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DEALING WITH RESALE PRICE MAINTENANCE (RPM)

Effects-based enforcement under the Chinese Anti Monopoly Law

*In August 2013, the Shanghai Higher People's Court ended China's first case on private anti-trust action against vertical restraints. In *Rainbow v. Johnson & Johnson*, the court found that Johnson & Johnson has violated China's Anti Monopoly Law (AML) by imposing minimum resale prices on its distributors. However, the court stressed that pricing agreements such as Resale Price Maintenance (RPM) are not 'per se' illegal. Rather, it needs to be demonstrated for each specific case that the conduct in question does restrict competition.*

Reasonable judgement

This call for effects-based enforcement of anti-trust law is reasonable. In fact, the economic impact of price maintenance along vertical supply chains is ambiguous. Although it tends to soften competition, RPM can also increase efficiency and consumer surplus. In fact, the case against RPM as a mean to distort competition is not even obvious. After all, why do upstream manufacturers with market power attempt to maintain prices at the retail level rather than simply reducing quantities or increasing prices at the wholesale level, just as in the case of a 'standard' oligopoly?

First, RPM increases transparency with respect to retail prices. This might help upstream manufacturers reduce inter-brand competition or even facilitate horizontal cartels as it makes it easier to detect deviations.

Second, when an incumbent manufacturer has significant power, it can use RPM to exclude more efficient competitors and share the extra profits with its distributors. Hence, distributors refrain from contracting with new entrants in fear of losing their extra profits.

Third, when wholesale prices are confidential, distributors have reason to fear that their suppliers sell to other distributors at lower prices. In extreme cases, this can lead to a situation where manufacturers have difficulties exerting market power at the wholesale level unless they can credibly commit to not supply rival distributors at lower prices. RPM can provide such a commitment. In this case, RPM might even allow a manufacturer to re-establish its market power by softening the (intra-brand) competition between its distributors.

No general theory

All these theories, however, are not of general nature. Rather, they apply only under specific conditions. Exclusion of smaller rivals requires significant market power and cartel facilitation is relevant only to the extent that structure and conduct on upstream markets support cartelization. Likewise, when producers and distributors interact regularly or when wholesale contracts can be observed, the commitment problem tends to be less significant since distributors can build up their expectations based on previous experiences. And even when commitment problems matter manufacturers can signal their commitment through other means such as exclusivity contracts for selected vendors. Hence, there is no general need for RPM in this context.

Efficiency benefits

With the anti-competitive impact of RPM by no means clear, economic analysis also helps identify the potential of RPM for increasing efficiency. Maximum sales prices are an obvious case in point. If two or more firms in a vertical supply chain can exert market power, the retail price of the final good can be higher than the profit-maximising price that a hypothetical vertically integrated firm would charge. The resulting double-marginalization reduces consumer demand and aggregate profits along the supply chain. If manufacturers use RPM to establish retail price ceilings this increases efficiency as well as final demand.

And even when RPM imposes price floors and thus, weakens intra-brand competition, it might still increase efficiency and welfare by shifting the focus of competition from price to non-price areas. Where distributors perform costly but non-contractible action -like keeping inventories or providing services and demand enhancing activities - price-driven competition might stimulate some to reduce prices by cutting extend and costs of non-contractible action and to free-ride on the efforts of other distributors. If this

becomes common conduct, consumers might incur losses, for example due to lower service quality. However, if producers can maintain price floors through use RPM, this can stimulate the provision of non-price action and thereby, increase consumer surplus.

Alternatively, if upstream manufacturers incur higher costs for improving quality by maintaining high hygienic standards or procuring high-quality inputs, a higher price stimulates high-quality provision. If quality is not directly observed by consumers, high prices also signal high product quality. If such products are sold through distributors, the latter have less interest to support the high-quality image of a product through higher retail prices as this erodes their own bargaining position vis-à-vis the producer. If, however, the producer can establish a price floor through RPM, this can increase product quality, efficiency and – under specific conditions – consumer surplus.

Conclusion

The objective of economic analysis in anti-trust cases is to identify the (economic) benefits from a specific conduct such as RPM while considering all relevant structural features of a given case. Essentially, whether RPM is detrimental or beneficial to consumer welfare varies from case to case and depends on factors including the intensity of inter- and intra-brand competition, the degree of upstream- and downstream market fragmentation, observability of contracts, bargaining and pricing strategies or whether or not distributors are dedicated to a single manufacturer. Conditional on these issues, economic analysis helps understanding the impact of RPM in a specific situation. Under effects-based enforcement, stakeholders should use these insights to determine whether RPM in a specific case constitutes a violation of anti-trust law that should be banned or whether it serves a positive purpose such as securing investments in higher quality levels.

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