The Economic Effect of Resale Price Maintenance and the Regulation of Antitrust Law

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Abstract: The effect of resale price maintenance on competition has always been a controversial issue. Its effect of promoting competition can be summarized as following points. Resale price maintenance is beneficial to the provision of professional services, and to the market entry of new enterprises. It can also help to prove the high quality of products and reduce the “free riding” phenomenon. The resale price maintenance can also hamper competition from following perspectives. It facilitates collusion among distributors and producers; it facilitates monopolists to maintain the market power, and prevents competitors from entering the market. Resale price maintenance can also lead to the loss of consumer welfare. Now in the world, there are two kinds of standards which can regulate the vertical price restraint, namely the per se rule (the principle of illegality) and the principle of rationality. The case of Ruibang v. Johnson & Johnson was concluded in August 2013. The principle of rationality was adopted in that case. To judge whether a vertical price restraint is legitimate or not, the court should consider market share, nature of agreement, degree of market entry barriers and the comprehensive economic effect. Due to the lack of mature theories and practical experiences, it is necessary to improve the system design for relevant regulation in the future.

1. Introduction

Resale price maintenance (RPM) is also known as vertical price restraint. It means that, in the vertical industry chain, upstream enterprises can restrict the prices of goods and services of downstream enterprises transferred to third parties. This kind of enterprise behavior is commonly seen in clothing, jewelry, oil, automobile, books, medicine and other fields. Compared with horizontal association agreements, resale price maintenance is a vertical agreement and belongs to one of the vertical restrictions. Vertical restriction agreement refers to the agreement signed between the provider of products or services and the upstream or downstream enterprises. Vertical restriction agreement generally includes the following types: maintenance of resale price, geographical restriction and exclusive transaction. Resale price maintenance generally includes maximum resale price, minimum resale price and suggested retail price. The essence of resale price maintenance is a contract arrangement in which the upstream enterprises retain the control over the price of products sold by downstream enterprises. Legally, the upstream enterprises have transferred the ownership of products, but they retain control over the price of products. Therefore, many legal scholars believe that the behavior is naturally illegal. Hilton, an American academic, points out that the essence of maintaining resale prices is that manufacturers limit the range of prices charged by retailers who sell their goods. Typically, manufacturers seek for limit price cuts. Economists found that resale price maintenance can promote competition after theoretical and empirical researches. There are different opinions on the role of resale price in maintaining economic life. Generally speaking, there are two opinions. One is that it hinders competition and should be firmly recognized as illegal and be prohibited. Another view is that its effect of competition promotion should be reasonably analyzed according to individual cases; the behavior is not necessarily illegal by itself.

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2. Resale Price Maintenance can Promote Competition

2.1 Conducive to the provision of professional services

When buy products with high technical contents, customers do not only consider the price, but also concern about relevant pre-sale and after-sale service. For example, automobile and computer retailers need to introduce the features and performances of the products, as well as relevant application methods. They also need to demonstrate the products on the spot or provide personal experience. These services need professional sales team. Salesman needs to be able to demonstrate skills. Then dealers have to pay considerable costs in training. If the product is sold at a low price and the dealer does not have enough profit, the dealer will not be willing to invest in providing more and better services.

On the other hand, manufacturers hope that all their dealers can present their products in an elegant and effective way, and introduce the products as much as possible to attract customers. Resale price maintenance requires dealers to realize manufacturer's pricing, but cancels dealers' pricing decision-making power. If dealers want to stand out from the competition, the best way is non-price competition, that is, the competition of service. Therefore, the maintenance of resale price is conducive to the provision of professional services by dealers.

2.2 Conducive to the market entry of new enterprises

If there are powerful manufacturers in the market, new producers will face greater difficulties when enter the market. Manufacturers usually have to spend more than original manufacturers in the market. They not only need to carry out market research and put on advertisement, but also need to spend money in infrastructure and pay other expenses. Meanwhile, they also need to face the risks of market failure. New entrants to the market have to face competitors with certain market channels and a variety of marketing advantages. For instance, some brand retailers have high quality shelf space and sTable customer recognition. New entrants must provide distributors for sTable revenue prospects in order to win distribution channels. Through RPM, new entrants need to guarantee that dealers can get a fixed profit margin under any circumstances, and that their own dealers will not compete with each other for discounts. Therefore, dealers will be happy to distribute new entrants' products and provide good promotion services. Therefore, the maintenance of resale price can attract new dealers and promote the construction and development of the sales network. In some cases, says Mr. Pould, sales depend not just on the price but also on the number of outlets. If the prices are so low, the number of outlets may shrink. Thus, upstream manufacturers have to strike a balance between keeping prices low and maintaining resale prices (in order to maintain the minimum number of retail outlets). By controlling resale prices, manufacturers can ensure that there are enough outlets and enough opportunities to display their products.

2.3 Beneficial to prove the high quality of products

Marvel and McCaffety put forward the quality proof theory of resale price maintenance. High price is actually a sign of high quality; the reduction or discount will damage the reputation of the brand. It is necessary to maintain the resale price in order to provide enough profit margins for merchants who provide excellent service, and prevent merchants from free-riding and damaging the image of product. Many high-end brands and well-known brands always adhere to the original price and refuse discount at all occasions, even in the off-season or holidays when similar products have been discounted. They hope to link high prices with good quality. Discounted sales will damage the image of high-end and good quality products, so the resale price maintenance is necessary. For high-end products and luxury goods, this theory has certain persuasion power.

2.4 Helps to reduce "free riding"

All sellers want to get a free ride. Different dealers operate products of the same brand. When one dealer provides pre-sales services such as product introduction and demonstration, other dealers may not provide such services but sell products at a lower price. This is especially common when products are sold through different channels of physical stores and online stores. Many consumers go to physical stores to try them on, use them, copy down the model and price, and buy products online. To avoid this free-riding behavior, manufacturers generally combine geographical restrictions and resale price maintenance to prevent distributors from being lazy and not providing services. Resale price maintenance in certain geographical areas, plus the sole right to sell their products to individual retailers and as the exclusive rights, the retailer is provided with regional protection and profit assurance. The enterprise can not only try to sell the goods, but also try to reduce the transport and transaction costs. The result is not only conducive to expanding the sales of goods, but also conducive to preventing similar dealers from hitchhiking opportunities.

3. Resale Price can Hamper Competition

3.1 Facilitate dealers' collusion

The retailer cartel is heavily criticized and severely restricted by law in many countries. The form of maintaining the resale price will form the essence of distributor cartel. The formation and maintenance of collusion have to face various difficulties, but if the manufacturer comes forward to require all dealers to charge a uniform price, it is equivalent to the transmission of price information among dealers. Dealers do not need to form collusion through secret negotiations on resale prices. At the same time, the contact between the manufacturer and the dealer is generally not subject to the same strict supervision as the horizontal contact between competitors. The manufacturer can assist the dealer to implement the fixed price agreement by punishing dealers who discount products, so as to assist dealers to supervise each other and implement the collusion. However, if a group of required dealers have the market power, they may propose RPM to the manufacturer to prevent other dealers from discount or price reduction. The manufacturer may yield to such requirements out of the consideration of protecting vertical sales channels, and passively implement the resale price maintenance.

3.2 Facilitate manufacturers' collusion

Horizontal collusion among producers is easy to be betrayed. In the game of collusion among producers, each producer wants other producers to abide by the price agreement. In that case, if the company secretly lowers the price, it will sell more products and occupy the market. Telser, Mathewson and Winter point out that it is easier for manufacturers to find the retail price of a rival company than finding out the wholesale prices. The longitudinal price limits can help manufacturers find out who has violated the mutual agreement. The longitudinal price limits do not adjust correspondingly with the changes of market conditions; so the retail price is fixed. When manufacturers are willing to take the longitudinal limit, competing manufacturers have formed a conspiracy, because the retail price is convenient for observation. Through mathematical model, Mathewson and Winter prove that the core purpose of vertical price restriction is to obtain vertical monopoly profit, and the result is the reduction of consumer welfare and social welfare in general.

3.3 Helps monopolists to maintain market power

Because of some reasons, the upstream monopoly enterprises can't make full use of the market power, so they maximize their monopoly profits through vertical price restriction. Oberlein and Shaffer analyze the problem of vertical commitment. Each retailer's contract with the monopoly producer is kept secret. The producer contracts the first dealer at the monopoly price, and then contracts the second and third dealer at a slightly lower price. Dealers expect this, so they will only sign a contract at a lower price than the manufacturer's price, which is the vulnerability of vertical commitment. In order to make dealers believe in themselves, manufacturers have to promise that they would not cut the price, or adopt vertical price limit or regional monopoly to restore their market power. Spier used mathematical models to analyze vertical constraints, assuming that the levels of service provided by retailers are different, and that consumers have different levels of willingness to pay. If the cost difference between the two retailers is not significant, the upstream monopoly will be willing to block the retailers with low level of service. The minimum price limit is one of these means, and the low level retailers will not be able to earn enough profit and will be expelled from the market.

3.4 Prevent competitors from entering the market.

Amish pointed out that “a group of producers may adopt vertical price limits to restrict competition. In the process of negotiating with retailers, manufacturers may ask retailers that they cannot have business transaction with other competitive manufacturers”. So the conspiracy and exclusive appeared at the same time. If there is no conspiracy organization, it is unlikely to produce the exclusive effect. This method excludes other producers through vertical price limits. Through the formal model, Shaffer, Ascoyan and Iska prove that the vertical price limit will exclude competition. The upstream producers make the profit of the downstream producers sTable through the vertical price limit, and limit the competition of the downstream dealers, so that the downstream dealers can get a higher profit. “PRM is likely to be used as a method to eliminate upstream competition, even if it does not significantly promote the formation of cartel,” says Itay Pelde. It is a measure adopted by incumbents in the market to prevent the entry of future competitors, and by dynamic companies in the market to oust competitors. It is even the method that entrants adopted to expel incumbents in the market.

3.5 Lead to the loss of consumer welfare

RPM has the advantage of providing good pre-sale and after-sale services, but the value of services depends on customers’ requirement. For highly technical or highly professional products, the necessary pre-sale services are valuable to most consumers. For simple goods, such as beer, salt and paper, consumers generally do not need special pre-sale services; low price products are much more attractive. There are also some old customers, or consumers with knowledge. They are very familiar with the use and performance of products. They do not need demonstration or introduction at all. Pre-sale services, on the contrary, cause their excessive payment burden; they are totally worthless. These customers prefer to buy from sellers who do not have many services but have low prices. Resale price maintenance restricts dealers to offer special discounts to these customers, which will lead to the losses of consumer welfare.

4. The Regulation of Antitrust Law on Resale Price Maintenance

4.1 Rules for judging the legality of low resale prices

The judgment criteria adopted by the United States and Europe can be roughly divided into two kinds: the principle of illegality and the principle of rationality. The economic analysis of the competitive effect of resale price shows that RPM has both the effects of promoting competition and anti-competition. Because of the uncertainty of the effect and the complexity of the analysis, it is difficult to say whether the anti-competitive effect or the effect of promoting competition is dominant. In fact, the production of anti-competitive effect usually requires multiple conditions, and the conditions for promoting competitive effect are much more relaxed. Therefore, we cannot conclude that RPM is illegal by itself. Only when a large number of facts and evidence prove that the maintenance of resale price always limits competition or impairs consumer welfare, can we affirm that the behavior is illegal and apply the principle of illegality. Otherwise, the principle of rationality should be adopted.

The principles of illegality means, as long as the anti-competitive acts occur in the market, they will be regarded as illegal regardless of the causes and consequences of acts. As long as the courts or administrative law enforcement organs confirm the existence of an act, they will directly determine the violation of the law. There is no need to conduct a lot of investigation or research on the case, which can save the human and material resources. In the Dr. Miles Case in 1911, the United States ruled RPM according to the principle of illegality. The European Union still adopt the principle of illegality supplemented with exceptions. The 2010 Vertical Agreement Collective

Exemption Regulation stipulates that the minimum resale price maintenance does not apply to collective immunity.

The principle of rationality means to judge whether a party's action is illegal after weighing the competition consequences of the action. This principle is made based on the uncertainty of the positive and negative effects of vertical price restriction on the competition effect. Since the Supreme Court of the United States overthrew the conclusion of Dr. Miles Case in Leegin Case in 2007, it has changed RPM regulation from the principle of illegality lasted for nearly a hundred years to the principle of rationality.

4.2 Regulation of China's Antimonopoly Law

The Anti-Monopoly Law of the People's Republic of China in 2008 only has very simple restriction on vertical price. The provisions include Article 14: The following monopoly agreements between business operators and trading counterparts shall be prohibited: (1) fixing the price of commodities for resale to third party; (2) fixing the lowest price for resale of commodities to third party; and (3) any other monopoly agreements as defined by the anti-monopoly enforcement agency of the State Council. Since the case of Ruibang v. Johnson & Johnson in 2011, vertical price restriction has formally entered the judicial trial procedure. In the first and second instances of the case, the principle of rationality has been generally accepted. So what basic factors should be considered in the regulation of the principle of rationality?

(1) The share of products in relevant markets should be analyzed. If the resale price is maintained by ordinary producers, the damage to the market competition will be relatively small. But dominant producers can set the resale price maintenance for downstream distributors; the regulation is often accompanied with severe penalties. Some manufactures even forbid their distributors to sell the products of other producers, resulting in the blockade of the market. The EU's collective exemption requires that the market share of the company should not exceed 30%. Our country can draw lessons from it. If the market share does not exceed 30%, the resale price maintenance can be considered as legal unless the plaintiff can prove that the act produces serious consequences of restricting competition.

(2) The nature of the protocol should be analyzed. First of all, it should be judged that whether the agreement is resale price maintenance. Then we should verdict which kind of resale price maintenance it belongs to: the maximum price limit, the minimum price limit, or the recommended price. Secondly, we should analyze whether the agreement has penalties for non-compliance, such as reducing supply, refusing supply, deducting margin and raising the supply price. If the resale price is maintained normally, it will be harmful to competition.

(3) The market entry barriers should be analyzed. The resale price maintains the high price of the product. If the profit of the product is higher than that of other products in the same trade, other competitors will be attracted to enter the market to produce or sell the product. If the relevant market entry barriers are not big, it means that the market is fully competitive. A fully competitive market indicates small destructive effects of resale price maintenance. If the barriers to entry are large, the destructive effects of resale price maintenance will be great. New comers may need to invest a large amount of time and money, or have to deal with difficult approval and exit procedures. Enterprises can maintain high price operation without the fear of losing market or consumers.

(4) The comprehensive comparative effect should be analyzed. If a resale price is maintained to promote competition and consumer welfare in general, the act shall not be illegal. If the comprehensive comparative effect is harmful to competition and the general welfare of the society, the behavior will be illegal.

5. Conclusion

Under the impact of the Leegin Case in which the rationality principle is adopted, many scholars in our country call China to follow the United States. In the judgment of the Johnson & Johnson case, Shanghai High Court has made a series of economic analyses based on the rationality principle, which is the only vertically price-limited court judgment. From Maotai spirit, FAW-Volkswagen to milk powder enterprises which were punished by the National Development and Reform Commission because of price restrictions, the administrative law enforcement process applied the principle of illegality. When China’s current anti-monopoly law does not have clear criteria for judging; a large number of administrative law enforcement indicates that the application of the principle illegality conforms to China’s national conditions. The study on how to regulate is still in the preliminary stage in our country. There are still long ways to go in theory and practice.

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