

Vertical Relations

Vertical restraints

- Between producers and retailers, contracts more complex than unit price.
 - Two-part or non linear tariffs;
 - Clauses that constraint the behavior of parties : RPM, tyed sales,
 - Clauses that reduce competition : exclusive territories, franchising
- Many controversies, and attitudes of comp. authorities w.r.t. these restraints vary over time and countries.
- Since the « Leegin » decision of the US Supreme court (2007), much debate even around RPM.

Main types of vertical restraints

- Non linear tariffs. Ex : 2 part tariff (unit price + fixed fee). Requires monitoring from the producer (a unique retailer could buy for all the others in order to avoid the payment of the fixed fee)
- RPM (resale price maintenance): the producer chooses the retail price (or a minimum /max price). Requires also monitoring.
- Quantity restrictions, quotas (like RPM).
- Exclusive territories : each retailer is assigned a given market (may limit active/passive sales)
- Exclusive dealing : the retailer cannot sell the products of a rival producer.
- Tied sales, full line forcing...
- Are these restraints good or bad for competition?

Vertical coordination : the double marginalisation problem

- Consumers' demand $D(p)$.
- A monopoly producer (unit cost c) sells through a monopoly retailer at unit price w , maximises its own profit : $(w-c)D(p)$, takes a unit margin $(w-c)$.
- The retailer (unit cost d) sells to consumer at price p_{nvi} that maximises $(p-w-d)D(p)$; takes a second margin : $(p-w-d)$.
- A vertically integrated structure would choose the price that maximises $(p-c-d)D(p)$, that is, p_{vi} .
- The price p_{vi} is lower than p_{nvi} , generates a higher consumers' surplus, **and** a higher profit for the vertical structure.
- Coordination problem : each agent ignores the effects of its own decisions on the other agent.
- Many vertical restraints can help solving this coordination problem.

Solutions to the coordination problem

- RPM : the producer imposes to the retailer the final price p_{vi} .
- 2 part tariff : the producer sells at unit price c (its cost), the seller maximises $(p-c-d)D(p)$, chooses p_{vi} . Then the producer makes profit through a fixed fee F (contract : c, F)
- Quantity fixing ($q_{vi} = D(p_{vi})$).
- Remarks :
 - Here only one target (the price)
 - Many vertical restraints allow a better efficiency
 - Different contracts reach the same result
- Positive effects of these restraints on profit, but also on consumers' surplus (elimination of the double margin problem).

Commercial services

- Retailers provide commercial services : before (information) or after sale (delivery).
- Services exert a positive externality on sales and benefit :
 - the producer (vertical externality)
 - the other retailers (horizontal externality), but can also generate negative externalities (free riding) when retailers compete.
- Producers may want to enhance the level of services : 2 variables (price and service)

Intrabrand competition and services

- If consumers can use the services where they are offered (before sale information or demonstration), and buy where the price is the lowest, and if the services are costly, then retailers suffer from a negative externality.
- This can lead to the disappearance of the services.
- In order to protect the incentive to offer services, producers may use different types of contracts.

Vertical restraints and services

- Exclusive territories : a retailer that offers the service has no rival on his territory.
- Selective retailing : offering the prescribed level of service is required to enter the network.
- RPM: cancelling price competition prevents free riding
- These restraints :
 - Reduce intrabrand price competition
 - But increase efficiency
- Tradeoff for competition authorities : if services highly valuable for consumers, then probably a good thing to allow these restraints.
- Concerning in particular RPM : 2 arguments in favor of RPM (double marginalisation + commercial services), 1 against it (reduction of intrabrand competition).
- For competition authorities, this should be quantified (...)

Interbrand competition

- Most economists have in mind the previous arguments in favor of vertical restraints, in particular regarding RPM.
- Debate during the 80's : RPM should not be considered as a per se infringement, but should rather be assessed through a rule of reason.
- Most economists also used to think that if interbrand competition is sufficiently intense, (many producers, free entry, etc) then restrictions to intrabrand competition are not a real problem (positive effects overweight negative ones).
- Recent papers show that this view is not necessarily justified.
- Both economists and lawyers have changed their mind !

The commitment problem

- First developed in the context of a monopolist, but proved true in many other cases.
- Benchmark situation : producer (monopolist) sells through a network of retailers.
- He would like to extract the maximum profit (vertical structure).
- He can in principle obtain this result by setting the gross price (= level of cost for the retailers) at the level that implement the right final price as a result of the competitive equilibrium between retailers.
- But this mechanism doesn't work if contracts are secret (not observable by other retailers).

The commitment problem

- If contracts are secret : each retailer has an incentive to ask for a secret cut in the gross price, which allows for a cut in the retail price.
- Higher sales (taken from other retailers), higher profits etc.
- O'Brien & Shaffer (1992) show that the producer has an interest to answer this request and lower the price.
- Can by no mean commit to a high gross price.
- All the retailers do the same : the final price falls to a level which is not profit maximizing for the vertical structure, and which benefits consumers.
- Retailers opportunism + producers' inability to commit to a given price prevents from maximising the profit.
- A number of solutions may « help » to restaure the price that maximises the profit of the vertical structure (but are then detrimental to consumers).

Solutions to the commitment problem

- Regulatory solutions :
 - prohibition of discrimination between retailers (France before the recent reform);
 - Since the basic mechanism is the existence of a retail margin (between final and gross prices), if these margins are 0, no incentives for the retailers: RPM (or maximum price) at the level of the gross price helps to avoid the commitment problem.
- Rey & Vergé (2004) show that this commitment problem appears even when there is interbrand competition.
- Here RPM is bad for competition (good for producers-retailers)

RPM as a collusive device

- Retailers may observe demand shocks that producers don't observe.
- Without RPM, retailers adjust their prices to these shocks.
- Under RPM, producers cannot benefit from price adjustments, but this makes prices more uniform : facilitates detection of deviation with regard to a collusive price (Jullien &Rey, 2007)

RPM as a collusive device

- Without RPM : when a retailer lowers its price, it can be interpreted as an adjustment to a shock or as a deviation /collusive price.
- If impossible to detect, the producers may be reluctant to punish retailers. Then collusive outcome difficult to sustain.
- RPM solves this problem : any price cut is necessarily a deviation and should be punished.
- Tradeoff (for the producers) between flexibility and collusion.
- Allowing RPM may help to facilitate collusion : arguments against RPM for competition authorities.
- Also against the idea according to which RPM is less harmful to competition when there is interbrand competition.

Another argument against RPM

- Usually, both intrabrand and interbrand competition both exist : producers of differentiated product sell through the same channels (Coca Cola competes with Pesi Cola, and they all sell through super markets).
- In order to counterveil the effects of intrabrand competition (that lowers the price under its optimal level), producers have an incentive to offer high gross prices.
- But interbrand competition makes it difficult!

Another argument against RPM

- RPM may help to eliminate intra- and interbrand competition :
 - If producers control gross prices, they can both choose high final prices and low gross prices;
 - When producers make 0 margin through gross prices, the whole profit is made by retailers, and producers can make profit by fixed fees.
 - Controlling final prices helps maximising the profit of the vertical structure.

Vertical restraints and the law

- 2790/1999 Regulation under the EC law : defines « block exemptions » in the field of vertical restraints:
 - vertical restraints can be allowed;
 - when no harm to competition (in particular if market share less than 30%)
 - except if downright restriction : RPM; quantity fixing.
- In particular, RPM cannot benefit from a block exemption, whatever the market shares concerned
- Even in these cases, individual exemptions maybe accepted (efficiency defence). In practice, they (almost) never are.

In France

- Vertical restraints are assessed through a rule of reason - in principle-.
- « Rebuttable presumption » : arguments brought by the parties (efficiencies) may be accepted
- The 2790/1999 regulation is used as « guidelines ».
- The conseil says it will appreciate on a case by case basis the defence of the parties.
- In practice, parties very scarcely bring evidence of efficiencies.

Standard of proof in France

- 3 elements should be proved
 1. The level of retail prices has been discussed between producers and retailers.
 2. Retail prices are monitored, with reporting and interventions of retailers and producer.
 3. A significant proportion (usually 80%) of the retailers apply the prescribed price.
 - If not, then statistics to evaluate whether prices are set well above / under the prescribed price.

Recent cases 1: Disney (videotapes for children), 2005

- Almost a monopolist;
- Sells through non selected retailers;
- Uses the french law (loi Galland) that prohibits resale at a loss, imposes to all retailers a very high gross price, imposes this level as the final price;
- Gives retailers profit through upstream margins.
- The level of the gross price is artificially inflated
 - some rebates, that are in fact granted, falsely appear as conditional to the achievement of some objectives by the retailer.
 - The law says that the non conditional rebates should be included in the gross price, and the conditional one excluded.

Disney (continued)

- Here the 3 criteria are fulfilled.
- No efficiency defence :
 - no commercial service,
 - no interbrand competition that could justify the need to attract retailers.
- Analysed as a collusion between Disney and its main retailers.
- Sanction to Disney and the retailers.

Recent Cases 2: Luxury Perfumes, 2007

- Different market structure : competing producers, competing retailers, selective distribution.
- Retailers selected on a « quality » basis (reputation, image related to luxury goods, commercial service).
- Differentiated products on the producers'side (Chanel, Dior, etc.. offer differentiated goods).
- But interbrand competition.
- Producers all have the same behavior : sell at a given gross price and impose a given multiplier (generally 2) to obtain the retail price.
- This determines both the share of the surplus obtained by each agent, and the final price.
- Very active monitoring +intervention : retailers report to the producer in case of a deviation, if true, intervention of the producer.
- More than 80% of the retailers set the prescribed price.

- The 3 conditions are met.

Other vertical restraints

- Exclusivity clauses :
 - the producer imposes on the retailer to buy its product to a given intermediary
 - the retailer cannot benefit from lower prices elsewhere (abroad, ...)
- Restrictions to active or passive sales : ex. Prohibition to sales on the Internet.
 - Problem with free riding, services ...