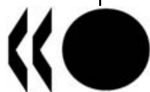

Organisation de Coopération et de Développement Économiques
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25-Jun-2009

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DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE

DAF/COMP/WD(2008)63
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ROUNDTABLE ON RESALE PRICE MAINTENANCE

-- Note by the United States --

This note is submitted by the United States to the Competition Committee FOR DISCUSSION at its forthcoming meeting to be held on 21-23 October 2008.

JT03267295

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1. Introduction

1. The United States Supreme Court recently addressed competition policy approaches to minimum resale price maintenance (RPM) agreements. In its 2007 *Leegin* decision, the Supreme Court (supported by the U.S. antitrust agencies) concluded that these agreements, under which the producer of a product sets a minimum price at which retailers can sell the product, should be evaluated under the rule of reason standard.[1] With *Leegin*, the Supreme Court firmly moved to overrule the existing case law based on the 1911 *Dr. Miles* decision, which held that RPM was *per se* illegal under Section 1 of the Sherman Act.[2] While over the years there have been certain exceptions to this *per se* treatment of RPM,[3] the *Dr. Miles* decision continued to prevent firms from adopting explicit minimum RPM agreements until the Court issued its opinion in *Leegin*. *Leegin* thus grants manufacturers, i.e., the upstream firms in the vertical chain of production, greater freedom to use RPM in their relationships with distributors and retailers, i.e., the downstream firms in the vertical chain of production.

2. The *Leegin* decision brings the legal treatment of minimum RPM in line with the treatment of other vertical restraints that U.S. courts evaluate under the rule of reason, such as exclusive territories and exclusive dealing. While the courts once viewed many vertical restraints with considerable suspicion, over time they began to recognise that these practices can lead to substantial efficiencies and may therefore benefit consumers.[4] Whereas vertical restraints may have an anticompetitive effect in some circumstances, they also may promote competition by allowing vertically related firms to structure their relationships in a way that improves their ability to compete against rivals. Because consumers may frequently benefit from these practices, it is inappropriate to condemn a particular vertical restraint as a *per se* violation of the Sherman Act without first considering its actual effect on consumers. This reasoning applies equally to minimum RPM as well as to other vertical restraints. As the Court noted in the majority opinion in *Leegin*, because adopting a *per se* rule against RPM "would proscribe a significant amount of procompetitive conduct, these agreements appear ill-suited for *per se* condemnation."[5] This perspective is shared by a substantial consensus of economists, many of whom have long argued that a consistent rule of reason treatment of RPM and exclusive territories is proper, since their potential effects and benefits to consumers are similar.[6]

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1. *Leegin Creative Leather Products, Inc.* v. *PSKS, Inc.* 127 S. Ct. 2705 (2007). See Brief for the United States as Amicus Curiae Supporting Petitioner, *Leegin* 127 S. Ct. 2705 (2007).

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

3. For a discussion of the scope of permissible RPM agreements prior to the repeal of the Miller-Tydings and McGuire Acts in 1975, see Pauline Ippolito and Thomas Overstreet, *Resale Price Maintenance: An Economic Assessment of the Federal Trade Commission's Case Against the Corning Glass Works*, 39 Jl. of Law and Econ. 285 – 328 at 287 (1996). For a discussion of permissible behavior under *United States v. Colgate & Co*., 350 U.S. 300 (1919), see Pauline Ippolito, *Resale Price Maintenance: Empirical Evidence From Litigation*, 34 Jl. of Law & Econ. 263 – 294 at 266 (1991).

4. A key turning point was the Supreme Court's decision in *Cont'l T.V. Inc. v. GTE Sylvania Inc.,* 433 U.S. 36 (1977), which held that U.S. courts would judge non-price vertical restrictions according to the rule of reason. For a discussion of the effects of *Sylvania*, see James Cooper, Luke Froeb, Dan O'Brien, and Michael Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 Int'l Jl. of Ind. Org. 639 – 664 at 640 (2005).

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

6. The brief filed in *Leegin* by a wide variety of leading antitrust and industrial organisation economists reflects a general consensus among economists regarding the proper legal standard for evaluating RPM agreements. See Brief of *Amici Curiae* Economists in Support of Petitioner, *Leegin* 127 S. Ct. For additional discussion of the desirability of evaluating RPM under the same standard as other vertical

3. In the wake of *Leegin*, vertically related firms such as manufacturers and retailers may now begin to adopt minimum RPM agreements as standard business practices. If RPM becomes more common,[7] the U.S. antitrust enforcement agencies – the Federal Trade Commission (FTC) and the U.S. Department of Justice (DOJ) – and the courts may need to evaluate the effects of these arrangements with greater frequency. To aid in this task, the antitrust community will be able to rely on the insights from a substantial economics literature that explores the rationales for and effects of RPM. The theoretical branch of this literature identifies both situations where RPM can benefit consumers and ways that firms can potentially use RPM to reduce competition. While this theoretical literature is ultimately inconclusive about whether minimum RPM is generally pro- or anti-competitive, it provides a useful backdrop for assessing the available empirical evidence about the effects of RPM and for guiding investigations into particular instances of RPM. This paper reviews some of the highlights of this theoretical and empirical research and then concludes by discussing some of its practical implications for competition law enforcers.

2. Theoretical Literature Related to RPM

4. A substantial theoretical economic literature related to minimum RPM developed during the years prior to *Leegin*. Although this literature explores ways that firms could use RPM to harm competition, just as importantly it identifies a variety of circumstances in which RPM may enhance competition and benefit consumers. This research thus generally supports the view that a policy of *per se* illegality for minimum RPM is inappropriate. On the one hand, minimum RPM agreements inherently suppress intrabrand price competition, i.e., competition among competing retailers of a particular good. On the other hand, however, RPM agreements may encourage competition among retailers along non-price dimensions. Whether a particular instance of RPM makes consumers better off or worse off depends on how they value these different kinds of competition. Furthermore, the net effect on welfare of a given instance of RPM depends on how it affects the intensity of interbrand competition between the manufacturer and retailers of the good in question and the manufacturers and retailers of other competing goods. The relative importance of these factors is ultimately an empirical question, but it is useful to review the main theoretical arguments regarding the effects of RPM to help identify the kinds of empirical inquiries that might be useful in the investigation of a particular instance of RPM.

2.1. Service Theories

5. A prominent strand of economic literature related to RPM emphasises its use as a mechanism to encourage retailers to provide valuable services to consumers.[8] Examples of such services include the provision of information about product attributes, product demonstrations, post-sale support, pleasant stores, and extended shopping hours. Such services have two key features. First, they are costly to

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restraints, see W. Kip Viscusi, John Vernon, and Joseph Harrington, *Economics of Regulation and Antitrust*, 2nd ed., 240 – 246 (1995).

7 Press reports indicate that this shift may already be occurring. See "Price-Fixing Makes Comeback After Supreme Court Ruling," August 18, 2008, p. A1, *Wall Street Journal*.

8 By "services" we refer to any non-price action by retailers that enhances the demand for the product. The seminal article on RPM's promotion of services is Lester G. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 Jl. of Law and Econ., 86 – 105 (1960) (examining the case in which retail services are subject to free riding by rival retailers). Telser's argument was generalised and extended to the case of downstream oligopoly by Frank Mathewson & Ralph Winter, *The Incentives for Resale Price Maintenance Under Imperfect Information,* 21 Econ. Inq., 337-348 (1983) and Frank Mathewson & Ralph Winter, *An Economic Theory of Vertical Restraints*, The Rand Journal of Economics, 27-38 (1984). The Mathewson and Winter papers also show that services need not be subject to free riding by rival retailers to motivate the use of RPM. The role of RPM when services are not free rideable is analysed further in Ralph Winter, "*Vertical Control and Price versus Nonprice Competition*," 108 Q. J. Econ. 61 (1993).

provide. Retailers will invest in these kinds of services only if they are able to recoup their cost, either directly by charging customers for the service, which is not always feasible, or indirectly through the price of the product in question. Second, such services typically expand demand for the product in question. For example, consumers who receive more information about a technologically complex product may be more likely to purchase it, because they have greater confidence that they will receive the product that meets their needs. In such cases, both consumers and the upstream manufacturer benefit from the provision of these services. The consumer benefits directly by receiving the service, and the manufacturer benefits from increased sales, e.g., when the additional retail services enable it to compete more effectively against the producers of other brands of the good in question.

6. Using RPM to create an incentive to provide retail services would not be necessary if the downstream retailer had an optimal independent incentive to invest in the services, or the upstream manufacturer had other, equally effective mechanisms for providing the necessary incentives. In many situations, however, neither of these conditions is satisfied. If retailers bear the full cost of the services they provide and yet do not receive the full benefit, their independent incentive to provide the services will generally be less than optimal. Furthermore, there may be only limited or ineffective mechanisms available to the manufacturer for overcoming the externality that arises from this divergence of private costs and benefits. For example, it may not be possible for the manufacturer to specify the desired level of selling services for its retailers in a contract that can be enforced in court.[9] If it is not possible or economical to write such a contract, then the retailers will independently choose how much of the relevant service to provide, given their individual incentives.

7. A manufacturer may wish to use RPM with its retailers in this situation in order to increase their independent incentive to provide retail services. At the margin, an individual retailer's incentive to provide such services depends on both the responsiveness of its own demand to the level of services it provides and the profit margin that it earns on sales of the product. A manufacturer can influence both of these factors by implementing RPM agreements with its retailers.

8. An important point that is relevant to policy discussions is that the retailer services need not be subject to free riding for RPM to be a profitable and consumer welfare-enhancing strategy. The motivation for RPM arises because retail competition reduces retail margins below the level that a fully integrated manufacturer would have. This causes retailers to provide less service than would an integrated firm. RPM can be used to increase the retail margin thereby giving the retailer incentives to provide additional service.

9. RPM may be especially useful when retailers cannot appropriate the full benefits of their investments in services because competitors are able to free ride.[10] The iconic example of this phenomenon is the provision of pre-sale information about a product.[11] If a product is highly differentiated or technologically complex, consumers may require information about product attributes before making a decision about whether to purchase. A full service retailer may provide this information, possibly by employing knowledgeable salespeople or offering free product demonstrations, but it would need to set a price that is sufficiently high to cover not only the wholesale price of the good and the usual selling costs

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9 This kind of situation, where one party in an economic relationship takes a costly action that benefits another party, and where it is not possible to verify the action in court, is commonly known as moral hazard. See, e.g., Paul Milgrom and John Roberts, *Economics, Organization, and Management*, at 167 (1992).

10 See Telser and Mathewson & Winter, *supra* note 8.

11 See Kenneth Elzinga and David Mills, *The Economics of Resale Price Maintenance*, in Wayne D. Collins (ed.), *Issues in Competition Law and Policy*, vol 3, 1841.

but also the provision of information to prospective customers. A discount retailer could then profitably undercut the full service retailer's price, since it would not need to bear the cost of educating customers. Consumers could inform themselves for free at the full service retailer and save money by purchasing from the discount retailer. This behavior would reduce the responsiveness of a full service retailer's demand to its investments in educating customers. Such free riding by discounters would generally undermine a retailer's incentive to provide the needed information to consumers. This underprovision of useful information would then lead to a reduction in demand for the manufacturer's product. Economic theory generally predicts a similar effect for any retail service that is vulnerable to free riding.[12]

10. RPM provides a mechanism for mitigating the effect of this free rider problem. By imposing a minimum retail price, RPM agreements would reduce discounters' sales by preventing them from undercutting the prices of their full service competitors. Retailers would then have a greater incentive to provide a higher level of service to their customers, since they would be more likely to internalise the benefits of such an investment. Although RPM in this case would reduce intrabrand price competition, it would increase service competition and increase interbrand competition. Its net effect on consumers' welfare would depend on how they assessed the tradeoff between these different kinds of competition.[13]

11. A related argument is that RPM may encourage the development of retailers that provide certification that a manufacturer's product is of high quality.[14] In many cases consumers are unable to observe the true quality of a product at the time of purchase. This uncertainty is a particular problem for a high quality manufacturer; it would increase demand for its product if it could credibly communicate its true product quality. If retailers are in a better position to assess product quality than consumers, they may find it feasible and worthwhile to develop a reputation for carrying only high quality goods. A retailer that possessed such a reputation would effectively certify that a manufacturer's product is of high quality by choosing to carry it. Establishing such a reputation would generally require costly investments, and retailers would need to earn a return to compensate them for undertaking these investments. This return would generally take the form of a higher markup over the wholesale cost of the product.

12. As is the case with other services that are vulnerable to free riding, a retailer that established a reputation for carrying high quality goods would be vulnerable to the appearance of discounters that could profitably undercut its prices. A consumer could first visit a retailer that had a reputation for carrying high quality goods in order to determine if it carried a particular product. After determining the product's quality, the consumer could then purchase from a discounter, which would free ride on the quality certification reputation of its competitor. Such behavior would reduce the incentive to invest in the development of a reputation for carrying high quality goods in the first place. As with other services, RPM could increase this incentive by preventing discounters from undercutting the retailer's price.

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12 But cf. Frederic M. Scherer & David Ross, *Industrial Market Structure and Economic Performance* 551-554 (3d ed. 1990). (Scherer and Ross describe limitations to the free rider argument, noting that: only presale service, including advertising and on-site demonstration, should be of concern under a free rider analysis; presale service is unnecessary when customers know what they want and why; and, free riding arguments apply mainly to high value purchases, often sold by high-quality stores enjoying a reputational advantage and an inelastic customer base. "To sum up, the free rider justification has severe limitations. Its plausibility is palpably low in many product areas where RPM is used.")

13 Observers have pointed out that the desire to provide an incentive to invest in these kinds of services can be a rationale for manufacturers to grant exclusive territories to their retailers. See, e.g., Viscusi et al., *supra* note 6 at 245. In such cases RPM arguably restricts retail competition less than exclusive territories.

14 See the discussion in Brief of *Amici Curiae* Economists, *supra* note 6, at 7, or Howard Marvel & Stephen McCafferty, *Resale Price Maintenance and Quality Certification*, 15 RAND Jl. Econ. 346 – 359 (1984).

13. While some retail services are clearly vulnerable to free riding, others are not. For example, a retailer that creates a pleasant shopping environment for its customers and has extended shopping hours would likely appropriate the benefits of these investments. It might then seem that retailers would have an optimal incentive to provide these services. This conclusion is not always justified, however, because a manufacturer may prefer that its retailers invest more in such retail services in order to increase the competitiveness of its product relative to those offered by other manufacturers. From the perspective of the entire vertical chain of production and distribution, the retailers' independent incentives may lead them to invest too little in demand-enhancing services. This outcome could occur because intrabrand price competition among the retailers reduces the profit margin that they earn from selling the product, which in turn reduces the incentive to invest in services that would increase sales.[15] There is no guarantee that independent price competition among retailers will lead to optimal incentives to invest in retail services. By imposing minimum RPM, a manufacturer could potentially overcome this problem by using the combination of its wholesale price and the minimum permissible retail price to increase the margin that its retailers earn from their sales of the manufacturer's product. This higher margin would provide the retailers with a greater incentive to invest in retail services.[16]

2.2. Using RPM to Influence Retail Inventories

14. Several papers argue that manufacturers may also wish to adopt minimum RPM in order to influence the amount of inventory that their distributors or retailers hold.[17] This literature observes that the level of final consumer demand for a manufacturer's product may be uncertain at the time that retailers must make their inventory decisions. For example, a retailer may not be able to predict perfectly the ultimate level of consumer demand for a particular book or music CD. If the actual level of demand turns out to be lower than expected, fierce price competition may ensue as retailers scramble to liquidate their inventories. In such cases price may fall below wholesale cost and the retailers might lose money. If the actual level of demand turns out to be higher than expected, the retailers may wish that they had ordered more units. Yet the possibility of aggressive competition when demand is low could lead retailers to place conservative orders.

15. Because minimum RPM inhibits the price cutting that would otherwise occur when demand is low, it may lead retailers to hold larger inventories when demand for a product is uncertain. These larger inventories would then lead to lower prices and higher quantity sold when demand is high. Whether consumers benefit from the higher inventories depends on whether their expected gain from the increase in available units in the event of high demand exceeds their loss from higher prices when demand is low. While the effects of this use of RPM on consumers are uncertain and would require an empirical investigation in any particular case, this literature does demonstrate that there are circumstances where the use of RPM can be competitively benign even if the level of retail services does not have an important effect on the level of demand.

2.3. Possible Anti-Competitive Uses of RPM

16. The preceding discussion notwithstanding, there are circumstances where it is possible that firms could use RPM to harm competition. One potential concern is that colluding firms could use RPM to

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[15] See Benjamin Klein & Kevin Murphy, *Vertical Restraints as Contract Enforcement Mechanism*, 31 Jl of Law & Econ. 265 – 297 (1988).

[16] See Mathewson & Winter and Winter, *supra* note 8.

[17] See Raymond Deneckere, Howard Marvel, and James Peck (1997), *Demand Uncertainty and Price Maintenance: Markdowns as Destructive Competition*, Am. Econ. Rev, 619 – 641 (1997). See also Raymond Deneckere, Howard Marvel, and James Peck, *Demand Uncertainty, Inventories, and Resale Price Maintenance*, Quar. Jl. of Econ., 885 – 913 (1996).

sustain a price-fixing cartel. Such a cartel could arise at either the retailer or the manufacturer level. As noted in the FTC and DOJ's joint *amicus* brief in *Leegin*, such cartels are themselves *per se* illegal and hence receive condemnation under the antitrust laws irrespective of the legal standard that the courts use to evaluate RPM.[18] Still, the possibility that RPM could be used to sustain such conduct in itself justifies scrutinising these agreements under the rule of reason, rather than adopting a rule of *per se* legality.

17. Enforcing discipline among its members is one of the main challenges that a price-fixing cartel faces.[19] Because it sets prices at supracompetitive levels, a cartel's members all have an incentive to offer secret price cuts to customers in order to steal sales from the other members. If the members are unable to detect and punish such defections, discipline is more likely to break down and the cartel is more likely to fail. Faced with these challenges, a cartel of retailers or distributors might welcome industry-wide RPM agreements that required the members to charge the collusive price. RPM might then enable the cartel to outsource enforcement of its anti-competitive agreement to upstream manufacturers. The use of RPM to sustain collusion, resulting in price increases, causes consumer harm. The Supreme Court recognised this risk in its *Leegin* decision, and emphasised that "the potential anticompetitive consequences of vertical price restraints must not be ignored or underestimated,"[20] and cautioned courts "to be diligent in eliminating [the] anticompetitive uses" of RPM from the market.[21]

18. While it is certainly possible that RPM could be used to support a cartel of retailers or distributors, there are good reasons to believe that such conduct is unlikely to be common. Most importantly, a manufacturer would generally not have an incentive to join a conspiracy that eliminated competition among its retailers, because this would lead to a decrease in the derived demand for its product. In effect, a retail cartel would exacerbate the well-known problem of double marginalisation.[22] Thus, absent substantial monopsony power that made a threat of boycott credible, it is unlikely that a group of retailers could successfully convince manufacturers to grant RPM agreements that implemented the terms of a downstream price-fixing cartel.[23] Even if it were compelled to accede to demands for such agreements, a manufacturer would have a strong incentive to foster the development of alternative channels of distribution for its product. The retailer cartel might therefore be short-lived.

19. A cartel of manufacturers would face the same problem of how to police its collusive agreement. Such a cartel could potentially use industry-wide RPM agreements as a mechanism to help enforce discipline among its members, provided that retail prices are observable.[24] If an individual manufacturer attempted to steal sales from its rivals by offering secret price discounts to its distributors, minimum RPM agreements would prevent retailers from passing on the discount to final consumers, thus limiting any

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18 See Brief for the United States as Amicus Curiae Supporting Petitioner, *supra* note 1 at 21 – 22.

19 See, e.g., George Stigler, *A Theory of Oligopoly*, 72 J. Pol. Econ. 44 – 61 (1964).

20 *Leegin*, 127 S. Ct. at 2717.

21 *Id.* at 2719.

22 See Viscusi et al., *supra* note 6 at 227 for a discussion of double marginalisation, also known as the problem of successive monopolies. See also the Brief for the United States, *supra* note 1 at 18.

23 Even if they could obtain such RPM agreements to implement a cartel, it is not clear how the retailers would be able to monitor the manufacturer's enforcement of the RPM if they were not in a position to directly monitor adherence to a mutual cartel agreement by observing each other's prices. It would generally be in the manufacturer's interest in this case to allow retailers to renege on their agreements in order to reduce the loss from double marginalisation.

24 See Ippolito, *supra* note 3 at 281. It is important to recognise that, while industry-wide RPM agreements might be consistent with the existence of a manufacturer cartel, they would also be consistent with a conclusion that RPM is generally efficient in the industry in question.

increase in the cheater's sales. The main effect of such a secret discount would then be to enrich the distributor, since it would earn a higher profit margin on sales of the discounted product. By limiting the responsiveness of final demand to secret price cuts, minimum RPM would reduce each manufacturer's incentive to cheat on their cartel agreements.[25]

2.4. Conclusion

20. Minimum RPM would cause great concern if its main effect were to reduce competition among retailers or manufacturers by, for example, facilitating the establishment of price-fixing cartels. While RPM may injure competition in some cases, the theoretical literature demonstrates that there are many situations where manufacturers may wish to use RPM to increase sales of their products. When the level of retail services has an important effect on demand, the manufacturer's goal is not to eliminate competition among the retailers of its product, but rather to provide them with an incentive to shift their emphasis from price competition to non-price competition. The manufacturer has an incentive to change the terms of its retailers' competition if doing so strengthens the manufacturer's ability to compete with its rivals. Consumers generally benefit from this increase in interbrand competition.

3. Empirical Evidence on the Effects of RPM

21. Theory alone may not be sufficient to resolve whether minimum RPM is beneficial or harmful to competition in a particular case. Given this uncertainty, careful empirical research on the effects of RPM is needed to help guide the competition law enforcement agencies and the courts as they evaluate this conduct in the future. While some empirical work exists, the fact that minimum RPM agreements have long been *per se* illegal has necessarily limited the amount of empirical research that could be done. Nevertheless, several relevant findings have emerged from the empirical literature that has appeared to date.

22. The available empirical evidence does not support a conclusion that RPM is widely used to support the operation of price-fixing cartels. Ippolito[26] analysed all litigated U.S. RPM cases between 1976 and 1982 and concluded that the collusion theory could potentially explain the adoption of RPM in only a small fraction of these cases. Only 13.1 percent of the cases in this sample included any allegation of horizontal collusion.[27] A study of the FTC's RPM enforcement efforts between 1965 and 1982 found that they typically involved very competitive retail markets where widespread collusion was not plausible.[28]

23. Ippolito's study also considers whether there is evidence to support the pro-competitive retail service theories for why firms adopt RPM. These theories are difficult to test directly. Nevertheless, this study sheds indirect light on the question by classifying the different products at issue in the cases in the sample into different categories, such as complex products, fashion goods, goods with unobservable quality, and simple products. It is plausible that the retail service theories are more likely to apply to cases that involved complex products, "for which quality and use information were nontrivial issues prior to

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[25] The cheating cartel member might enjoy some increase in its sales even if RPM agreements were in force, if retailers had the ability and incentive to use non-price means to shift sales to the relatively more profitable product.

[26] See Ippolito, *supra* note 3.

[27] *Id.* at 282.

[28] Thomas Overstreet, *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics, Federal Trade Commission (1983).

purchase,"[29] than for simple goods. This analysis concludes that the retail service theories could explain a large fraction of the cases in the sample.

24. In another study, Ippolito and Overstreet[30] take a different tack by closely examining the record in one individual case for evidence for and against different possible theories for why firms might adopt RPM. This study examines the evidence gathered during the FTC's successful case against Corning Glass Works over its long-standing use of RPM. Subsequent to the court upholding the FTC's decision, Corning abandoned its RPM program. Based on their review of the record in this case, Ippolito and Overstreet conclude that the evidence is inconsistent with a conclusion that RPM supported collusion at either the retailer or distributor level.[31] Furthermore, they conclude that the evidence does not support a theory that Corning used RPM in order to support a manufacturer cartel in any plausible product market.[32] Based on an analysis of Corning's and its competitors' sales and promotional spending before and after the decision in the FTC case, Ippolito and Overstreet conclude that the evidence provides some support for the service theories.[33] For example, their analysis demonstrates that Corning's sales declined in the years following the FTC case, while its competitors' sales generally did not. This pattern of effects is consistent with the conclusion that Corning's RPM enabled it to compete more effectively against its rivals.

25. While the available empirical evidence regarding the effects of RPM is limited, it is consistent with the conclusion that it is appropriate to analyse RPM under the rule of reason. If explicit RPM agreements become more common in coming years, there should be opportunities to develop additional empirical evidence on the effects of this practice.

4. Implications for Enforcement

26. In the wake of *Leegin*, the U.S. competition enforcement agencies and the courts may more frequently need to evaluate the competitive effects of individual RPM agreements. In fact, the FTC has already considered a request by Nine West Footwear Corporation to release it from an earlier consent agreement that settled a case dealing with Nine West's use of RPM.[34] Relying on *Leegin*, the FTC granted Nine West's petition on the basis that its potential use of RPM agreements was not deemed to harm consumers at this time. In particular, the FTC reviewed the three factors cited by the Court as particularly relevant to the application of the rule of reason to RPM agreements.[35] These factors are: the number of competitors in the market that have adopted RPM agreements (The Court notes that interbrand competition would divert consumers to lower priced substitutes, thus limiting the likelihood that resale price maintenance could facilitate a manufacturing or retail cartel in markets in which only few competitors employ RPM.[36]); whether the RPM originated with the manufacturer or the retailer (The Court observed that because a manufacturer generally has incentives to promote efficient distribution that are aligned with the interests of consumers, harm to competition is more likely if RPM agreements are brought about as a result of retailer pressure rather than on the manufacturer's own initiative.); and, whether the manufacturer

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[29] Ippolito, *supra* note 3 at 283.

[30] Ippolito and Overstreet, *supra* note 3.

[31] *Id*. at 300.

[32] *Id.* at 301.

[33] *Id.* at 305 – 306.

[34] See *In the Matter of Nine West Group, Inc*., Docket No. C-3937, Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000.

[35] *Leegin*, 127 S. Ct. at 2719-20.

[36] *Id.* at 2719.

or retailer party to the RPM agreement has market power ("If a retailer lacks market power, manufacturers likely can sell their goods through rival retailers . . . [a]nd if a manufacturer lacks market power, there is less likelihood it can use the practice to keep competitors away from distribution outlets."[37]). The FTC concluded that Nine West demonstrated that it did not "run afoul of the *Leegin* factors," due, *inter alia*, to its "modest market share."[38] The Commission concluded that Nine West's use of RPM at this time does not pose any potential competitive concerns.

27. The FTC's order states that "the Court's elaboration of these relevant factors provides an approach for identifying when RPM might be subjected to closer analytical scrutiny,"[39] and in particular, whether RPM could be used to support either a manufacturer or retail cartel. Accordingly, an investigation into a particular instance of RPM should begin by examining whether there is any reason to believe that such a cartel is possible. One key question is whether RPM is widespread in the industry in question. If few manufacturers have RPM agreements in place with their retailers, or if few retailers have RPM agreements in place with a given manufacturer, then it is not plausible that RPM is being used to help enforce a cartel. Of course, a finding that RPM is widespread in a particular industry would be only a necessary, and not a sufficient condition to conclude that a cartel might exist. Widespread use of RPM is equally consistent with a hypothesis that its efficiencies are widespread, so further evidence would be needed to determine whether collusion was likely.

28. If the evidence does not point to a manufacturer cartel, possibly because RPM is not widespread among the different manufacturers, it would be appropriate to evaluate whether the manufacturer in question possesses meaningful market power in the relevant product market. If it does not, it is not clear how retailers could use RPM to enforce a cartel agreement; raising the retail price of the one manufacturer's product would just shift sales to the other manufacturers' products. If those products are not also covered by RPM agreements, or if they are sold in other channels of distribution, then the retail cartel might not be able to earn supracompetitive profits.

29. In the absence of market power, a manufacturer selling through competitive retailers would generally not be able to use RPM unilaterally to harm competition. Although a manufacturer could use RPM to shift the terms of competition among its retailers away from intrabrand price competition and towards competition on non-price dimensions, the presence of robust competition from other manufacturers would prevent consumers from suffering harm from the change in the nature of competition. If price increased by more than the value of the additional retail services, consumers could just switch to one of the alternative products. If a manufacturer selling through competitive retailers faces vigorous competition from rivals, its decision to adopt RPM likely reflects an effort to improve its ability to compete. The existence of market power is therefore a useful screen to determine whether a more thorough consideration of the actual effects of RPM on consumers is warranted. In fact, the FTC cites the lack of significant market power as one reason that it was appropriate to release Nine West from the consent agreement it entered into in 2000, following the FTC's investigation of Nine West's use of RPM.[40]

30. While the presence of market power is a necessary condition for RPM to harm consumers, it is important to recognise that it is not a sufficient precondition in and of itself. Indeed, consumers could

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37 *Id.* at 2720.

38 *In the Matter of Nine West Group, Inc.*, Docket No. C-3937, Order Granting in Part Petition to Reopen and Modify Order Issued April 11, 2000 at 15, May 6, 2008.

39 *Id.* at 14.

40 *Id.* at 15.

benefit from the effects of minimum RPM agreements even if the upstream manufacturer is a monopoly.[41] Accordingly, it would be inappropriate to conclude merely from a finding that the manufacturer possessed market power that its use of RPM is likely to be harmful to consumers. If products are highly differentiated or technologically complex, it would not be unusual for manufacturers to possess significant market power, and this is exactly the kind of setting where RPM may be most useful to encourage retailers to offer valuable services to consumers.[42]

31. If available, reliable evidence regarding the effect of RPM on sales of the product in question would be directly relevant to an assessment of its competitive effect. If RPM enables a manufacturer to compete more effectively against its rivals, it should gain sales at their expense. Even if the manufacturer is a monopolist, it may still wish to use RPM to encourage retailers to promote its product or hold greater inventories, thus expanding output and benefiting consumers. A finding that RPM caused sales of the manufacturer's product to increase would also be strong evidence against the hypothesis that its purpose was to sustain a cartel among either retailers or manufacturers.

32. Critics of RPM generally express a concern that it will lead to higher prices for consumers.[43] Therefore, it might seem that a direct examination of the effect of RPM on retail prices would be useful and important to help to discern whether this is indeed the case, and if so, in which circumstances. The pro-competitive theories about why firms may adopt RPM rest on the manufacturer's desire to influence retailers' behavior by increasing their profit margin on sales of the product in question. These theories make no prediction about whether RPM leads to higher or lower prices.[44] The manufacturer could increase this margin either by imposing a higher retail price through RPM or by using RPM to maintain the current price (or even lower it) and then reducing its wholesale price. A manufacturer might choose to lower price if the additional demand it expected from enhanced retail services enabled it to exploit economies of scale more fully. If an increase in retailer services is associated with an increase in the price elasticity of demand, RPM can lead to lower retail prices. Of course, a manufacturer might also choose both to increase the retail price and reduce the wholesale price. However, a careful empirical analysis would be needed to establish that RPM had this effect in practice.

33. Even if the available evidence established that RPM led to a higher retail price for a product, it would still be inappropriate to conclude on that basis that consumers had been harmed. If the higher retail price created an incentive for retailers to provide valuable services or higher quality, consumers could be better off, and evidence that sales had increased despite the price increase would suggest that they are. In general, evidence of RPM's effect on quantity is far more probative than price evidence for establishing its

41 In Deneckere et al., *supra* note 17, a monopoly upstream manufacturer adopts RPM in order to influence its retailers' inventory choices, and they show that there are conditions under which this RPM benefits consumers. Furthermore, the retail service theories do not generally require that the manufacturer faces competition in order for RPM to benefit consumers.

42 As noted above, Ippolito, *supra* note 3 at 283, found that RPM was widely used with the sale of such products.

43 Writing in dissent in *Leegin*, *supra* note 1, Justice Breyer expresses exactly this concern.

44 Whether minimum RPM leads to higher or lower retail prices depends on a range of factors, including the elasticity of demand with respect to price and service, the effect of additional service on the price elasticity, the presence or absence of scale economies, the nature of upstream and downstream rivalry, and the nature of supply terms (e.g., linear or nonlinear contracts). For a discussion of one set of conditions in which RPM reduces price, see Howard P. Marvel & Stephen McCafferty, *The Political Economy of Resale Price Maintenance*, 94 J. Polit. Econ. 1074 (1986) and Howard P. Marvel & Stephen McCafferty, *The Welfare Effect of Resale Price Maintenance*, 28 J.L. & Econ, 1985.

effect on consumer welfare. While it might still be useful to investigate directly whether service competition among retailers is significant, it is important to recognise that knowing only how RPM affects final retail prices provides little or no information about its effect on consumer welfare.

34. Third, any evaluation of the effect of RPM on price should recognise that, if RPM is not an option, a manufacturer may choose to adopt an alternative, less-preferred strategy to accomplish its goals. For example, it may choose to establish exclusive territories or to vertically integrate. Any conclusion about the effect of RPM on retail prices should be based on the appropriate counterfactual comparison. Eliminating RPM may not lead to an increase in intrabrand retail competition, and it may harm interbrand competition.

5. Conclusion

35. As we concluded in our *amicus* brief in *Leegin*, "[t]here is no sound basis for treating RPM differently from other vertical arrangements."[45] The shift to a rule of reason treatment has the potential to create substantial benefits for consumers, and there is no reason to believe that competition law enforcers and courts will not be able to protect against anticompetitive abuses. While it is unlikely that *Leegin* has ended the debate over RPM, it may spark a new wave of studies that will allow the conversation in the future to be even better informed.

[45] Brief for the United States as Amicus Curiae Supporting Petitioner, *supra* note 1.