EC 360: Industrial Organization
Vertical Restraints

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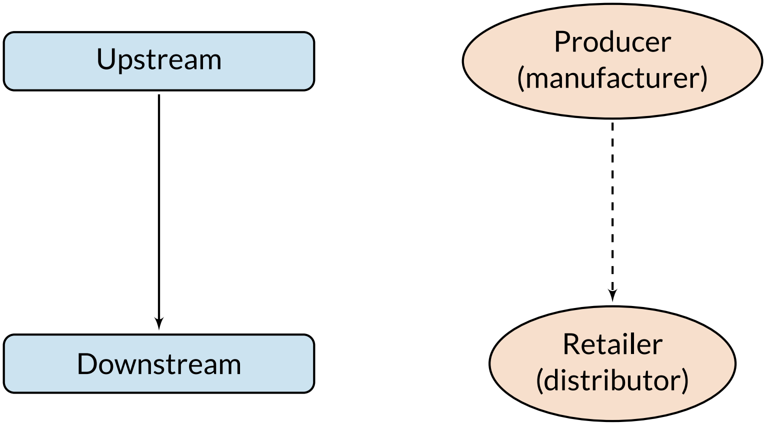
Price resale fixing

- In this lecture, we will extend the number of firms active in creating a good and delivering it to the consumer
  - The producer manufacturers the good
  - The retailer distributes the good to the consumer
- There are two common business practices firms use that restrict the price that retailers can resell their product
  - Maximum resale price fixing
  - Resale price maintenance

Upstream and downstream firms



Maximum resale price fixing

Maximum resale price

- Many items have a maximum resale price imposed, either formally or informally
  - Video games debut at the same price, regardless of the store or location
  - New cars have a listed manufacturer's suggested resale price (MSRP), and almost all dealers adhere to this rule
  - Fast food chains advertise deals nationally, and most local franchises honor the deals
- Why should a producer of a good care about the resale price of the good?
  - **Claim**: suppose the manufacturer has a monopoly in the production of a good. If a distributor has a local monopoly, then the manufacturer makes less money than it would if distribution were perfectly competitive
  - Graph 9.1 and example 9.1

Economics of maximum resale price

- The manufacturer doesn't like having its profits reduced, and can respond in two ways
    1. Vertically integrate and perform its own distribution
    2. Impose a maximum resale price
- Both of these outcomes result is less welfare loss than allowing distributors to choose their own profits
- There are other ways to induce the same outcome as setting a maximum resale price
    - Performance standards
    - Price announcements
    - Lump-sum franchise fees

Performance standards

- A **performance standard** is a quota on sales that the manufacturer imposes on the distributor
  - The manufacturer can impose that the distributor sells the profit-maximizing quantity, and market forces will lead to the same price as maximum resale price fixing
- However, there are issues with this approach
  - Enforcement: what penalty is imposed on a distributor who does not meet the performance standard?
  - Distributors hate performance standards

Price announcements

- A manufacturer can announce a price that is “only at participating retailers”
  - Subway’s $5 footlong
  - MSRP of a new car
- The case of *Jack Walters & Sons v. Morton Building, Inc.* (1984) provides precedent
  - Morton manufactured the good, and Jack Walters distributed the good to consumers
  - Morton advertised directly to its customers any rebates, special prices, or discounts
  - Morton threatened to terminate Jack Walters’ contract or sell directly to the consumer if they did not honor the price
  - The courts ruled that this advertising was legal, as the final price is the only thing consumers cared about

Lump-sum franchise fees

- In theory, a manufacturer can gain the same amount of profit by allowing potential distributors to bid for the right to carry the product
    - This is equivalent to getting all of the profit up front, rather than as the units are ordered
    - Graph 9.2
- There are issues with this approach
    - Once the franchise rights are bought, the franchise has no incentive to act in the way the manufacturer wants
    - Many franchise owners won't have the money to bid up to the full value of the franchising rights
- An alternative is to charge periodic royalties, whose prevent value equals the optimal lump-sum franchise fee

Kiefer-Stewart Co. v. Seagram & Sons (1951)

- Seagrams & Sons was a distributor of liquor in Indiana that imposed a maximum resale price to its retails
    - Kiefer-Stewart refused to honor the maximum price set by Seagram and was excluded from the distribution chain
    - Seagram showed the price ceiling was meant to prevent cartel activities by its distributors
- The court ruled in favor of Kiefer-Stewart, as they were excluded from the market
    - Notice that this logic does not match up with the intent of the Sherman Act

State Oil Co. v. Khan (1997)

- The Khan case reversed the precedent set by Kiefer-Stewart
    - State Oil Co. leased a gas station to Barkat Khan and mandated that Khan buy its gas from State Oil
    - State Oil would suggest a retail price that Khan could appeal
    - If the appeal was unsuccessful, Khan could still charge a different price; however, he was required to rebate any excess profits back to State Oil
    - Khan filed suit for an antitrust violation
- The Supreme Court ruled in favor of State Oil
    - This established new precedent that each maximum resale price fixing case would be evaluated under the **rule of reason**

Resale price maintenance

Resale price maintenance

- Many manufacturers mandate that their products not be resold for less than some specified price
  - This is called **resale price maintenance**, or RPM
- RPM can be used as both an anticompetitive and procompetitive strategy
  - Anticompetitive: cartels
  - Procompetitive: product-specific services, quality certification

Anticompetitive motives for RPM

- A dealer cartel can benefit from RPM
    - Suppose a group of dealers want to form a cartel on a product
    - Due to incentives to cheat, the dealers would all try to lower their prices just below each other
    - If the manufacturer sets a minimum resale price at the cartel level, then no dealers can cheat
- RPM was per se illegal in antitrust cases
    - In practice, there is essentially zero evidence that RPM is used for anticompetitive reasons

Procompetitive motives for RPM: product-specific services

- There are certain types of products where value is added if it's bought from a store that provides expert service (i.e. running shoes, REI products)
  - This service is costly to the retailer, and the service does not guarantee that the product is purchased from the source of service
  - Many manufacturers recognize that the demand for their product could increase with these services; however, retailers may deem is optimal to cut prices and not offer the services
- RPM incentives firms to provide the services
  - Since all firms have the same minimum price, retailers compete in non-price aspects
  - If a retailer doesn't provide the service but sells the good, they are offering less than their rivals
  - Graph 9.3

Procompetitive motives for RPM: quality certification

- Product-specific services don't apply if the good requires no service
  - Quality certification is an alternative to product-specific services
- Some manufacturers make especially high-quality goods, and they can signal the high quality if they are carried by fine retailers
  - Retailers will want to buy the good, but low-quality retailers will have incentive to sell the same good at a discount
  - RPM can prevent free-riding and incentivize the all retailers to carry the high-quality good

RPM example: Arc’teryx

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- Arc’teryx is an outdoor retailer that holds promotions at its stores

- These events include free ski waxings, directing customers to competing stores if needed, parties, etc.

RPM example: Luxottica

- Luxottica makes high-end sunglasses
  - The rise of the internet made selling sunglasses at a low price much easier
  - To "protect the reputation" of the brand, Luxottica responded with a minimum average price that retailers could sell their product

Fair trade legislation

- Many states have passed **fair trade laws** that promote vertical price fixing
  - This conflicted with the federal ban on RPM
  - As a way to help small merchants, the McGuire Act required all firms to adhere to any fair trade laws
  - In the 1970's, the McGuire Act was repealed due to massive backlash

RPM legislation

- *Dr. Miles Medical Co. v. John D. Parks & Sons* (1911) set precedent for RPM antitrust cases
    - Dr. Miles produced medicine, and John D. Parks was a wholesale druggist
    - Dr. Miles required wholesalers to only sell to approved retailers, but John D. Parks didn't listen
    - Dr. Miles filed suit, claiming he was damaged due to hurting the reputation of Dr. Miles' products
- The Supreme Court sided with John D. Parks, as they believed these controls lessened welfare by restricting vendor activity
    - Since RPM was done under agreement, it is a per se violation

RPM legislation

- *US v. Colgate* (1919) established an exception to the per se illegal treatment of RPM
  - This Colgate exception allows a manufacturer to unilaterally develop a policy that its product must be sold at a certain price, otherwise it would **refuse to deal** with distributors
- *Leegin Creative Leather Products, Inc. v. PSKS, Inc.* (2007) overrulled the Dr. Miles case
  - Now, RPM vertical price restraints are judged on the **rule of reason**