ECONOMICS OF RPM

This section of this paper looks further at the economics of RPM, and why economists find the choice described above so difficult.

Efficiency benefits of RPM

There is a wide and still-growing literature on RPM, but the literature on the efficiency benefits of RPM is, for the most part, older and better-established than that on its anticompetitive effects.[25] Essentially there are three broad economic arguments for allowing RPM.

[25] See for example Peeperkorn, L. (2008), “Resale Price Maintenance and its Alleged Efficiencies European Competition Journal, Vol. 4,.pp. 201-12. Or Stallibrass, D. and E. Giovannetti (2009), “Three Cases in search of a Theory: Resale Price Maintenance in the UK”, European Competition Journal (VOL. 5 NO. 3 641-654).

The first, which formed the basis of the DoJ and FTC's submissions in the *Leegin* case, is that while RPM reduces intra-brand price competition, it can promote inter-brand competition. It can do this by providing quality certification[26], or by reducing free riding at the distribution level on aspects such as service provision.[27]

The idea here is straightforward. Where retailers carry out some form of service on behalf of manufacturers, but where this service involves the retailers incurring a cost, there is a risk – absent RPM - that retailers that do not provide the service could cut prices and win business away from retailers that do. A typical concern might be a customer spending time in the testing room of a posh hi-fi shop, comparing a variety of speakers, and then going and buying the chosen speakers elsewhere from the cheapest outlet. If this occurs, then clearly the incentives of retailers to provide these services will be reduced, which will be bad for the manufacturer and also for consumers.[28]

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[26] As suggested in Marvel, H. P. and S. McCafferty (1984) "Resale Price Maintenance and Quality Certification." Rand Journal of Economics, 15. pp. 346-359.

[27] This argument was first elaborated in Telser, L.G. (1960)."Why should manufacturers want fair trade?" Journal of Law and Economics, 3. 86-105.

[28] The quality certification literature is essentially the same, but the 'service' which the retailer provides is a form of 'quality

The second argument relates to the 'indispensability' question which is asked when assessing efficiency benefits under 101(3).[29] While other vertical restraints can achieve some of the same benefits as RPM, there will be circumstances (for example the presence of risk aversion) in which RPM is more effective than these other restraints.

An intuitive example might be a supplier of a branded product, who primarily sells through a specialist bricks and mortar retail network and is keen to protect this network since it is its primary route to market, but who has been approached by an internet retailer. The supplier is concerned that if he supplies the internet retailer, absent RPM, then the internet retailer could price low and damage the viability of his bricks and mortar network. Two possible options open to him are to refuse to supply the internet retailer, through not including

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certification' service. By stocking a given product the retailer implicitly guarantees the quality of that product in the eyes of consumers. An example might be a smart department store stocking a particular perfume and thereby raising the brand profile of that perfume. There is a cost involved in being a smart department store, so if all customers just go and buy the perfume more cheaply elsewhere, the department store will not be able to survive. This will in turn not only remove a valued outlet for customers but also an important quality certification mechanism for suppliers. (In practice, the department store is more likely simply to refuse to stock any perfume for which this is likely to happen).

[29] See Supranote 6

him within his (legal) selective distribution system, or to agree to supply him but on an RPM basis. If, as here, the counterfactual to RPM is not to supply at all, then RPM may in fact be the more efficient and procompetitive option.

The third argument is based on the standard Chicago school argument that, in any given market, there is only one monopoly profit.[30] An upstream monopolist has no ability to increase its profits through RPM, since it should in any case be able to extract the full monopoly market rent through its wholesale pricing structure (at least so long as non-linear pricing is possible). As such, the argument runs, RPM cannot be welfare-reducing and, if it is undertaken, should be assumed beneficial.[31]

Anticompetitive effects of RPM

Whilst the literature setting out procompetitive rationales of RPM has existed for some time, the anticompetitive literature is relatively more recent and still developing. In the following, we have (we hope without doing too much injury to the

[30] See Posner R.A. (1976), Antitrust Law an Economic Perspective. University of Chicago Press. Chicago, USA.

[31] It should be highlighted that the elimination of double marginalisation is *not* a good argument for the imposition of RPM, since it is in fact solved by maximum RPM, which is typically legal.

subtleties of each individual paper) classified the literature under five types of effect.[32]

The first relates to RPM as *a facilitating practice to sustain upstream collusion*. This theory relates to inter-brand competition. When upstream firms wish to collude, but negotiate contracts with wholesalers or retailers in private, it can be hard for any collusive agreement to be monitored; rival wholesale prices cannot be monitored and enforced, and retail prices are an imperfect proxy for them. Jullien and Rey (2007) have shown that in this context upstream firms can use RPM as a facilitating practice for collusion since it brings the publicly observable element of price under their control.[33]

The second relates to RPM as *a facilitating practice to sustain downstream collusion*. This can occur where downstream firms wish to engage in collusion. They can use the imposition of multiple RPM agreements by an upstream firm (acting as a 'common agent') to facilitate downstream price collusion. The enforcement of RPM can facilitate agreement on prices, monitoring of prices, and even punishment for cheating on the collusive agreement. In some instances, the RPM is effectively

[32] Each of these effects is robust to the Chicago critique described above.

[33] Jullien, B. and P. Rey (2007) “Resale Price Maintenance and collusion” Rand Journal of Economics, 38-4, pp. 983-1001.

no more than a 'sham' vertical agreement, masking a pure horizontal agreement.[34]

The third relates to the use of RPM as *a commitment device to protect upstream monopoly rents*. This relates to a now well known monopoly commitment problem, originally identified in Hart and Tirole (1990).[35] A monopolist maximises its profit by selling the right to distribute to only one downstream player. However

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[34] In the UK, the practice of retailers coordinating their behaviour via an upstream supplier has become known as "A to B to C" coordination.

In *Argos Ltd & Anor* v *Office of Fair Trading* [2006] EWCA Civ 1318, the Court of Appeal held (at paragraph 141) that '… if (i) retailer A discloses to supplier B its future pricing intentions in circumstances where A may be taken to intend that B will make use of that information to influence market conditions by passing that information to other retailers (of whom C is or may be one), (ii) B does, in fact, pass that information to C in circumstances where C may be taken to know the circumstances in which the information was disclosed by A to B and (iii) C does, in fact, use the information in determining its own future pricing intentions, then A, B and C are all to be regarded as parties to a concerted practice having as its object the restriction or distortion of competition ... The case is all the stronger where there is reciprocity: in the sense that C discloses to supplier B its future pricing intentions in circumstances where C may be taken to intend that B will make use of that information to influence market conditions by passing that information to (amongst others) A, and B does so.'

[35] Hart, O. and J. Tirole (1990). "Vertical Integration and Market Foreclosure", Brookings Papers on Economic Activity: Microeconomics, 0, pp. 205-276.

ex post it has an incentive to break this agreement and sell to additional downstream players. The overall effect is that, absent a commitment device, the upstream firm is unable to extract the full rent associated with its market power, because it cannot commit itself to not cutting prices on later contracts. RPM solve this problem, by allowing the upstream firm to commit to the monopoly price and extract its full monopoly rents. This has also been shown under different conditions by O'Brien and Shaffer (1992) and Rey and Vergé (2004a).[36]

The fourth relates to the use of RPM as a means *either to soften downstream competition or deter downstream entry*. Shaffer (1991) has shown that downstream firms may have a unilateral incentive to ask the upstream firm to implement RPM as a means to soften competition between themselves.[37] More generally RPM can benefit downstream firms by making it harder for cut-price entrants to steal business through undercutting them. Such

[36] Hart and Tirole (1990) discuss commitment problems in a Cournot setting. Similar results were then derived for a differentiated product market in O'Brien, D. and G. Shaffer (1992), "Vertical Control with Bilateral Contracts", Rand Journal of Economics, 23.pp. 299-308 and generalised in Rey, P. and T. Verge' (2004). "Bilateral Control with Vertical Contracts", Rand Journal of Economics, 35. pp. 728-46.. Note that price ceilings can also solve this commitment problem.

[37] See Shaffer, G., (1991) "Slotting Allowances and Resale Price Maintenance: A Comparison of Facilitating Practices" Rand Journal of Economics, 22. 120-136.

entrants can still make additional profits through greater efficiencies, but they cannot use these efficiencies to steal business through lower prices.[38]

The final theory relates to the use of RPM as a means *to dampen system competition through networks of interlocking RPM agreements*. The simplest example would be a market where there is a duopoly of manufacturers upstream and a duopoly of retailers downstream and both retailers carry the products of both manufacturers, a situation defined as “double common agency”. Dobson and Waterson (2007) have shown that in a bargaining framework, RPM can reduce retailers’ incentives to negotiate on wholesale prices by preventing downstream undercutting.[39] This, in turn, dampens upstream competition and creates higher retail prices, to the detriment of consumers.[40] More generally Rey and Vergé (2004b) have shown that RPM can potentially eliminate all effective competition – at the inter-brand level as well as at the intra-brand level – and yield

[38] See OFT (2007) "An evaluation of the impact upon productivity of ending resale price maintenance on books" and Davies et al (2004).

[39] Dobson, P.W. and M. Waterson (2007) “The Competition Effects of Industry-Wide Vertical Price Fixing in Bilateral Oligopoly” International Journal of Industrial Organization, 25, pp. 935-962.

[40] Essential to Dobson and Waterson is the bargaining process, whereby wholesale prices depend on the distribution of bargaining power between manufacturers and retailers. See Supranote 39

instead the monopoly outcome, if used jointly with franchise fees.[41]

The dreaded question: How often is RPM likely to be on balance harmful?

Given that there is the potential for both anticompetitive harm from RPM and also for efficiency benefits, which of these is most likely to be dominant? Or putting it another way how likely are these theories of harm, and how significant are the efficiencies likely to be?

It is worth noting that there is not a particularly strong empirical literature regarding RPM. Lafontaine and Slade (2008) provide the most recent summary of the existing empirical evidence on RPM.[42] Within a broader analysis of vertical restraints they identify three empirical research papers looking

[41] Rey, P. and T. Verge' (2004b) "Resale Price Maintenance and Horizontal Cartel" Department of Economics, University of Bristol, UK, Leverhulme Centre for Market and Public Organisation.

[42] See Lafontaine, F. and M. Slade (2008) Exclusive Contracts and Vertical Relationships: Empirical Evidence and Public Policy. In Paolo Buccirossi (ed.), Handbook of Antitrust Economics, Cambridge: MIT Press. See also Ippolito and Overstreet (1996) "Resale Price Maintenance: an economic assessment of the Federal Trade Commission's case against the corning glass works", Journal of Law and Economics, Vol. XXXIX and Cooper, Froeb, O'Brien and Vita (2005), "Vertical antitrust policy as a problem of inference International", Journal of Industrial Organization.

at RPM.[43] One of these papers examined cases where RPM was imposed by government,[44] whilst two of them examined cases in which RPM was imposed by firms.[45] Lafontaine and Slade conclude that self imposed RPM cases have an overall positive impact while the exogenously imposed ones have a negative impact.[46] However the authors themselves caution against drawing strong policy conclusions given the quantity and quality of the empirical work has still a ways to go.[47]

Looking at actual cases can potentially give a misleading impression too, since these cases are self-selected by the competition authorities. That said, the OFT has intervened against RPM on a number of occasions, and in each case the evidence supported the view that the RPM in question was anticompetitive and not outweighed by efficiency benefits. For

[43] These are Ippolito, P. M. and Overstreet, T.R., Jr, (1996) "Resale Price Maintenance: An Economic Assessment of the Federal Trade Commission's Case against the Corning Glass Works," *Journal of Law and Economics*, 39: 285–328; Gilligan, T.W. (1986) "The Competitive Effects of Resale Price maintenance," RAND *Journal of Economics*, 17: 544–556; Ornstein, S.I. and Hanssens, D. (1987) "Resale Price Maintenance: Output Increasing or Restricting? The Case of Distilled Spirits in the US," Journal of Industrial Economics, 36: 401–432..

[44] Ornstein, S.I. and Hanssens, D. (1987). Supranote 47.

[45] Ippolito, P. M. and Overstreet, T.R., Jr, (1996) and Gilligan, T.W. (1986). Supranote 47..

[46] Supranote 42

[47] Supranote 42

example, two recent OFT infringement decisions had theories of coordination closely interlinked with them, albeit not always explicitly stated within the decision.[48]

On the benefit side, the OFT commissioned research on the impact of the removal of RPM in books, which took the form of the “Net Book Agreement”.[49] This agreement was in place from 1901 until 1997, and allowed publishers to set the retail prices of books.[50] In 1962, when the agreement was given legal sanction under the Restrictive Practices Act, many efficiency arguments were made as to how removal of this longstanding agreement would damage the market for books.[51] The Agreement was disbanded in

[48] In the OFT’s case on children’s toys (OFT, 2003), the RPM was closely associated with exchanges of information between two large downstream retailers, which is consistent with RPM being used as a facilitating device to sustain downstream collusion. In the case on replica football kit (OFT, 2003) the RPM practice and market circumstances were consistent with facilitating collusion upstream or downstream. For more details on our analysis of these cases, see Stallibrass and Giovannetti (2009) in Supranote 25.

[49] See OFT (2007) "OFT 981 An evaluation of the impact upon productivity of ending resale price maintenance on books". Report prepared for the OFT by the Centre for Competition Policy at University of East Anglia.

[50] See Davies, S W, Coles, H, Olczak, M, Pike, C, and Wilson, C, (2004), 'The benefits from competition: some illustrative UK cases', DTI Economics Paper No. 9.

[51] See Davies et al, supranote50, page 32: “In 1962 the Restrictive Practices Court considered the illegality of the NBA, and contrary to

1995, following pressure from the competition authorities.[52] In practice, and contrary to expectations, the research found that total sales volumes for books increased, as did the number of titles published.[53] There was also a significant increase in retail diversity, with the growth of new retail formats facilitated by their ability to offer discounted books.[54] The UK situation also compared very positively with the situation in Germany where RPM had been maintained.[55]

On balance, it is far from obvious which way the scales tip on RPM. As the academic literature acknowledges, the body of research is simply not large enough to suggest strong conclusions either way. More empirical evidence would be invaluable.[56] However, on the basis of the evidence available to date, if we have to make a binary choice between 'object' and 'effect', we believe that there is simply not enough evidence to conclude that RPM should be moved from the 'object' category

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initial intuition, its judgement exempted the NBA, allowing it to continue. In the judgement, Mr. Justice Buckley famously emphasised that 'Books are different', and considered the NBA to be in society's interest.".

[52] See Davies et al, supranote 50, paragraph 2.3.

[53] Supranote 49

[54] Supranote 49

[55] Supranote 49

[56] This is one of the main conclusions of Lafontaine, F. and M. Slade (2008) in Supranote 42

into the ‘effect’ box. Two main factors tip us towards this view.

First is the role of RPM in facilitating coordination, a role which other vertical restraints do not seem to have. We believe this is not just a minor theoretical point, as is illustrated by the recent OFT infringement cases described above.

Second is the fact that many of the benefits that RPM provides may also, at least in theory, be secured by other vertical restraints. Whilst there are some cases (for example risk aversion) in which RPM may be better suited to securing efficiencies than other types of restraints, it is unclear how frequently these occur in practice.

3. SMALL STEPS TOWARDS A MORE NUANCED POLICY?

As discussed above, given the legal framework described in Section 1, we on balance support the retention of RPM within the ‘object’ box. However, the preceding discussion shows that we have some reservations about a legal framework which, in the name of legal certainty, forces into a ‘presumed illegality’ box some agreements and practices which either do not restrict competition or, if they do, would nevertheless be justified by the efficiency benefits they bring. This issue is particularly relevant to the case of RPM.

In this final section, we set out our thoughts on a few small steps that might be taken towards a slightly more nuanced approach to assessing RPM. These would substantially ameliorate our current reservations, while preserving a position where RPM will, for the most part, remain unlawful.

(i) Ensuring that the presumption of illegality is truly rebuttable

The first step that we would propose towards a more nuanced approach should be relatively straightforward and uncontentious. This would be to widen the gap between the EU 'object' box and the US '*per se* illegality' box. Under the former, there is potential for parties to rebut a presumption of illegality, and we believe that the potential for rebuttal should be given more serious consideration; whether this be on the grounds of there being no restriction of competition (that is, no infringement under Article 101(1)) or of countervailing benefits (that is, exemptibility under Article 101(3)).[57]

In order to facilitate rebuttal where appropriate, we would also argue that the authority should set out one or more

[57] In this light, we are pleased to note that there have been several changes made in the draft revised block exemption guidelines to stress the importance of efficiency arguments in the context of Article 101(3) See Treaty on the Functioning of the European Union See Official Journal of the European Union, C 115/372, 9.5.2008, Supranote 12.

‘theories of harm’. These would not need to be 'proven' – this change should not be seen as moving to the ‘effect’ box via the back door – but merely 'plausible'. That is, they would need to be ‘consistent with’ the facts, including the market circumstances in which the RPM had been applied.[58]

(ii) The use of screens for prioritising RPM cases

The second step we propose is that a series of screens might usefully be adopted for considering whether there is likely to be a credible theory of harm in any particular case of RPM, and for prioritising cases on this basis.

Returning to our review of the existing economic literature in this area, we have attempted to identify three relatively simple screens, at least one of which would need to hold in order for there to be the possibility of a credible theory of harm associated with the RPM.

- First, is there unilateral market power or concentration upstream? If not there is unlikely to be a theory of harm

[58] In order to preserve legal certainty, we would propose that the hurdle for rebuttal be fairly high. For example, it would not be enough for a party to state that “the authority has not proven that this instance of RPM was likely to have a harmful effect”. Rather the burden would be on the party to demonstrate that “this instance of RPM could not possibly have been expected to have a harmful effect, as evidenced by the fact that the authority cannot come up with a theory of harm which is consistent with the known facts”.

regarding protecting upstream market power. Nor is there likely to be a strong theory of facilitating upstream coordination if the upstream market is fragmented.

- Second, is there significant downstream buyer power or concentration? If not, there is unlikely to be a strong theory of harm regarding RPM facilitating downstream coordination or deliberately foreclosing downstream entry. We note that this screen could be further strengthened by evidence that the RPM is manufacturer instigated rather than retailer.
- Third, are there networks of RPM agreements involving a number of upstream suppliers who account for a significant share of the upstream market? If not there is unlikely to be a theory of harm regarding RPM facilitating upstream market coordination

If none of these three elements hold in a particular case, there is unlikely to be a credible theory of harm, and therefore the case would not be prioritised.

We recognise that there is room for further thinking in this area. (For example, how exactly does one define concentration?) Indeed, further developments in the economic literature may be required before a definitive view can be taken on the appropriate screens. Nevertheless, we see real potential for such screens being used by authorities for case prioritisation purposes.

(iii) The use of screens within a legal standard

The final step considered in this section is perhaps more controversial, but we think it is nevertheless worthy of further discussion.

While the use of screens for prioritisation of RPM cases may have an impact in the EU, we recognise that a prioritisation approach may not be effective in a system, such as the US, where much enforcement of competition law is via cases brought by private litigants. However, there may also be some potential to use screens of this sort to help define a legal standard. Under this approach, the authority (or plaintiff) would have to satisfy itself that at least one of the screens was satisfied before taking a case. If all screens were failed, this would be taken to demonstrate that there is no credible theory of harm associated with a particular case of RPM, and in such circumstances, the presumption of illegality would be overturned and the RPM would be viewed as legal.

We believe that this approach would nevertheless leave most potential cases of RPM in the ‘illegal’ box, and would preserve legal clarity, but that it would avoid cases – such as (arguably) *Leegin* – where there is no clear credible theory of harm, and which have the potential to bring the competition system into disrepute by making it appear out of touch with reality.

There are, however, some noteworthy cons to this approach. Some would no doubt argue that, by blurring the lines of what is an ‘object’ infringement, firms become less able to self-assess, smaller retailers find it more difficult to stand up to powerful suppliers who try to impose RPM, authorities become less able to bring cases, and we start to move inappropriately towards a standard ‘effects’ analysis. For us, however, a more compelling concern is that the screens not only relate to the practices and position of the parties involved in a particular RPM agreement, but also the concentration in the relevant market and whether there is a network of similar RPM agreements across the market. If this approach means that a firm cannot assess the legality of its own RPM without knowing (possibly secret) information about its competitors, then it may be that they prove unworkable.

Nevertheless, we think this approach is worthy of further consideration. It is also worth noting that such an approach would have similarities to the sorts of screens that are commonly applied in the EU when assessing abuse of dominance cases under Article 102 of the EC Treaty.[59]

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[59] Supranote 18.

CONCLUSIONS

Within the current legal framework there is, in our view, not yet sufficient evidence available to justify moving RPM out of the ‘presumed illegality’ or ‘object’ box and into a case by case assessment ‘effect’ box. However, from the above discussion, it is clear that RPM falls a long way short of more extreme anticompetitive behaviour such as naked horizontal price fixing.

In an ideal world, the law would reflect this difference, and in the final section of this paper we set out some small steps towards a slightly more nuanced approach to assessing RPM. While further work is required before these could be fully implemented, we believe that these few small changes could greatly ameliorate our reservations about the current legal framework, while preserving a position where RPM will, for the most part, remain unlawful.