

Vertical Control in Newly Regulated Economies: Lessons from the Theory and Practice of RPM

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**Vertical Control in Newly Regulated Economies: Lessons from the Theory
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Abstract

This paper develops conceptual arguments to analyze RPM from the antitrust viewpoint. Through a general model, we conclude that minimum RPM in general would reduce consumer's price. Consequently, it could harm consumers only under very special circumstances, that can be checked by antitrust authorities in a very simple way. Thus, the paper suggests that the influence of the USA antitrust legislation and tradition in LDCs, and particularly in Chile, the country with the most advanced antitrust practice in less developed countries, has unnecessarily restricted franchising. Not surprisingly, though, the application of such dogmatic vision has created ways to by-pass the regulation, like vertical integration, that may be legal, but create cost for distribution channels.

Keywords: Resale price maintenance, vertical control, antitrust.

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1. Introduction

Resale price maintenance from a producer to a wholesale distribution or to a client who is not the final consumer (RPM) is a commercial practice which may have great advantages in distribution, but which until very recently, was prohibited in the United States and, consequently, has also been prohibited in those Latin American countries which have sought inspiration in the North American antitrust legal framework. Since its beginnings, North American law declared the RPM illegal per se, and although there is nowadays a relative consensus among analysts that RPM may have positive effects on marketing channels, the inertia affecting the North America system still prompts its prohibition.

To prohibit RPM may lead to a greater vertical integration between production and distribution which, in turn, can inhibit one of the most efficient forms of market expansion, franchising. Hence, it is important, from the perspective of the countries that are in the process of developing their own legal frameworks, to analyze when RPM might have anti-competitive effects.

The purpose of this paper is to analyze RPM in terms of its pro and anti competitive effects, that is, analyze whether RPM reduces the costs of reaching the final consumer and to what extent, through this or any other way, it is beneficial or detrimental to welfare. In doing so, we intend to set forth elements allowing the antitrust practice in Latin America — a region whose countries do not have the North American tradition and where jurisprudence is not binding — to attain a flexibility such as to address RPM under the concept of the “rule of reason” and to permit it in those cases in which it is justified for reasons of efficiency. To this end, we resort to the experience in Chile, the country featuring the greatest antitrust tradition in Latin America and possibly among less developed countries in the world, and analyze it on a comparative basis to that of the United States.

In Chile, the antitrust ruling has been absolutely contrary to RPM, but recently the possibility to look at the problem from the right standpoint was opened. Even though the Chilean Antitrust Commission has not fully settled the matter, the arguments set forth shed new light on these practices and should be instrumental to enforcing a more correct doctrine as already permitted in countries such as Chile, Mexico, Argentina and Peru, where statutes are more flexible than the North American one.

The paper is structured in four sections, besides this introduction. The second section develops three economic models addressing RPM, sufficiently general in scope to broadly understand the subject. The third section critically describes North American and Chilean jurisprudence. The fourth section hinges on a practical case recently resolved by the Chilean Antitrust Commissions, shedding light on some key aspects involved in the discussion. The fifth section sets forth the conclusions.

2. The Economics of RPM

RPM was defined by Asch (1970) as: “[the situation] under which a manufacturer sets a minimum price under which there may not exist a resale”. p. 380. This definition, very consistent with more strategy and marketing oriented literature (Sudharshan, 1995), is however restrictive because RPM also involves a significant number of cases in which the price is a maximum one. Therefore, RPM is to be defined as an implicit or explicit contract whereby a manufacturer sets the price or the range that a distributor may charge for his product.

2.1 Vertical Restraints

RPM is a vertical restraint practice, since it restricts actions of one participant in the input-output chain. The most relevant aspect of a vertical restraint justifying a special analytical treatment is that, unlike non vertical commercial relationships, they are characterized by the fact that a vertically related agent closely affects the other agent through its actions. In the case of an agent selling footwear, for instance, independently from its monopolistic power, whatever the buyer does — wear, keep or destroy the footwear — will not affect his business. The case of an ice-cream producer, who in order that his product be accepted, needs that the retailers maintain it under refrigeration at a certain temperature, is completely different. The same happens in the case of a wholesale distributor of fuels and the actions which retailers may take, particularly with respect to the services provided, preservation of the corporate image and, most obviously, the prices charged to the public. In these cases, what the retailers do affects the benefits of not only the retail distributors, but also the wholesale distributor and consumers.

Summing up, vertical restraints are viewed in the literature as contracts that tend to ensure that the same result that would take place in a vertically integrated structure is generated in vertically disintegrated structures, that is, maximizing joint benefits at different stages (e.g., production and distribution). The fact that this type of contracts is preferred relative to vertical integration depends on the costs of becoming integrated, but particularly, on how the law addresses vertical contracts, vertical integration (Blass and Carlton, 1999).

2.2 The Costs of Vertical Disintegration

In this section we offer a simple model closely following Tirole (1985), in which two externalities associated to vertical disintegration are observed. Obviously, any externality may be overcome by integrating firms, but that entails costs. To the extent that integration costs are higher than those required to enforce contracts that overcome the externality, disintegration will prevail.

Tirole’s model involves two stages in the vertical chain: a manufacturer and a retailer, and there are fixed proportions in the production function. We also assume that the demand of a good (q) depends only on two variables: price (p) and service (s).

$$(1) \quad q = D(p, s), \quad D_s > 0, \quad D_{ss} < 0 \quad \text{y} \quad D_p < 0$$

We further assume that the average and marginal manufacturing cost is c_m and that the average and marginal distribution cost is c_d , the latter depends on the level of service (s):

$$(2) \quad cd = \phi(s)$$

If there is vertical integration between the manufacturer and the distributor, the objective function to be maximized is:

$$(3) \quad \Pi = (p - cm - \phi(s)) * D(p, s).$$

from (3) the integrated firms gets P_m^* and S_m^* , the levels that maximize profits and which, naturally, would correspond to the maximum potential profit that the manufacturer and retailer would obtain jointly, if they were not integrated.

In a vertically disintegrated structure, the manufacturer's profits will be:

$$(4) \quad \Pi^m = (P_w - cm) * D(p, s),$$

where P_w is the price that the manufacturer charges the distributor. In turn, the distributor's profits will be:

$$(5) \quad \Pi^d = (p - P_w - \phi(s)) * D(p, s).$$

The manufacturer charges $P_w > cm$ so as to maximize his own profit.

The externality problems that stand out in this example are two. First, the retailer takes the price P_w as a component of his cost and maximizes his own profits. Second, when deciding the service provided, he does not consider how it may affect the manufacturer's profits. The two problems may be analyzed separately, so we first analyze the problem concerning the level of service and, then, the problem associated with pricing.

Regarding the decision on the level of service, the retailer does not consider the "extra profit" for the manufacturer when he increases the service by one unit. He chooses the level of services that maximizes his own profit and not that of the sum of manufacturer and the retailer. In this way, there is a loss of $(P_w - cm)dD/ds$, represented by distance $P^* - P'$ in figure 1.

Figure 1

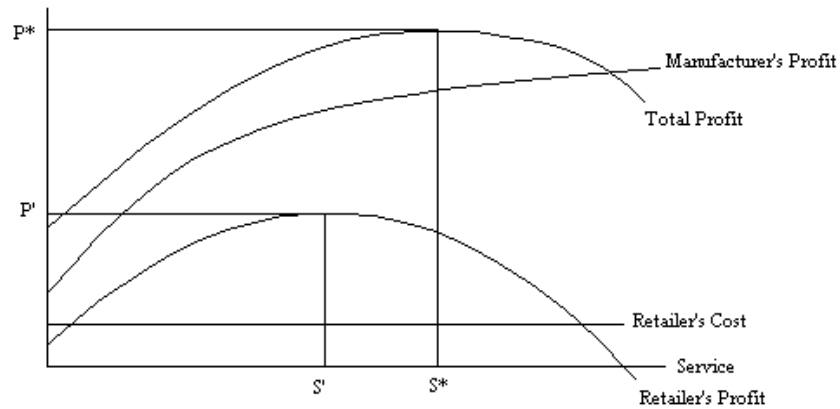


Figure 1 shows that the level of services determined by the distributor is suboptimal for the sum of manufacturer and retailer. The latter wishes that S' be provided instead of S^* , which is suboptimal because if a level S^* is determined, there would be a gain P^*-P' that is beneficial, regardless of how it is shared.

The second problem that can be illustrated in our example is evident if we assume a situation in which, due to location or coordination costs, there is some monopoly power. In this case, the manufacturer charges P_w , the retailer chooses a level of service and the marginal cost for him becomes $P_w + \phi(s)$. Given this cost, the retailer chooses the final price that maximizes his profits, that is, he marginalizes the demand again, since the manufacturer had already done so to determine P_w .²

Strictly speaking, what the retailer charges will depend on what the manufacturer charges. If P_w is very high, the margin for the retailer will necessarily decrease. In turn, what the manufacturer charges also depends on how much “he thinks” the retailer will charge.

There is a wealth of literature on game theory which addresses this problem. This literature suggests, for instance, that the more times the players relate, the lower the final price paid by consumers will be, coming close to the price that an integrated operator would charge. However, the most important thing in this case is that, unless there is total coordination between manufacturer and retailer, in which case the price will be the same as that of an integrated firm, the price would exceed that level, thereby creating an incentive to either a vertical integration or an agreement between the parties, benefiting not only the firms, but also the consumers.

2.3 Minimum RPM and Services

The predominant vision until the decade of the fifties conceived RPM as a mechanism facilitating monopolistic coordination between retailers, through which the price finally paid by

² The manufacturer marginalizes the demand, which is a derived demand from the final good, and that takes as parameters the distribution costs and substitution possibilities between inputs. In the case of a production function of fixed proportions, the manufacturer subtracts cd from the demand for the final good.

the consumer is higher. This vision entails for some reason that RPM simplifies monitoring the members of the cartel.

This was the dominant vision until Telser (1960), where the central idea is that price discounts among retailers could allow them to act as free-riders with respect to other retailers and the manufacturer. The example of the introduction of personal computers illustrates Telser's point of view.

Let us consider a firm, say Apple with a unit production cost for its computers cm and that the willingness to pay for computers depends on how clearly the retailer gives information (i.e., provides a service). Apple may advertise the advantages of owning a personal computer in a general way, but retailers are absolutely essential in giving information as to what type of program the computer can run and what is especially suitable for a customer interested with very specific interests (e.g., marketing, econometrics or a word processor). In addition to the price that the manufacturer charges, P_w , the distribution cost is $cd+s$, where s takes value 0 or 1. We also assume that if there is a service provided by the retailer, the consumer's willingness to pay increases more than \$1, which makes it convenient for Apple and the retailers, as a whole, to provide the service.

The distribution cost, then, is $P_w + cd$ for those not providing the service and $P_w + cd + 1$ for those providing it. Considering a great number of distributors, the market price should be the price charged by the retailers providing the service. The problem, however, is that if a retailer provides the service, customers will obtain the service from him and will then buy the good from a retailer who does not provide it and who is in a position to give them a discount of up to \$1.

Equilibrium in these circumstances is that the service is not provided, and that those who do provide it lose money at the expense of those not providing the service and acting as free-riders. Telser suggests that the problem may be solved by setting a minimum resale price of $P_w + cd + 1$, since this will prevent retailers from not providing the service. Thus, RPM protects both the interests of the manufacturer as well as that of retailers that provide the service and for which they incur in costs. This sums up the relationship as perceived by Telser between RPM and the provision of services as an incentive-compatible situation with the incentives for each one of the agents.

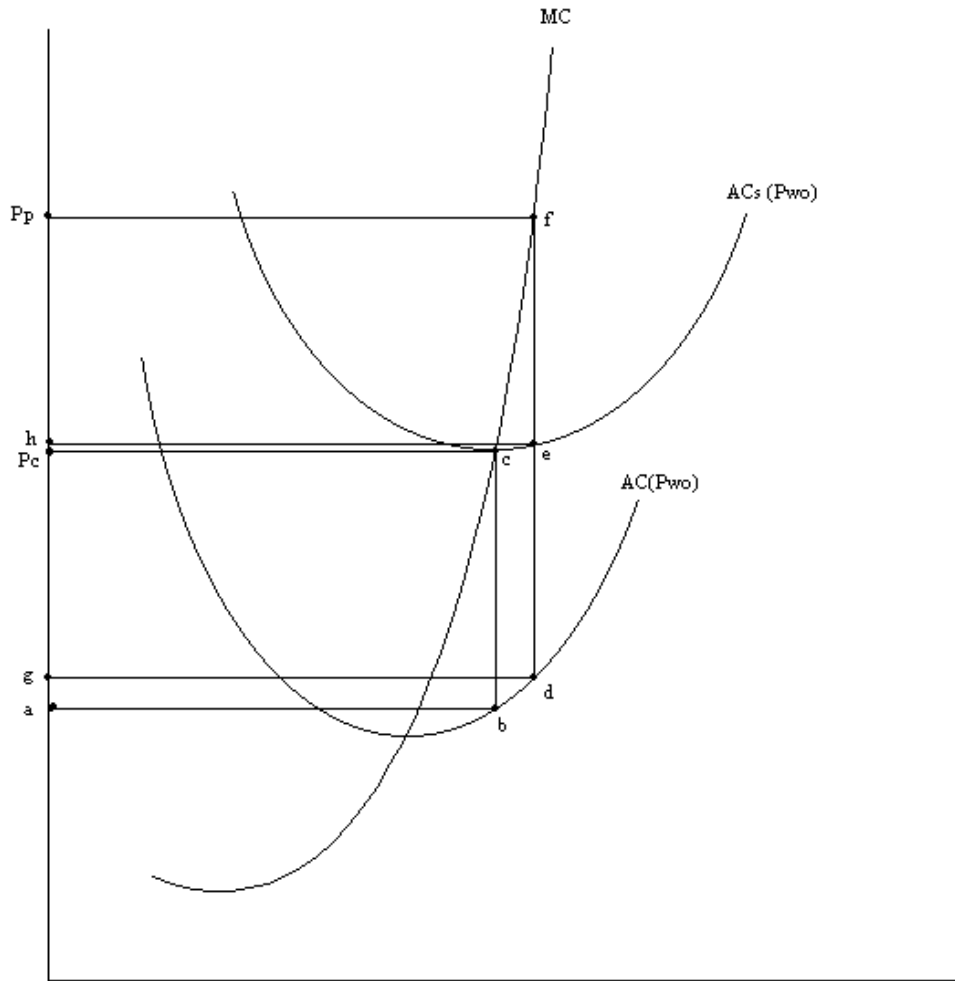
Telser's model, inspiring as it may be, is subject to two main criticisms. On the one hand, the solution of RPM is not self-sustainable by itself, because retailers retain the incentive not to deliver the service which the manufacturer wishes and instead render any other service that may be valued by consumers. This criticism may be stated in terms that RPM calls for monitoring in any event. However, the most debatable point in this model is that it suggest that RPM would apply only to goods in which it is possible to dissociate the service sought by the manufacturer from the consumption of the good. In our example, the consumer may obtain the service at one store and buy the good at another. But, what about RPM as determined by the company that produced beer in the US or Savory ice-creams in Chile? In the latter case, the service sought was adequate refrigeration of the ice-creams and that service can in no way be dissociated from the good.

2.4 A More General Model

In this search for a more general approach, Klein and Murphy (1988) develop a model which is not subject to the critiques levied against Telser's model. This model which is not only increasingly accepted, but also with a very simple extension, not attempted as yet as far we know, allows determining the effect of minimum RPM on the price that is finally paid by the consumer, a critical aspect of public policy.

The essence in the Klein and Murphy's model is grasped by resorting to the following assumptions: i) there exists a manufacturer with unit cost c_m ; ii) there is a set of infinite potential distributors with cost of $c_d + s$, where s takes only values 0 and 1; iii) consumers value the good only to the extent that it entails service, but they are only able to detect if the service was rendered after having consumed the good; and iv) in the case that they have been taken in, consumers realize it immediately after buying the good and never again consume a good sold by that distributor.

Figure 2



For the manufacturer it is, then, very important that retailers provide the service. However, he also knows that distributors will not provide the service if, through competition, they dissipate all rents or quasi-rents. To see this point, let's consider that the manufacturer changes P_{w_0} to retailers. Consumers know that retailers cost can not be lower than P_c in figure 2, that is, $P_w + cd + s$. However, P_c cannot be the final price.

If the retailer provides the service and changes P_c , the margin will be zero and though he can remain in business indefinitely, the present value of offering the service will be zero. On the other hand if he does not offer the service and charges P_c , he will have a margin $P_c - b$, which multiplied by the units he sells on one single occasion, will involve a rent of area "abcPc" in figure 2. In that figure, the retailer unit cost, when the service is provided, is AC_s and that cost when the service is not provided is AC .

The "competitive solution" requires as in Klein and Leffler (1981), that P_p be the price, which is determined by the condition that make incentives compatible, that is, the price making it more convenient for the retailer to offer the service rather than not offer it. In terms of figure 2, P_p is

the price that makes up the present value in the area “ $hefPp$ ” marginally higher than the area “ $gdfPp$,” the latter being the present value of not providing the service.

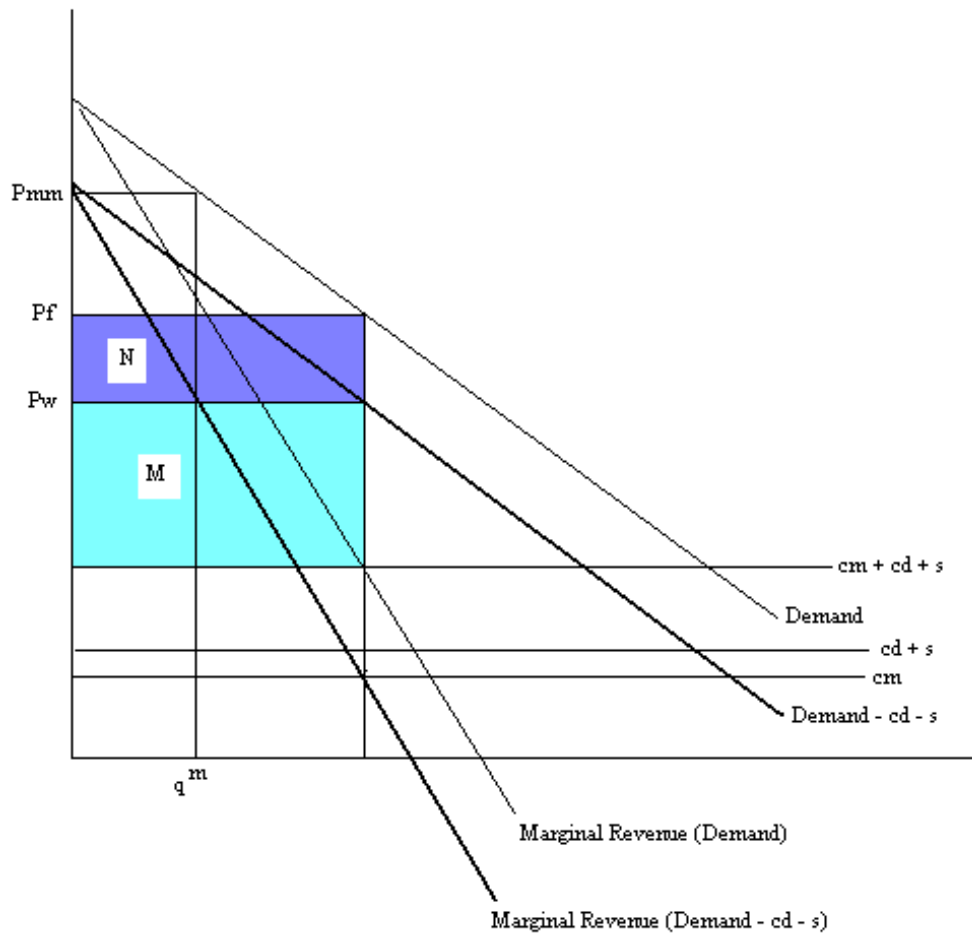
In this model, RPM creates a premium to the retailer. This premium prompts him to provide the service which the manufacturer wishes to be given, as otherwise the manufacturer terminates the contractual relationship and in doing so he also does away with the premium.

2.4.1 Do Minimum Resale Prices Increase the Price to the Consumer?

This is one of the questions which is most relevant when it comes to decide whether the practice should be permitted or not. A natural but incorrect answer is that minimum RPM increases the final price, as otherwise the practice would not be operative. Inducing retailers to provide services through a premium by using RPM, is one of several alternatives the manufacturer has to do so, including vertical integration and other ways of giving premiums, such as granting exclusive territories. Consequently, if RPM is prohibited, the manufacturer will seek other more expensive mechanisms to attain the same purpose of providing the service.

Let us focus our attention on RPM and its most direct alternative, namely, vertical integration. If vertical integration does not entail any costs for the manufacturer, he would become integrated and the final price (P_f) would be determined by marginalizing the demand, getting the marginal revenue and equating it to the manufacturing plus distribution costs, as in figure 3. In the case where the manufacturer and the distributors are vertically disintegrated, there is no cost to monitor the retailer and he commits himself to provide the service, the manufacturer marginalizes his derived demand ($Demand - cd - s$), gets the manufacturer’s marginal revenue makes it equal to his marginal cost and charges P_w to the retailers. Considering this price, each distributor adds $cd+s$ and the final price to the consumer is again P_f identical to that in the case where there exists vertical integration.

Figure 3



Assume now that there are costs for being integrated and for monitoring retailers, but that the cost of being vertically integrated is higher than the cost which the manufacturer would incur by giving a premium through RPM, and this inducing the provision of services. It should be borne in mind that this premium is determined optimally from the manufacturer's viewpoint, that is, it is the minimum premium that induces the retailers to render the service. The question that arises is how it is more convenient for the disintegrated manufacturer to give the premium; by charging P_w and allowing distributors to charge a higher price than P_f or, alternatively, by allowing distributors to apply P_f and charging them a price lower than P_w ?

The answer arises directly from examining figure 3. Before considering the premium, the maximum joint profit $M+N$ occurs when the final price is P_f and, therefore, any premium will be given by reducing P_w , so as to ensure that the final price does not exceed P_f . In conclusion, our analysis ascertains that, against what could be thought, RPM, if made to induce the provision of services along the lines suggested by Klein and Murphy's model, will not represent higher prices than those in place if it were prohibited. Consequently, RPM will mean lower cost for manufacturers than other alternative structures created to provide the service; more services, which are valued by consumers, and lower prices to consumers.

2.5 Maximum Resale Prices: The End of the Successive Monopoly

Though it is less usual, RPM associated with maximum prices is also common. In this case, the economic literature shows a higher consensus in terms that it does not admit realistic possibilities that through maximum RPM competition could be harmed. The exception is that prices are established at predatory levels. In the case of complementary stages, though, predation is less conceivable. In any event, as analyzed in section 4, in the case of a vertical price restraint, no distinction is made in the law in most countries.

The reason that accounts for the existence of maximum RPM was partially set forth earlier. It is that the manufacturer would prevent the distributor from acting as a monopolist and not only harm consumers, but also the manufacturer because the demand for his product will go down. In terms of figure 3, a distributor with monopolistic power could marginalize the demand and charge a price p^m . In such a case, the manufacturer will not be able to sell more than q^m .

2.6 FPR as a Barrier to Entry.

Thus far, and with the exception of the argument stating that RPM facilitates collusive agreements, the arguments suggest that RPM should be permitted. There is however a different case that, clearly harms consumers by reducing competition. This case we deem it to be sufficiently important so as not to suggest that RPM is always pro competitive as Bork (1978) suggests.

The situation is adequately illustrated by a case that involved different producers of sports footwear in Chile in 1991, Diadora, Power and Nike among others. In this case, there was no clear requirement of services, associated to Telser or Klein and Murphy. It was not a maximum price either, that could lead to suspect the existence of successive monopolies.

Even though this case was reported as RPM, it was never really investigated by the antitrust Commission, which explains why we have no detailed information. However, some pieces of evidence suggest that what was behind the case was the generation of barriers created not by the manufacturers that competed vigorously, but by two main distribution department stores which had by that time a substantial market share. In fact RPM was imposed by these department stores. Given the size of these retailers, the manufacturers had no other choice but to make such a requirement to whoever wished to distribute their product.

The foregoing is consistent with the form that competition with the dominant department stores had to assume. These department stores feature many amenities, offer variety, are very roomy and provide services of different types. The competition they were facing in the market of sports articles, was from small distributors, with little capital, extremely modest sales outlets and low costs, but which for some types of customers, allowed them to buy the goods at substantially lower prices. When the requirement of an RPM makes the price charged by the small stores be equal to that of the dominant department stores, the possibility to compete with the department stores is reduced to a great extent.

The second piece of evidence is given by the appearance of stores owned by the manufacturer that sell “second choice” sports footwear. The quality of these second choice goods was the same as that of those of first selection. They were sold directly by the manufacturer in stores with characteristics similar to those described for the competitors of the department stores,

which suggests that this was a way to dodge the dominant distributor requirement. Finally, the third piece of evidence is that RPM disappeared in this market, which coincides with entry by JC Penney and other department stores as important as those existing previously.

3 Jurisprudence on RPM in the United States and Chile

3.1 Jurisprudence in the United States

The most paradigmatic RPM case from the antitrust statutory standpoint in the United States was that of *Dr. Miles Medical Co. versus John D. Park & Sons Co.* (1911). The central point of the lawsuit filed by Dr. Miles, a producer of a secret drug that was not patented, against J.D. Park was that the defendant, who was in a position to give discounts, induced the rest of the distributors to violate the price agreements entered into between them and Dr. Miles. The Court ruled that Dr. Miles could not restrain J.D. Park from reducing prices, since what this distributor did was eminently competitive and that encroaching on such a right attempted against public interest and social welfare.

With respect to this case, that set an important jurisprudence in the United States, much has been debated and a consensual opinion is that:

“The Court seems to have overlooked the economic purpose of the contractual arrangement and its effect on social welfare... Though the majority opinion does not make it explicit, the result of the ruling in the case may have been guided by the concern that RPM facilitated an horizontal agreement at the level of either the producer or the distributor”. Gellhorn and Kovacic (1994)

The doctrine that judges established in the United States, though possible, is very difficult to modify. Therefore, in cases that are as debatable and controversial due to their effects on competition as that of Dr. Miles, the doctrine that has been generated over the last years, and which in some way modifies the original one, suggests that though in the formal sense the per se illegality continues, in actual practice some advances have been progressively overcome.

An illustration of what has been stated is the case of *Business Electronics Corp. versus Sharp Electronics Corp.* On dismissing the charges against Sharp for terminating a contract because Business Electronics Corp. sold at a price below that suggested by Sharp, the Supreme Court of the United States ruled that:

“The distributor may not have absolute freedom to set prices at the level that it wishes”. Cited in Viscusi, Vernon and Harrington (1997).

These authors go even further by pointing out that for an RPM to be illegal, the standing doctrine in the United States is:

“There must exist a conspiracy between the manufacturer and the distributors to fix prices. It is not illegal for a manufacturer to set resale prices unilaterally and to refuse to sell to distributors that do not abide by the resale price. Two recent cases [*Monsato Corp. versus Spray-Rite Service Corp.*, 456 U.S. 752 (1984) and *Business*”

Electronics Corp. versus Sharp Electronics Corp. 485 U.S. 717 (1988)] have established the required conditions to infer the existence of such a conspiracy. The first case involved a Monsanto herbicide distributor [Spray-Rite] selling at prices with a discount [below the price set by Monsanto]. There was evidence that the other distributors had filed a complaint with Monsanto, which led Monsanto to terminate the distribution agreement entered into with Spray Rite. The Court pointed out that the evidence of complaints to Monsanto was not proof enough of a conspiracy, unless there existed additional evidences that excluded the possibility of independent actions taken by Monsanto” Viscusi, Vernon and Harrington (1997).

The inertia of the jurisprudence of Dr. Miles also involved cases of maximum resale price maintenance in the United States. Thus, in 1968, the Supreme Court ruled in *Albercht v. Herald*, that manufacturers could not impose price ceiling on distributors. Recent lawsuits with respect to this type of restraint also show a shift in the direction of the doctrine on RPM.

“In the Arco case, [related to the fuels market], the Supreme Court ruled that the plaintiff (a fuel distributor) could not prove any damage by arguing that its offeror established a maximum resale price for gasoline. In the Court’s opinion, only an abnormally low predatory price could have met the requirement of generating a monopolistic damage, which damage results in reducing competition and not simply in reducing the benefits of individual participants in the market... If the maximum price had been set at a lower level, though not predatory, the plaintiff would lose benefits due to his lower margins, but only because the defendant was behaving in a manner that benefits consumers.” Gellhorn and Kovacic (1994), p. 303.

Despite this change in the technical criteria, the weight of tradition was so important that affected the law:

“Indeed, the (Antitrust) Division had filed, early in the 1980's, an amicus brief urging the Supreme Court to overturn the long-established per se rule against resale price maintenance, and only desisted from such efforts after Congress passed a law forbidding it from expending any funds for any activity "the purpose of which is to overturn or alter the per se prohibition of resale price maintenance." Excerpt from the speech delivered by Willard K. Tom, Counselor to the Assistant Attorney General Antitrust Division U.S. Department of Justice on vertical price restraints, at the American Bar Association Section of Antitrust Law Washington, DC April 7, 1994.

In 1997 though, the Supreme Court explicitly and unanimously declared maximum resale price maintenance subject to the rule of reason (Blair and Lafontaine, 1999). As shown in the next section, the effects of the U.S. legal inertia in LDCs still remains.

3.2 Jurisprudence in Chile

3.2.1 Illegality per se?

One of the most serious problems that the North American legal framework is the series of conducts, among which is RPM, considered illegal per se. That is, regardless of the reasons which may have determined the conduct, it is illegal.

In the Chilean case this discussion was raised given the ambiguous nature in which one of the key articles of the Chilean law was drafted. However, it has become progressively clear that the Chilean legal framework must deal with each one of the conducts under the rule of reason. In fact, the Chilean law does not define any particular conduct as illegal per se, which in the light of modern economic is the correct thing. This, in fact, has been what has happened over the last fourteen years, when the commissions explicitly began to interpret a list of conducts mentioned in article 2 within the broader context provided for in article 1. That is, they interpreted not as a list of illegal practice but as a number of potentially unlawful ones (Paredes, 1997).

3.2.2 The Doctrine

In consideration that RPM is not a per se illegal conduct, it is worth asking whether there is any doctrine that underlies the actions of the antitrust commissions in Chile and, if it is not clear, whether there exist mechanisms to generate it. The Commissions have systematically ruled out any economic interpretation of RPM. In turn, the Commissions have adopted as the key element of analysis the contractual relationship between manufacturers retailers. If the commercial relationship is that of an agent on a commission or if he sells on a consignment basis, then RPM has been permitted. The argument has been that if the distributor acts on behalf of the producer (related by the legal figure of a “commercial mandate”), it is a form of vertical integration and in this relationship the Commissions have felt that they may not interfere. On the other hand, in the case of goods that the manufacturer sells, the Chilean Antitrust Commissions have prohibited RPM.³

The Commissions have not considered the arguments of service, explicitly stated by some firms, such as the existence of quality requirements, the existence of a trade mark reputation and of special services requirements. This was the case, for instance, in cases associated to the tire industry (Goodyear), the wine industry (Viña Santa Rita) and the paper industry (Papelería del Pacífico).

Despite the absence of an economic doctrine, there are elements suggesting that it is possible to set forth a doctrine based on the conceptual elements considered above. In the first place, the Antitrust Commissions underwent and made explicit an important change in criteria and doctrine in 1992 regarding another vertical restraint, on occasion of the query posed by Nichimen-Daihatsu and which resulted in Ruling 808. In this case, exclusive distribution was approved on the basis that the automobile market was competitive enough to make the existence

³ See Rulings 11, 32, 76, 78 (ratified in resolution 19) on the automobile market (the last three of them), 124, 171, 172 (until May 1978) and 388 (automobiles).

of a monopolistic advantage not possible on the basis of such practice. This stood for a substantial progress by the Commission, as it included the degree of competition as a criteria, a determinant factor in the potential of any conduct to negatively affect consumers and which had not been considered up to then.

The change in criteria regarding exclusive distribution is precisely an important shift from what is formal to what is essential. However, there are two additional elements that suggest that there exist an important possibility for the Antitrust Commission to clearly determine an appropriate RPM doctrine. In the first place, there are situations in which the Commissions have in fact permitted RPM. In Resolution 71, for instance, the Commission adopted the criteria of the Fiscal Attorney when he asked for the dismissal of charges against two publishing companies for setting the sales price to the public of their books. The reason wielded was that in this case RPM was resorted to so as to permit the calculation of the author's rights, but that it did not imply that the prices to the final consumer were being fixed. However, to calculate author's rights, it suffices to indicate in each book how much is paid for such rights, without making any reference at all to the final price. The fact that the Commission authorized such practice has, in this case involving books, no interpretation other than that the Commission deemed that were no merits to consider it a practice against social interest. In other words, the Commission was not able at the time to set forth a clear and precise doctrine reflecting not only aspects of an economic situation, but also a recognition of a mistaken past doctrine as it did in the case involving exclusive distribution.

In the second place, in the most recent RPM case, the arguments of Fiscal Chief Law Officer (FCLO) regarding the economic information that justified RPM, though aimed at confuting them, do nothing but create the conditions so that the practice may be considered legal. This case shows a set of evidences that are very consistent with the conceptual developments, leading us to focus our attention on them in the section that follows.

4 The Case of Copec against Retail Distributors in Punta Arenas

On August 27, 1996, Copec S.A., the major fuel wholesale distributor in Chile, was charged with incurring in maximum RPM with a group of retail distributors. Copec is a company having a relevant presence in the Chilean market, a traditional competitor of Esso, Shell and which in recent years has been facing a progressive competition not only by the entry of new wholesale distributors (YPF, Texaco), but also in Chile there is no restrictions to importing refined products. Market information indicates that Copec also competes with Enap (the state-owned refining company) that, having installations in the same area, actually acts as a distributor. Despite the latter, Chile's geographic characteristics lead to situations, as in the case of Punta Arenas, where geographic isolation created quasi-monopoly at the level of retail distributors.

The legal action against Copec began with a complaint lodged by the Fuel Distributors Association (ADICO) stating that Copec had exerted pressure on its four concession operators in Punta Arenas and each one in Puerto Natales and Puerto Porvenir, so that as from of May 18, 1996, they should lower the prices of gasoline and diesel oil by \$ Ch\$ 7 and Ch\$ 15, respectively.

The investigation showed that though no measures of pressure were exerted to proceed with such a decrease, it was established that the prices, which had been in place for 45 days, had gone

down and had become uniform. The pressures which the Copec Area Manager in Punta Arenas had allegedly exerted on the distributors consisted in threatening concession operators in the sense that “the failure to comply with the price imposed on them, would at least bring about a change in the procedures for distribution, substituting the concession system by a consignment system, the latter permitting the mechanism of price setting by the owner of the fuel subject to the distribution”.

Other elements were that contracts between the concession operators and Copec contain clauses that are related to the conduct and actions which the distributors are to have regarding the good acquired from Copec. Thus, sales goals are established for the concession operator. The failure to meet these goals is, pursuant to that same clause, a reason for the termination of the contract, providing that they are not for reasons beyond the control of the concession operator. Likewise, it is also established in the contracts that the concession operators are to maintain an inventory to ensure an uninterrupted supply to users. Furthermore, the contract states the need that the concession operator takes action so as not to impair Copec’s situation.

“As a safeguard of the value which the parties have assigned to the trade name Copec and the reputation which this Company has in the distribution of fuels in Chile, the concession operator binds itself to clearly identify the building with Copec’s corporate colors, to maintain advertisements ... and to provide the public a good service and to maintain the reputation of the network of Copec distributors”.
(Clause 13).

Finally, the contract provides relatively easy terms and conditions so that Copec may terminate the relationship. In fact, contracts are in effect for a term of six months and are renewable on a yearly basis, unless one of the parties should notify the termination of the contract with one month’s notice.

The discussion focused initially on whether there were impositions on final prices. Copec systematically denied that there were suggestions or impositions connected to the price to its distributors. In turn, the FCLO was unable to ascertain any signal to support the statement that impositions were made.

According to Copec what happened was a conversation to share the commercial strategy that Copec wished to share with the concession operators. Specifically, Copec argued that this strategy required sharing a reduction in margins in order to increase the demand. Thus, Copec would reduce the prices to its distributors by Ch\$ 4.20 for gasoline and by Ch\$ 12 for diesel oil and required that distributors reduced their margins by lowering the price to the public by Ch\$ 7 and Ch\$ 15, respectively.

The empirical evidence shows that in period prior to May 1996, Copec had reduced its sales of gasoline by 7.5% and diesel oil by 14%, while total sales of those products in the area had experienced increases of 8.2% for gasoline and 1% for diesel oil. Thus, Copec lost market participation due to an important increase in the price to the public driven by the distributors by 10%, increase not due to input prices. Additional evidence supports the idea of collusion among retailers. The margin for retail distribution in Punta Arenas not only increased, but also exceeded to a great extent the typical margin in service stations in the country. While the margin in Santiago, which is the market with greatest entry and turnover, was Ch\$ 4 per liter, in

Concepción was Ch\$ 6, in Osorno was Ch\$ 10, and in Punta Arenas reached prior to May 1996 Ch\$ 16 per liter.

A third element is the traditional relationship that exists between wholesale and retail distributors. Ever since the industry was deregulated in 1978, there has been a progressive vertical integration in wholesale retail distribution. However, it is known that wholesale distributors depend on their disintegrated partners for their expansion. A conflictive relationship with existing retailers is a very bad signal to attract new ones. In fact, RPM applied to a very small portion of them in the country (i.e., only in Punta Arenas), practically rules out the hypothesis that RPM would be a mechanism to make them go bankrupt and buy out their facilities.

Contractual relationships between wholesale and retail distributors consider requirements of service, of exclusivity and clauses of unilateral termination. In this context, the absence of minimum resale prices may be explained by the requirement to make investments that create sunk costs (such as investing in lots of land owned by third parties, or install tanks owned by Copec), generate the same effect that would be brought about by a RPM (Klein and Leffler, 1981).

In the lawsuit against Copec two fundamental elements were at play. In the first place, the negative effect that RPM would have on the welfare of consumers and competition. This is the fundamental aspect which had to be addressed in the main by the regulators. In this case, it was the setting of maximum resale prices, which basically entails benefits for wholesale distributor, consumers and the country, in the understanding that the loss accrued by retail distributors is relatively small in relation to the benefits accrued by the other parties. The empirical evidence in this case is no surprise at all, they are perfectly consistent with the theory.

In the second place, the lawsuit invoked the assumed illegality per se of the conduct. However, it was possible to prove that for many years the Commission has been implicitly permitting RPM in the case of automobile distribution. Despite a number of resolutions contrary to RPM in the automobile market, newspapers in fact carry advertisements that definitely evidence such a situation, which is in no way a covert one. The case was made with the Fiscal Chief Law Officer that, instead of alleging unawareness of such an evident situation, what was needed was a resolution prescribing a clear doctrine stating that under conditions that do not entail a conspiracy against clients, RPM should be legal. Instead, the case was solved in a way that though it solves the problem for Copec, it does not contribute anything along the lines that the antitrust laws and legal framework in Latin America should promote. That is, the Commission, without pronouncing itself on the matter at issue, dismissed charges against Copec, by considering that there was no proof that Copec had actually fixed the prices of retailers. However, there was a pronouncement that can not be overlooked in this case and for Chilean jurisprudence, and which was made by the FCLO in his report in which he insists in the lawsuit against Copec. This is that, in the face of the evidence that effectively RPM was a practice that was actually carried out in the automobile market, he argued that there was a difference and it is that such market was undoubtedly competitive. With that argument, one of central points of this paper is settled: RPM is to be evaluated in function of its own merits, not under a rule of illegality per se.

5. Conclusions

The relationships of manufacturers with their distribution channels are important strategic development tools and have attracted increasing attention in the literature on industrial organization, strategy and marketing. The development of a tool as fundamental as franchising is explained as a form of efficient monitoring, a cost element which is very much present when it comes to decide the expansion of a firm and the alternatives that are available to each company to do so. It is here where certain vertical contracts, commonly known as vertical restraints, among which the RPM is a major one, play a key role.

In this paper we have analyzed the key aspects of RPM and, we have suggested why, through a very simple model, within the context of one of the most reasonable ideas of minimum RPM, it is not possible that the prices that the consumer finally pays may increase. Along this line, it is possible to arrive at the conclusion that only one type of RPM has a potential for competitive damage, a case where RPM is imposed by a powerful retailer to block entry at that level, and which has conditions that are relatively easy to ascertain.

The conceptual framework that we have set forth contrasts with the practical approach of antitrust agencies in the United States, and of some Latin American countries. It is not strange that countries in Latin America should have followed the same approach with respect to this practice as the United States, because the laws of Chile, Mexico and Venezuela, only to name three countries with laws which have been in operation over a longer span of time (especially Chile), closely followed the pattern of North American law.

Despite the above, the study of the Chilean case, which for practically thirty years has been implementing the antitrust law and could well be the one featuring the greatest inertia, shows that it is possible to interpret correctly the practice since in addition, the Latin American laws have a wider and clearer space to make it possible to reconcile an academic insight of RPM with an understanding provided by public policy.

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