COMPETITION BETWEEN ESTABLISHED DISTRIBUTORS AND INTERNET RETAILERS: SOME ANTITRUST CONCERNS

William S. Comanor
University of California
Santa Barbara and Los Angeles

June 22, 2011

Presentation at American Antitrust Institute
Symposium on Antitrust Challenges of
Multi-Channel Distribution

Structure of Retailing (1)

- Because there are generally a large number of rivals, many lawyers and economists treat this sector as perfectly competitive.
  - in that case, there would be fewer antitrust concerns.
  - exclusionary actions would not generally have price effects.
- That picture overly simplifies the economics of the distribution sector.
  - a more nuanced picture emerges from the work of Robert Steiner.*
- The function of retailing is not merely as the final point in the distribution process, but also to provide necessary advice and product information to consumers.

* See especially Robert L. Steiner, "The Nature of Vertical Restraints," The Antitrust Bulletin, Vol. XXX, Spring 1985.

Structure of Retailing (2)

- Retail establishments are differentiated by their sales forces and the image and reputation of the store.
  - critical issue is manner by which product information is provided.
- A robust relationship is the inverse association between a brand's popularity and its retail margin.
  - brand popularity often follows from the extent of manufacturing advertising.

Structure of Retailing (3)

- Highly popular brands can enforce low retail margins; less popular brands and generic commodities permit much higher margins.
- Private label products and store brands tend to have relatively high margins.
- Critical distinction is who provides consumer advice and product information: manufacturers through advertising or retailers through direct contact and services.

Effects on Competition in Retailing

- Intensity of intra-brand competition varies greatly among items. It is influenced by consumers' preferences for specific brands.
- Intra-brand competition cannot be equated with retail competition since most retailers sell a vast array of brands and items.
- Some retailers can dominate a particular class of products, particularly in specific geographic areas.
- But dominance can be threatened by "intertype competition." * New forms of retailing typically offer a different assortment of services and frequently have lower costs.

* This term was introduced in J. Palmountain, The Politics of Distribution, 1968.

Significance of Intertype Competition

- Major innovations in distribution have typically been embodied in new retailing institutions.
  - department stores and mail-order houses of mid-19^{th} century
  - chain stores in the early 20^{th} century
  - supermarkets and discount houses mid-20^{th} century
  - super stores in late 20^{th} century
- And the growth of internet retailers in the past 20 years.
- All of these innovations have limited the prospects of older retailing institutions and led to efforts to limit their impact. That is also true of the internet revolution.

Free Rider Issues

- Recent attacks on internet retailers are similar to the charges levied earlier at discount houses.
  - their lower prices were ascribed to their avoidance of costs incurred by traditional stores for services on which the discounters could free ride.
  - consumers would receive selling and information services at traditional stores, without paying for them, and then purchase the product at a lower price from a discounter.
- Free Riding was presumed to harm manufacturers who relied on the distribution services of their distributors to enhance their selling efforts.

Internet Retailing and Free Riding (1)

- Internet retailers often charge lower prices than conventional retailers.
  - Study of books and CDs sold in 1998/1999 finds lower internet prices of $2.16 per book and $2.50 per CD than conventional retailers on average. *
- New technology permits lower costs despite their providing broader and deeper assortments of goods. It also permits new means for providing product information to consumers.
- Does the new technology lead to consumers' free riding on services provided by conventional stores when they purchase from internet retailers?

* R. R. Betancourt, The Economics of Retailing and Distribution, 2004, p. 103.

Internet Retailing and Free Riding (2)

- The Free Riding story requires that consumers first inspect the product and gain price and quality information at conventional retailers, and then afterwards purchase the product at a lower price from an internet retailer.
- However, often their information-gathering activities go the other way:
  - "Online shopping…ha[s] changed the way people shop. Even consumers who do not buy online, often look online before going to the storefront to purchase products." *
- More consistent with free riding on internet services than the opposite.

* Harvard Law Review, Vol. 121, 2008, p. 1614.

Market Reactions of Conventional Retailers

- Internet retailers represent a threat to conventional retailers. The question for them is how to respond.
- An expected response is for large conventional retailers to pressure suppliers not to sell to internet retailers in any case, or alternatively not to do so if they undercut existing price levels.
  - pressure takes the forms either of an exclusive dealing arrangement or of resale price maintenance.
- Form of the restraint is less important than its result: to reduce sales made by lower priced, internet retailers and maintain sales made by established retailers at higher prices.
- The purpose of the restraint is to limit the impact of the internet revolution in retailing.

Antitrust Treatment of This Restraint

- This issue addressed directly by the U.S. Supreme Court in its 2007 Leegin decision. *
  - "A dominant retailer, for example, might request resale price maintenance to forestall innovation that decreases cost. A manufacturer might consider it has little choice but to accommodate the retailer's demand for vertical price restraints if the manufacturer believes it needs access to the retailer's distribution network." (p. 2717)
- The Court continued:
  - "The manufacturer does not establish the practice to stimulate services or to promote its brand" but rather " supports a dominant, inefficient retailer." (pp. 2717, 2719)

* Leegin Creative Leather Products v. PSKS, 127 S Ct. 2705 (2007).

The "Babies R Us" (BRU) Case (1)

- First case brought on these issues following the Leegin decision.
  - a class action brought against BRU and various suppliers of certain baby products for enforcing Resale Price Maintenance (RPM).
  - the RPM scheme was designed primarily to protect BRU from the competition of internet retailers.
- BRU was the dominant re-seller of various "high-end" baby products. These brands were highly advertised with considerable consumer acceptance.
- Other large retailers such as Wal-Mart, Sears and Target did not distribute these brands but emphasized more generic products.
- Some internet retailers began to sell substantial quantities of these "high-end" brands at lower prices.

The “Babies R Us” (BRU) Case (2)

- In response, BRU pressured its suppliers to impose or enforce RPM restraints.
  - internet prices increased and their sales of these brands declined. The Judge found that “the restraints caused higher prices.” (p. 35)
- The Defendants raised the Free Rider issue.
  - in response, the Judge referred to evidence that 33% of mothers buy these products online and another 61% research such products online before shopping at conventional stores. (p. 36)
  - if anything, BRU benefited from free riders, not the other way around.
- These findings were made in the context of class certification proceedings in which the class of final consumers was certified.
  - and the case eventually was settled.

Conclusions

- The BRU case dealt directly with intertype competition between established distributors and internet retailers.
- Antitrust intervention was needed to maintain the active presence of independent internet retailers.
- The analysis contained in the Supreme Court’s <u>Leegin</u> decision proved important for this outcome.
- The gains to consumers from internet distribution were promoted by the outcome of the BRU case.