

>>DANIEL P. O'BRIEN

Okay, folks. Warren, can you hear us? Great, we still can't hear you, but we'll definitely turn you up again when we get into the discussion part. Okay. Discussing the presentations on RPM today, we have distinguished legal and economic scholar. Our first discussant is Tim Brennan, a Professor of Public Policy and Economics at the University of Maryland in Baltimore County and a Senior Fellow at Resources for the Future in Washington. Prior to his academic career, Tim served as an economist at the Antitrust Division and a Senior Economist with the Council of Economic Advisors. He recently held the T.D. McDonald Chair in industrial economics at the Canadian Competition Bureau, and he has consulted with competition authorities in Mexico, New Zealand, Sweden and Uzbekistan. His research covers a broad range of topics in economics, and he's published numerous articles including important papers on vertical restraints. Our second discussant today will be Richard Brunell, the Director of Legal Advocacy and a Senior Fellow at the American Antitrust Institute. He's a graduate of Harvard Law School where he was an editor of the "Harvard Law Review", he's been a law professor at Boston College, Boston University, and the Roger Williams School of Law. He's been a litigator with the firm Foley Hoag, and his policy experience includes work with the Massachusetts Office of the Attorney General and the Antitrust Division of the U.S. Department of Justice. He's a contributing editor of the Antitrust Law Journal, and he's published numerous articles including a recent article on RPM titled, Overruling Dr. Miles, The Supreme Trade Commission in Action. Okay. We'll start with Tim.

>>TIMOTHY BRENNAN

Thanks. First of all, thanks, Dan, for the introduction. I want to thank, as everyone else has, Commissioner Harbour's office and John and Dan for putting this together. I thank them not as a producer, but as consumer. I was able to be here on Tuesday as well, and I've learned an enormous amount, which I'm still processing. I just told Rick, I guess I've run out of time to figure out what I'm going to say as a discussant just before I got introduced because of everything that I've learned in the last couple of days, so I really appreciate it on that basis. Great to be in the audience. On the way down here this morning, I came down from the Gallery Place Metro Station and passed the Museum of Crime and Punishment. I'm sort of hoping for future panels maybe Dan will organize a field trip to the RPM wing. They must have their -- maybe they've got a Cuisinart on display where we can sort of touch it. I just have a few things I want to talk about. One of the rules of the game here, everything's coming up at once, but that's okay. We sort of had to have our presentation sort of together before we knew what the people were discussing were going to say, so the slides I have here are a little ahead of that, but I am going to touch on things that people have said that apply to this. I'm going to focus mostly on the single firm side of this, the exclusion side as opposed to the facilitating collusion issues that Patrick raised, so maybe this applies more to the vertical foreclosure aspect that he's written on as opposed to the facilitating practice aspect of this. One sort of thing in my role as a discussant, I will mention that I would hope that maybe that the Tuesday panel and the Thursday panel could engage in was the claim that there's not a lot of data on what happens with RPM. They were talking about that with the facilitating collusion thing because it's been illegal. On the other hand, Howard Marvel had tons and tons of stories about people who went out of business allegedly on that. I don't have any

independent assessment of those stories, but it seems like one person said we have a lot of experience with what happens, and someone says we don't, so I'm not sure what the story is on this. My interest in this issue is rekindled by this particular line from the Leegin decision, which is essentially that you're thinking about RPM as an exclusionary device. And Greg's talked about that to some extent, so I want to talk about basically four things very quickly because I don't have a lot of time. The first is direct exclusion of harm, the second is indirect exclusion if RPM as being facilitating other exclusive dealing arrangements. Greg's stuff speaks to that a little bit, and some of what Warren had to say did a little as well, although I'm a little less sure of that now. And the last two things are somewhat more generic, although they've been raised by points that both Warren and Patrick have made which I'm going to call this equivalence principle, which is if X is legal and Y is no worse than X, should Y ever be illegal? And then some stuff on the Rule of Reason, practicality things which may be sort of some of the things I think people who are concerned about the Leegin discussion are worried about with some justification. Okay. On this side of it, let me say first here that in a -- we had a conference call planning out the sessions a week or so ago, and in that I think Warren started off by saying that he and I don't agree on anything, and I don't think that's true. One thing that I certainly agree with him about is that if there's something wrong with RPM, it ought to be reasonably simple. There's a line about econometrics that I think people have heard here. Which is that econometrics is a worthwhile enterprise, there's a line if you torture the data long enough, they'll confess, (laughing) and sometimes when I get -- I think that strategic theories are very useful, but there's something about a certain torturing that still seems to go on if we construct these things with enough assumptions and stories, although I'm not sure whether it's the data being tortured or the judges being tortured enough that he'll go along or whatever, whatever the story is, but I think that if there is a general rule to be had, even a Rule of Reason, I think it is going to be a fairly direct story. And the direct story that sort of struck me from reading that quote that I had before, this sort of novel, was on exclusion. Now there's -- I've been thinking about this, it's probably what triggered it in my mind. I said and a longer slide presentation, which is, I think available on the website and some other things will go into this in detail. I don't want to go into it here, but the basic idea is in a very simplistic way that a practice is exclusionary, like exclusive dealing or something would be if it -- it ties up a dominant, and I'll leave dominant in quotes because I'm not sure exactly what that means empirically. The dominant share of a relevant compliment market like distribution or retailing through the exclusive arrangement and then what's the effect of this arrangement on the price that rivals have to pay for the retailing or distribution, so I would think of this as being essentially the margin that's left with the retailer to cover the cost of shelf space or service or whatever it is that we think that the retailers are doing. A number of things that were enumerated by Howard and Ralph and Ben Klein on Tuesday. Some of Greg's theories speak to this as well, but I'm quite sure that they do too, number 2 and 3 in particular which are variations on a very similar theme that goes along these lines, and I think basically just to leave it, I think that RPM could be exclusionary in this way if a variety of things were met which I somewhat doubt they would be. The first if we're thinking about in single firm terms, a single firm has to impose it over a dominant share of a relevant retail market otherwise rivals could go to other retailers that offer high service or whatever it is you think you're getting, that the covered retailers must have

some limited capacity that's created by this to carry the type of products sold by the upstream firm. If you think of point of sale service, if I hire this retailer who I think is a good point of sale service, it doesn't necessarily exclude someone else if they can just hire another sales person to do it. So you need some sort of capacity limitation, and the opportunity cost story that Warren essentially used and Greg essentially used about if I can make a lot of money I'm not going to retail somebody else's stuff, you may think of as being a limited capacity story of that sort, and that other outlets can't be acceptable substitutes, the discount houses are still there. If that's an acceptable way of doing things, the rivals could still go to them. So I think the direct exclusionary story for RPM is going to be a pretty tough one to tell. There's an indirect story, and I think from trying to trace through the sites in the Leegin decision on this, I think this is what the Leegin Court had in mind, although everybody else here is better at reading Supreme Court Justice's minds than I am. And the basic story, the reference here is cryptically put in is based on things that were covered Tuesday, that there's a long standing argument of RPM that it essentially leaves money on the table for the retail which the manufacturer could then use to say if you don't do what I want, I'm going to take away this pile of money from you, and that way you can get the retailer to do things. That's usually told of the story of the manufacturer getting the retailer to do things that we kind of like, like servicing the product or promoting it or whatever. Well, maybe we don't like it, but that sort of thing, but one other thing could be that hey, if you carry a rival's product, I'm going to pull this pile of money away from you. So and that essentially is the story that I traced down by trying to track down the sites from the thing that basically went through an old paper by Dick Zurbey (ph) on the sugar cartel, and how it was enforced. And that was basically the story that's in there, although very, very briefly. If that is a problem, RPM is ancillary to an exclusive dealing practice. It's not the problem itself, and the harm is making RPM a contingent reward for not carrying the rival's product, so in a sense banning RPM for that reason would be like banning cash contracts or anything that induces a retailer to do what a manufacturer wants. If you think there's an exclusive dealing issue at stake, go after that, don't go after the means to the end. And just very briefly, then, two other things that have been sort of come up in this. One is something that I want to -- learn more about. I hope the presenters talk more about this, particularly Warren and Patrick because they both raised it. In this sort of equivalence principle, this is something it looks like it's persuasive to the Leegin Court because of a general expectation which has been questioned by some of the panelists today that there's really no difference at the end of the day between nonprice and price restraints. I guess I'm sort of old school enough to think that if you think that just for horizontal cartels that have -- if you're worried about -- if you want to make price fixing per se illegal, then you should make horizontal market allocation per se should be illegal for exactly the same reason. It's not obvious in principle that price fixing is -- that cheating on price fixing is easier to detect than, say, cheating on a market allocation agreement. My guess is the market allocation is probably a more effective device than this, so I wonder about that particular aspect. Who cares about intrabrand cartels if complete vertical integration is legal? I think there was an example about Toyota dealerships in either the Leegin decision itself or in the oral argument beforehand, and while Toyota owned its own dealers you wouldn't have any intrabrand competition anymore, that's perfectly legal, so do we care about that suppression, and I'm sure there will be answers for that sort of -- that don't entail

banning vertical integration. We'd be happy to find out what they are. There are a few other similarities, too, but in the interest of time I'll pass up on those and just leave this question about well, should there be an equivalence principle? Should it apply at all? So that's just one question I'll leave, and the last question I'll leave is this sort of -- is the move to the Rule of Reason status. Now, doing Rule of Reason is pretty obvious. You've seen it in the presentations Tuesday and Thursday to some degree. The Tuesday presentations arguably you could say well, ignoring anticompetitive problems, let's look at benefits, and the things today have been quite appropriate because this is how the science advances. Ignoring efficiency issues, what are the potential harms? And if you think that one side of an equation is zero, it's pretty easy to do it. If you think both sides in the equation are zero, when reading of the (inaudible) trial court opinion, I can't think of a benefit to exclusive dealing, but I can't think of a harm either, so I will find for the defendant. Then maybe tie goes there, and the harm of course is what if you really do have things on both sides. Now -- and how do we do this without instruction on now do the cost benefit test. And let me give -- we've heard on Tuesday that price doesn't do it. We heard today that output may not do it, so tests like that don't seem to be very good. Let me give a contrasting example. We've known for 40 years what the tradeoffs are in mergers come there's efficiencies at issue. One could argue as a separate matter whether you want to do total welfare or consumer welfare analysis for these things, but if you're inclined to count them, here's the rectangle, here's the triangle, we can go out and try to measure it, here's how one would do it. How would one do it here? Especially if we're talking about strategic theories that are basis for it and not some kind of direct exclusionary effect of the sort that I was talking about before. I'm not exactly sure how to do this, and this may have some implications. There's a paper that Doug Ginsberg had -- Judge Ginsberg had in the Antitrust Law Journal some time ago where he basically looked at the cases -- the nonprice restraint cases following Sylvania, and I believe his conclusion was that it was essentially per se legal despite being officially Rule of Reason, and I wonder whether that's going to happen again with this. And so I'll just leave in the last minute with a suggested standard that hasn't come up here yet, which is whatever happened to our old profit sacrifice test? I confess I am not a big fan of profit sacrifice tests in general, so I think there are essentially absolute defenses, and they should be applied only in situations where you're looking at exceptions to something that for theoretical reasons or other reasons is presumptively good. I actually found the arguments presented primarily by most clearly to me by Ralph, but by the others on Tuesday, that the fact that retailers and manufacturers don't have the same incentives enough to persuade me that maybe we should think about RPM in illegality and exceptionalism terms in which case we say we're only going to go after it if we're convinced that the firm would be losing money but for its adoption. So I'll leave it at that. Thanks very much. [ Applause ]

>>DANIEL P. O'BRIEN

Thank you, Tim. Okay. Michael. Rick. I'm sorry. I'm still back on Tuesday.

>>RICHARD BRUNELL

Thanks Dan. I want to join in commending the Commission for engaging in this important project and thank you Commissioner Harbour and to Dan and Commissioner

Harbour's office for inviting me to discuss the presentations of these distinguished panelists. Frankly, I was a little concerned about the order of the panels. Procompetitive came on Tuesday, and anticompetitive is Thursday, and we know that Tuesday's child is full of grace, Thursday's child has far to go. But I'm not going to assume that the scheduling reflects any bias about where the burden of proof should lie under the Rule of Reason. And I will concede that Tuesday's panelists were quite graceful. I am not an economist and I will try to put the presentations in the context of the general policy debate that has surrounded RPM. I should say at the outset that Professor Shaffer and Professor Rey's work was unfamiliar to me before this workshop, and I think perhaps to many in the American antitrust policy community, for example, their articles were not cited in any of the briefs before the Supreme Court in *Leegin* which in my view is unfortunate because they have much to add to the debate. Thank you. So let me start with Professor Grimes whose legal scholarship in this area is well known. Professor Grimes emphasizes an important anticompetitive cost of RPM, namely, the inability of more efficient retailers to pass along the benefits of their lower costs in the form of lower prices to consumers which not only elevates prices, but creates a barrier to entry to new, more efficient forms of retailing. Interestingly this harm was alluded to by the Supreme Court as far as back as Justice Brennan's concurrence in the *White Motor* case. As sometimes suggested that a manufacturer has no interest in curtailing the development of more efficient retailers, but as Bob Steiner pointed out on Tuesday, manufacturers face a transition and collective action problem in promoting new lower cost forms of retailing. Now, I wasn't really prepared to talk about Tim's presentation. But I did want to mention that this theory of anticompetitive harm of excluding new, more efficient forms of retailing is highlighted by the recent study on the effect of eliminating RPM on books in the United Kingdom in the mid-1990s, so in a report prepared for the Office of Fair Trading by Greg Shaffer's institution, the University of East Anglia, researchers concluded that the abolition of RPM contributed to the entry and rapid growth of innovative forms of book retailing, namely Internet sellers and supermarkets. But I would suggest, as Warren does, that the anticompetitive harm that results from preventing discounting by more efficient retailers doesn't necessarily require industrywide RPM or an anticompetitive story or model under which a manufacturer is pressured by dominant retailer or retailers seeking to exclude more efficient rivals. Rather this harm would appear to be an anticompetitive side effect of RPM regardless of the purpose for which it is employed, and I think ought to be given weight in the Rule of Reason. Let me turn to Professor Shaffer and Professor Rey's presentation. What I find most interesting about their theories is that they focus on interbrand competition, and they offer some support for the forgotten assertion in *Sylvania* that RPM almost invariably reduces price competition not only among sellers of the affected product, but quite as much between the product and competing brands. Professor Rey addresses the traditional concern that RPM might facilitate collusion among manufacturers and retailers, which has been important historically as both the Supreme Court and the economists brief in *Leegin* pointed out. For Professor Rey, I would simply ask to what extent does his theory accommodate theories of implicit or tacit collusion or oligopoly pricing because of course there's some proponents of RPM who argue that a rule against RPM is unnecessary to police cartel behavior because it's already per se illegal, but if the principal harm is oligopoly pricing or tacit collusion, then clearly there's a role for -- a rule against RPM to

address that practice. In my mind more interesting than the traditional collusion theories and perhaps more important are the theories that RPM can be used to soften or dampen upstream or downstream interbrand competition without any collusion. And I would reiterate that these theories seem novel to the American antitrust literature and to me they explain some important intuitions about the anticompetitive effects of RPM. So Professor Shaffer's fourth model under which RPM dampens competition between retailers carrying different brands, even when other retailers are not subject to RPM or particularly when other retailers are not subject to RPM, in the upstream market is competitive. Now, it seems to me, perhaps that's simple minded, but that when a retailer of product "A" commits to a price floor, price competition against a retailer of product "B" is impaired, and this strategic agency theory apparently confirms why to the economists that might be considered harmful. That point is also perhaps the basis for the Supreme Court's point that RPM invariably reduces interbrand price competition. Okay. So some recent empirical work that I noticed actually supports the idea that RPM can raise the price of brands that are not subject to RPM, and there's a study done by the University of British Columbia which showed that Toyota's no haggle pricing policy not only raised the price of Toyotas in the provinces where it was adopted, but also led to higher prices of Hondas. So whether this would be considered anticompetitive or not under some kind of output test, it is not clear. Now, Professor Shaffer's third model, which involves manufacturers who distribute through multi-brand retailers, built on a similar intuitive point that placing a price floor on product A sold through a multi-brand retailer may lead the retailer to raise the price of product B. Particularly when RPM is designed to increase the retailer's margin on A. So the procompetitive story that Ben Klein told on Tuesday turns out perhaps to be an anticompetitive story, not only because of the deception concerns that Professor Grimes speaks of, but because multi-brand retailers may raise the price of their competing products even when they're not subject to RPM, and Professor Rey's theory addresses this issue where multiple manufacturers adopt RPM with a common multi-brand retailers and Professor Rey suggests that one should look very skeptically at those situations. Okay. Professor Shaffer's first model explains another intuitive point, the idea that manufacturers adopt RPM in order to mitigate their incentive, to offer wholesale price concessions. That seems to explain the common perception of business executives that intense retail competition has an adverse effect on wholesale margins. Let me conclude by observing it seems to me distinguish the anticompetitive theories presented here today from the procompetitive theories presented on Tuesday. The precompetitive theories seem to start from a strong premise that a manufacturer having set its per unit wholesale price has no interest in adopting RPM unless it increases demand, at least in the absence of significant retail market power which is assumed to be rare, so consumer and manufacturer interests are generally aligned. By contrast, the anticompetitive theories start from the premise that wholesale pricing is often nonlinear and that the wholesale price may be dependant on the retail price. Further retail market power is not uncommon, and the retail price floor can maximize joint manufacturer and retail profits in a host of ways that have nothing to do with increasing demand. In short, there's no reason to think that manufacturer and consumer interests in low prices are aligned. The Commission is obviously looking for assistance in identifying markets -- identifying markers for procompetitive versus anticompetitive uses of RPM which is quite important, but also critically important is

going to be deciding who bears the burden of proof and who does bear the burden of proof is likely to depend on whether one accepts the Tuesday or Thursday premises. Thank you. [ Applause ]

>>DANIEL P. O'BRIEN

Thank you very much, Rick. Okay. First, I'd like to start off by giving the panelists a chance to respond or offer comments on the discussant points. We'll start with Greg, I guess.

>>GREG SHAFFER

I'd like to comment on something that Tim had on one of his slides. He equated RPM and exclusion or at least linked the two together, and maybe RPM and exclusive dealing, I'm not sure, so I just want to clarify one of my stories which was the markup manipulation story. Let's suppose you've got two products on the shelf, retail shelf, and the manufacturer sets a resale price maintenance on this product. One of the reasons why this can be beneficial to the manufacturer it will induce the retailer to raise the prices of the other product. You can also get the retailer to raise the price of the other product by simply imposing exclusive deal coming which would be telling the retailer to set it at infinity. But I'm not going there. I don't think that the idea is to knock out the other product because the other product is generating profits for the retailer, and if you try to knock it out, you'd have to compensate the retailer for the loss of the profits from the other product. So that's not at all sort of where I'm going with this. Still I think there is room to get the retailers to raise the price because prices are too low to begin with because of competition. So I see the story as the manufacturer sets resale price maintenance on this product, it induces the retailer to raise the price of this product, profits overall are higher, so I would stop short of saying that this is in any way related to exclusive dealing. You're not going to go that far. You're going to raise prices, but you're going to stop well short of exclusive dealing. So if that's the sense you meant exclusion, I would disagree. On the other hand, I do think what we'll observe is a decrease in sales of the other product. And in that sense, you might call that partial exclusion and maybe perhaps that's what Tim meant, but I do not equate resale price maintenance with exclusive dealing.

>>DANIEL P. O'BRIEN

Patrick, did you have any observations?

>>PATRICK REY

I'd like to come back on this issue that has been raised by the discussants on price versus nonprice restrictions. My general theme on this is if you look at the (inaudible), it's difficult to say the price restriction is necessarily worse than nonprice restrictions or the other way around. What instead we find is that there was some circumstances, specific circumstances where price restrictions may raise anticompetitive concerns. There are specific circumstances in which nonprice restrictions can raise serious anticompetitive concerns, and, therefore, this really suggests that we should not necessarily try to systematically oppose price versus nonprice restriction but more look at both circumstances in which some or another type of restriction may (inaudible). I'd like to

move through this very quickly. If you look at the general types of arguments first you have arguments on what I would call the vertical coordination, within some vertical structure. Coordination problems between the manufacturer and its retail network, and without going into the equation of whether what is good for the firm is good for consumers or society, the short story there is that both price and nonprice restrictions can be used to enhance vertical coordinations and Tuesday workshop went through various examples of this. So it's difficult to use that to make a difference or to argue very strongly in favor of differentiated treatment of price versus nonprice restrictions. Then you have to -- line of argument about the fact that those vertical restraints could be used to alienate or reduce or weaken downstream competition. So sham vertical agreements fall into this, Greg had stories that fall into this, and, again, price restrictions could be used, nonprice restrictions could also be used to eliminate (inaudible), and we have a sense of when this can occur. And the last line of argument is what is the possible strategic use of those vertical restraints in a way that is weakened interbrand competition or upstream competition. (inaudible) The type of restrictions that are usually at the core, and I concur with your comments, are exclusivity, discriminatory practices, (inaudible), it's not really RPM. RPM can be as you say part of the picture, but it's not necessarily the key one. Then you have -- there's been -- you mentioned the work I did with (inaudible) on competition (inaudible) effect which applies to situations where you have a competing rival or competing franchise networks competing against each other. The idea is that franchisers or manufacturers marginally could design, fine-tune the vertical contracts with their agents, their distributors so as to dampen, weaken the rivalry, the intensity of the rivalry between those vertical structures. Exclusive territories could serve this purpose. RPM does not go. It cannot be a very effective device for this because RPM which gives moderate control of the retail prices to the upstream manufacturers result typically in more intense direct head to head competition, so that's good. That fosters the rivalry, the intensity of competition between all the structures. So this is an area in which nonprice restrictions could appear in a worse light than price restrictions. And then you have the facilitating practices -- I've already covered this. I will only make my own comment on this is to answer the question. Facilitating practice, we are looking here of RPM are being used as a way to help facilitate either tacit collusion or more explicit forms of collusion that still have to rely on enforcement of the collusive agreement. So this applies to purely tacit collusion, which cannot be caught in other ways. Legal enforcements -- it's difficult to fight legally purely tacit collusion and even in the case of more explicit forms of collusion, (inaudible) it's been very successful in fighting those more explicit cartels, and (inaudible) and I have actually argued in favor of developing those programs and maybe going even further and offering rewards in order to fight those, but the fact remains that it's probably the case that quite a few explicit cartels are still running and not being caught and RPM could be -- can help enforce those cartels even though there was some tools that -- that may allow agencies to fight explicit forms of collusion, to the extent that this fight is not entirely successful, it may be a good idea to keep in mind that RPM may be facilitating practice. Finally, the last item on my list going through in the general theme of how vertical restraints can be used to weaken, eliminate, or dampen (inaudible) competition is in the case where you have multi-brand retailers and competing manufacturers use the same multi-brand retailers, and there

indeed I think RPM, specifically RPM as opposed to other nonprice restrictions can be a most serious concern.

>>DANIEL P. O'BRIEN

Okay. Warren Grimes, did you have a reaction to the discussants or comments on any of the other points you've heard?

>>WARREN S. GRIMES

Yes, can you hear me?

>>DANIEL P. O'BRIEN

Yes, we can.

>>WARREN S. GRIMES

Great. First of all let me definitively resolve the correct pronunciation of the Leegin case. The Leegin first is located out here in Los Angeles, and it's named after Lee and Jenny, and it's pronounced "legion." Now that we've resolved that we can move forward with the less important point. I want to address Tim's comment about the equivalence principle. As I understand his point, it would be roughly this, if you can freely, vertically integrate, why can't you use less integrative restrictions such as vertical restraints freely or I suppose another way of saying this or another way of looking at this, if you can use nonprice vertical restraints with relative impunity, why not price restraints, since in some cases they have similar or identical effects. Let me just explain my position on this, and then I'll give the mic back. I think not all nonprice vertical restraints are okay. The kind that I think should be treated leniently are those vertical restraints that limit distribution, and the reason I say that is I believe they can be procompetitive by encouraging investment by the dealer and the manufacturer brand and they can be an important way for a new manufacturer to gain market penetration, gain distribution. So that's one reason. Another reason for treating market-limiting, distribution limiting restraints more leniently is that they are self-limiting. Once a manufacturer gains preeminence with its brand, they want wide-open distribution, so there's a strong built-in incentive for the manufacturer to abandon the narrow -- distribution narrowing restraints and move to wide-open distribution, and at that point I believe the presumption against resale price maintenance should operate with full force. Thank you.

>>DANIEL P. O'BRIEN

Okay. Discussants, did you have a reaction? Okay? Well, I have some questions, and then we'll take some questions from the audience. First, I wanted to start with some of the things that Warren Grimes said. You had a slide that suggested that the anticompetitive effect -- the primary anticompetitive effect of RPM is the loss of intrabrand competition, okay, and I have to confess that without a lot more, I don't quite understand that because as a general matter manufacturers like more intense competition because they sell more. And that's was basically a large focus of what we heard on Tuesday. So I'm just wondering if you could articulate concisely what exactly it is about the loss of intrabrand competition that worries you. Let me add one of your themes was if you have a more efficient retailer and that retailer is excluded, that could be bad. Well,

a manufacturer has to be concerned about whether or not it's losing an efficient retailer that might be a good retailer to distribute its product, and it would only want to exclude such a retailer if there were some benefits from doing so. And so I'd like your reaction to that.

>>WARREN S. GRIMES

I think the reason a manufacturer wants resale price maintenance is to increase its sales, and that's why -- it's first priority is increasing sales, not helping efficient retailers, so if I'm a manufacturer and I have a brand at WalMart and the other big retailers aren't interested in carrying at all or at least not prominently shelving or promoting, I need some way to get -- some retailers and maybe even the big stores to want to carry and promote it. And so I reach for resale price maintenance to do it. Yes it does increase output for that manufacturer but it does so at the expense of efficient, for example, efficient Internet retailers. Some of you may have seen the story in the "Wall Street Journal" about the Internet seller of baby furniture who I believe is involved in litigation now, but this is not a big firm of the size of Amazon.com or WalMart, so his operation is smaller, and he is threatened by the fact that a lot of the manufacturers of the products that he's selling won't let him discount them anymore, so he's threatened with being driven out of business. I guess the second point, though, is that the prices go up when you have RPM, and that's one of the consequences of resale price maintenance when you limit retail intrabrand competition. Even let's leave aside the question of whether it reduces interbrand competition at the manufacturer level. There is definitely some evidence that it does do that, but let's just talk about what happens at the retail level the prices go up. If my daughters come to me and say I want to buy the latest "Harry Potter" book, the only game in town is intrabrand retail price competition. I can't convince my daughters to buy a different book if it's cheaper. So the only thing that gives me some competitive choices is intrabrand retail competition. I readily admit that the "Harry Potter" example isn't typical for all brand selling. If you're talking about the choice between a Sony and a Samsung television set, consumers are somewhat more ready I think to switch brands if they are charged too much for the Sony, but even in an area like that, the manufacturers work very hard to limit intrabrand competition by distinguishing their brand and convincing the consumer that the Sony has certain features that the other brands don't have. So retail intrabrand competition is of central importance to the consumer and becomes more important, not less important as brand selling increases.

>>DANIEL P. O'BRIEN

I guess I would like the panelists to respond to the idea that if sales go up, we could still be worse off, for example, if they went up but a more efficient retailer was excluded by RPM.

>>MALE SPEAKER

I would love to hear from Greg on this who focuses of course on the sales of the industry. The premise that the manufacturer wants to increase sales I think with all due respect to Warren is that the manufacturer wants to increase profit and not sales, and Greg can explain why that's the case.

>>GREG SHAFFER

No, I would agree. I think the manufacturers' interest is to increase its profit, and that doesn't mean increasing sales necessarily. If the price is higher --

>>MALE SPEAKER

But my question was if sales do go up and a more efficient retailer has been excluded, how do we feel about that?

>>GREG SHAFFER

First let me talk about if sales did go up. I tried to make the point in my talk that the RPM product -- manufacturer of the RPM product sales could go up, but you also have to look at what's happening in sales in the other product in the category. And if overall the category sales are going down, I would find that to be anticompetitive, and then the second part of your question how do I feel about exclusion of --.

>>MALE SPEAKER

No, you just answered the question. You answered it based on overall sales.

>>GREG SHAFFER

I would look at overall sales. I wouldn't focus so much on sales of the RPM manufacturer's product because you've got efficiency stories and you've got anticompetitor stories which suggests that it could go up, but I think one distinguishing feature is what's happening to category sales. That's one thing I would look at.

>>PATRICK REY

In this scenario I agree with Greg that you should look at the picture industry -- the intermarket level, but looking at the survival or the existence of a particular type of retailer search is not necessarily a very useful way of determining whether some action is wanted or not. If output does raise -- assuming that industrywide output raises, then that would mean more consumers find their product that meets their needs, so that's fine. If in the process some types of retailers are discovered to the extent that this is not going to lead in the future to a restriction on output and make the competition work in the future, setting that aside, a search would be more interested in looking at the output in prices than looking at what other retailers that are active or the type of retailers that are active in the market.

>>MALE SPEAKER

Okay.

>>MALE SPEAKER

Very briefly, one argument that's been -- I think Warren suggested and it also came up a little bit on Tuesday was that everybody's sales could go up, but that's because of this arms race in promotional activity that RPM induces, and I think that there's a claim out there that that's wasteful, in the same way that one could argue that advertising is wasteful because it's just basically this thing where everybody tries to take profits from everybody else and the gains get dissipated in advertising expense which on people who

take that view think is a waste. I don't necessarily do that, but that is another one that's out there. On the more -- on the efficient retailer issue, any long-term relationship means that in the short run where there's a long-term contract, hiring somebody, whatever, that I'm going to be able to point to an instance because I made that long-term contract that there was some conceivably efficient thing that could have happened in the short run that didn't because of it. That doesn't necessarily mean that it was an incorrect thing to do. I'll leave it at that.

>> DANIEL P. O'BRIEN

Okay. I have another question about the parallel widespread use of RPM which was something that Warren Grimes discussed a little bit arguing that it's really almost like a cartel, and I guess I'm wondering how I can draw that conclusion if we thought RPM was motivated by the desire to induce retailers to want to sell the product as you discussed in your very first slide. If that were true in an industry and true for all manufacturers in an industry, and RPM were used for that reason, I guess we might expect to see widespread use of RPM for efficiency reasons so equating that with a cartel I didn't quite understand, so I wondered if you could expand on that.

>>MALE SPEAKER

Well, I guess I have a couple of reactions. Some years ago Mike Sharon (ph) and Bill Commoner (ph) wrote about how the wide spread use of RPM in a category could actually reduce category demand because prices go up across the board, and the promotion benefits of creating a higher margin are lost to the manufacturer if all the other manufacturers are providing the same kind of high margin. So I think it's a more likely result of widespread use of RPM that the overall category demand will go down. I think from a manufacturer's point of view, manufacturers would rather be the only one in the category using RPM because then he has this wonderful incentive that he's providing his retailers to really focus on selling his brand. If all manufacturers are adopted it, what is going to make that retailer care which brand is sold? One final point about this I am an advocate of the concern the RPM creates incentives for exploitation of consumer information gaps but that concern disappears or at least largely disappears when there's widespread use of RPM in the category because all manufacturers have created big margins for the retailers.

>>MALE SPEAKER

Another way to think of it is if there's widespread use then the assumption that it was adopted for efficiency reasons or even for brand promotion at the local level just is not going to be true, so we should look for some other explanation. I mean Ben Klein was not -- would not say if you're the tenth manufacturer down the road, you'd have any interest in then trying to get manufacturers' specific promotion in -- at the retailer level because by definition there's no longer any sort of ability to have manufacturer specific promotion.

>>DANIEL P. O'BRIEN

Any other panelists have response to that point? I guess I don't understand how widespread use is inconsistent with manufacturers' using RPM to induce retailers to promote their product.

>>PATRICK REY

First clearly in the case where there is one isolated new entrant that uses RPM to establish his network and launch his product, we probably would agree that we would be more open and more sympathetic to the practice, then in contrast when you have RPM across the board in an industry where we may be more cautious, and we may want to have more detailed investigation of what was going on, so in that respect, there is some ground for making the distinction between the two. But even if you have -- if all manufacturers are relying on RPM and are doing so for efficiency reasons in order to encourage their retailers to promote, therefore, again, you would have competition between rival networks, or rival franchise networks let's say, where vertical integration could be an alternative to the price restrictions, then I do not see why we would not be willing to accept the fact that if it is efficient to do so, then all manufacturers should do so.

>>DANIEL P. O'BRIEN

Okay. I have --

>>MALE SPEAKER

If I could comment briefly. I don't see necessarily a relationship between how many firms are using RPM and whether it's efficient or not. I think you can tell anticompetitive stories and procompetitive stories when just a single firm uses RPM and you can tell anticompetitive stories and procompetitive stories when all firms are using RPM, so I don't really see that this is a criterion that I would use. If all firms are using RPM, then I think we've got an output test. If we're worried about a cartel, look to see what's happening to total output. If output is going up and all firms are using RPM, then I think we can dispense with the cartel story, but I then the general thing I want to communicate is I don't think you can look at how many firms have RPM and decide whether that makes it more likely to be anticompetitive or procompetitive.

>>DANIEL P. O'BRIEN

Okay. I have a list of questions that I'd like to run past Greg and Patrick about the strategic agency models, but before I do that I'd like to take questions from the audience. Panelists.

>>FEMALE SPEAKER

Yes, I've also been intrigued by the footnote in Sylvania where the Court gives far more value to intrabrand -- interbrand competition than intrabrand, so if one were going to test that proposition, do you think there's any empirical or theoretic basis that the Court was looking to when it made that pronouncement? If one were to argue in favor of that, I'm going to turn to Dr. Brennan to ask you to make that argument and then if one were going to argue against that, is there a basis for giving more value to interbrand competition than intrabrand?

>>TIMOTHY BRENNAN

Let me say something on both sides of that question a little bit. The main argument I think that's sort of the familiar one is that intrabrand competition is no worse than complete vertical integration. So that would be -- I think that is simply it right there. The one thing on the other side that does sort of strike me is that one could imagine situations where the manufacturer has elected to set up independent retailers for its own purposes, monitoring, that sort of thing, and that those potential benefits could be subverted if in fact the retailers were colluding with each other. In which case if there were a problem, one would expect that the manufacturer would be the plaintiff in the lawsuit, not the defendant.

>>FEMALE SPEAKER

And Professor Shaffer, if you were going to make the counterargument --

>>GREG SHAFFER

The counterargument being -- can you repeat the question?

>>FEMALE SPEAKER

Interbrand competition was given more weight in the Sylvania opinion in the footnote than intrabrand competition, and I wonder if there's some theoretical basis for that, and if you were going to argue that that's not so, what sort of argument --.

>>GREG SHAFFER

I think I pretty much agree with Tim on that. It's very hard to distinguish -- if we just look at interbrand competition, the procompetitive and anticompetitive stories, if there's just a vertical effect, then you've got -- like I said procompetitive and anticompetitive stories, it's hard to distinguish. But I see most of these anticompetitive stories as having to do with effects on interbrand competition where you're trying to -- I wouldn't say extend the monopoly but you are trying to get rivals' prices to be higher because that's what's putting a restraint on your prices, and so that's why I would look at interbrand competition as a key to deciding whether the practice is good or not.

>>FEMALE SPEAKER

One more question. I look to Dr. Grimes. I know that you had said that that was an unfortunate footnote and perhaps misguided. Do you have anything to add on that discussion?

>>WARREN S. GRIMES

Yes, I do believe it was a misguided and unfortunate statement, and I guess I would disagree respectfully with the view that the only thing you need to look at -- or the primary thing you need to look at is interbrand competition. I think Bob Steiner's work is seminal on this, and he has shown that the two often are inversely proportionate when there's more interbrand competition at the manufacturer level, there tends to be less intrabrand competition at the retailer level. And I think for me, I guess I'm not doing a very good job of communicating my convictions on this or my beliefs, but brand selling which by the way is a good thing, brand selling is a wonderful thing that allows the

economy to scale for the manufacturer, it creates incentives for the manufacturer to keep quality control high. There are many, many wonderful things about brand selling that have moved us beyond the 19th century when our products were slip shod and of low quality in many ways. But brand selling is a way of reducing interbrand competition. It creates incentives for the consumer to want a particular brand, and so when that happens, that makes intrabrand competition at the retail level all the more important, and I wish there were more research and more of an effort by the Academy not only economists, but other researchers as well, marketing experts, to examine this question more closely.

>>DANIEL P. O'BRIEN

Ralph Winter had a question early on.

>>RALPH WINTER

Thanks, Dan. I'm going to ask a question of Patrick. Patrick, I really liked your refinement of the cartel theory. I think that's something we have to understand and practice to make sense of certain cases like Electric Large Lamps. My question was about your other theory, the interlocking relationships, the theory that even without coordination across manufacturers you can get monopoly pricing in a market with many retailers and many manufacturers as a result of resale price maintenance. So this is the question. Suppose you're a small manufacturer in a market, there's ten manufacturers and ten retailers. As the equilibrium -- monopoly price equilibrium you're proposing is established, or just about to be established, what prevents you as a manufacturer from just renegotiating your contract with other retailers to undercut the other manufacturers? In other words, would you review for us the intuition about how resale price maintenance inhibits these standard competitive process by which prices are driven down below the monopoly level in terms of a renegotiation if you like.

>>PATRICK REY

The very point is that if competing manufacturers use the same retailer to carry their brands, then the retailer can act as a common agent basically for the manufacturers and eliminate (inaudible). We know that from (inaudible) and so on. If you have now several retailers that are competing against each other, then the argument breaks down except if resale price maintenance (inaudible) to eliminate this intrabrand competition. To put it another way, if the manufacturers sell at cost and then use fixed fees or other ways to recover part of the profits, the retailers has internalized the full margin on all the sales of all the brands, so when the manufacturer is going to visit the retailers and suggest the renegotiation that you present, the retailer will not be necessarily willing to go along because he's the one that gets all the margins on the rival brand as well, so why would the retailer accept to reduce those things. That's the (inaudible).

>>DANIEL P. O'BRIEN

Patrick, isn't it important in this story that the contracts between manufacturers and retailers be observable to all retailers to make the story work?

>>PATRICK REY

So as a general remark, whether contracts are public or private, whether the price flow is an industrywide price flow that is known to everyone or whether those price flows are negotiated on a purely bilateral basis, and therefore, are really vertical in nature, that makes a difference. Whether -- we know that when contracts, tariffs, conditions that a manufacturer negotiates with a retailer are secret in the sense that they are not observed by retailers, we know this may prevent the exercise of market power, and it may allow intrabrand competition downstream competition to percolate upstream or prevent the full exercise of market power upstream. So in that sense to come back on the previous question -- the previous topic if there is no interbrand competition, so if you really have a strong market power, then indeed intrabrand competition may be useful in contrast when you have a lot of intrabrand competition, we don't need to pay that much attention anymore to interbrand competition. So we know that private contracts indeed may be a problem, and Greg and Dan have worked on this and have shown if -- this (inaudible) arises resale price maintenance can be an effective way to restore the exercise of market power. Let me just note with respect to your -- to that argument that as you mentioned max RPM is sufficient to restore the exercise of market power, so this is not necessarily an argument that applied to min RPM assuming that max RPM is legal anyway.

>>DANIEL P. O'BRIEN

Just to get back to Ralph's example quickly, so you're saying if a manufacturer and a retailer could get together and sign a contract in private, which you don't allow in your model, then the equilibrium that you identify, that supports the monopoly outcome would no longer hold, correct?

>>PATRICK REY

It's not clear. I cannot answer that completely because we have not done that, so I need to be cautious, but the idea that if one manufacturer uses franchisees or other ways to eke out profits, the retailer will internalize all the sales -- will still be there whether the contract is public or secret. So it remains to be seen.

>>DANIEL P. O'BRIEN

Okay. Tim.

>>TIMOTHY BRENNAN

Very quickly, one thing that Ralph's question brings to mind, I'm far from a good enough game theorist to be able to analyze models like this is on fly. Just to say for everybody else out there, is that a lot of times there's an enormous difference between two and three. A lot of these models have just two retailers, two manufacturers, whatever, so that what happens is when one group of those makes up their mind, you don't have any competition left over between the other people who may be doing this. So one has to be careful about whether these things have general application and just check sometimes if a model seems to work out when you just have two at either stage, see if it works out with three.

>>PATRICK REY

I agree with this, but in that particular case, the extension is straight forward, and actually in the empirical exploration that was done by my colleagues, they extended this

framework if I remember correctly to seven manufacturers, eight retailers, plus the possibility that some manufacturers have multiple brands and multiple products, plus the fact that they were private labels on top of that and you add this without altering the thrust of the argument.

>>DANIEL P. O'BRIEN

James Cooper had a question.

>>JAMES COOPER

Greg, this is a question for you really about the -- your model number 3, the raising rivals price model, the retail price where you have RPM --.

>>GREG SHAFFER

Multi-brand story.

>>MALE SPEAKER

Yes, exactly. RPM goes in product A, product A's retail price goes up, retailer optimally responded by raising the price of product B. Product B's retail sales decline. What is manufacturer B's optimal response then? Do they just accept the retail price decline? How is this an equilibrium in that sense? Does manufacturer B turn around and say it goes back to the retailer and say I'm going to put a max RPM in place because I don't want to accept -- manufacturer B now is losing profits, manufacturer B's prices have declined because retailer A has upped his prices to make his product less competitive with the RPM product, so now what is manufacturer B, what is his response after that? So I wonder if that is a stable equilibrium?

>> GREG SHAFFER

I have two responses. I think in some sense Patrick has looked at that situation where you've got multiple upstream firms and both can choose to have RPM or not have RPM, but specifically you said isn't manufacturer B worse off? Maybe, but maybe not. I see what's happening is all retail prices are rising, so manufacturer A puts resale price maintenance on its product, it gets the retailer to raise the price of product B, that relaxes the constraints that were on manufacturer A so that it can raise its price. I see all prices rising and I see profits increasing, and then how those profits are allocated along the various players is kind of a black box. That depends on the contracts that they have. Manufacturer B is not necessarily worse off from this. It may be very happy that manufacturer A has taken the lead and increased all prices and gotten all profits up. It may be able to capture some of that, but more specifically exactly how manufacturer B will respond, I think that's in Patrick's -- one of Patrick's stories.

>>JAMES COOPER

I have one follow-up, just a general question for all the models. They tend to -- and correct me if I'm wrong -- rely on downstream competition where prices are strategic complements. Is that true, number one? And, number two, if that a really robust assumption? I ask that out of curiosity. Is that a -- should we model prices as strategic

complements or strategic substitutes, and if we switch the two, how do the outcomes of the models change?

>> DANIEL P. O'BRIEN

I think he's asking the nature of downstream competition, the idea that with differentiated Bertrand (ph) which is usually what you assume in these models you have strategic complementarity, you could have a different kind of oligopoly model in the downstream market where you wouldn't have strategic complementarity and the question is would that change things, and I think the answer is well, we don't really know because we haven't worked through those models, but I'll let Greg answer.

>>GREG SHAFFER

Yes, and I haven't looked at that, Jim, and I don't really want to speculate on what would happen in that case. If you're asking if the retailers choose quantities instead of prices for example --.

>> DANIEL P. O'BRIEN

I think there are cases, I'm interrupting you Greg where it would change things. But there are probably cases where we -- .

>>GREG SHAFFER

But maybe not in this case. I do want to speculate but I do want to say that for this multi-brand story that I told, the retailers need to have some power over price. They have to be able to set the price. If the retailers themselves are perfectly competitive and they basically take the product and don't have any kind of markup, then they're not going to be raising the price of product B, and so that story won't hold in that case. So I'm assuming that they have some ability to set their own prices and to raise prices. That part I'm sure of.

>> DANIEL P. O'BRIEN

Okay. Bob Steiner is trying to get a word in edgewise here so.

>>BOB STEINER

I'd like to get two words in about two topics. One is about intrabrand competition. Disciplining retail margins. Has anybody been a retailer other than Bert or a manufacturer in this room? You know the answer to that if you had been. But it's very well known, I've given a great many empirical examples of it, when brands are very well known, things like Tide have very thin retail gross margins, the manufacturer profit is a high gross margin as Procter & Gamble does. And intrabrand competition is what disciplines retail margins, not interbrand competition. That's backwards, and the Commission got it backwards in Nine West. You can see that with intrabrand competition between stores on Tide, people know that the Tide at store A and the Tide at store B are identical, and, therefore, the retailer that tries to price Tide higher than another retailer is going to lose a lot of market share, and also consumers take the probable level of a store's other goods pretty much from the few items that are high profile that they can compare, so he's got a lot to lose. Competition between differentiated items are different,

so you never can rise to the same level as competition among items that consumers know are the same. And I've written -- Warren referred to it -- all kinds of evidence out there that retail gross margins are very low on very popular items, and that's because of intrabrand competition is fierce, but on items that are not popular, retailers can make consumers change brands within stores, and therefore instead of changing stores within brand.

>>DANIEL P. O'BRIEN  
Did you have a question?

>>BOB STEINER  
I have a question also or a statement on sort of if you look, by the way, at Sylvania at note 19, look at the second to last sentence. Not just the last one. The second to last sentence has the case of the inverse association between margins. I do have some questions about something as to whether exclusive daily and locational restrictions -- how that compares with RPM. If you don't mind I'd like to give you an example. When I was at the Federal Trade Commission in the Bureau of Economics some years ago, and we had a case against the detergent manufacturers, and we wanted to see whether brand A got socks whiter than brand B. And the Commission called in somebody who was an expert at bundle testing, and this person showed that when the two socks -- they would wash socks in brand A and one side in brand A and the other sock in brand B, when people could see those close up, they could tell which brand got the sock whiter. But when you took the sock in the other room, people couldn't tell, and this gave me the thinking that one of the problems with exclusive dealing is no matter -- it can be procompetitive, but you cannot make good price comparisons when you have to visit many stores, and you cannot make good comparisons of quality and performance attributes unless the brands are side by side, so that with exclusive dealing even amongst procompetitive (inaudible) and on the other hand -- I'm afraid I'm taking up more time than you've planned, but I've written on all of these things, and I've studied them, and I do want to say that RPM can be more beneficial than -- for that reason than exclusive dealing. Except for missionary work or a struggling brand like Sylvania TV sets. There you can't use RPM because you don't want anybody to free ride on your efforts if they're successful. And in those cases you will go to exclusive dealing at least for a while.  
Thank you.

>>DANIEL P. O'BRIEN  
Thank you, Bob. Is there a reaction from the panel? Bert.

>>MALE SPEAKER  
Thank you, Dan. By the way, as former retailer, I agree with Bob Steiner's view of this, and I find it surprising that the rest of the world has not been more persuaded despite his really quite tremendous record of analysis and discussion and empirical research, but I wanted to raise a different kind of a question, more of a political economy question as we move toward presumptions and the strength of presumptions. And Dr. Rey said something I thought was very illuminating. I'd like to let you all -- ask you all to develop it perhaps further. It seems to me that a very important question is what is our default in

terms of who should be making decisions about the terms of trade? And the information -- the local information advantage that the retailer has I think is an important point, although I would add to it that the retailer is not focused strictly on price. The retailer's decision on price involves other types of decisions about service and presentation and promotion, and they all come together in the retailer's mind. So I think we have a bit of overemphasis caused by the microeconomic theorizing that is ignoring some of the reality and the decision-making. My question, though, is what theory -- what thinking do we have that would put the default position for making decisions on the retailer as opposed to the manufacturer or vice versa?

>>PATRICK REY

There has been of course recognition of the fact that in many markets, the retailers not only have more information than the manufacturers, but also have significant buying power, and, therefore, in France actually we have been going through a series of regulations and rules trying to supervise and monitor the way the relationships are between manufacturers and retailers, the concern being that the largest of these retail chains could dictate the terms and conditions to a small manufacturers like (inaudible) and Procter & Gamble, so we have this -- in the literature this has translated into -- in the economic literature this has translated into both a theoretical and nontheoretical study trying to assess the whole of this bargaining power of retailers. In terms of who has the information of what and who is in a better position to determine what should be done, in particular when it comes not only to prices, but to whether it's a good idea to have this type of product or that type of product or introduce this feature or not introduce this feature or develop a product that is -- that is better suited for specific need, I think that there is -- we need to do more work on this and the development of the private labels. For example, in that context it sometimes says retailers are now better equipped and have more information and therefore are better placed to determine what products should be put, should be developed, but there has been not much -- not enough academic work on this.

>>DANIEL P. O'BRIEN

Okay. I'm afraid we're out of time. I think we could probably go on all afternoon. I'm quite sure we could. But there will be panels in the future on the topic, and I would like to thank all of the panelists for participating today, and once again thank Commissioner Harbour and her staff for putting together this workshop. And hope to see you at the next workshop on RPM which are not on the schedule yet, but there will be some more coming. Thank you. [ Applause ]