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Resale Price Maintenance in South African Competition Law

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I hereby declare that I have read and understood the regulations governing the submission of Master of Laws dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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A. Introduction

Resale Price Maintenance ('RPM') refers to a particular type of vertical agreement in which an upstream firm controls or restricts the price at which a downstream firm can on-sell its product or service, typically to final consumers.[1] Usually the parties agree to set either a minimum or maximum resale price. Maximum RPM covers those situations in which an upper limit or ceiling is placed on the price the retailer can charge for a product. In contrast, when it comes to minimum RPM, a lower bound or floor is placed on the price at which the retailer can on-sell the product.[2] Fixing the minimum resale price is generally treated more strictly by competition law as it is considered to have more severe anti-competitive effects, for example the elimination or reduction of intra-brand competition and an increase in price transparency that might facilitate horizontal collusion upstream or downstream. Intra-brand competition refers to competition between retailers offering the product of a given manufacturer within a given vertical structure.[3] Minimum RPM is frequently practised in connection with the fixing of penalties for deviating from the prescribed price, e.g. by threatening to cut off supply to the retailer.[4] In such cases RPM may constitute a violation of competition law. In contrast, in most cases no competition concerns are raised if a manufacturer just recommends the retail price.[5] The present work focuses solely on the practise whereby manufacturers and dealers agree on a price below which the dealer may not sell products purchased from that manufacturer, commonly known as 'vertical price fixing' or minimum RPM. Unless stated otherwise, therefore, the term 'RPM' refers to minimum resale price maintenance.

RPM must be seen against the background that it is a type of vertical agreement, imposed by a supplier to its distributor. Exceptionally, it may also be agreed between suppliers operating on the same level and therefore be horizontal.[6] Horizontal relationships are generally expected to be harmful. They normally offer the greatest danger to competition as they are frequently used in order to eliminate or at least reduce competition between rivals.[7] However, horizontal relationships' effects on competition have to be distinguished from those of vertical relationships. Vertical

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[1] OECD 'Resale Price Maintenance' Competition Policy Roundtable 2008 at 9.
[2] Ibid. at 9.
[3] Roger J. Van den Bergh and Peter D. Camesasca *European Competition Law and Economics: A Comparative Perspective* 2nd ed (2006) 205.
[4] OECD, supra note 1, at 9.
[5] Cf section 5(3) of the South African Competition Act 89 of 1998.
[6] Philip Sutherland and Katherine Kemp *Competition Law of South Africa* (2007) para 6.5.
[7] Joanna Goyder and Albertina Albors-Llorens *Goyder's Competition Law* 5th ed (2009) 18.

agreements are characterised by a complementary relationship between the parties. The undertakings involved do not compete with each other.[8] Vertical agreements frequently enhance economic efficiency. Pro-competitive effects of RPM will most likely occur as long the relevant market is competitive. In this respect *Sutherland* states that "in such cases the profit maximizing result for the firms will be the most beneficial result for the market".[9] Nevertheless, vertical agreements may be anti-competitive where one or all of the parties have (downstream or upstream) market power in their respective markets. The same applies if there is collusive behaviour or potential for collusion in the upstream or downstream market.[10]

South African competition law has taken a hostile approach to RPM. Section 5(2) of the Competition Act[11] ('Act') declares RPM to be *per se* illegal. European competition law has a quite similar approach. RPM is considered to be a 'hard core restriction', which is presumed to be anti-competitive. In the US, RPM was *per se* illegal for nearly a century. But a fundamental change has taken place. In its recent *Leegin*[12] decision, the Supreme Court concluded that RPM can have anti-competitive and beneficial effects. As a consequence, it brought RPM under the rule of reason, balancing potential anti-competitive effects against potential efficiency benefits. Thus, there is nowadays a significant difference between South Africa and the EU on one side and the United States on the other regarding the approach that competition law should take towards RPM.[13] From a South African perspective, this raises the question of whether the current *per se* approach is still appropriate or whether the time has come for a paradigm change.

Contrary to the fact that national competition laws mostly declare RPM as *per se* illegal, most economists argue that RPM should be analysed under a rule of reason. It is clear to them that RPM can have anti-competitive effects, for example by facilitating collusion on manufacturer level or among retailers, but, at the same time, RPM may frequently also be pro-competitive.

It will be seen that the Act's current *per se* rule on RPM should be rejected and the Act should be amended in such a way that a (structured) rule of reason analy-

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[8] Occasionally, relationships between undertakings not currently in competition, but with a potential to compete with each other may pose competition law problems, cf Goyder, supra note 7, 18.
[9] Sutherland, supra note 6, 6.3.
[10] Ibid.
[11] Republic of South Africa Competition Act 89 of 1998 (as amended).
[12] *Leegin Creative Leather Products Inc. v PSKS, Inc*., 551 US 877 (2007).
[13] Cf OECD, supra note 1, at 9.

sis is the benchmark for assessing practises of RPM. The *per se* rule is an out-dated approach to the complex economic issues raised by RPM. RPM may have entirely different potential competitive effects. As it allows weighing of potential anti-competitive effects with potential efficiency benefits, the rule of reason analysis should be preferred over the *per se* rule in general. In contrast, when a *per se* rule is applied to RPM, it is not possible to claim offsetting efficiencies as a defence.

Eliminating the current *per se* rule on RPM does not only have advantages; it also has risks. In respect of the unique structural situation in South Africa's markets and the consequences of a relatively new system of competition law enforcement, namely often highly concentrated markets and limited resources of the competition authorities, one has to look very carefully where the onus of proof lies and who is proving anti-competitive effect. Otherwise an alternative approach's net effect on competition and society might be worse compared to the current *per se* rule. Taking these aspects into consideration, preference will be given to a "structured" rule of reason. This approach is characterized by the use of legal presumptions, which help to guarantee that obtaining the proof of a RPM agreement's unlawfulness is not an impossible task. Besides this adventurous solution in respect of the burden of proof, a "structured" rule of reason may be seen as a "tailor-made" approach, which takes into account South Africa's history and the context in which legislation works in South Africa sufficiently.

The following introductory chapter considers RPM under the Act and in terms of the South African competition authorities and compares it to the US and European approaches.[14] To prove the raised proposition that the Act should be amended, the economic effects of RPM will then be examined.[15] Subsequently, the question is discussed whether a harsh or a lenient rule should be applied to RPM and how the Act can be revised in regard to RPM.[16] All these points will in particular be considered in the light of the US and EU approach to RPM, and especially in the light of the recent *Leegin* decision.

[14] See B.
[15] See C.I.
[16] See C.II.

B. RPM in terms of the Competition Act

The Act categorically distinguishes between horizontal and vertical practises. Horizontal practises are governed by section 4 of the Act and vertical practises are governed by section 5 of the Act. Both sections distinguish between restrictive practises that are *per se* illegal and those that are subject to a rule of reason analysis in which the practices' pro-competitive and anti-competitive effects are weighted up. In contrast to the South African approach, the major competition law regimes do also distinguish between horizontal and vertical restraints, but not in the same formal manner.[17] However, it is not unreasonable that the Act makes such a distinction, especially because both types of restraints may have immense economic effects[18] as will be shown later.[19]

When is RPM covered by the Act? To answer this, an initial overview on the structure of the relevant regulations will be provided next.

I. Structure of section 5 Competition Act

Section 5 of the Act focuses on vertical restrictive practises. In contrast to horizontal relationships between competitors, a vertical relationship is one that exists between a firm and its suppliers, customers or both.[20] The relationship concerns the different levels of the vertical chain such as production or distribution. Despite situations where firms may enter into both vertical and horizontal relationships, e.g. vertical integrated producers or suppliers may compete with their wholesalers or retailers in downstream markets, usually the vertical relationship is characterised in that the involved firms operate in distinctive markets.

Section 5 of the Act is divided into two main parts. The first part is a general prohibition against agreements between parties which substantially prevent or lessen competition in a market and which are not justified by pro-competitive effects (see 2.). Besides this rule of reason approach, section 5(2) of the Act *per se* prohibits the practise of RPM (see 3.)

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[17] For example see section 1 Sherman Act and art 101 TFEU.
[18] Sutherland, supra note 6, 6.3.
[19] See C.
[20] Charles Simkins Micro-Economics Applied To Competition Policy in Martin Brassey (ed) Competition Law (2002) 121.

II. General prohibition in section 5(1) Competition Act

While RPM is a subject to *per se* prohibition, other forms of vertical restraints such as maximum price fixing and all non-price restraints do not fall under such a categorical legal prohibition. Regarding all other types of vertical restraints, the Act allows the weighing up of anti-competitive effects and pro-competitive gains within a rule of reason analysis to determine the lawfulness of an agreement or practise.[21] According to section 5(1) of the Act a vertical agreement (apart from RPM) 'is prohibited if it has the effect of substantially preventing or lessening competition in a market, unless a party to the agreement can prove that any technological, efficiency or other pro-competitive gain resulting from that agreement outweighs that effect'. Thus, finding a violation usually depends on showing an actual anti-competitive effect. Practically, this is a quite difficult, costly, and time-consuming task, not at least because the balance of probabilities has to be shown. It will therefore be seen later that the onus of proof is a fundamental point which has to be taken into account when it comes to possible ways of amending the Act.[22]

III. *Per se* prohibition of RPM in section 5(2) Competition Act

RPM is *per se* unlawful under the Act. Paragraph 2 to section 5 of the Act provides a *per se* rule for RPM in determining that 'the practice of minimum resale price maintenance is prohibited'.

This negative stance to RPM is also shown by the fact that RPM is the only form of vertical restriction for which an administrative fine may be imposed even without proof that it is a repeat of a practice previously found to be a prohibited practice by competition authorities.[23] In contrast, according to section 59(1)(b) of the Act contraventions which are not classified as *per se* prohibited only expose firms to an administrative penalty for a repeat contravention.

However, according to section 5(3) of the Act a supplier may recommend a minimum resale price to the reseller of good or service provided the supplier makes it clear that the recommendation is not binding and the product must have the words 'recommended price' appearing next to the stated price.

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[21] Cf Robert Lengh 'Competition Law Sibergramme 3/2007' (2007) 3.

[22] Cf C. II. 2. & 3; E.g. shifting away from the per se ban of RPM to a „pure" rule of reason would mean that the onus would have to be brought by the authorities which may cause serious practical problems.

[23] Section 59(1)(a) of the Act; Sutherland, supra note 6, 6-38.

As section 5(2) of the Act prohibits the 'practice' of RPM, the first question is how this term should be interpreted and if the *per se* rule might be limited to forms of bilateral conduct by excluding unilateral measures from section 5(2) of the Act.

1. Competition Commission of South Africa v Federal Mogul Aftermarket Southern Africa (Pty) Ltd and Others

This issue was discussed by the Competition Tribunal in *The Competition Commission of South Africa v Federal Mogul Aftermarket South Africa (Pty) Ltd and Others*, dealing with a de facto establishment of minimum prices.[24] A RPM practice in terms of section 5(2) should be given if there was an understanding in the case (bilateral practices).[25] Besides an agreement, a 'practice' shall also exist when resellers or distributors know the price at which they are expected to on-sell the goods or services, and there is a sanction for non-compliance with the expected or desired price (unilateral practises).[26]

The respondent Federal Mogul Aftermarket South Africa (Pty) ('Federal Mogul') distributed motor vehicle components, including products of the brand Ferodo. Midas, a distributor of friction products, sold Ferodo products, which were supplied by the respondent. Erasmus, the complainant and a former employee of the complainant started working for PD Gauteng ('PDG'), which from then on successfully competed with Midas on Ferodo products. PDG undercut the price of Midas by giving a higher rebate to its customers.[27]

Midas responded to PDG's lower prices with a price cut, which in turn resulted in a 'price war' between these firms on retailer level. Federal mogul, specifically after several complaints about the 'price war', was unsatisfied with the strong price competition between Midas and PDG and tried to restore the former price level by

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[24] *Competition Commission of South Africa v Federal Mogul Aftermarket South Africa (Pty) Ltd and Others* 08/CR/Mar01.

[25] See *Competition Commission v Toyota South Africa Motors (Pty) Ltd* 41/CR/May04 where an understanding was required.

[26] *Competition Commission v Federal Mogul Aftermarket Southern Africa (Pty) Ltd and Others* 08/CR/Mar01 para 22 with reference to the 'implied acceptance agreement" theory by Phillip E. Areeda and Herbert Hovenkamp *Antitrust Law* (2004) para 1443d.

[27] In this regard, the general pricing practise was that Federal Mogul sold its products to distributors for a list price minus a rebate. As the rebate level depended on the number of products sold by the distributor, the latter sold Ferodo products to their customers for the list price minus a smaller discount. Therefore, the profit on retailer level was the difference between the rebate given by Federal Mogul and the smaller discount given to the distributors' customers. Stepping out of line of the system was sanctioned with a cutting of the rebate or finally with a supply stop.

reducing the rebate given to the complainant. The Competition Commission initiated a complaint against Federal Mogul for violating section 5(2) of the Act.

Federal Mogul argued that the term 'practise' in section 5(2) of the Act refers only to agreements between distributors and suppliers linked with a sanction, which did not exist in the current case due to solely unilateral behaviour.[28] The complainant argued that the reduction of his rebate rendered his business non-viable, effectively forcing him out of business.

The Competition Tribunal's assumption that section 5(2) of the Act may not necessarily require an agreement was confirmed by the Competition Appeal Court ('CAC').[29] According to the CAC, this follows from the different wording in section 5 paragraphs 1 and 2. Paragraph 1 expressly refers to agreements; paragraph 2 only focuses on practises. Since section 5(2) strictly outlaws practises of RPM, the Act should not be limited in the form that its scope for application depends on an agreement that exists, as is expressly the case in section 5(1).[30] In this context the CAC defined the term 'practise' as a 'form of repetitious or habitual conduct of a kind which can be discerned from the evidence as being known and recognised to the interested parties'.[31]

The Competition Tribunal compared the effects of vertical price restrictions with the effects of horizontal price restraints by emphasising that RPM constitutes

> '*a species of price fixing, the vertical variant of that set of contraventions generally construed as the most anti-competitive of business practices. It is for this reason that resale price maintenance is prohibited per se, why, in other words, it permits of no pro-competitive defence*'.[32]

In regard to eventual pro-competitive effects of RPM the Competition Tribunal stated that 'minimum resale price fixing is still widely construed to be an unequivocally

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[28] Competition Commission v Federal Mogul Aftermarket Southern Africa (Pty) Ltd 08/CR/Mar01 para 22.
[29] Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission 33/CAC/Sep03 3ff.
[30] Ibid. 5ff.
[31] Ibid. 9 referring to the definition given within the particular context to 'unfair labour practice' in *Marievale Consolidated Mines v President*, Industrial Court 1987(2) SA 485(1) at 498 BD.
[32] Competition Commission v Federal Mogul Aftermarket Southern Africa (Pty) Ltd 08/CR/Mar01 paras 159, 173.

anti-competitive variety of vertical arrangement and this […] is reflected in the particular status that this contravention is accorded in the Act'.[33]

Since the Federal Mogul decision, RPM played a role particularly in industry-wide investigations into the automotive sector triggered through *Competition Commission v Toyota South Africa Motors (Pty) Ltd*.[34] Several manufacturers of motor cars were alleged practising RPM by determining the maximum rebate their dealers give to their customers. The cases were settled by concluding various consent agreements, always including the payment of an administrative penalty.[35]

In summary it can be held that South African competition authorities interpret section 5(2) of the Act relatively widely by taking forms of bilateral and unilateral pricing practises into account. Next we will see that the Act's system of differentiation between RPM and all other types of vertical restraints corresponds to a large extent to the former approach on vertical restraints in US jurisprudence.

2. US approach on RPM

US antitrust law distinguishes between restrictive practises that are *per se* illegal and those that are subject to a rule of reason analysis. Section 1 of the Sherman Act prohibits 'every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations'[36]. The rule aims to cover only unreasonable restraints.[37] This broad approach is substantially relaxed, as US courts in practice analyse most antitrust claims under the rule of reason[38] and only few types of conduct are deemed *per se* illegal.[39] When examining under the rule of reason whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition,[40] all the circumstances of the case have to be taken into account, including specific information about the rele-

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[33] *Competition Commission v Federal Mogul Aftermarket Southern Africa (Pty) Ltd* 08/CR/Mar01 para 174.
[34] *Competition Commission v Toyota South Africa Motors (Pty) Ltd* 41/CR/May04; see also *Competition Commission v Italtile Franchising* 90/CR/Dec02; *Competition Commission v Oakley Athletic* 79/CR/Sep06; *CUM Christian Book Stores v Marantha Record Company* (unpublished), see Competition Tribunal, Annual Report 2003/2004 at 25.
[35] *Competition Commission v DaimlerChrysler SA* (Pty) Ltd 115/CR/Dec05; *Competition Commission v General Motors SA* (Pty) Ltd 115/CR/Dec05; *Competition Commission v Boundless Trade 154 (Pty) Ltd t/a Citroën South Africa* 115/CR/Dec05; *Competition Commission v Volkswagen SA (Pty) Ltd* 115/CR/Dec05; *Competition Commission v Nissan South Africa (Pty) Ltd* 115/CR/Dec05; *Competition Commission v BMW Dealers* 11/CR/Feb06.
[36] Ch. 647, 26 Stat. 209, as amended, 15 U.S.C. § 1.
[37] *State Oil Co. v Khan*, 522 U.S. 3, 10 (1997).
[38] Cf *Leegin*, supra note 12, 885, quoting Texaco Inc. v Dagher, 547 U.S. 1, 5 (2006).
[39] Cf Van den Bergh/Camesasca, supra note 3, 219.
[40] *Continental T. V., Inc. v GTE Sylvania Inc*., 433 U.S. 36, 49 (1977).

vant business, the restraints history, effect,[41] and the market power of the businesses involved.[42] The US Supreme Court has stated that 'in its design and function the rule distinguishes between restraints with anticompetitive effect that are harmful to the consumer and restraints stimulating competition that are in the consumer's best interest'.[43]

Some types of practises are seen as *per se* unlawful, for example horizontal price fixing agreements or dividing markets.[44] Since such restraints are illegal in each case, a rule of reason analysis, in particular by taking factors into account that may lead to the reasonableness of the restraint, does not apply. Regarding to the US Supreme Court, the *per se* rule covers 'manifestly anticompetitive'[45] restraints 'that would always or almost always tend to restrict competition and decrease output'[46].

Historically, RPM was seen as clearly anti-competitive since the US Supreme Court decision in *Dr. Miles Medical Co. v Park & Sons Co.*[47] ('Dr. Miles') from 1911. *Dr. Miles* established a *per se* rule on RPM in the United States. However, in 2007 the US Supreme Court had given up this constant jurisdiction in its *Leegin* decision in favour of a rule of reason analysis.

As section 5(2) of the Act still follows a *per se* approach, the decision in *Dr. Miles* will be displayed more comprehensively within the next paragraph.

a. Dr. Miles Medical Co. v Park & Sons Co.

In *Dr. Miles*, the complainant (Dr. Miles Medical Company), a manufacturer of trademarked non-prescription medicines, fixed the wholesale and retail prices of its products by agreements with its wholesalers and retailers.[48] The defendant, a wholesale drug concern, refused to enter into such an agreement, and is charged 'with procuring medicines for sale at "cut prices" by inducing those who have made the contracts to violate the restrictions'.[49] In this respect, the defendant induced suppliers to sell to it and then turned around and sold at cut-rate prices.

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[41] *State Oil Co. v Khan*, 522 U.S. 3, 10 (1997).
[42] *Copperweld Corp. v Independence Tube Corp*., 467 U.S. 752, 768 (1984).
[43] *Leegin*, supra note 12, 886.
[44] *Texaco Inc. v Dagher*, 547 U.S. 5 (2006); *Palmer v BRG of Ga., Inc.*, 498 ,U.S. 46, 49-50 (1990)(per curiam).
[45] *Continental T. V., Inc. v GTE Sylvania Inc*., 433 U.S. at 50, 97.
[46] *Business Electronics Corp. v Sharp Electronics Corp*., 485 U.S. 717, 723 (1988).
[47] *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911), overruled by *Leegin*, supra note 12, 877.
[48] *Dr. Miles*, supra note 47, 394.
[49] *Dr. Miles*, supra note 47, 394.

Dr. Miles Medical Company argued that the defendant interfered with those contracts. It is acquiring the goods only 'to be advertised, sold, and marketed at cut rates' and 'attract and secure custom and patronage for other merchandise and not for the purpose of […] profit'.[50] Therefore, the complainant claims that its medicine was being used as a *loss leader*. In addition it alleged that the discounted products sold by the defendant's customers such as department stores lead to a worsening of its dealer density as the 'majority of retail druggists […] cannot, or believe that they cannot, realise sufficient profits'.[51] Price cutting undermined the complainant's effort to guarantee an adequate dealer density.[52] Besides that, Dr. Miles feared a loss of its products reputation because the customers might hold products sold as 'reduced' or 'cut' prices as products of inferior value and demand.[53]

The US Supreme Court held that it was illegal under section 1 of the Sherman Act for a manufacturer and its distributors to agree on a minimum price that the distributor must charge for the manufacturer's good, upon resale. The court addressed such contracts as a class, without taking the market circumstance in the individual case into account. Therefore, a general rule of *per se* illegality was assumed for cases involving vertical price fixing.[54]

The Court based its decision on the assumption that even when manufacturers have the freedom to decide if they sell or not sell their products, this does not contain the right to restrain the products' subsequent alienation by the dealer purchasing the product to resell it.[55] Such a restraint may only be sustained if it is reasonable in terms of the public and private interests involved.[56] The Court rejected Dr. Miles' allegation that it was directly injured by lower sale price, stating that 'the enlarged profits which would result from adherence to the established rates would go to them [dealers] and not to [Dr. Miles]'.[57] If RPM redounds primarily to the benefit of dealers by securing their profits, it cannot be seen as an advantage for the manufacturer which might make the restraint to the dealers' freedom reasonable. The Court con-

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[50] Ibid. 381-382.
[51] Ibid. 373, 375.
[52] Philipp E. Areeda and Herbert Hovenkamp *Antitrust Law: An Analysis of Antitrust Principles and Their Application* Vol. VIII 3ed (2010) para 1620a, p223.
[53] *Dr. Miles*, supra note 47, 375.
[54] Cf Areeda/Hovenkamp, supra note 52, para 1620a, 224.
[55] Cf *Dr. Miles*, supra note 47, 404.
[56] Ibid. 406.
[57] Ibid. 407.

tinued that the situation is comparable to horizontal dealer cartels which are clearly unlawful in general as they restrict the competition between the participating dealers.

b. Post Dr. Miles jurisprudence

An increasingly less restrictive attitude towards the desirability of *per se* rules can be observed in the US Supreme Court's case law after *Dr. Miles*. The strict prohibition of RPM was softened only 8 years after the ground-breaking decision. In *United States v Colgate and Co.* the court decided that a manufacturer could unilaterally determine its retail price and refuse to sell to discounters.[58] Colgate sanctioned dealers who 'stepped out of line' by selling below the suggested price through a delivery stop. However, there was no evidence of an agreement between Colgate and its retailers. By distinguishing between (legal) unilateral and (illegal) mutual agreement the court concluded that only a unilateral decision did not involve the agreement necessary for a violation of section 1 of the Sherman Act (the so called 'Colgate Doctrine'). At this point, it should be noted that the *Colgate Doctrine* has been rejected by the CAC in the context of minimum RPM in South Africa.[59]

During the 1930s retailers' lobbyists crucially influenced policy making in the United States. As a result various states passed laws on minimum RPM, the so called fair trade laws, which made RPM legal under state law aiming to support the growth of large, low-cost retail chains.[60] However, the *Dr. Miles* rule had its 'comeback' when the fair trade laws were repealed in 1975 and the *per se* prohibition obtained full validity. In subsequent years also the Colgate Doctrine, namely the limitation of the *per se* rule's scope to bilateral conduct, was refreshed. In *Monsanto Co. v Spray-Rite Service Corp.* the Supreme Court made clear that 'a conscious commitment to a common scheme designed to achieve an unlawful objective' is required to apply the *per se* rule to RPM.[61] Furthermore, the *per se* rule's coverage was limited even more when the Supreme Court held that 'a vertical restraint is not illegal *per se* unless it includes some agreement on price or price levels'.[62]

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[58] *United States v Colgate and Co*., 250 U.S. 300 (1919).
[59] *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission* 33/CAC/Sep03 5ff.
[60] Stephen Martin Industrial Economics: Economic Analysis and Public Policy 2ed (1994) 511.
[61] *Monsanto Co. v Spray-Rite Service Corp.*, 465 U.S. 752 (1984), para 1469.
[62] *Business Electronics Corp v Sharp Electronics Corp*, 485 U.S. 717 (1988), para 728.

Nevertheless, regarding maximum price fixing[63] and non-price restraints[64], a trend in US jurisprudence towards adopting a rule of reason analysis can be observed, not least because the Chicago School[65], mainly focussing on consumer welfare, changed the attitude to vertical restraints from the late 1970s onwards.[66]

Following this series of decisions that successively turned away from the *per se* rule in vertical relationships, with *Leegin* the US Supreme Court closed the circle and found that a rule of reason is the appropriate legal standard for analysing RPM-cases.

c. Leegin Creative Leather Products Inc. v PSKS Inc.

In Leegin Creative Leather Products, Inc. v. PSKS, Inc., the Supreme Court held in a 5:4 decision that vertical price fixing agreements between manufacturers and retailers are not *per se* violations of § 1 of the Sherman Act, and instead should be governed by a rule of reason analysis to determine if they restraint trade.

Defending petitioner Leegin Creative Leather Products, Inc. produced leather goods sold under the 'Brighton' brand. Leegin preferred to sell its products to small stores, because it believed they treated customers better, provided customers more services, and made their shopping experience more satisfactory than did large discounters.[67] In 1997 Leegin adopted its 'Brighton Retail and Promotion Policy' under which it refused to supply retailers who charged less than its specified prices. Plaintiff PSKS owned the discount retailer Kay's Kloset, which sold Brighton products at discounted prices. The parties were in dispute about Kay's Kloset's customer appeal und pricing policy. After Kay's Kloset was found to be discounting Brighton's entire line by 20 or more per cent in December 2002, Leegin requested PSKS to raise prices. The request was rejected and thereupon Leegin refused to fill further orders. PSKS sued, alleging the Leegin had violated the antitrust laws by entering into a vertical price fixing scheme with its retailers.

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[63] *State Oil Co v Barkat U. Khan and Khan and Associates Inc*, 522 U.S. 3, 10 (1997).
[64] *Continental T.V., Inc. v. GTE Sylvania Inc.,* 433 U.S. 36, 55 (1977), which had overruled *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).
[65] Chicago scholars believed in the self-corrective abilities of markets. Therefore invention by antitrust law should be limited and only necessary in order to promote consumer welfare by furthering allocative efficiency; see Sutherland, supra note 6 para 2.4.
[66] David Unterhalter *Restrictive Vertical Practises* in Martin Brassey (ed) *Competition Law* (2002) para 6.4.
[67] *Leegin*, supra note 12, 882.

The responsible District Court, applying the longstanding Supreme Court precedent which refers to *Dr. Miles* that such vertical price fixing schemes are *per se* illegal, did not allow Leegin to introduce evidence that its pricing policy was pro-competitive. A jury returned a verdict in favour of PSKS. The verdict was affirmed by the U.S. Court of Appeals for the Fifth Circuit. The Supreme Court granted certiorari to review this ruling.

The Supreme Court overruled *Dr. Miles* and found that vertical price restraints are to be judged by the rule of reason. A *per se* rule should only be applied when a restraint is unlawful *per se*.[68] *Per se* rules are appropriate when the restraint 'would always or almost always tend to restrict competition and decrease output'.[69] Furthermore, the Supreme Court stated that a '*per se* rule is appropriate only after courts have had considerable experience with the type of restraint at issue'.[70] The *per se* rule requires, that restraints have to be 'always or in almost all instances invalid under the rule of reason'.[71]

The Court assumed that the *per se* rule on vertical price fixing could be overturned because it was created under common law principles and therefore not statutory in nature. Thus, the rule of reason analysis implements the Sherman Act's dynamic approach. In 'the light of the market forces', the rule of reason 'distinguishes between restraints with anticompetitive effect that are harmful to the consumer and those with pro-competitive effect that are in the consumers best interests'.[72]

In determining if a *per se* rule is appropriate in the present case, the Supreme Court examined pro- and anti-competitive effects of RPM. Against the above mentioned background that the *per se* rules are appropriate only to restraints that would always or almost always tend to restrict competition and decrease output, the Court found that RPM agreements can be either anti-competitive or pro-competitive. In consequence, they should be judged by the rule of reason, in which the burden of proof that a RPM agreement is anti-competitive rests with the plaintiff. The Court examined different types of possible pro-competitive economic effects of RPM.

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[68] *Leegin*, supra note 12, 887.
[69] Ibid. 886, quoting *Business Electronics Corp. v Sharp Electronics Corp.*, 485 U.s. 717, 723 (1988).
[70] Ibid. 886, quoting *Broadcast Music Inc. v Columbia Broadcasting System Inc*., 441 U.S. 1, 9 (1979).
[71] Ibid. 887, quoting *Arizona v Maricopa County Medical Soc.*, 457 U.S. 332, 344 (1982).
[72] Ibid. 886.

The first finding was that RPM can stimulate inter-brand competition among manufacturers selling different brands of the same type of product by reducing intra-brand competition among retailers selling the same brand. Here, the increasing inter-brand competition is given the preference over the decreasing intra-brand competition because antitrust laws primary purpose is to protect inter-brand competition.[73] The Court stated that 'a single manufacturer's use of vertical price restraints tends to eliminate intra-brand price competition; this in turn encourages retailers to invest in tangible or intangible services or promotional efforts that aid the manufacturer's position as against rival manufacturers'.[74] In terms of the consumer, RPM 'may also give consumers more options to choose among low-price, low-service brands; high-price, high-service brands; and brands falling in between'.[75]

Increasing inter-brand competition might also be an effect of RPM when retailers are encouraged to provide services to consumers they would have not provided when a profit margin would not be guaranteed. The may be 'the most efficient way to expand the manufacturer's market share by inducing the retailer's performance and allowing it to use its own initiative and experience in providing valuable services'[76].

RPM 'can also increase inter-brand competition by facilitating market entry for new firms and brands'[77]. A manufacturer's new brand might become better known in a market due to retailers which are not competing among themselves by price but by providing better services to consumers.[78]

Finally, RPM should avoid the so called *free-rider problem*. In accordance with the commonly stated assumption that RPM prevents free-riding the Court continued that 'absent vertical price restraints, retail services that enhance inter-brand competition might be underprovided because discounting retailers can free ride on retailers who furnish service and then capture some of the increased demand those services generate'.[79] A consumer might buy a product from a retailer at a discounted price, having learned from the benefits of that product in the showroom of a retailer that invests in service for the consumer such as fine showrooms, demonstration mod-

[73] Ibid. 890, quoting *Khan*, supra note 37, 15.
[74] Ibid.
[75] Ibid.
[76] Ibid. 892.
[77] Ibid. 891.
[78] See ibid.
[79] *Leegin*, supra note 12, 890.

els or knowledgeable employees.[80] Another point is a possible transfer of reputation from a retailer having a reputation for selling high-quality merchandise to the product, on the basis of which the consumer decides to buy the product. When consumers decide to buy the products at a discounted price from a retailer which is not investing in such services in those situations, the high-service retailer loses sales to discounters. This may result in a cutting of services by high-service retailers lower than consumers would otherwise prefer. In the opinion of the Court RPM 'alleviates the problem because it prevents the discounter from undercutting the service provider. With price competition decreased, the manufacturer's retailers compete among themselves over services'[81].

The Court continued that RPM can also have different anti-competitive effects, especially in connection with RPM practises solely designed to obtain monopoly profits.[82] As an example, the Court mentions the usage of RPM for facilitating a manufacturer cartel. Price fixers would be enabled to discover price-cutting manufacturers who are serving retailers who also sell at a lower price. RPM may also hinder cheaper consumer prices as manufacturers lose their incentive to cut prices to retailers when retailers maintain theirs.[83] Aside from that, the Court noted that 'vertical price restraints might be used to organize cartels at retailer level'.[84] If a vertical price fixing agreement is used to facilitate a horizontal cartel among competing manufacturers or competing retailers, it 'would need to be held unlawful under the rule of reason'.[85] Further, 'this type of agreement might also be useful evidence for a plaintiff attempting to prove the existence of a horizontal cartel'.[86] As a final point, the court observed that RPM can be abused by a powerful manufacturer or retailer in order to forestall innovation in distribution that decreases costs or other price cutting by rival dealers.[87] Furthermore the Court assumed that a manufacturer with market power might use RPM 'to give retailers an incentive not to sell the products of smaller rivals or new entrants'.[88]

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[80] Ibid. 891.
[81] Ibid.
[82] Ibid. 892.
[83] Ibid.
[84] Ibid., quoting *Business Electronics*, 485 U.S. at 725-726.
[85] Ibid. 893.
[86] Ibid.
[87] See ibid.
[88] *Leegin*, supra note 12, 893.

Based on this range of possible competitive effects the Court concluded that RPM certainly did not fulfil the criteria required for *per se* treatment.[89]

Furthermore, the Court rejected the plaintiff's arguments that the *per se* rule is justified by administrative convenience, since applying the *per se* rule is less cost-intensive than the rule of reason analysis. Considered as a whole, *per se* rules may decrease administrative costs, but they also can 'increase the total costs of the antitrust system by prohibiting pro-competitive conduct the antitrust laws should encourage'.[90] In addition, the Court stated, that 'any possible reduction in administrative costs cannot alone justify the *Dr. Miles* [*per se*] rule'.[91] Furthermore, the court also rejected the argument that a rule of reason analysis leads to higher prices for the manufacturer's goods, because the plaintiffs could not sufficiently explain a link between higher prices and anti-competitive effects. In theory, pricing effects are not necessarily connected with pro-competitive or anti-competitive effects. The Court continues that 'a manufacturer has no incentive to overcompensate retailers with unjustified margins', as the manufacturer usually seeks to minimize the difference between the price it charges to retailers and the price which the consumer is charged.[92] In this regard, 'the retailers, not the manufacturer, gain from higher prices'.[93] As RPM can lead to increasing inter-brand competition, 'a single manufacturer will desire to set minimum resale prices only if the 'increase in demand resulting from enhanced service […] will more than offset a negative impact on demand of a higher retail price'' .[94]

In its further justification of its ruling the Court mentions factors which are relevant when applying the rule of reason to RPM. A first instruction provides the number of manufacturers that make use of the practice in a given industry.[95] This number indicates whether there is likelihood that a manufacturer cartel[96], or a retailer cartel[97] is being facilitated.[98] Furthermore, the source of a price restraint should be

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[89] Ibid. 898.
[90] Ibid. 895.
[91] Ibid.
[92] Ibid. 896.
[93] Ibid.
[94] Ibid. 896, quoting Frank Mathewson and Ralph Winter 'The Law and Economics of Resale Price Maintenance' (1998) 13 Rev. Indus. Org. 67.
[95] *Leegin*, supra note 12, 897.
[96] If only a few manufacturers lacking market power adopt RPM, they can easily be undercut by rival manufacturers.
[97] Unlikely when only a single manufacturer in a competitive market uses RPM. Inter-brand competition would divert consumers to lower priced substitutes and eliminate any gain to retailers from their price-fixing agreement over a single brand.

taken into account. If there is evidence retailers were the impetus for a vertical price restraint, there is a greater likelihood that the restraint facilitates a retailer cartel or supports a dominant, inefficient retailer. By contrast, if 'a manufacturer adopted the policy independent of retailer pressure, the restraint is less likely to promote anti-competitive conduct'.[99] Finally, anti-competitive conduct is more likely when the manufacturer or the retailer have market power. In respect to a retailer lacking market power, 'manufacturers likely can sell their goods through rival retailers'. If the manufacturer is the relevant entity, little market power will probably not 'keep competitors away from distribution outlets'.[100]

In addition, the Court recognised a general shift in its decision-making from the *per se* rule in *Dr. Miles* to a rule of reason analysis in its more recent decisions regarding vertical restraints.[101] Accordingly, the Court stated that 'the Dr. Miles rule is also inconsistent with a principled framework, for it makes little economic sense when analysed with our other cases on vertical restraints'[102].

The Court reversed the judgement of the Fifth Court and remanded the case to further proceedings.

3. EU approach on RPM

Looking to the other main competition law regime, in Europe a 'quasi' *per se* rule is applied to RPM since it is prohibited as far as possible under art. 101 of the Treaty on the Functioning of the European Union (TFEU). However, compared to the South African view, also the European view seems to be more relaxed towards RPM because efficiency benefits should be taken into account in the future at least to some extent. Nevertheless, the approach is far less flexible than the rule of reason standard recently introduced in the US.

The TFEU approaches vertical restrictions in a formalistic manner that is quite different to the regulations in other countries. Prior to the recent revision of the Vertical Restraints Block Exemption[103] and the European Commission's Guidelines on Verti-

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[98] *Leegin*, supra note 12, 897.
[99] Ibid. 898.
[100] Ibid.
[101] Cf ibid. 900-903, quoting e.g. *United States v Colgate & Co.*, 250 U.S. 300 and *Continental T.V., Inc. v GTE Sylvania Inc.*, 433 U.S. 36.
[102] *Leegin*, supra note 12, 902.
[103] Commission Regulation (EU) No 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices (Vertical Restraints Block Exemption) [2010] OJ L 102/1.

cal Restraints[104] many expected that the legal framework for RPM would change according to the *Leegin* decision in the United States. But no major move towards a more economics oriented, effects based approach took place. Instead the EU approach to RPM remained form-based as RPM is still classified as a 'hardcore restriction'. Probably the new guidelines might bring at least marginal changes in addressing RPM.

European competition authorities have condemned RPM on various occasions.[105] The rule applicable to all types of horizontal and vertical restraints is art. 101 TFEU.[106] Measures may infringe art. 101 TFEU if they (i) include an agreement or concerted practises; and if they (ii) lead to an appreciable restraint in competition. The imposition of RPM is expressly held to violate art. 101(1) as such agreements are considered to have as their object the restriction of competition.[107] Art. 101(1) may be declared inapplicable when art. 101(3) is fulfilled. Also unilateral actions, resulting in RPM, can fall under art. 101(1) of the TFEU under certain criteria.[108]

Pursuant to the Vertical Restraints Block Exemption most restraints in agreements concerning supply and distribution are permitted unless there is market power. Such agreements might be made to manage the distribution chain so as to improve efficiency.[109] In general, the regulation stipulates that all vertical agreements are exempted from art. 101(1) TFEU (safe harbour) if the following conditions[110] are met:

- The upstream party has a market share below 30 per cent or, in cases of exclusive supply, the purchaser has a market share below 30 per cent and

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[104] Guidelines on Vertical Restraints [2010] OJ C 130/1.

[105] Eg.*Deutsche Philips* Commission Decision 73/322/EEC [1973] OJ L293/40, *Gerofabriek* Commission Decision 77/66/EEC[1977] OJ L16/8; *Hennessey/Henkell* Commission Decision 80/1333/EEC [1980] OJ L383/11; *Novalliance/Systemform* Commission Decision 97/123/EC[1997] OJ L47/11; *Nathan-Bricolux* Commission Decision 2001/135/EC [2001] OJ L54/1paras 86-90; *JCB* Commission Decision 2002/190/EC [2002] OJ L69/1; more examples at Richard Wish *Competition Law* 6ed (2009) 638 fn270.

[106] Case IV /3344 *Grundig-Consten* [1964] O.J. 2545.

[107] See Article 101(1)(a) TFEU.

[108] Cf Case C-70/93 *BMW/ALD* [1995] ECR I-03439 para16; Case T-62/98 *Volkswagen AG v Commission* [2000] ECR II-2707, upheld on appeal to the ECJ Case C-338/00 [2003] ECR I-9189 paras 60-69.

[109] Commission Regulation (EC) No 2790/1999 of 22 December 1999 on the application of Article 81(3) of the Treaty to categories of vertical agreements and concerted practices (Block Exemption Regulation 2790/1999)[1999] OJ L336/21 para 10.

[110] In the case of single branding there is the additional condition that the duration of the agreement does not exceed five years.

- The agreement does not include any hard-core restrictions as defined in art. 4 of the regulation.

Regarding firms' market power it is the fundamental approach of the Vertical Restraints Block Exemption that firms with small market share are allowed to use the vertical agreements they prefer.[111] If a manufacturer has a market share below 30 per cent the regulation presumes legality and the agreement is excluded from the application of art. 101(1) TFEU because smaller agreements are seen as to have low impact on competition either upstream or downstream. In contrast, when the 30 per cent threshold is exceeded, a rule of reason applies under art. 101(3) TFEU bringing into question if competition might be impaired by foreclosing other suppliers, raising barriers to entry or reducing inter-brand competition and facilitating collusion. However, the courts have rejected the view that a rule of reason already applies to art. 101(1) TFEU correlate to the practise in the United States regarding section 1 Sherman Act, letting anti-competitive practises falling outside art. 101(1) TFEU if they have more positive than negative effects on competition in a given market. In *Metropole Television v Commission*[112] the Court of First Instance made clear, that the existence of a rule of reason in art. 101(1) TFEU is doubtful because 'Article 81(3) EC [now art. 101(1) TFEU] would lose much of its effectiveness if such an examination had to be carried out already under Article 81(1) EC [now art. 101(1) TFEU]'.[113]

Since the Vertical Restraints Block Exemption in art. 4 declares certain distribution restraints including RPM[114] as hardcore competition law violations (hardcore restrictions), RPM cannot benefit from the group exemption. The Vertical Restraints Block Exemption establishes that vertical agreements containing such hardcore restrictions will not be exempted from the application of art 101(1) TFEU, regardless of the involved firms' market share.[115] It is also unlikely that RPM will be permitted by way of individual exemptions as it usually cannot meet the criteria under art 101(3) TFEU.[116] Nevertheless, in its Guidelines on Vertical Restraints[117] (Guidelines), which accompany the Vertical Restraints Block Exemption, the Commission states in regards to potential pro-competitive effects that

[111] Massimo Motta, Patrick Rey, Frank Verboven and Nikolaos Vettas 'On the Economics of Vertical restraints', report by the Economic Advisory Group for Competition Policy (2009) at 1.
[112] [2001] ECR II-2459.
[113] [2001] ECR II-2459 para 74.
[114] Art 4(a).
[115] Block Exemption Regulation 2790/1999 [1999] OJ L336/21 para 10.
[116] Cf Guidelines on Vertical Restraints [2010] OJ C 130/1 para 47.
[117] Guidelines on Vertical Restraints [2010] OJ C 130/1.

> *'where the undertakings substantiate that likely efficiencies result from including the hardcore restriction in the agreement and demonstrate that in general all the conditions of Article 101(3) are fulfilled, the Commission will be required to effectively assess the likely negative impact on competition before making an ultimate assessment of whether the conditions of Article 101(3) are fulfilled'.*[118]

A marginal shift from the de facto *per se* prohibition of hardcore restraints to a consideration of certain efficiency defences can be observed through the Guidelines. In contrast, the previous Guidelines had established that 'individual exemption of vertical agreements containing such hardcore restrictions is also unlikely'.[119] *Reindl's* finding that the European Commission has never recognised possible efficiencies in a RPM case corresponds with this interpretation.[120] But the recently published Guidelines 'open the door a little' to a more economic approach when applying art 101(3) TFEU.[121] After assessing several anti-competitive effects of RPM, the Guidelines now also mention potential pro-competitive effects, in particular with regard to facilitating market entry for new products, enhanced consumer benefits through better dealer services, the necessity when organising a distribution system of applying a uniform distribution format, a coordinated short term low price campaign, and in preventing the free-rider problem.[122]

The first part of the next chapter will examine these and further pro-competitive effects more precisely.[123] Then, also potential harmful effects of RPM will be considered[124] before the focus will fall on possible standards of analysing RPM.[125] The findings from these two subchapters will help to develop an approach to reform of the South African competition law's approach on RPM.

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[118] Guidelines on Vertical Restraints [2010] OJ C 130/1 para 47.
[119] Block Exemption Regulation 2790/1999 [1999] OJ L336/21para 46.
[120] Andreas P. Reindl 'Resale Price Maintenance and Article 81 EC: Developing A More Sensible Analytical Approach' (2010) 33 Fordham Int'l L.J. 1300 at 12 fn 56.
[121] See also Wish, supra note 105, 637 stating that 'in principle there is no reason to believe that a defence of resale price maintenance under Article 81(3) could never succeed".
[122] Guidelines on Vertical Restraints [2010] OJ C 130/1 para 225.
[123] See C.I.1.
[124] See C.I.2.
[125] See C.II.

C. Should minimum resale price maintenance be *per se* unlawful?

I. Economic effects

Before an analytical framework for RPM can be discussed, it is necessary to focus on the possible harm and benefits that may result from RPM.

In the early days of competition laws, vertical restraints in general and in particular price restraints were seen as detrimental to competition.[126] In contrast, in the 1980s, as a consequence of the development of efficiency theories, economists generally considered vertical restraints as relatively innocuous for competition.[127] Today, welfare effects of vertical restraints are being assessed more cautiously. One reason for this is that the costs of distribution are now being taken into account instead of ignoring them as in the early assessments of vertical restraints.[128] Restraint of competition and harmful product price increases are not the only effects of vertical restraints.[129]

In fact, vertical restraints such as RPM can have ambiguous effects on economic welfare, depending on the context in which they are used.[130] Even if a vertical restraint is anti-competitive at first sight, it is not necessarily clear that it should be outlawed since it may have efficiency benefits that might outweigh the anti-competitive effects.

In a vertical relationship the parties produce complementary products and each wants the other firm to reduce prices as a manufacturer wants the retailer to price low as this maximises demand for the product. Conversely, the retailer wants the manufacturer also to price low as the price set by the manufacturer is the retailer's input price. As a consequence, this mutual will to lower prices may result in lower consumer prices and hence in the enhancement of consumer welfare.[131] It is self-evident to RPM that it does not result in enhanced price competition as it is characterized by the fact of resale prices being fixed.

But vertical restraints can be suitable instruments to solve coordination problems in vertical structures. The net effect of their implementation may be enhanced

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[126] Cf Van den Bergh/Camesasca, supra note 3, 207.
[127] Cf ibid. 207.
[128] Ibid. 206.
[129] Ibid. 206.
[130] Cf ibid. 206.
[131] Simon Bishop and Mike Walker *The Economics of Competition Law* 2ed (2002) para 5.36, 156, 157.

(intra-brand) competition. Efficiency problems often result from asymmetries between manufacturers and retailers. Manufacturers might impose RPM on retailers in order to align their interests with the corresponding interest of the customers (e.g. a high level of pre-sale services) since retailers normally pursue different goals (e.g. low distribution costs).[132] RPM may improve the manufacturer's position because the long term advantages arising from more efficient distribution exceed the short term disadvantage of reduced demand through higher retail prices.[133] Consequently, demand does not result only from price effects. Other factors influence demand too. An example of an inefficiency resulting in decreasing demand for a product is too little offered pre-sale services for customers as a consequence of retailers free-riding on other retailers' pre-sale services. Such inefficiencies can be sub-optimal not only for the manufacturer and the retailer, but also for customers or -more broadly speaking- for society in general.[134]

By comparison, parties to horizontal agreements may have fundamentally different incentives than those of vertical agreements. In horizontal relationships the firms produce substitute products and might be willing to soften price competition by preferring the competing firm to raise its prices. Otherwise, if the rival firm decreases its prices, the demand for the other firms' products will usually decline.[135] As horizontal price fixing clearly raises prices and is detrimental to consumers it is regularly anti-competitive.[136] This assumption is particularly true when the firms involved have market power.

The next subchapter will focus on RPM's potential pro-competitive effects. Afterwards its potential anti-competitive effects will be analysed.

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[132] Bishop/Walker, supra note 131, 161.
[133] Van den Bergh/Camesasca, supra note 3, 210.
[134] Vertical restraints might remove the problem of each firm in the vertical relationship pricing higher than it is optimal for the other firm in the relationship (i.e. the double marginalisation problem); see Bishop/Walker, supra note 131, 160.
[135] Bishop/Walker, supra note 131, para 5.36, 156.
[136] Mart Kneepkens 'Resale Price Maintenance: Economics call for a more balanced Approach' (2007) 28 European Competition Law Review at 656.

1. Potential pro-competitive effects

RPM might perform useful functions and may help to promote stronger competition in a marketplace. It requires that elimination of intra-brand price competition is more than compensated for, through efficiency benefits in the individual case. Potential pro-competitive effects of RPM can be distinguished by their source on the one hand. They may result from retailers' decisions at service level (a.) or from pricing decisions (b.). On the other hand, RPM may set incentives to retailers (c.).

a. Spillover effects of retailers' service-level decisions

Manufacturers may see RPM as an effective marketing instrument that helps to increase the demand for their products, i.e. through stronger intra-brand competition following from better services on retail level, more investments in inventory and other retailer actions.[137]

(1) Enhancement of pre-sale services

Pro-competitive effects often revolve around the idea that RPM improves inter-brand competition by enhancing distribution efficiency. It might be advantageous for a manufacturer to market its products at fixed minimum prices with the intention of encouraging his retailers to offer special services.[138]

Once a product is being sold the retailer usually had provided pre-sale services to its customers in advance, for which the retailer typically cannot directly contract for. Such pre-sale services are valuable to the consumer and they are more efficiently provided by the retailer than by the manufacturer.[139] Pre-sale services also enhance the value of the manufacturer's product. For example, such services might be advice from qualified salespersons or the availability of a well-stocked showroom and demonstration models. Other complementary services can be scope of offered products, level of inventory, level of associated services, geographic proximity, quality certification, shelf-space provided, and location of that shelf-space or degree of promotional activities.[140]

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[137] Frederic M. Scherer and David Ross *Industrial Market Structure and Economic Performance* 3ed (1990) 551.
[138] Van den Bergh/Camesasca, supra note 3, 210.
[139] Richard A Posner *Economic Analysis of Law* 7ed (2007) 308.
[140] See OECD, supra note 1, at 24, in particular fn. 25.

(a) Potential positive net-welfare effects

The welfare effects of increased pre-sale service lie in the assumption that the demand for the manufacturer's product rises and more consumers will buy the product at every price level compared to a situation lacking such pre-sale services. Due to an increase in both manufacturer's and consumer's surplus, the imposition of RPM may have positive welfare effects.[141]

When a manufacturer introduces RPM, price competition between the retailers regarding the concerned brand is eliminated. From that moment onwards retailers cannot compete on price any more, but may on services. Their rivalry diverts into non-price channels.[142] Retailers will probably try to compete by increasingly efficient service as a way to attract customers if they are going to remain competitive with other dealers.[143] Consequently, RPM enhances their ability to engage in other types of competition than price competition. In other words: RPM eliminates intra-brand price competition, but overall intra-brand competition is not necessarily reduced because it may only shift from intra-brand price competition to intra-brand service competition.[144] This trade-off between price and non-price competition may cause higher prices but also better service quality.[145]

Distribution efficiency may be enhanced in the way that retailers are encouraged to provide more of the pre-sale services that customers are willing to pay for in the form of higher prices for the relevant product.[146] It may be the case that customers buy a product only because of such extra services and would not have bought the product if those extra services had not been provided. A higher total demand and sales follows from the fact that better pre-sale services outweigh the potential decrease of sales due to presumed higher retail prices associated with RPM.[147] As stated above, manufacturers want to avoid higher retail prices without related benefits for customers resulting from better services by its retailers. Sales will not decrease due to RPM only if retailers can compensate the result of higher product prices by better services. No decrease of the retailers' sales of the manufacturer's brand is the

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[141] Kneepkens, supra note 136, 658.
[142] Areeda/Hovenkamp, supra note 52, para 1631c, 351.
[143] Kneepkens, supra note 136, 658.
[144] Posner, supra note 139, 310.
[145] Ibid.
[146] OECD, supra note 1, at 24.
[147] Ibid. at 25, quoting Roger Blair 'The Demise of *Dr. Miles*: Some Troubling Consequences' (2008) 53 Antitrust Bulletin 133, 143.

crucial factor for the latter when RPM is being practised, as the product's wholesale price is usually not affected by the RPM programme.[148]

When retailers provide better services in regards to the affected brand this might also make it more attractive relative to other brands.[149] This may lead to enhanced inter-brand competition as competition is accelerated towards rival brands. A manufacturer may give its products an image of quality or sophistication by limiting the price competition among retailers.[150]

(b) Criticism

The criticism has often been made that those enhanced services are not necessarily pro-competitive. This may particularly not be true when such services are excessive such that some consumers have no need for them, or they mislead consumers or waste resources through spurious or mutually offsetting product differentiation, or impede future entry by rival producers.[151] In addition, firms and consumers may disagree on the right mix between the amount of retail services and the price level.[152] Even such negative factors might be compensated for by other effects. For example a service that is unnecessary to some customers might be so much more important to many other customers as to result in a net gain.[153]

In addition the pre-sales services argument has been criticised because there is no guarantee that RPM indeed leads to the provision of the desired services.[154] The retailer might not follow the manufacturer's interest and decide not to provide the services that are desired by the manufacturer. Instead, the retailer could simply get his hands on the better resale margin resulting from the higher resale price. However, this argument is weakened by the assumption that consumers will choose the retailer providing pre-sale services when they can choose between retailers offering a product at the same price, one including pre-sale services and one without pre-sale services.[155]

Furthermore, inefficiencies might arise where retailers misunderstand the manufacturer's ideas of better pre-sale service and offer their services in an unex-

[148] OECD, supra note 1, at 25.
[149] Posner, supra note 139, 310.
[150] OECD, supra note 1, at 28.
[151] Areeda/Hovenkamp, supra note 52, 1631c2, 352.
[152] Van den Bergh/Camesasca, supra note 3, 211.
[153] See Areeda/Hovenkamp, supra note 52, para 1631c2, 352.
[154] Kneepkens, supra note 136, 658.
[155] Cf ibid.

pected way. But not defining pre-sale services exactly, in particular by contract, may also be useful for a manufacturer. If the retailers themselves develop their pre-sale service according to a certain product it is ensured that specific local needs are being considered.[156] Retailers probably have a better sense of their consumers' preferences. In addition, standardized guidelines on pre-sale services will probably not be optimal for non-average dealers.[157]

Some commentators have pointed out that not necessarily all customers share the benefits of increasing demand and consumer welfare. This refers to situations in which consumers can be divided into marginal and infra-marginal consumers. Marginal consumers are buyers whose valuation of a product approximates its price and who are sensitive to any price change.[158] Manufacturers will try to attract this group of customers through increased sales efforts. A benefit for the marginal consumer appears when the increase in service outweighs the increase in price. Unlike marginal consumers, infra-marginal consumers who already know how to use the product may be are harmed by the higher prices RPM tends to cause because they would have bought the product anyway, even without extra services.[159] Infra-marginal consumers are relatively insensitive to a price increase and will continue to buy the product even if better pre-sale services do not outweigh the increase in price.[160] In contrast to these infra-marginal consumers who now pay a higher price for which their decision to purchase was already made, the initially less informed marginal consumers will buy substantially more, benefitting most from the extra services.[161] Whether the consumers as a whole benefit from the effects of RPM (higher prices and increased services) depends on the net welfare effects for both marginal and infra-marginal consumers. The positive welfare effects on marginal customers have to outweigh the negative welfare effects on infra-marginal costumers, because otherwise there would be no pro-competitive effects left. But the argument is hard to prove as the net effect on consumers stay ambiguous. It poses serious practical difficulties to get empirical evidence for the net effect of RPM on consumers. It may be impossible to determine whether the welfare loss for infra-marginal consumers is larger than the gain for

[156] Alan J. Meese 'Property Rights and Intrabrand Restraints' (2004) 89 Cornell Law Review 553.
[157] Kneepkens, supra note 136, 658.
[158] Ibid.
[159] OECD, supra note 1, at 34.
[160] Van den Bergh/Camesasca, supra note 3, 211.
[161] OECD, supra note 1, at 34.

marginal consumers.[162] In addition, it has to be taken into account that other measures (e.g. an extended warranty or more product colours) might strengthen the overall value of the product, which in principle would attract marginal consumers more and would also benefit infra-marginal consumers less.[163]

(2) Avoiding the free-rider problem

When a retailer voluntarily provides presale services then he runs the risk that he may be undercut by a competing retailer who does not, as it might be more profitable to offer no pre-sale services. This phenomenon is called the *free-rider problem*. Such undercutting retailers may take a free ride on the investment, in particular on the pre-sale services, of another. For example, retailer A sells a brand and invests in this particular brand by improving its services in the form of recruiting highly qualified salesmen or a well-stocked showroom, and creates a demand for it. It is in A's interest that other retailers which are also selling the brand are not making sales in circumstances where they have made no contribution to the creation of that brand.[164] Other retailers who are not providing such services voluntarily might urge their consumers to visit A's store and then come back to them for a bargain price, made possible by them through saving the expenses of providing such elaborate services.[165] By providing pre-sale services free of charge, retailer A confers a benefit on competing retailers of the manufacturer's brand.[166] As a consequence, free-riding might lead to a low-level service on retailer level. Retailers voluntarily offering pre-sale service cannot continue to provide such services if too many customers are diverted to the free riders. A manufacturer only profits from increased services when its net profits increase. Therefore such extra services must reflect either increased output or increased wholesale price, and the latter does not usually come along with imposing RPM.[167] When free-riding is common in a market, increased output cannot be achieved by having better services provided.

A final consequence of free-riding might be that full-service retailers cannot survive or at least will curtail or eliminate the service used by the free-riders' cus-

[162] Kneepkens, supra note 136, 659.
[163] Ibid.
[164] Cf Wish, supra note 105, 616.
[165] Cf Posner, supra note 139, 308.
[166] Cf ibid.
[167] Areeda/Hovenkamp, supra note 52, para 1631c, 351.

tomers, which may result in an inefficient under-provision of such services in the market.[168]

RPM can help to avoid the free-rider problem and presumably stimulate greater pre-sale services in addition as competitors are discouraged from taking a free ride.[169] RPM does avoid free-riding by stopping discounters from discounting.[170] As a result of equal prices on retailer level, customers have no incentive to shop at one store and buy at another. When free riding is prevented through RPM, it is probably easier for manufacturers to motivate their retailers to offer the services that it expects to be provided to its product's customers. A guaranteed profit margin and the elimination of price competition on certain products, both resulting from RPM, enable retailers to provide the level of service the manufacturer desires regarding these products. With RPM, dealers are not able to use lower prices to attract consumers who have been attracted to purchase through the advertising and pre-sale services such as product demonstration and testing of other dealers.[171]

Not all services are subject to free-riding. Free-riding will mostly be a problem if a specific service is provided before sale.[172] High-service retailers can often charge their customers for after-sale services such as repairs without fearing the competition of low-service rivals. Therefore, the free-rider problem will be less likely to arise in such situations. In addition, post-sale services will typically be provided in an already established dealer-consumer relationship; other retailers cannot free-ride on such services.[173] A further requirement would be that in the relevant market the specific service is not separately charged to the customers and the service is directly linked to a specific product and not to the retailer's business in general.[174] Examples for the latter are services consisting of attractive business hours or a convenient location.[175] Consequently, *Kneepkens* states that the theory of preventing free-riding 'can only explain the pro-competitive use of RPM for a limited group of promotional pre-sale services'.[176] In addition, it is argued that relatively few products

[168] OECD, supra note 1, at 26.
[169] Ibid. at 26.
[170] Ibid.
[171] Cf Areeda/Hovenkamp, supra note 52, para 1631c, 351.
[172] Scherer/Ross, supra note 137, 551.
[173] Kneepkens, supra note 136, 657.
[174] Ibid.
[175] Ibid.
[176] Ibid.

qualify under the free-rider argument.[177] Free-riding will most likely affect branded products that are differentiated, complex and feature-rich, in particular consumer electronics items such as mobile phones or digital cameras.[178] From a consumer perspective, there is often an increased need for advice and testing before buying such products. These characteristics are particularly fulfilled when goods of reasonable high value are purchased.[179]

The practical significance of the free-rider problem is questioned by some commentators. The theory is not relevant when the customer has already decided what he wants without visiting the high-service retailer.[180] This might be the case if the customer has bought the product frequently or advertising by the manufacturer has already caused the buying decision.[181] The customer's choice might also already be informed when he buys goods for daily supply, for instance in supermarkets or clothing stores. In such situations, unrestricted intra-brand competition does not lead to free-riding situations.[182] The same applies to when customers patronise the dealers from whom they receive the services or simply because such dealers offer a unique shopping experience (e.g. luxurious ambience) on which free-riding is simply not attractive because customers specifically want to enjoy this atmosphere.[183] Also the practical significance of free-riding is questioned. How often do customers inform themselves about a product in a high-service store and then buy the product somewhere else at a discounted price? There is no empirical evidence that this is a popular practise. What the supporters of the free-riding theory do not often consider is that high-service stores and discount outlets might coexist and no special protection of high-service stores through RPM might be needed.[184] Moreover, some commentators argue that the free-riding problem could be avoided by alternative means than RPM. Especially in regard to products to which a wide access is not absolutely necessary,[185] for example luxuries, free-riding may also be avoided by exclusive distribution.[186]

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[177] Unterhalter, supra note 66, 170.
[178] OECD, supra note 1, at 26; Cf Sutherland, supra note 6 para 6.7.1.
[179] Scherer/Ross, supra note 137, 552.
[180] Ibid.
[181] Ibid.
[182] Areeda/Hovenkamp, supra note 52, para 1601e, at 13.
[183] Ibid.
[184] Cf Scherer/Ross, supra note 137, 552.
[185] In contrast, a wide access would be necessary in case of most medicines.
[186] Block Exemption Regulation 2790/1999 paras 117-118; Sutherland, supra note 6, para 6.7.1.

To sum up, there are several limitations to the theory that RPM prevents free-riding. It only applies to certain categories of products and services. Also its actual occurrence remains unclear. Not least the question arises whether RPM is the necessarily desirable means to solving the free-riding problem.

(3) Quality certification

RPM may help to preserve the 'certification effect'. Free-riding can also take place on a type of service called 'quality certification'.[187] This argument is based on the assumption that 'certain retailers perform a valuable service by identifying "good" products and certifying to consumers, through the fact that they stock the products, that they are indeed a good purchase'.[188] These retailers might also emphasise their reputation for carrying the best quality brands or the most fashionable products through special efforts in advertising, store location or store furnishing.[189] Just from the fact that such dealers stock certain products customers may draw the conclusion that these products are of excellent quality.[190] In other words, the retailer has done a pre-selection work for customers and virtually provides 'quality certification'. Customers need not necessarily buy at this store because they are free to shop around and find the lowest price. However, quality certification is costly. If free-riding on the reputation of high-end stores wins the upper hand, these stores might lose their motivation to offer these services resulting in information asymmetries for customers.[191]

Some maintain against this theory that it is quite unlikely that high-end retailers will change their strategy by discontinuing their non-brand specific certification service because they are being free-ridden with respect to a few individual products.[192] However this criticism overlooks the fact that free-riding occurs on a certain brand and therefore concerned retailers will not stop offering such services in general. But they might refuse to continue stocking the affected products; a situation that could be averted by RPM.[193] What has also been taken into account is the fact that free-riding has become easier through internet shopping. For the customers it is very easy to have a look at a product in a shop and order the product online afterwards.

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[187] Howard P. Marvel and Stephen McCafferty 'Resale Price Maintenance and Quality Certification' (1984) 15 Rand Journal of Economics at 346-359.
[188] Scherer/Ross, supra note 137, 552.
[189] OECD, supra note 1, at 27.
[190] Kneepkens, supra note 136, 657f.
[191] Cf Van den Bergh/Camesasca, supra note 3, 212.
[192] Areeda/Hovenkamp, supra note 52, paras 1613d-g.
[193] Cf OECD, supra note 1, at 27.

However, it must also be said that RPM cannot fully avoid the *quality certification problem*. Even when RPM is applied, discounters may still make higher profits than exclusive shops because they simple do not have the same selection costs. Therefore discounters would still have an advantage towards high-service retailers when retail prices are fixed.

(4) Market entry

A special case of the free-rider argument is the theory that RPM may help to promote entry to markets. When a manufacturer intends to enter a market with a new and unproven product, he needs support from a retailer to achieve this as long as he is not vertically integrated. To open up markets, the pioneering retailer has to incur costs, especially in the form of advertising and promotional costs. Such a substantial investment in facilitating the dealership is a major risk. He will therefore be concerned about regaining his pioneer costs. But he might face new market participants before he has recovered the investments costs. A potential pioneer might fear to enter the market for that reason, since increasing price competition with its rivals might force prices and the pioneer's profits down. The second and third retailer in the market face a lower financial risk since they can free-ride on the pioneer's preliminary work, saving the cost of achieving a sufficient consumer appeal which was already carried by the pioneer. Another scenario occurs when a pioneer has already entered a market and faces new entrants before he has recovered his pioneer costs. Here, the investment in opening up a market is under threat from free-riding, which may result in too little overall investment in the new brand and an eventual failure of its market introduction.[194]

Manufacturers may use RPM to overcome the problem by convincing distributors to carry their new items. RPM functions like a shield to pioneers, guaranteeing the retailer a substantial profit at least until its pioneer cost are recovered. Therefore, RPM helps to motivate retailers to enter new markets by compensating dealers for their first time investments.[195] This applies especially to retailers with a high reputation in the market since customers might rely on brands sold by such retailers. Without RPM, it might be possible that a supplier would not find a dealer to market its new product at all, at least without providing direct financial support. In addition,

[194] Cf OECD, supra note 1, at 10.
[195] Areeda/Hovenkamp, supra note 52, para 1617a1, 208, 209.

such a restraint might be necessary to ensure enough investment in opening up the market.

RPM may ease the entry of new products that otherwise might not be available to consumers. It also helps to enhance inter-brand competition through new market participants on an upstream level, which can rely on the pioneer's support due to carrying over the investment for establishing new products. RPM may promote entry on a downstream level as well.

However, the assumption that RPM promotes market entry is limited. Pioneering dealers may be deterred since they are exposed to the risk that the manufacturer changes the resale price before the retailer's costs for developing the market been recovered.[196] As RPM leads to a shift from price-competition to non-price competition, rivals can hinder the recovery of the pioneer's first time investment when they simply perform better on the non-price channels by attracting more consumers. As a consequence the pioneer's profits might decrease even in the presence of RPM. Furthermore, it must always be considered in the individual case if encouraging market entry can be achieved through less restrictive means, for example by imitating the number of retailers within the territory concerned.[197]

b. Spillover effects from retailers' pricing decisions

(1) *Loss leader* argument

A traditional justification for RPM is that it is needed to prevent the practise of loss leading. This refers to the situation in which a retailer discounts a product at an unreasonably low price or even sells it below purchase price to attract customers. The objective behind this practise is to lure into a shop customers who will then buy additional items on which the retailer earns substantial profits.[198] The practise is also described as 'the island of losses in the oceans of profits'.[199]

Manufacturers wish to avoid having their products carried as *loss leader*s for a number of reasons. Primarily, they are afraid that using their product as a *loss leader* might lower their overall returns on a product as a consequence of declining sales. Product availability may be limited as retailers drop the affected products. Manufac-

[196] Areeda/Hovenkamp, supra note 52, para 1617a2, at 210.
[197] Cf ibid. para 1617a3, at 210.
[198] Ibid. para 1619, at 219.
[199] Cf Van den Bergh/Camesasca, supra note 3, 213 fn. 22.

turers additionally presume that they might face the risk that their reputation will be injured due to loss leading.

Regarding the first concern, customers may assume the *loss leader*'s price as the general price of the product which they have to pay at an outlet. This price level seems to be 'unfair' even for efficient rivals as the price lies beyond the competitive price. Affected retailers might lower their price in reaction to the rival's discounted price. But if they have to set the price to a certain level they might find that margins are too low to make it worthwhile keeping the item on the shelf and decide to stop selling it.[200] Beside the refusal of brands used as a *loss leader*, at the worst, a dealer might be destroyed due to the low price level.[201] In contrast, manufacturers want to see their products widely distributed through many retailers because this may allow them to increase sales and revenues. This is based on the assumption that an effective distribution can only be guaranteed when a wide variety of outlets is available.[202] Retail distribution would become thinner, where margins were not protected by RPM. Loss leading might limit a manufacturer's access to the market when retailers will be reluctant to stock its items.[203] This may actually reduce sale volumes.

In the latter case manufacturers primarily fear that consumers often classify the quality of a product by its price and the widespread use of their products as *loss leader*s will negatively affect sales as consumers lose confidence in their quality.[204] Loss-leader prices injure the manufacturer by impairing its reputation for quality.[205] In *Competition Commission v Federal Mogul* the respondent argued that RPM was imposed to keep prices high since the price is an indicator of quality and therefore of the brand's value. The brand in question should not be damaged by a 'price war' which would lead to retailers bargaining down prices.

This argument is quite weak, since there are other less drastic means available for manufacturers to influence the retail price, compared to the determination of price competition through RPM. If prices on the downstream level seem to be too low they may be adjusted simply by raising the wholesale price on the upstream level.[206] Be-

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[200] OECD, supra note 1, at 11.
[201] Cf Areeda/Hovenkamp, supra note 52, para 1619, 220.
[202] Howard P. Marvel and Stephen McCafferty 'The Welfare Effects of Resale Price Maintenance' (1985) 28 Journal of Law and Economics at 376.
[203] Scherer/Ross, supra note 137, 552.
[204] M.A. Utton Market Dominance and Antitrust Policy 2ed (2003) 238.
[205] Scherer/Ross, supra note 137, 552.
[206] Sutherland, supra note 6, para 6.7.1.

sides that, the *loss leader argument* has other significant weaknesses. Loss leading generally seems to be a relative harmless problem, in particular as long as it is practised not among a whole industry but only by a few retailers. *Areeda* and *Hovenkamp* state in this regard that it is not a strong objection that customers 'erroneously infer from one low price that most of the dealer's prices are low' and 'nor would many manufacturers worry enough about this to adopt resale price maintenance'.[207] There is also a lack of empirical evidence that *loss leader* selling harms manufacturers or consumers with any frequency.[208] However, this is not surprising because loss leading practises are normally not predatory competition. Instead, such tactics may be seen as aggressive but still fair competition which benefits consumers through lower prices.[209] As a rule, it is also unlikely that loss leading eliminates rivals because affected retailers usually still have normal returns on other products they stock. Consequently, loss-leading might only be a serious threat to single brand dealers. It seems that RPM is a very drastic way to prevent loss leading, which in turn seems not to be extraordinarily harmful to consumers and manufacturers. In general, it cannot be seen as a justification for restraining competition through RPM.

(2) Enhancing demand for certain products

The assumption that discounts harm a brand's image can be emphasised in connection with luxury products. Here, the phenomenon appears that the higher the demand for these products, the higher the retail price is. High prices may serve as a product feature of certain branded products, especially for status symbols such as super sports cars.[210] In other words, for the buyer of prestige goods, a high price is a good thing.[211] Besides damaging the reputation of a prestige brand, discounts would also lead to easier affordability of such products with the implication of lessened exclusivity.[212]

In this regard the argument is being stressed that it would be unfair to the manufacturer to allow dealers to sell its product, against the manufacturer's wishes,

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[207] Areeda/Hovenkamp, supra note 52, para 1619, 220.
[208] Robert Pitofsky 'In Defense of Discounters: The No-Frills Case for a *Per se* Rule against Vertical Price Fixing' (1983) 71 Georgetown Law Journal at 1494; Areeda/Hovenkamp, supra note 52, para 1619, 221.
[209] Cf. Areeda/Hovenkamp, supra note 52, para 1619, 220.
[210] Barak Y. Orbach 'Antitrust Vertical Myopia: The Allure of High Prices' (2008) 50 Arizona Law Review at 285f.
[211] George R. Ackert 'An Argument for Exempting Prestige Goods from the *Per se* Ban on Resale Price Maintenance' (1994) 73 Texas Law Review at 1208.
[212] Ackert, supra note 211, 1209.

at discount prices.[213] RPM might support manufacturers in delivering prestige goods to customers, working as a mechanism to maintain high prices. The manufacturer retains control over its products' status as prestige by hindering price competition which would reduce this vital product attribute.[214]

Even if this argument has a very limited scope as it only applies to prestige-orientated goods like perfume, wine, or luxury cars, it could plausibly justify the application of RPM to prestige products. However, it is questionable why keeping prices high cannot be achieved more simply by less restrictive means such as refusing to do business with discounters[215] or exclusive distribution.

(3) Manage demand uncertainty

According to the *demand uncertainty theory*, manufacturers may adopt RPM in order to encourage retailers to hold larger inventories of their products.[216] This theory is based on the scenario that retailers discover that the demand for a new product may turn out to be unexpectedly low. Their typical reaction will be to try and sell off these goods at discounted prices, often with substantial loss. At this point one has to distinguish between discounters and high-end stores. Discounters always sell at low prices. When demand is low, they are probably still able to sell their stock because for the remaining demand they offer the requested products at an attractive price. Competition amongst discounters ensures low prices even when demand is high. In contrast, high-end stores always sell at high prices. They are more dependent on demand than discounters since they will sell only if demand is high enough to support their prices.[217] If demand is low, however, they are facing the risk that they might sell nothing if it comes to the worst and will record a loss due to unsold products.[218] For this reason high-end retailers might be even more unwilling than discounters to carry sufficient inventories to satisfy demand if it turns out high.

When a manufacturer tries to introduce new products into a market, its retailers usually carry this risk of uncertain demand. Therefore, when dealers are placing

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[213] Cf Pitofsky, supra note 208, at 1494.
[214] Ackert, supra note 211, 1209.
[215] Brief of Amicus Curiae Consumer Federation of America in Support of Respondent at 19, *Leegin Creative Leather Products Inc. v PSKS, Inc*., 551 U.S. 877 (2007).
[216] R. Deneckere, H.P. Marvel and J. Peck 'Demand Uncertainty, Inventories, and Resale Price Maintenance' (1996) 111 Quarterly Journal of Economics at 885.
[217] OECD, supra note 1, at 28.
[218] Kneepkens, supra note 136, 660.

their orders, they will be less willing to carry a product the higher the risk is that demand may be low and prices will drop.[219]

RPM may help to reduce the problem of uncertain demand, in particular in regard to the unequal diversification of risks between discounters and high-end stores. It makes it more likely that both types of retailers, discounters and upscale outlets, participate in the overall consumer demand because even if demand is low both can at least sell a portion of their stock at the RPM price.[220] As it guarantees stable prices in case of low demand, it is likelier that retailers will hold larger inventories under RPM. The potential losses due to lower demand are offset by the additional profits through the RPM price. This assures a better availability of goods to consumers as it is more likely that stores stock new items and maintain adequate inventory levels.

For manufacturers it is also more attractive to use RPM to encourage retailers to hold larger inventories instead of lowering the wholesale price, what would lead to increased retailer's margins, because it means less profit.[221] However, what might also be efficient for the manufacturer is if it agrees a buy-back scheme with its retailers.

The theory is also limited as it applies primarily to products for which demand is uncertain and that have a limited shelf-life, in particular music and movie merchandise or seasonal and fashion goods. Aside from that, although it is clear that the increase in inventories is beneficial for manufacturers, its welfare effects are uncertain.[222] *Areeda* and *Hovenkamp* state in regard to CDs that RPM used to motivate dealers to stock items of uncertain demand 'most likely benefits consumers in most cases. Customers benefit by having access to both the hot-selling and the slow-selling CDs; however, they are burdened by higher CD prices and the absence of a discount market'.[223] What appears again is the infra-marginal consumer theory.[224] Marginal consumers are more price sensitive and buy products when the demand is high, benefitting from increased inventories In contrast, infra-marginal consumers would also buy the products if demand is low; as they would have bought the product

[219] OECD, supra note 1, at 28.
[220] Ibid.
[221] Kneepkens, supra note 136, 660.
[222] Cf Van den Bergh/Camesasca, supra note 3, 214.
[223] Areeda/Hovenkamp, supra note 52, para 1614f, at 186.
[224] See Kneepkens, supra note 136, 660.

anyway they profit less from the higher stock. Ultimately, it is an issue of the single case if the advantages for the marginal consumer outweigh the disadvantages for the infra-marginal consumers. Nevertheless, positive net welfare effects are definitively not unlikely and may justify the usage of RPM.

c. Retailers' incentives

(1) Increasing retailers' sales efforts

RPM may help a manufacturer to ensure that retailers are motivated in marketing its products. Since intra-brand competition changes from price-competition to service competition, retailers may make stronger efforts to sell the products with RPM prices because they guarantee a certain profit margin on each unit sold. These guaranteed margins are the financial basis to invest in intensified pre-sale services for their part.[225] If one assumes that retailers can choose on which products they want to spend the most promotion efforts they will most likely focus on the higher-margin items. Increasing efforts to sell a certain product this are typically associated with improving intra-brand competition.[226]

(2) Disciplining retailers who fail to provide desired services

RPM may give manufacturers a means to discipline retailers who fail to provide the desired services, by the threat that RPM could be removed or supply be ceased. Manufacturers may assure the loyalty and honesty of their retailers by guaranteeing them a profit through RPM greater than pure competition would give them. This effect is accompanied by the fact that termination of dealership would be a more severe sanction for disloyalty or dishonesty because a worthwhile source of revenue would get lost.[227] As a consequence, even if the competitive situation in the relevant market does allow a stronger competition by services, retailers might be motivated to re-invest the extra profits resulting from RPM prices not least because they fear the manufacturer's termination or dismantling of the RPM agreement.[228]

2. Potential anti-competitive effects

Vertical restraints can be used purely for anticompetitive purposes since they may significantly limit both intra- and inter-brand competition.

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[225] OECD, supra note 1, at 25.
[226] Ibid. at 11.
[227] Posner, supra note 139, 310.
[228] OECD, supra note 1, at 25.

For the most part, potential anti-competitive effects of RPM arise from their effects at horizontal level, namely when it is used to facilitate either a manufacturer cartel or a retailer cartel.[229] However, such effects may also arise from the vertical aspect of the relationship, in particular when manufacturers push through their interests with regard to forestalling innovation or market foreclosure. These risks of RPM will be assessed next, starting with the aspect of facilitating collusion on upstream and on downstream level. Arguments surrounding the forestalling of innovation and market foreclosure will be discussed afterwards.

a. Facilitating collusion

The major concerns against RPM revolve around the idea that it might help manufacturers to coordinate their prices horizontally or that it might help dealers to obtain excess profits without having competitive pressure. Both collusion hypothesises will be discussed next, starting with RPM as a facilitating device on the upstream level. Afterwards possible anti-competitive effects through a potential facilitation of collusion among retailers will be ventilated.

(1) Manufacturer collusion theory

Besides the effect that it eliminates intra-brand competition, RPM leads also to increased transparency on price and responsibility for price changes.[230] This characteristic supports horizontal collusion among manufacturers, namely by helping to stabilise the cartel. The parties' goal of a manufacturers' cartel is to fix wholesale prices, because the margin between a manufacturer's costs and the wholesale price determines the manufacturer's profit.[231] In a non-RPM scenario, all members of a cartel face the risk that a single member may start to cheat, trying to gain its market share at the expense of the others. A typical means of cheating would be to lower the wholesale price (secretly). Retailer prices would certainly fall, resulting in increasing demand. Due to the overall output rise the manufacturers would earn more profit.

With RPM, cheating can be counteracted in two ways. First, fixed retail prices may reduce the involved manufacturers' incentive to lower wholesale prices.[232] Demand on downstream and on upstream level is stable under RPM as cheaper con-

[229] Cf Bishop/Walker, supra note 131, 160.
[230] Van den Bergh/Camesasca, supra note 3, 208.
[231] Kneepkens, supra note 136, 661.
[232] Cf Lester G. Telser 'Why Should Manufacturers Want Fair Trade?' (1960) 3 Journal of Law and Economics at 91.

sumer prices cannot stipulate demand. Consequently, cutting the wholesale price is less desirable for manufacturers, since it will not result in higher output.[233]

Aside from that, RPM can be utilized as a monitoring instrument.[234] It enables manufacturers participating in a cartel to more easily detect cheating participants who are cutting the wholesale price and deliver to discounting retailers.[235] Because they are visible to the public, retail prices are less complicated to observe than wholesale prices since the latter are often agreed secretly and individually negotiated.[236] This also makes it easier to detect price deviations on retailer level than on manufacturer level. The link between the wholesale price and the retail price lies in the fact that, under RPM, the only information necessary to unmask the cheater is the knowledge of who supplies the discounter.

The argument that RPM may help to facilitate horizontal collusion has been criticised in several ways. First, one factor that makes manufacturer cartels relatively unlikely is the general deterrence before establishing a cartel. It must be borne in mind that cartel behaviour, as it is regulated by the provisions of section 4 of the Act, is not merely prohibited by the Act. Directors or managers of companies which are involved in cartel conduct will also face criminal liability through the Competition Amendment Act ("the Amendment Act") in the future.[237]

Furthermore, certain market requirements encourage cartelisation but others may make it rather unlikely or at least unreasonable. The fact that RPM might facilitate horizontal collusion is imminent when the restraint is used industry-wide.[238] As market concentration is favourable to horizontal collusion, however, it is less likely when the market is highly competitive.[239] *Areeda* and *Hovenkamp* assume that 'the risk of such concentration is probably not very high when the market's HHI[240] is less than 1200'.[241] In contrast, when several producers are imperfectly competing at the

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[233] Cf Richard A. Posner 'The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision' (1977) 45 University of Chicago Law Review at 1.
[234] Bruno Jullien and Patrick Rey 'Resale Price Maintenance and Collusion' (2007) 38 RAND Journal of Economics at 991.
[235] See *Leegin*, supra note 12, 893.
[236] Sutherland, supra note 6, para 6.7.2, 6-46.
[237] The Amendment Act has been signed into law it is not in force as yet, but will come into force on a date to be proclaimed by the President.
[238] Kneepkens, supra note 136, 661.
[239] Areeda/Hovenkamp, sura note 52, para 1632d, 365.
[240] Herfindahl–Hirschman Index indicates the market concentration and therefore the amount of competition in a certain market through the sum of the squares of the firm's market shares. For example, a market with an HHI of 1000 has the equivalent of ten equal-size firms.
[241] Areeda/Hovenkamp, sura note 52, para 1632d, 365.

upper level, the vertical restraint may serve to facilitate collusion.[242] RPM might also not facilitate collusion when the relevant market is 'so structured and concentrated as to make tacit price coordination among manufacturers feasible'.[243]

In addition, in some cases manufacturers might not need to use RPM to facilitate a cartel because other, probably more effective, means for monitoring discipline or minimising manufacturers' incentive for competing through lower wholesale prices are available. An unwanted consequence of using RPM to facilitate a manufacturers' cartel might be that attention is directed to that specific market.[244] In particular competition authorities might start to investigate in order to discover the rationales behind the uniform retail prices on a market. Therefore, imposing RPM is always a risk for members of a cartel to be discovered. The collusion argument is also weakened by the fact that RPM is a relative expensive way for cartels to prevent cheating because RPM usually comes along with higher prices which lead to declining overall industry sales. Therefore manufacturers may make lower profits than without RPM.[245]

Moreover, one can question if RPM is such an effective means that it can prevent cheating entirely. Manufacturers still could 'step out of line' when they agree on extra non-price competition or tying among their products with retailers in return for the higher RPM-margins. A (powerful) manufacturer might expect its retailers to enhance demand by offering additional services to the manufacturer's products.[246] Alternatively, sales of a certain manufacturer's product might be boosted when the retailer is forced to tie addition products to it at its own cost.[247] In the end, there will often be further monitoring instruments necessary to enforce a manufacturer cartel, e.g. exclusive dealing.

Besides that, the cartel might be destabilised by secret discounts allowed to retailers as a reward for non-price competition against other cartelists' products. A 'traitor' might choose to circumvent the cartel agreement by granting retailers extra rewards for promoting the cheater's product more than the products of the other

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[242] Patrick Rey and Joseph Stiglitz 'Vertical Restraints and Producers' Competition' (1988) 32 European Economic Review, 562.
[243] Areeda/Hovenkamp, sura note 52, para 1632d, 365.
[244] Ibid. 364.
[245] OECD, supra note 1, 32.
[246] See Kneepkens, supra note 136, 661.
[247] However, such a tying agreement might also be subject to competition law, namely to section 5(1) of the Act.

manufacturers involved. As a consequence, demand for the cheater's product and output will substantially increase.[248] In this regard, the inherent feature of RPM that it stimulates non-price competition by enhancing pre-sale services might be utilized to break out of a cartel. This behaviour pays off when the cheater can take away enough sales from other cartel members to recoup the secret price cut.[249] Corresponding to *free-riding*, this cheating practise is limited to service-intensive goods, which in turn allows the assumption that higher incidence of abusing RPM for horizontal collusion will appear on simple products.

Another counterargument is that there is a lack of empirical evidence on the assumption that RPM is used to facilitate upstream collusion.[250] There are only a few cases documented from the US where the use of RPM strengthens manufacturer cartels.[251]

In summary, it can be assumed that it is possible that RPM might help to facilitate horizontal collusion in certain cases. However, it cannot be said that this is necessarily the regular outcome of RPM from the outset. For example, it is also possible that collusion is less likely in respect to certain market conditions or that RPM is not effective in safeguarding the cartel from cheating.

(2) Distributor collusion theory

RPM might also be indirectly used by retailers to serve as an enforcement mechanism and to disguise the existence of a dealer cartel. When they act as a group, dealers may have the power to induce the manufacturer to introduce RPM and, as a result, they benefit from higher retail prices. In contrast, the manufacturer has no advantage from RPM in this situation, since the higher resale price is not accompanied by higher wholesale prices. As the manufacturer's profit will decrease through less overall sales, a manufacturer will only adopt this if he is forced to do so. This might be the case if the manufacturer depends on the retailers such that he is threatened by a boycott by a sufficient large group of retailers, without having alternative retail methods.[252] The retailers' goal by such a practise may be to discipline price cutting among distributors or, particularly with regard to online trading, to prevent the evolution of more efficient forms of distribution. When prices are being fixed above the

[248] Blair, supra note 147, 137.
[249] OECD, supra note 1, 662.
[250] Summary given by Marvel/McCafferty, supra note 202, 365.
[251] See Telser, supra note 232, 86; Areeda/Hovenkamp, supra note 52, para 1632c5, 364.
[252] Kneepkens, supra note 136, 661.

competitive price in such situations, it may have the same effects as a retailers' cartel.[253] In other words, the vertical restraint (RPM) is used to circumvent the prohibition of horizontal price fixing and to camouflage a dealer cartel. This retailer initiated cartel agreement is enforced and monitored by the manufacturer, which imposed RPM. For example, when a cartel member cheats he will be punished by the manufacturer and not by other cartel members.

The *distributor collusion theory* is weak for various reasons. First, it is limited to certain economic conditions. Manufacturers will fear boycotts only if there are close substitutes on their products available that can satisfy the demand of consumers. But this also hinders retailers in claiming supra-competitive RPM-prices, since consumers easily could change their preferences to a substitute product. In particular, this might happen in supermarkets, where many different substitutes are available. Therefore, an effective cartelisation would require expanding the practise to all manufacturers which produce substitutes.[254] This might often fail because of the practical feasibility. Second, the theory requires a powerful group of retailers to exert the appropriate pressure on the manufacturer. Without sufficient upstream power, manufacturers will probably simply 'not play the game'. Beyond that, a stable dealer cartel presumptively requires an additional agreement to restrain non-price competition as it remains unaffected by RPM. When non-price competition is not significantly softened after a manufacturer imposed RPM, this may allow the conclusion that there is no distribution cartel or at least that it works imperfectly.[255]

Against the theory is also that manufacturers are normally interested in making maximum sales and not decreasing their sales in favour of higher retailer margins resulting from RPM. Further negative consequences from imposing RPM would be a foreclosed access to discounting stores, with which a significant financial loss may be associated.[256] This suggests that manufacturers will prefer to report collusion to the competition authorities instead of being instrumentalized to enforce a dealer cartel.

What has also to be taken into account is that high retailer margins resulting from RPM will attract new market entrants. Therefore, it is often questionable

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[253] Kneepkens, supra note 136, 661.
[254] Ibid.
[255] Ibid.
[256] Van den Bergh/Camesasca, supra note 3, 209.

whether it is likely that retailers want to have a collusive price through vertical price fixing.[257]

Some of the general reasons why manufacturer cartels are quite unlikely also apply to dealer cartels. This is especially true because cartels are illegal activities and therefore require criminal intent. Retailers may also be able to implement and monitor their cartel well enough without RPM.[258]

It can be noted that there are several arguments which weaken the *distributor collusion theory*. Therefore, the theory appears to be relatively implausible; it does not seem that dealers' collusion is a major explanation for RPM.[259] This applies in particular when the relevant market is highly competitive and retailers probably do not have the necessary power to induct RPM.

b. Softening price competition

RPM may in general be more anti-competitive through softening competition between manufacturers and/or between retailers. This might be in particular true, when 'manufacturers use the same distributors to distribute their products and RPM is applied by all or many of them'[260] because RPM might reduce their motivation to compete.[261] The situation may be quite similar when a group of manufacturers makes use of RPM in a very similar way to their retailers. When this "network of RPM" covers a large portion of the retail market, in other words the market players have significant market power, RPM potentially leads to anti-competitive effects. Retailers' incentives to behave aggressively among themselves or to bargain for lower wholesale prices may be strongly limited. Due to the elimination of intra-brand price competition customers cannot benefit from the lower prices that more efficient retailers would normally offer. In addition, retailers with inefficient cost structures are not under the same competitive pressure as they would be under normal competitive conditions, especially in not having to fear being driven out of the market.[262]

This general concern is somewhat undermined by the pro-competitive effects of RPM, which were previously discussed. The decrease of intra-brand price competition may be compensated for by increasing intra-brand service competition. There-

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[257] Ibid.
[258] OECD, supra note 1, 30.
[259] Cf Marvel, supra note 202, 359; Van den Bergh/Camesasca, supra note 3, 209.
[260] Guidelines on Vertical Restraints 2010/C 130/01 para 224.
[261] Bishop/Walker, supra note 131, para 5.48, 165.
[262] OECD, supra note 1, 35.

fore, the most efficient market players can still make the highest profits and gain their market share at their less effective rivals' expense, in particular though attracting more consumers by enhanced pre-sale services. Consumers would benefit from those improved services even though they would be paying higher prices.[263]

c. Commitment problem

A possible anti-competitive effect of RPM is that it solves the so-called *commitment problem* of a monopolist, and would hamper a monopolistic manufacturer from enjoying monopolistic profits.[264] The starting position in this theory is the model that one manufacturer simultaneously supplies two retailers that compete in quantity. The supply agreements are secret or can be renegotiated. To maximise its supra-competitive profits, the manufacturer would produce the amount of its product that corresponds to consumers' demand.[265] After having collected these supra-competitive profits, the manufacturer might be willing to increase its outputs and profits by offering one of the retailers the products at a lower wholesale price. The dealer now might accept the offer as it brings him into the position of undercutting his rival's price in order to take market share and to eventually eliminate a rival. As soon as both retailers realize this practise they will no longer be willing to accept paying a high wholesale price for the product and the monopolist is therefore not able to earn supra-competitive profits.[266]

The imposition of RPM on both retailers helps the monopolist to overcome the *commitment problem* and to restore market power. Through RPM, retailers cannot compete on price and start predatory price competition. Consequently, the monopolist has no incentive to renegotiate a wholesale price with a retailer to the detriment of the rival retailer because there are no additional profits to achieve.

This theory is limited to situations in which a manufacturer has market power. There might be also several other instruments available to overcome the *commitment problem* such as price ceilings[267] or granting exclusivity to a retailer.[268]

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[263] See OECD, supra note 1, 35.
[264] See Oliver Hart and Jean Tirole 'Vertical Integration and Market Foreclosure' (1990) Brookings Papers on Economic Activity: Microeconomics 205-286.
[265] Cf Kneepkens, supra note 136, 663.
[266] Massimo Motta, Patrick Rey, Frank Verboven and Nikolaos Vettas 'Hardcore restrictions under the Block Exemption Regulation on vertical agreements: An economic view' at 2.
[267] See Daniel O'Brien and Greg Shaffer 'Vertical Control by Bilateral Contracts' (1992) 23 Rand Journal of Economics 299-308.

d. Abuse of RPM by powerful manufacturers and retailers

When manufacturers and retailers have market power, they might abuse RPM in an anti-competitive way.

From the perspective of a powerful manufacturer, supra-competitive RPM-margins might minimize retailers' incentive to sell products of rivals or smaller entrants.[269]

A dominant retailer may use its buying power to force a manufacturer to impose RPM in order to prevent firms that are more efficient, in particular by having lower costs, from entering the market and undercutting its prices.

In such a situation, a powerful retailer might not only restrain competition by foreclosing the market to more efficient firms; it might also seek to preserve its market position by forestalling innovation in the distribution channel.[270] Other firms will not have an incentive to design innovate business models that allow them to reduce prices. For the same reason, RPM may slow technical progress in distribution.[271] For example, online retailers that generally have lower distribution costs may be deterred from entering the market since they cannot offer lower prices.[272] Since they cannot make use of this competitive advantage, which usually results from lower overhead costs and greater efficiency, towards incumbent dealers, it is more difficult for them to obtain market share.[273]

The theory that RPM deters entry at the retail level is questionable. Indeed, RPM forecloses market entry in regard to price competition. There is no possibility that new entrants will discount popular brands in order to attract consumers. However, this does not mean that RPM prevents market entry by all means. There are still reasons why customers would patronise a new dealer. These may be better services, a more appealing way of shopping, or special offers on products that are not subject to

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[268] Cf Massimo Motta, Patrick Rey, Frank Verboven and Nikolaos Vettas, supra note 266, at 2; Kneepkens, supra note 136, 663.
[269] Basil Selig Yamey *The Economics of Resale Price Maintenance* (1954) 34-35; *Leegin*, supra note 12, 894.
[270] Ibid. 893.
[271] Marvel, supra note 202, 359.
[272] Daniel B. Nixa 'Internet Retailers and Intertype Competition: How the Supreme Court's Incomplete Analysis in Leegin v. PSKS Leaves Lower Courts Improperly Equipped to Consider Modern Resale Price Maintenance Agreements' (2009) 11 Vanderbilt Journal of Entertainment and Technology Law 474.
[273] *Leegin*, supra note 12, 922 (Breyer, J., dissenting).

RPM.[274] Furthermore, selling at RPM-prices may still be attractive to a new dealer when it is more effective than its rivals and will therefore earn higher profits.

3. Conclusion

The analysis in this chapter has shown that one cannot make a blanket statement on whether RPM is anti-competitive or pro-competitive. It can either have pro-competitive or anti-competitive effects, depending on the current circumstances in the individual case. Therefore, the view of *Qunta P* in *Cancun Trading v Seven Eleven Corp SA (Pty) Ltd*[275] that minimum price fixing will always be anti-competitive must be rejected in the light of this rationale.

The arguments traditionally brought forth regarding anti-competitive effect are now facing significant criticisms. In many instances it is rather unlikely that they occur. In turn, there can be no doubt that RPM also has potential benefits to consumers and might therefore be pro-competitive in numerous situations. A categorical denying of all manufacturer benefits and the equation of the RPM's effects on competition with the effects of horizontal restraints as assumed in *Dr Miles* is no longer tenable.[276] We have also seen that RPM does not primarily benefits the dealers, since it may also serve the legitimate interests of the manufacturers and of the consumers. There are situations conceivable where RPM preserves dealers' margins and still benefits the manufacturer and finally the consumers.

However, what is ambiguous are the probabilities assigned to these positive and negative outcomes. Even if economics knows what can happen if a manufacturer uses RPM, it remains unclear how likely it is that something either bad or good will happen. This results mainly from a lack of empirical evidence about the effects of RPM.

RPM may be utilized for several reasons, which have different consequences for competition. Therefore, it is necessary to ask if potential competitive gains from RPM outweigh the restraint's anti-competitive potential. For that, factors such as the specific market conditions in the upstream and in the downstream market, particularly focussing on manufacturers' and retailers' market power, the manufacturer's impetus to impose RPM, or the number of manufacturers that make use of RPM should be taken into consideration. The importance of taking into account individual cir-

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[274] See Kneepkens, supra note 136, 662.
[275] *Cancun Trading v Seven Eleven Corp SA (Pty) Ltd* 18/IR/Dec99 para 48.
[276] Cf Areeda/Hovenkamp, supra note 52, para 1620c, p.228.

cumstances for the analysis of RPM's effect on competition is particularly evident with producers' competition because RPM may have fundamentally different effects if imposed by a dominant manufacturer than if imposed by a small manufacturer.

In the light of this chapter's findings about RPM's potential pro-competitive and anti-competitive effects, it remains an open question why South African Competition Law treats RPM more harshly under the *per se* rule than other vertical restraints, which are analysed under the rule of reason. In the next chapter, therefore, the question is asked whether there is an alternative analytical framework available which would allow an objective appraisal of the actual effects of an RPM agreement.

II. Appropriate analytical framework for assessing RPM

After having seen that RPM may have very different effects on competition, the predominant issue is whether it should be unlawful *per se,* subject to the rule of reason, or ruled under an alternative approach. Thereto, the appropriate standard of analysis needs to be discussed.

This section considers the *per se* rule by taking into account the general strengths and weaknesses of this approach. Afterwards, the more lenient rule of reasons and its modifications will be reviewed.

1. Per se rule

The *per se* rule in section 5(2) of the Act simply condemns the practise of RPM as a violation of the competition laws. When courts apply the *per se* rule, they do not examine if the practise may be beneficial in some way. The *per se* approach relieves the complainant from having to prove that RPM actually has anti-competitive effects. Instead, it is solely necessary to prove the existence of a unilateral announced price and a sanction that the retailer faces when he fails to comply. Since RPM is prohibited outright, it is not possible for the parties to put forward justifications. In contrast, for all vertical restraints other than RPM the rule of reason is the prevailing standard for judging vertical agreements under the Act. A violation of section 5(1) is, however, not as simple to prove as it seems, because the complainant has to prove the existence of an agreement and a causal effect of substantial prevention or lessening of competition in a market. The latter requires proving this in the market, which is relatively difficult in practise.[277]

[277] Unterhalter, supra note 66, 167.

The rule is based on the idea that RPM is so harmful to competition that it must be always prohibited and that usually no justification is given.

a. Per se illegality

(1) Advantages

Even if a substantial majority of commentators argued against a *per se* approach in the last twenty years,[278] there are some serious arguments in favour of a *per se* rule. Primarily, RPM offers some technical advantages regarding legal certainty, operational efficiency and functionality and costs. First, the approach guarantees clarity to businesses as it is clear that RPM is prohibited without exemption. Second, it guarantees a high degree of legal practicability in law enforcement because administering any exception is not applicable. Competition authorities are relieved from making time-consuming additional investigations and assessments of potential anti-competitive effects. In addition, one might argue that there is no efficient way available for case-by-case distinctions to distinguish between beneficial and harmful effects of RPM.[279] Furthermore, efficiency is also warranted by the fact that there is already experience with the *per se* prohibition of RPM through corresponding case law. At this point it should be noted that the competition authorities in South Africa were set up quite recently and therefore have generally limited past experience with RPM cases. South Africa does not have a long rich history in competition law enforcement, compared to the US with more than 120 years of experience in this field. Third, the *per se* rule is accompanied with the saving of administrative costs and costs in decision making. As the *per se* rule prohibits business persons altogether from practising RPM their planning costs and litigation costs are minimized.[280] However, as the *Federal Mogul* case has shown, there are still issues for litigation. Compared to a rule of reason one might argue that RPM is less costly and potential benefits of RPM are too few to warrant the 'costly scrutiny that a rule of reason imposes'.[281] With respect to the limited resources of competition authorities, especially those of the Competition Commission as the investigative and executive body, investigations can possibly be carried out only on a certain level. As a consequence, investigations are probably not as effective as they would be when carried out with greater

[278] Cf OECD, supra note 1, 23.
[279] Cf Areeda/Hovenkamp, supra note 52, para 1628b, 331.
[280] Ibid. para 1628b, 332.
[281] Ibid. para 1628b, 331.

resources. Nevertheless, as the Act addresses the majority of vertical restraints under the rule of reason even now, this seems to be a more general concern. In 2003 the OECD summarised that competition authorities' 'resources are stretched, and there is a critical need to improve the depth and strengthen the capacity of the professional staff'[282] As a consequence of limited resources and the fact that the authorities focused more on section 4(1)(b) enforcement and mergers in the past, there has been little enforcement action on vertical restraints in South Africa so far.

(2) Disadvantages

Nevertheless, as we have seen in the previous chapter, RPM cannot be characterised as manifestly anti-competitive. In particular, it does not regularly have the same negative effects as horizontal combination among competing distributors. Instead, establishing RPM can have either pro-competitive or anti-competitive effects. The assumption that RPM is always or almost always anti-competitive is incorrect. But if this requirement is not met then there is no basis for applying the *per se* rule. As long as the *per se* rule is still being applied there is a lack of justice in the single case because under the *per se* rule some conduct that is actually pro-competitive will also be condemned.[283] *Areeda* and *Hovenkamp* refer to potential overall effects of a *per se* rule by stating that 'categorical illegality deprives society of the benefits that might flow from resale price maintenance'[284]

It is inconsistent that section 5 of the Act condemns RPM in its paragraph 2, but simultaneously allows reasonable non-price and price restraints other than RPM in its paragraph 1. The justification for such restraints is quite similar and does not allow a categorical classification. In other words, it is not necessarily true that RPM is more anti-competitive that maximum resale price maintenance or exclusive dealing.[285]

Another major weakness of section 5(2) is that it has no market power requirement.[286] It applies equally to dominant firms and those without market power. Consequently, firms can violate section 5(2) whether they are big or small, entrant or

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[282] OECD 'Competition Law and Policy in South Africa' Peer Review 2003, 7.
[283] OECD, supra note 1, 36.
[284] Areeda/Hovenkamp, supra note 52, para 1628b, 332.
[285] Cf ibid. para 1628e, 336.
[286] Grant Saggers, 'The end of the Prohibition? The economics of minimum resale price maintenance and its relevance for South Africa' (2008) available at http://www.crai.com/ecp/assets/Saggers_WITS_paper.pdf, 14.

incumbent.[287] But as we have seen above, evils attending RPM often occur when market power is given, especially in cases of manufacturer and dealer cartels. Such effects will usually not occur when only small firms lacking market power use RPM. Correspondingly, in *Leegin* the court stated 'that a dominant manufacturer or retailer can abuse resale price maintenance for anticompetitive purposes may not be a serious concern unless the relevant entity has market power'. The *per se* prohibition of RPM deprives small firms of opportunities to use RPM as an (pro-competitive) business practice.

Furthermore, the argument that the *per se* rule saves the competition authorities money and time is quite inaccurate. It is not guaranteed that the savings of the *per se* rule are lower than the overall benefits society may have when RPM could have been used with pro-competitive effect.[288] In addition, there might be negative welfare effects when firms use 'less efficient, potentially more harmful, but not *per se* illegal, strategies to achieve their objectives'.[289]

Ultimately, it can be concluded that the *per se* rule is not appropriate to govern RPM. In the next subchapter the contrary position to the *per se* rule, a rule of *per se* legality is discussed.

b. Per se legality

A seldom raised analytical framework for RPM is to declare it *per se* legal. This theory goes back to *Posner*[290], who argues that RPM has been linked with horizontal collusion in relatively few cases.[291] The few harmful cases in which RPM is being used to facilitate a manufacturer cartel or a dealer cartel can be covered by the rules governing horizontal collusion.[292] In addition, disadvantages for society resulting from RPM will probably be corrected by the market forces, for example by consumers readjusting their product preferences due to higher RPM prices.

Simply allowing RPM is probably the least costly approach to administer. It also provides the greatest certainty.[293]

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[287] Saggers, supra note 286, 15.
[288] *Leegin*, supra note 12, 895.
[289] Saggers, supra note 286, 16.
[290] Richard A. Posner 'The next step in the Antitrust Treatment of Restricted Distribution: Per se Legality (1981) 48 University of Chicago Law Review 6.
[291] Ibid. 24.
[292] Ibid. 22.
[293] Areeda/Hovenkamp, supra note 52, para 1628b, 332.

However, *per se* legality is no appropriate standard for assessing RPM cases. As RPM might also have anti-competitive effects, *per se* legality would expose society to the risk of harmful effects that would otherwise be prevented. It can be expected that benefits through lower administrative cost and legal certainty are being outweighed by the social losses that will occur when RPM would be legal in any situation.[294]

Even if the cases in which vertical price fixing are used for horizontal collusion purposes might in fact be rare, presumed illegality of RPM also functions as an enforcement mechanism for competition authorities. Through to its better visibility it is easier to detect cases of horizontal price fixing.[295]

2. Rule of reason

Starting from a purely economic perspective, governing RPM under a rule of reason, as it does section 5(1) of the Act or as adopted by the US Supreme Court in *Leegin,* seems to be superior to a treatment under a *per se* rule only at first sight.

a. Definition

Under the rule of reason approach, competition authorities and courts analyse the effect of the particular restraint given the prevailing market circumstances, in order to decide whether it is reasonable or not. In general, the concept of a rule of reason considers factors that support the finding of an unlawful agreement as well as exculpatory factors. The analysis asks whether the net effect of a practise harms competition, especially in causing net harm to consumer welfare.[296] A number of factors are weighted including specific information about the business' and the restraints' history, nature and effect.[297] In *Leegin*, the court mentioned as such factors the number of manufacturers using RPM in a market, the source of the price restraint and the parties' market power.[298] Section 5(1) of the Act is an 'unstructured' rule of reason since it declares the restraint unlawful if unreasonable without expressly providing rules that clarify 'reasonable' means.[299]

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[294] Cf Areeda/Hovenkamp, supra note 52, para 1628c, 334.
[295] OECD, supra note 1, 13.
[296] The Preamble of the Act states inter alia 'That an efficient, competitive economic environment, balancing the interests of workers, owners and consumers and focussed on development, will benefit all South Africans'.
[297] *Leegin*, supra note 12, 885.
[298] Ibid. 897.
[299] Cf Areeda/Hovenkamp, supra note 52, para 1628b, 331.

If RPM were covered by section 5(1) the presumption that RPM is anticompetitive would be removed. But attention must be paid to the onus of proof. As already mentioned above, the complainant has to show the existence of an agreement that causes a substantial preventing or lessening of competition in a market. In turn, the respondent can put forward evidence that the practise is justified if its pro-competitive effects outweigh its anti-competitive harm.[300] *Unterhalter*, therefore, concludes that 'the judgement required to trigger prohibition is not simply an "all things considered" view of the matter'.[301]

b. Advantages

Why is a rule of reason a better enforcement approach to RPM compared to a *per se* prohibition? The starting point to determine the answer to that question is that the rule of reason is the more lenient and flexible approach with regard to RPM's potential anti-competitive and its possible pro-competitive effects.[302]As it is a circumstance specific, case-by-case approach to determining whether a restraint causes an unreasonable substantial harm to competition, it is best suited to consider these different potential effects of RPM on competition in the individual case. It can take into account various inputs related to the conduct to find out the individual net effect of the RPM-measure. In contrast to a *per se* rule, therefore, it can preserve pro-competitive effects of RPM and help to warrant fairness in the individual case.[303] This is particularly true when RPM benefits manufacturers and consumers, for example by higher output through better services.[304]

Taking various economic conditions into account would also be in accordance with the purpose of the Act. According to the Act's preamble, goals of the Act are to ensure an effective and efficient economy, to 'provide for markets in which consumers have access to, and can freely select, the quality and variety of goods and services they desire', and to 'restrain particular trade practices which undermine a competitive economy'. The likelihood of higher retail prices through RPM, which might be contrary to these objectives at first sight, is only one aspect of the Act's aims. There are other potential (pro-competitive) effects of RPM that may be aligned

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[300] Saggers, supra note 286, 14.
[301] Unterhalter, supra note 66, 167.
[302] Cf Saggers, supra note 286, 15.
[303] Areeda/Hovenkamp, supra note 52, 331.
[304] In *Leegin*, supra note 12, 888 the US Supreme Court concluded that RPM does not meet the criteria for per se treatment as it does not always or almost always tend to restrict competition and decrease output.

with the Act's promises, namely product choice, access to market for smaller businesses, and efficiency. Vertical price fixing could, in certain instances, be useful in achieving these objectives.[305]

c. Disadvantages

The rule of reason has some serious disadvantages. Since the rule's content is not specified in detail by law, it is relatively vague, leaving courts and society with little guidance for determining when business practises adjudicated under the rule of reason will be deemed illegal.[306] Also legal uncertainty will accompany a rule of reason since businesses can hardly foresee the lawfulness of a RPM measure. Without doubt, the approach is costly in terms of time as it is more complicated to apply compared to a *per se* prohibition.[307] A rule of reason may also result in higher administrative and error costs.[308]

A major concern against applying a rule of reason standard to RPM results from South Africa's unique market situation. South Africa has a history of highly concentrated markets. Due to long standing habits of central ownership and control, high market concentration has been characteristic especially in heavy industry. But virtual monopolies or oligopolies can also be found in sectors of consumer products.[309] Consequently, there is a significantly higher risk in the highly concentrated South African economy that RPM may facilitate manufacturer and retailer collusion than in other jurisdictions, in particular in the US.[310] Indeed, the market structure in several sectors may particularly support such an abuse of RPM. Also the Preamble to the Act mentions the concentrated nature of the South African economy and the historical reasons for their emergence.[311] The Competition Commission notes that

> *'[…] Strong correlation between industrial concentration and profitability'* [has been observed in South Africa and] *'the 1996 South African manufactur-*

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[305] Saggers, supra note 286, 15.
[306] Richard A. Posner 'The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision' (1977) 45 University of Chicago Law Review, 14.
[307] OECD, supra note 1, 36.
[308] Areeda/Hovenkamp, supra note 52, para 1628b, 332.
[309] E.g. there is a virtual monopoly for beer in South Africa; cf OECD, supra note 1, 10f.
[310] See Heather Irvine, Should the South African Competition Act Impose a Per Se Prohibition on Minimum Resale Price Maintenance?' (2007), Paper for the First Annual Competition Commission, Competition Tribunal and Mandela Institute Conference on Competition Law, Economics and Policy in South Africa, University of the Witwatersrand, 21st May 2007, section 6; Saggers, supra note 286, 15
[311] '[…] apartheid and other discriminatory laws and practices of the past resulted in excessive concentrations of ownership and control within the national economy […]'.

> *ing census reveals that almost 20% of the major sectors are a tight oligopoly […]. At the sub-group level, this increases substantially to about 50%, coming from key sectors like dairy, beverages, textiles, […] and motor vehicles'.*[312]

Irvine emphasizes that the higher risk of facilitating horizontal collusion through RPM in South African markets 'alone might justify the retention of the *per se* prohibition in our [the South African] Act'.[313]

It is obvious that one should not mistakenly assume that foreign approaches on competition law can be incorporated without a problem. Besides highly concentrated markets, there is also a rather high income disparity in South Africa which has to be taken into account. Compared to other countries, a substantial majority of people in South Africa do not yet enjoy wealth. These people, for example, do not benefit from increased intra-brand competition resulting from RPM when they cannot afford the particular product. Furthermore, South Africa's geographical situation must be highlighted. South Africa is distant from many other major markets and production centres,[314] which makes it harder for consumers to buy (cheaper) products sold in neighbouring countries as is possible in many countries within the EU for example. Therefore, in respect to the specifics of the South African economy, the courts have been careful in applying principles from foreign countries, and especially from the US, in South African competition law 'blindly'. The CAC noted relating to an application of the Colgate doctrine that 'great care should be taken before critically applying principles borrowed from the United States or indeed other competition law regimes'.[315]

The former argument can theoretically be rebutted by taking the specifics of South African market structures into account as a factor within the rule of reason analysis.

Another fundamental problem of the rule of reason is its onus of proof.[316] It is extremely difficult for plaintiffs to prove violations under the rule of reason in prac-

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[312] Cf Competition Commission 'Competitiveness and Job Creation: Bedfellows and Enemies' available at http://www.compcom.co.za/assets/Uploads/AttachedFiles/MyDocuments/Dec-04-Newsletter-.pdf.
[313] Irvine, supra note 310, 27.
[314] OECD, supra note 1, 10.
[315] *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission* 33/CAC/Sep03 5.
[316] Unterhalter, supra note 66, 168.

tise since the competitive effects are hard to measure. For example, even if the loss in intra-brand price competition after RPM has been introduced might be relatively easy to prove through higher prices, it will still be challenging for a complainant to prove that this effect is not compensated for by enhanced intra-brand service competition. Proving anti-competitive effect requires more than evidence showing increased prices.[317] *Irvine* notes that in South Africa no case under the rule of reason standard in section 5(1) of the Act was won so far.[318] Therefore, in a rule of reason scenario the burden on a complainant would be greater since it might be harder to win the case compared to a *per se* prohibition case. *Saggers* concludes that the problems with providing evidence 'might discourage complainants from taking up cases'.[319] This difficulty might also support the opinion that a rule of reason standard will have little deterrent effect.[320] Due to the aforementioned problems, some commentators come to the conclusion that judging business practices under the rule of reason is often tantamount to *per se* legality.[321]

It can be concluded that an unstructured rule of reason is not a proper approach to govern RPM, in particular because it is weak in respect of its onus of proof. In particular, practical difficulties in demonstrating anti-competitive harm occur. This danger can be seen as particularly critical in the light of the current concentrated structures in numerous South African markets. Consequently, simply deleting the prohibition of RPM in section 5(2) with the result that the practise would be ruled under section 5(1)'s rule of reason standard is out of the question.

Due to these weaknesses of the general rule of reason, it may be appropriate to adopt an approach that minimises the burden placed on the complainant. Such an alternative approach will be discussed in the next chapter.

3. Compromises

So far it has been shown that South African competition law should move away from a system of prohibiting RPM outright. However, the three blanket positions *per se* prohibition, *per se* legality, and an 'unstructured' rule of reason are not appropriate

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[317] Saggers, supra note 286, 18.
[318] Irvine, supra note 310, 27.
[319] Saggers, supra note 286, 16.
[320] Robert Pitofsky 'The "Sylvania" Case: Antitrust Analysis of Non-Price Vertical Restrictions' (1978) 78 Columbia Law Review, 34ff.
[321] See Areeda/Hovenkamp, supra note 52, para 1628b, 331; *Leegin*, supra note 12, Note 'Leegin's Unexplored "Change in Circumstance": The Internet and Resale Price Maintenance' (2008) 121 Harvard Law Review, 1620.

standards for analysing RPM.A system needs to be found that 'acknowledges the risk, and protects the economy from, anti-competitive RPM, but also allows firms the flexibility to use the policy if there are strong pro-competitive justifications'.[322] A key point is the question of who should bear the onus of proof since it often determines the decision whether a restraint is lawful or not in the individual case. The next subchapters will discuss a number of alternative approaches.

a. Presumptive legality with a rule of reason exception

It may be considered that the Act permits RPM unless the complainant proves anti-competitive harm.[323] Once the complainant has shown certain market facts indicating anti-competitive effect the Competition Commission judges reasonableness under a rule of reason standard.[324]

This approach will probably have a quite similar effect to a *per se* legality standard since proving anti-competitive harm would be very challenging. Furthermore there would be significant legal uncertainty for firms introducing RPM because in a case where a complainant successfully demonstrates anti-competitive harm there is great uncertainty as to whether the defendant in turn can prove offsetting benefits. Applying the rule of reason would be relatively complex, too. As a consequence, firms might hesitate to make use of RPM. Under such circumstances, society could not benefit from possible welfare gains triggered by RPM.

b. Presumptive legality with per se and rule of reason exceptions

Related to the just mentioned approach would be presumptive legality of RPM with *per se* exceptions for downstream and upstream collusion on the one hand, and a rule of reason exception induced by a powerful dealer on the other.[325] However, even if this approach tries to take the different economic effects of RPM into account such a rule would be quite complicated and probably difficult to enforce. Regarding the *per se* rule, it may also be questioned if it captures the circumstances in the single case properly. *Areeda* and *Hovenkamp* provide the example that 'not every group of dealers complaining about a manufacturer or a discounting competitor is fixing prices'.[326] It does not necessarily mean that retailers form a cartel when they act as a group. Therefore, there is also a non-negligible uncertainty with this approach.

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[322] Saggers, supra note 286, 16.
[323] OECD, supra note 1, 13.
[324] Areeda/Hovenkamp, supra note 52, 331.
[325] See ibid. 249.
[326] See ibid.

c. Presumptive illegality with certain defences

Another standard to govern RPM would be to declare RPM illegal and give the complainant the opportunity to demonstrate that anti-competitive effects are unlikely in the concrete situation, or to prove pro-competitive effects.[327] Defences may exist with respect to market effect or market coverage.[328] The defendant may show that only a small number of firms in the market use RPM and that firms using it are so small that no harmful effects could be expected.[329] In addition, defendants may also show offsetting efficiency benefits as justifications, for example that RPM is being used to encourage retailers' services in connection with the introduction of a new and complex product.

This approach's practical significance is quite ambiguous. An argument in its favour is that it may saves enforcement costs compared to an unstructured rule of reason standard. However, the approach has probably the same effect as a uniform *per se* rule. Demonstrating defences and justifications may be very complicated and the experiences with the rule of reason in section 5(1) show that firms often fail to show anti-competitive harm (complainant) and credible efficiency benefits (defendant). Furthermore, declaring RPM illegal does not take into account that the practise can also be benefitting. Such an approach would regularly not answer the question of competitive effects through an analysis of the facts in the individual case but on the basis of the onus of proof. Due to problems with providing sufficient evidence, placing the burden of proof for defences and justifications on the defendant will often be equal to a pre-condemnation.

A comparable approach is practised in European Competition Law. RPM is considered to be a 'hard core restriction' which is presumed to be anti-competitive. Theoretically, the presumption can be rebutted with the proof of offsetting benefits. As shown above, in practice this almost never succeeds.[330]

d. Per se rule with up-front exceptions

Saggers mentions another possible solution for handling RPM under the Act. According to the current system practised in Australia, RPM would still be *per se* illegal, but the opportunity would be given to firms 'to apply to the competition authori-

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[327] See OECD, supra note 1, 13.
[328] Areeda/Hovenkamp, supra note 52, 332.
[329] Ibid.
[330] See B. III. 3.

ties for immunity from prosecution in advance of implementing the policy'.[331] Authorisation for immunity would be granted on the basis of public interest. Firms who want to make use of RPM would have to prove the practises pro-competitive effects in order to get an exemption.[332] This approach's advantage would be that firms with anti-competitive motives would still face the *per se* rule, but these with pro-competitive motives have the chance to use RPM. In addition, the approach would support competition authorities' work since RPM may be better monitored as it is on the public record. *Ex ante* investigation also prevents society from damages that might occur when *ex tunc* investigations would be applied.

However, firms with pro-competitive motives would be disadvantaged under this approach since the onus to prove the facts for the up-front exemptions is with them. Again, firms would face serious difficulties in demonstrating the requirements for authorisation. *Saggers* annotates that this may 'place regulatory and resource hurdles in front of smaller firms and new entrants'.[333] In particular those firms have a greater interest in using RPM, for example because the associated higher profit margins may give retailers the incentive to provide enhanced service regarding the particular product. Furthermore, evaluating authorisations for immunity by reference to public interest means a certain legal uncertainty. Compared to the current *per se* rule, this standard would also mean an increased administrative work for competition authorities.[334]

e. Per se rule with a market power screen

A further solution may be to restrict the scope of application of the *per se* prohibition in section 5(2) to dominant firms.[335] As shown in the previous chapter, anti-competitive effects resulting from RPM predominantly occur when the manufacturer, or retailers in case they have power to induce the manufacturer to introduce RPM, has market power. Declaring RPM illegal only when implemented by a dominant firm allows non-dominant firms, in particular small firms and market entrants, to benefit from RPM.[336] A *per se* rule with a market power screen may also be easier to handle as a rule of reason standard for competition authorities since the analysis is

[331] Saggers, supra note 286, 16.
[332] Ibid.
[333] Ibid.
[334] Ibid.
[335] See ibid. 17.
[336] Ibid.

limited to the determination of market power.[337] Therefore, this approach also comes with a greater predictability for businesses. Nevertheless, these benefits are outweighed by the disadvantage that the complainant would have to show the respondent's dominance which usually requires a 'costly and time-consuming market investigation'.[338] By focussing on dominant firms, this approach might also leave abuses of RPM through non-dominant firms unaddressed.[339] *Fiala* and *Westrich* note that 'If a small number of manufacturers together make up a very large share of the market, it is more likely that they will be able to use RPM to facilitate horizontal collusion'.[340]

f. Safe Harbour approach

Adopting the (unstructured) rule of reason burdens competition authorities with a complex and costly evaluation of the facts and circumstances in the individual case, which ties up resources. Under this standard, private parties also face legal uncertainty about the reasonableness of any particular instance of RPM. Remedy could be provided through so called 'safe harbours'. Situations in which it is unlikely that RPM is harming competition would be declared as 'safe harbours', automatically allowing the conduct in question. In consequence, affected firms could make use of the practice without applying for authorisation. For example, a 'safe harbour' might exist for cases in which the defendant does not exceed a certain threshold of market share. In the European Union, the Vertical Block exemption provides such 'safe harbours' for non-blacklisted vertical practices when the supplier has a market share below 30 per cent.[341] However, RPM is not covered by the Vertical Block Exemption as it is blacklisted as a 'hard-core restraint'.[342]

The 'safe harbour' approach is weak in respect of conduct by firms with a market share below the threshold. Even if RPM will probably have an anti-competitive effect more often when it is used by firms with market power, it cannot be assumed that there would be no anti-competitive effect at all under these circumstances. For example, market-share orientated threshold would give RPM instigated

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[337] Saggers, supra note 286, 17.
[338] Ibid.
[339] Ibid. 17 referring to Marie L. Fiala and Scott A. Westrich 'Leegin Creative Leather Products: What does the new rule of reason standard mean for Resale Price Maintenance claims?' (2007) Antitrust Source, 4, available at http://www.abanet.org/antitrust/at-source/07/08/Aug07-Westrich8-6f.pdf (August 2007).
[340] Fiala/Westrich, supra note 339, 4.
[341] Article 3 Vertical Block Exemption.
[342] Article 4(a) Vertical Block Exemption.

by retailers a 'safe harbour' because the affected manufacturer's market share will most likely not exceed the threshold, since otherwise the retailers would not have the power to initiate RPM.[343] Therefore, this approach would lead to significant protection gaps.

g. Comanor and Scherer approach

The approach brought forward by *Comanor* and *Scherer*[344] in their amicus brief in the *Leegin* case is strongly guided by the economic realities of RPM. The approach provides differential treatment for RPM induced by manufacturers and RPM induced by retailers. As the former may have different competitive effects it would be ruled under a rule of reason. Under the rule of reason the analysis should be abbreviated through two thresholds. The first threshold is to be a volume of more than 50 per cent resale-price-maintained sales in the relevant market. The second threshold is met when the defendant's RPM sales add at least 10 per cent to the volume of overall RPM-sales. When both thresholds are met, a *per se* illegality standard shall displace the rule of reason. RPM would be presumed to be illegal unless the defendant successfully rebuts the presumption. In contrast, RPM induced by retailers would be *per se* illegal from the start 'because there are no arguments in economic analysis supporting restraints arising from distributor actions or pressures'.[345] But defendants would be given the opportunity to prove anti-competitive effect.

In regard to manufacturers' RPM, this approach may speed up procedures by imposing rebuttable presumptions of illegality in certain situations, which frequently have anti-competitive effects.[346] It also reduces legal uncertainty and is less costly to administer compared to an 'unstructured' rule of reason. Judicial economy may also be strengthened since complainants would probably more often bring cases with structural features forward that fall under the rule of *per se* illegality.[347] However, there is the risk that the approach reduces the number of arising cases to those in which the rule of presumptive illegality applies. Cases where the thresholds are not met still have to be judged under the rule of reason standard. But higher costs, higher risk, and time-consuming investigations may deter firms from bringing forward claims under this standard. Furthermore the approach focuses strongly on structural

[343] See OECD, supra note 1, 46.
[344] William Comanor and Frederic M. Scherer, Amicus Brief *in Leegin Creative Leather Products v. PSKS, Inc.*, 2006 U.S. Briefs 480 (22 January 2007).
[345] Comanor/Scherer, supra note 344, 8.
[346] OECD, supra note 1, 47.
[347] See ibid. 47.

factors and broadly ignores non-structural factors such as the source of the restraint. Therefore, the approach would be rather one-sided in practise.

h. 'Structured' rule of reason

Probably the clearest guidance on how a rule of reason standard could be simplified to make it more practical is provided by the 'structured' rule of reason given by *Varney*. The approach takes into account various elements, both pro- and anti-competitive, in RPM agreements and evaluates them in practical terms in particular with the use of legal presumptions.

Varney suggests the following 'matrix' to govern RPM: First, the complainant would be required to make a *prima facie* showing (a) that an RPM-agreement exists and (b) 'the presence of certain structural conditions under which RPM is likely to be anti-competitive'.[348] If the plaintiffs succeed in proving these two points then a *prima facie* case that RPM is unlawful would be given. As a consequence upon a sufficient showing for such a *prima facie* case, the burden of proof shifts to the defendant to justify the arrangement. Now, the defendant has the opportunity to prove either the actual pro-competitive usage of the practise or that the complainant's characterization of the marketplace was erroneous. *Varney* notes that "in all events, the defendant's burden should be commensurate with the strength of the showing made by the plaintiff".[349]

The *prima facie* cases are developed from four generally acknowledged scenarios where the use of RPM might be anti-competitive. In these situations, RPM would be *prima facie* presumed to be illegal and, therefore, the burden of justifying the RPM practise as pro-competitive would be imposed on the defendant. The 'structured rule of reason' under discussion would be applied to manufacturer collusion, manufacturer exclusion, retailer collusion, and retailer exclusion.

(1) RPM might be a means for members of a manufacturer cartel to identify other members who are cheating on a price-fixing agreement (manufacturer collusion theory).[350] According to *Varney*, a *prima facie* case would consist under these circumstances when '(i) a majority of sales in the market are covered by RPM, (ii) structural conditions are conducive to price coordination […], and (iii) RPM plausi-

[348] Christine A. Varney 'A Post-Leegin Approach to Resale Price Maintenance Using a Structured Rule of Reason' (2009) 24 Antitrust, 22ff.
[349] Varney, supra note 348, 22.
[350] See C. I. 2. a. (1).

bly helps significantly to identify cheating'.[351] This is based on the assumption that unless the use of RPM does not cover the majority of sales in a market, RPM cannot work as an effective detection mechanism. Furthermore, manufacturer collusion will be unlikely when the upstream market is not strongly concentrated. The same applies when wholesale prices are transparent. In contrast, the lack of wholesale price transparency would "suffice to show that RPM plausibly could facilitate manufacturer collusion".[352]

(2) Dominant manufacturers might want to discourage retailers from carrying products of (smaller) rivals or new entrants by guaranteeing larger RPM-margins (*manufacturer exclusion theory*). In this situation, a *prima facie* case would require a showing that (i) the manufacturer is dominant, (ii) the manufacturer's RPM agreements cover a "substantial portion" of distribution outlets to result in material foreclosure, and (iii) RPM "plausibly has a significant foreclosure effect that impacted an actual rival".[353] The last criterion requires showing that the alleged harm is actually anti-competitive.[354] *Varney* explains that RPM is unlikely to be capable of having a material foreclosure effect when the first two elements are not met, since retailers would simply shift to rival manufacturers' products. The third element should provide some practical evidence that at least one particular rival is being foreclosed in the individual case in order to show that manufacturer exclusion is not only a theoretical concern.[355]

(3) Pro-competitive justifications are unlikely when RPM is imposed by retailers in order to facilitate a retailer cartel (*retailer collusion theory*). In this situation, a *prima facie* showing should focus on the evidence that "retailer coercion was responsible for RPM".[356] When RPM is being used as a cartelization device this might be identified when (i) "RPM is used pervasively, namely with respect to at least 50 per cent of the sales in the market, (ii) that RPM "was instituted as a result of coercion by retailers" and not merely one of "persuasion", and (iii) that "retailer collusion plausibly could not be thwarted by manufacturers". *Varney* notes that retailer collusion is unlikely to be substantially facilitated when the first requirement is not fulfilled. The third element should assure that the manufacturer could not easily

[351] Varney, supra note 348, 24ff.
[352] Ibid. 24.
[353] Ibid.
[354] Ibid.
[355] Ibid.
[356] Ibid.

avoid the power of certain retailers by integrating into retailing or sponsoring new retailers. This element might be met in situations of "extensive reliance on well-established retailers carrying the products of many manufacturers".[357]

(4) The last scenario for a *prima facie* case concerns retailer driven RPM. Especially a dominant retailer might coerce manufacturers to establish RPM and thereby to cease price-competition and new distribution channels to protect itself from new competition by retailers with better distribution systems and lower cost structures (retailer exclusion). A *prima facie* case might be established by showing that (i) the retailer(s) involved had sufficient market power to coerce manufacturers, (ii) this resulted in RPM covering "much of" the market (at least 30 per cent), and (iii) RPM "plausibly has significant exclusionary effect".[358] *Varney* notes that only when (i) and (ii) are given, has RPM the potential to exclude.[359] Retailer exclusion is not unlikely when the retailer uses market power and coercion to force manufacturers with a significant overall market share to introduce RPM. The last criterion should assure the practical significance of an exclusionary situation.

Varney's approach leave some questions unanswered. It remains unclear when a "dominant market position", a "significant foreclosure effect", or a "significant exclusionary effect" may appear. What is also not defined is the line between "persuasion" and "coercion".[360]

However, this "structured" rule of reason is to be advocated as it provides a clear framework to evaluate RPM claims. Its advantage is that it is concise and clear. Therefore it might be much more manageable for courts, competition authorities and undertakings concerned. It is also sensitive to the underlying economic theories (and -if any- empirical observations), but without being too theoretical and complex. Parties get relatively clear guidance on how to apply the rule of reason. But even if it kept simple, *Varney's* rule of reason might sufficiently cover scenarios in which RPM might be used to create or maintain manufacturers' or retailers' market power without serving any legitimate business purposes. By shifting the burden of proof in consequence of the existence of a *prima facie* case, the approach is also fair in regard to the usually high hurdle for complainants to prove the unlawfulness of an agree-

[357] Varney, supra note 348, 25.
[358] Ibid.
[359] Ibid.
[360] However, due to the CAC's broad definition of the term 'practice', this point is settled and therefore of minor significance in the context of South African competition law; see *Federal Mogul Aftermarket Southern Africa (Pty) Ltd v Competition Commission* 33/CAC/Sep03 9.

ment. Once it has been shown that a "structured" rule of reason should be applied to RPM, the question occurs how this can be implemented.

4. Amendment of the Act

Incorporating a "structured" rule of reason into South African competition law would necessarily mean to amend the Act. The wording in section 5(2) of the Act currently precludes an application of this approach. Even if section 5(2) were repealed, it would hardly be possible to rule RPM under the standard preferred here. Without the *per se* prohibition in section 5(2), RPM would be covered by section 5(1). The rule of reason's wording expressly requires plaintiffs to prove actual anti-competitive effect. This fact cannot be ignored when addressing a "structured" rule of reason to RPM. Practically, there is no scope in the Act for such an approach to be incorporated simply though a wide interpretation of section 5(1) or accompanying guidelines which provide instruction on how to apply the "structured" rule of reason. Instead, such a fundamental change in the law necessarily requires a (solid) legislative basis in the form of a separate statutory regulation

However, this does not mean that the Act has to be amended right away. It would also be possible to await the outcome of the first experiences without a *per se* ban on RPM in the US. The practical approaches on how to apply a rule of reason which have to be developed now, might give helpful advice on how to handle a more economic based approach in practise. It might also be interesting to see if there will be also a fundamental paradigm change in the EU following indirectly from *Leegin*.

Therefore, South Africa would be well advised to amend the Act in general, but only at a time when reliable evidence from other jurisdictions on the practical side is available.

D. Conclusion

This thesis comes to the conclusion that section 5(2) of the Act should be amended by incorporating a structured rule of reason for cases of RPM, even if not immediately.

The current rule in section 5(2) of the Act is misguided because it is not aligned with the potential economic effects of RPM. Currently there is no perfect harmony between economic insights and competition law: RPM can have signifi-

cantly different economic effects, either pro-competitive or anti-competitive. Its effects cannot be generalised to assume that RPM always leads to higher prices.

The two strongest points in favour of RPM are that it could promote inter-brand competition through increased demand for a manufacturer's products resulting from better services offered to customers and that it might help to mitigate the adverse effects of free-riding. More limited potential pro-competitive effects of RPM are that it may help to preserve the so-called certification effect, that it helps to promote market entry and that it enhances the demand for certain products, especially luxury products. It may also help to manage demand uncertainty, help to increase retailers' sales efforts, and discipline retailers who fail to provide the desired services to their customers. Comparatively weak, however, is the loss leader argument since manufacturers can easily avoid having their products carried as a loss leader by less drastic means than RPM.

RPM's alleged primary anti-competitive effect is that it leads to higher consumer prices due to a loss of intra-brand price competition. But, this negative effect on consumer welfare might be outweighed by increased intra-brand non-price competition or further efficiency benefits. Potential anti-competitive effects are that RPM might help to facilitate manufacturer or retailer collusion. It might also lead to situations of market foreclosure aligned with a softening of price competition. RPM might also solve a dominant manufacturer's *commitment problem*.

Nevertheless, the analysis has shown that such theories on RPM's negative effects have significant weaknesses and negative effects are more likely only under certain market conditions.

A general problem is that there is a lack of empirical evidence on RPM's economic effects. From an empirical point of view it is unclear how frequent RPM can have anti-competitive or pro-competitive effects. On the other hand, there are also no empirical reason for treating RPM as a *per se* violation.

On the practical side, it has been seen that it is not possible to simply incorporate foreign approaches into South African competition law. With respect to the competition authorities, limited resources for investigations at a certain level and the fact that especially the Competition Commission is a new and therefore quite inexperienced (e.g. compared to the FTC) agency, the current *per se* rule's advantage is that it is easy to administer and less costly to apply than a rule of reason approach. From a competition authorities' perspective where the onus of proof lies is the fundamental

factor about the current *per se* approach since it appears to be quite adequate not having to prove the anti-competitive effect.

However, the current *per se* rule does not allow a fact based analysis of RPM's real effects in the individual case since it does not distinguish between harmful and harmless usages of RPM. Since RPM may have positive effects on competition the *per se* rule cannot be defended on theoretical grounds. The *per se* rule would only be an appropriate means when RPM is anti-competitive virtually in every instance, which is definitely not the case. Therefore, applying the *per se* rule may cause inefficiencies and over-enforcement so that situations where RPM has no harmful effects result in a liability under the Act.

Consequently, it becomes clear that the legal framework for analysing RPM under the Act should be revised. As it was also emphasized by the US Supreme Court in its fundamental *Leegin* decision in 2007, the application of a rule of reason approach generally responds better to the nature and possible effects of RPM. But the application of an unstructured rule of reason would be aligned with its major disadvantage, that demonstrating anti-competitive harm is, in practise, so difficult that its application would amount to governing RPM by a rule of *per se* legality. In this respect, no case has been won so far under section 5(1)'s rule of reason. In addition, as its requirements are quite unclear the rule of reason would result in significant legal uncertainty. It would also be aligned with higher administrative and error costs.

Against this background, a structured rule of reason seems to be the most appropriate method of dealing with cases of RPM in South African Competition Law since it is the midway between *per se* illegality and an unstructured rule of reason. It would minimise the burden placed on the complainant. The rule of reason would be simplified such that in situations in which anti-competitive effects are likely legal presumptions apply. Therefore, the onus of proof for the complainant is limited to the showing of a *prima facie* case in which RPM is unlawful. Such a *prima facie* showing contains two points, the existence of an agreement and the presence of certain market conditions. Even if the complainant shows a *prima facie* case successfully, the defendant may still justify the usage of RPM by showing its pro-competitive effects or by rebutting the complainant's definition of the relevant market. The *prima facie* cases would be defined in regards scenarios, in which RPM is most likely to be harmful. Criteria for the *prima facie* cases could be taken from the scenarios provid-

ed by *Varney* in respect to manufacturer and retailer collusion and manufacturer and retailer exclusion.

One might argue that different economic conditions underlie South Africa's competition law and that therefore findings from other jurisdictions like the US and especially from the *Leegin* decision should not be transferred. This is probably true with regard to the higher levels of concentration in certain industry sectors. Nevertheless, a rule of reason standard may take such conditions into account. Rather findings from other major competition law regimes such as the US could function as a role model when it comes to questions on how to improve national completion law in consequence of changing views in the underlying economic theory. In this regard it should also be taken into account that divergent standards among competition law regimes in the field of RPM may bring about inefficiencies, in particular for international businesses.[361] This may also lessen the legitimacy of competition law enforcement in general.[362]

However there is no need to act hastily. South Africa's historically highly concentrated markets require special attention as we have seen that vertical restraints are only problematic where there is market concentration and market power. Here the negative effects of RPM may be particularly serious. In an economy where markets show those features, shifting from a *per se* approach to a structured rule of reason must be implemented very carefully. Instead of amending the Act immediately, it therefore makes sense that South African law makers should wait for experiences from other countries before the Act is amended. The amendment itself requires a legislative amendment by incorporating an entirely new rule for RPM which replace the current prohibition in section 5(2) of the Act.

[Words: 22,511 (26,087 incl. footnotes)]

[361] OECD, BIAC, 258.
[362] Ibid.

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