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### Abstract

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# Retail Price MFNs: Are they RPM 'at its worst'?<sup>1</sup>

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## Abstract:

A number of recent cases have involved a hitherto rarely observed form of Most Favoured Nation clauses in which sellers through an internet retail platform agree not to sell at a lower price elsewhere, including through other retail platforms. We first note that such Retail Price MFN clauses rely on some form of RPM for their existence. We then argue that much of the existing academic literature and case law on RPM effectively combines two elements of RPM, an explicit (and inherent) vertical element and a more implicit horizontal element, the latter being particularly egregious in terms of anticompetitive harm. As retail price MFN clauses essentially mimic this latter, and worst, element of the RPM, we finally argue that such clauses should be treated no less harshly than RPM under competition law.

Key words: Most Favoured Nation clauses; Resale Price Maintenance.

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<sup>1</sup> Funding through ESRC is gratefully acknowledged. Amelia Fletcher was Chief Economist at the UK Office of Fair Trading until March 2013, and was involved in both OFT cases relating to Retail Price MFNs described below. For a period, she led the case relating to online hotel booking. This paper, however, relies purely on information already in the public domain. We would like to thank Greg Shaffer, Paul Dobson, Matthew Bennett and Tony Curzon-Price for helpful comments on the paper. Earlier versions of this paper have been presented at the Antitrust Law Journal symposium on European Competition Law at Leuphana University, Lüneburg; the ESRC Centre for Competition Policy at University of East Anglia; Dusseldorf Institute for Competition Economics; and at economic consultancies Compass Lexecon and Charles River Associates, London. We thank all participants for their comments. The opinions expressed in this paper and all remaining errors are those of the authors alone.

<sup>2</sup> <http://business.uea.ac.uk/people/amelia-fletcher> and <http://www.uea.ac.uk/law/people/profile/m-hviid>.

## 1. Introduction

When Apple launched the iPad in 2010, its then CEO Steve Jobs was quizzed on camera about the price of e-books to be sold through the device's iBooks application. Why would someone buy a book from Apple for \$14.99 if the same book was offered for \$9.99 from (its key competitor) Amazon? Steve Jobs response: "Well, that won't be the case .... The price will be the same".<sup>3</sup>

How could he be so sure? It emerged that this was a contractual condition imposed by Apple on the book publishers; a form of Most Favoured Nation (or MFN) clause requiring that the publishers priced their ebooks no higher on Apple's iBook platform than they were priced on other online platforms. In commitments signed with the European Commission, Apple has now agreed to remove these terms from its contracts in the EU.<sup>4</sup> The same has also been required in the US (albeit this judgment is subject to appeal).<sup>5</sup>

A similar 'price parity' condition has also been dropped across Europe by major internet retailer Amazon, in the face of antitrust concerns. The clause in question was imposed on traders selling through the online retail platform, Amazon Marketplace. It required that a trader could not sell a product, including the delivery charge, for a lower price on its own website or on another retail platform such as eBay or play.com. Amazon had stated this rule was "critical to preserve fairness for Amazon customers" who expect to find low prices on Amazon Marketplace.<sup>6</sup> The UK competition authority, the Office of Fair Trading (OFT), was not persuaded. It closed its investigation into the clause only after it had been dropped.<sup>7</sup>

Authority interest in such clauses does not stop there. The OFT is currently consulting on commitments offered in respect of a similar case involving the online travel agents Expedia

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<sup>3</sup> See <http://allthingsd.com/20100128/boomtowns-apple-ipad-day-starring-walt-mossberg-plus-a-steve-jobs-cameo/>

<sup>4</sup> Commission decision C(2012) 9288; Case COMP/AT.39847-E-BOOKS. Text at: [http://ec.europa.eu/competition/antitrust/cases/dec\\_docs/39847/39847\\_26804\\_4.pdf](http://ec.europa.eu/competition/antitrust/cases/dec_docs/39847/39847_26804_4.pdf)

<sup>5</sup> <http://www.nysd.uscourts.gov/cases/show.php?db=special&id=325> [Need to add reference in proper legal form!]

<sup>6</sup> <http://www.amazonstrategies.com/2012/08/amazons-price-parity-warnings-suspensions-and-reinstatements-.html>

<sup>7</sup> See OFT press release (29 August 2013): [http://www.oft.gov.uk/news-and-updates/press/2013/60-13#.Umj2\\_PmSwTk](http://www.oft.gov.uk/news-and-updates/press/2013/60-13#.Umj2_PmSwTk). The German competition authority, the Bundeskartellamt, has since also dropped its own case against the same clause. See press statement: [http://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2013/26\\_11\\_2013\\_Amazon-Verfahrenseinstellung.html](http://www.bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2013/26_11_2013_Amazon-Verfahrenseinstellung.html).

and Booking.com and their activities in the online market for hotel booking. This followed a complaint by small online travel agency Skoosh. Due to the MFN conditions imposed on hotels by these online travel agents, Skoosh was unable to reduce its own commission and thereby offer discounted hotel rooms on its website. Skoosh claimed that this harmed its ability to build a presence in the market and enhance competition, as well as harming customers.<sup>8</sup> In addition, the UK Competition Commission has raised concerns about the use of such clauses in respect of sales of private motor insurance through online price comparison websites (which can be seen as a form of online retail platform).<sup>9</sup>

These various cases, on both sides of the Atlantic, all involve a hitherto rarely observed form of Most Favoured Nation, or MFN clause, which we term Retail Price MFN clauses, to distinguish them from the more standard wholesale price MFN clauses. Since these clauses have primarily arisen in the context of online retail platforms, they are also sometimes known as platform MFNs or platform parities. The essence of the restriction involved is clear from the cases already described; they occur in situations where suppliers set final retail prices, rather than retailers, and they require suppliers not to offer lower final retail prices through any other retailer.

The economic literature on these clauses is still nascent. Nevertheless, it seems that the authorities have been willing to take on cases, and push them towards successful conclusion, with the parties either agreeing, or being required, to drop Retail Price MFN clauses. So why do these clauses create such concern?

In this paper, we do not seek to provide a detailed formal model of these clauses. Rather we set out the key intuitions underlying findings from modelling work set out elsewhere and in particular Boik and Corts (2013) and Foros, Kind and Shaffer (2013).<sup>10</sup> This work identifies three potential anti-competitive effects arising from Retail Price MFNs: they act to soften competition between retailers on the margin they charge to suppliers, they can restrict entry at the retailer level, and – in a market with asymmetric business formats where some

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<sup>8</sup> For one of many statements by Skoosh Director Dorian Harris on this subject, see <http://dorian.skoosh.com/open-letter-to-william-baer-arnold-porter-llp/>

<sup>9</sup> Competition Commission (2013) “Private Motor Insurance Market Investigation: Provisional Findings Report”, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131217\\_summary.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131217_summary.pdf).

<sup>10</sup> Boik, A. and K. S. Corts (2013) “The Effects of Platform MFNs on Competition and Entry”, [http://individual.utoronto.ca/andreboik/BoikCorts\(MFN\).pdf](http://individual.utoronto.ca/andreboik/BoikCorts(MFN).pdf); Foros, Ø., H.J. Kind and G. Shaffer (2013) “Turning the Page on Business Formats for Digital Platforms: Does Apple’s Agency Model Soften Competition?”, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2317715](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2317715).

retailers set their own prices – they can act to eliminate price competition at the retail level such that prices are set as if there were industry-wide RPM.

We then examine the relationship between Retail Price MFNs and more standard Resale Price Maintenance (RPM), on which there is a wider and more established economic literature and body of case law. We observe that Retail Price MFNs rely on some form of RPM for their existence. As is clear from the above, they can only work if suppliers set prices, rather than the platform or retailer. More importantly, however, we highlight that RPM can properly be distinguished into two elements. First there is the vertical element, whereby an upstream firm sets final downstream retail prices. This is the pure and explicit element of RPM. Second, there is a horizontal element, sometimes incorporated more implicitly, but standard within RPM as we typically observe it in actual cases, whereby the upstream firm sets identical retail prices across all downstream intermediaries/retailers.

We note that this horizontal element of RPM functions in a very similar way to Retail Price MFNs. As such, this wider literature may provide a useful guide to further anti-competitive effects that might be expected to arise from Retail Price MFNs, albeit they have not yet been analysed formally in this context.

We then note that much of the academic literature on the anticompetitive effects of RPM, and indeed much existing case law on RPM, effectively combines both vertical and horizontal elements of RPM. They can, however, be separated conceptually and once this is done it becomes clear that many of the most egregious concerns arising from RPM cases relate to the horizontal element. The vertical element of RPM is, in itself, of relatively less concern.

On this basis, we argue that Retail Price MFNs can be seen equivalent to the ‘worst’ of RPM. There is an ongoing policy debate about the appropriate legal treatment of RPM. In Europe, it is seen as an infringement of Article 101(1) TFEU *by object*, which essentially means it can be presumed harmful, without the authority needing to demonstrate any anticompetitive effect. The burden of proof is instead on the alleged infringers to demonstrate that the RPM has efficiency benefits which satisfy the conditions in Article 101(3) TFEU. In the US, RPM was viewed as a *per se* infringement until the well-known *Leegin* case<sup>11</sup>. While RPM is now subject to the *rule of reason* approach at Federal level in the US, many still consider that

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<sup>11</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007).

there should be a strong presumption that RPM is harmful, and there is significant variation across antitrust laws at the state level.

There is also an ongoing debate about the proper scope of RPM law. Many of the current cases relating to Retail Price MFNs involve internet retail platforms, which are in some ways different from standard retailers, and could even be argued not to be downstream at all, such that RPM does not occur when suppliers through these platforms set prices. We do not opine in this paper on the scope of RPM or where the appropriate policy line should be drawn on RPM.<sup>12</sup> However, we note that the effects of Retail Price MFNs are broadly the same whether or not RPM is technically involved. Moreover, wherever the policy line on RPM is drawn, we argue that Retail Price MFN clauses should not be treated any less harshly, since they work very similarly to the more problematic horizontal element of RPM.

In the remainder of this paper, we begin by setting out what we mean by Retail Price MFN clauses (Section 2). We then summarise the key conclusions and intuitions within the nascent economic literature in this area (Section 3). We also highlight in this section that, in terms of the economic analysis, such clauses can be viewed as formally identical to another type of price relativity clause which does not require RPM. Under this alternative price relativity clause, retailers set final retail prices but are required to set these retail prices such that the product covered by the clause is priced no higher than are competing products. Such clauses were previously observed in the UK Monopolies and Mergers Commission (MMC) investigation into foreign package holidays (1997).<sup>13</sup> They were also alleged in the UK OFT's decision on tobacco (2010)<sup>14</sup> and appear to be currently part of an ongoing European Commission investigation into Apple's distribution contracts for the iPhone.<sup>15</sup>

We go on to consider the relationship between Retail Price MFN clauses and RPM (Section 4). After looking briefly at the potential efficiency benefits arising from RPM (Section 5), in which we again consider the extent to which distinct efficiencies may be expected to arise from the horizontal and vertical elements of RPM, we then provide a view on the

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<sup>12</sup> This issue is addressed in in Bennett, M, A. Fletcher, E. Giovannetti and D. Stallibrass (2010) "Resale Price Maintenance: Explaining the Controversy, and Small Steps towards a More Nuanced Policy", *Fordham International Law Journal*, Vol 33-4, pp 1278-1299.

<sup>13</sup> 'Foreign package holidays: A report on the supply in the UK of tour operators' services and travel agents' services in relation to foreign package holidays' Cm 3813 (19.12.1997).

<sup>14</sup> Although it should be noted that this decision has since been overturned. For the original OFT Decision, see: [http://www.of.gov.uk/shared\\_of/ca98\\_public\\_register/decisions/tobacco.pdf](http://www.of.gov.uk/shared_of/ca98_public_register/decisions/tobacco.pdf). For Competition Appeals Tribunal judgment overturning the decision, see: <http://www.catribunal.org.uk/167-7403/Judgment.html>.

<sup>15</sup> See <http://www.ibtimes.co.uk/apple-iphone-distribution-deals-investigated-eu-commission-471821>.

appropriate relative treatment under competition law of these two forms of agreement (Section 6).

## 2. What do we mean by Retail Price MFN Clauses?

In a standard retail model, suppliers do not set final retail prices. Rather they sell their products or services at wholesale prices to a downstream retailer and then leave it up to the retailer to set final retail prices. The retailer is remunerated for its own services through the difference between retail and wholesale prices. In some situations, however, suppliers themselves set final retail prices and then pay the retailer directly for its services. This has been the standard business model for online retail platforms such as Ebay or Amazon marketplace. It can also occur in an offline environment where suppliers sell through downstream agents, or more generally where suppliers engage in RPM. It is only when suppliers do set final retail prices in this way that Retail Price MFN Clauses can exist.<sup>16</sup>

Perhaps surprisingly, from a consumer perspective, either variant of such a clause may look like a ‘best price promise’, whereby a retailer promises consumers that they won’t find cheaper prices anywhere else in the market. Consider for example the claim offered by one UK department store, John Lewis, that it will be ‘never knowingly undersold’.<sup>17</sup> Some of the online platforms involved in the antitrust cases described in the following section have made claims of exactly this sort to consumers. Such ‘best price promises’ are often offered

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<sup>16</sup> There are in fact three possible subtle variants of Retail Price MFNs clauses. The first *wide* variant, which is the focus within most of this paper, requires of the price-setting supplier that it must not sell at a lower retail price anywhere else than it does through the retailer with which it has the Retail Price MFN agreement. Clearly the supplier cannot guarantee this unless it controls retail prices everywhere its product is sold. A second variant is narrower in that it requires of the supplier only that, wherever it does set retail prices, it must ensure that these are no higher than the lowest available on the market. Under this variant, the supplier need not control the retail price of its product everywhere that it is sold, but it must be in a position to ensure that, for those retailers where it does set prices and where this clause applies, it can match the lowest available prices. In practice, and as is shown by Foros, Ø., H.J. Kind and G. Shaffer (2013) and as discussed in Section 3iii) below, the effect of such a clause will be to change the incentives of retailers that are not price-controlled such that they in fact price match anyway. As such, there is likely to be little practical difference in the effects if these different variants of Retail Price MFNs. As has been highlighted, by the UK Competition Commission in its inquiry into the Private Motor Insurance market, there is another possible narrow variant of the Retail Price MFN clause, which requires that prices through the retailer concerned are no higher than through specific named rival retailers. For example, a retail platform might require that a supplier prices its products no more cheaply through its own proprietary sales channel than it does through the retail platform. See pp. A 9(3) 26 & 27 in [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131219\\_appendices\\_and\\_glossary.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131219_appendices_and_glossary.pdf). We do not focus specifically in this paper on this variant, but we would expect much of the same discussion to apply.

<sup>17</sup> See <http://www.johnlewis.com/inspiration-and-advice/never-knowingly-undersold-policy>.

unilaterally by retailers. Consumers may even view them favourably, although they can in fact raise competition concerns in their own right.<sup>18</sup>

In the case of Retail Price MFN clauses, however, there is an extra element; the ‘best price promise’ is not simply put in place unilaterally by a retailer or retail platform; it is enforced via explicit agreement with third party, the upstream supplier. It is this supplier that sets the retail prices, and it is the Retail Price MFN clause signed with a given retailer that then ensures that this supplier’s retail price is no higher when sold through this retailer than it is through any other retailer. If the supplier has reciprocal Retail Price MFN arrangements with a number of retailers, then the combined effect of these clauses is to create a parity whereby prices are identical across these retailers.

While we have chosen, in this paper, to focus on a generalised description of these clauses which considers their use by upstream suppliers and downstream retailers, we note that they have most commonly been observed in relation to online retail platforms. This is perhaps not surprising, given that effective RPM is required for Retail Price MFNs. Despite a recent relaxation of the law in the US through the *Leegin* case<sup>19</sup>, suppliers and retailers alike continue to exercise caution around engaging in RPM in the offline environment, and without RPM we do not observe Retail Price MFNs.

By contrast, the legal treatment of RPM for online retail platforms has been rather less clear, opening up the potential for both effective RPM and Retail MFNs to exist in this environment. Certainly there is some confusion as to whether such platforms are properly viewed as downstream resellers, which would be required for the law on RPM to apply. They may alternatively be seen as shopping malls, or even upstream suppliers providing an input that can perhaps be best characterised as ‘access to customers and sales logistics services’, or somesuch, in which case they may sit outside the law on RPM. There has also been a debate as to whether such platforms can be viewed as ‘genuine agents’ acting on

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<sup>18</sup> ‘Best price promises’ can alternatively be called ‘lowest price’ or ‘price match’ guarantees. The economic literature in this area has been summarised in OFT Research Report 1438 “Can ‘Fair’ Prices Be Unfair: A Review of Price Relationship Agreements”, prepared by Lear (September 2012) and R. A. Winter “Price-Matching and Meeting Competition Guarantees”, in 2 Issues in Competition Law and Policy 1269 (ABA Section of Antitrust Law) (2008). The link between price promises aimed at rivals’ prices and those aimed at own prices has been explored in M. Hviid and G. Shaffer (2010) “Matching Own Prices, Rivals’ Prices, or Both”, *Journal of Industrial Economics* 58, 479-506. A key insight from the ‘best price promise’ literature is that efficiency benefits require prices, at equilibrium, varying either within or across retailers. As price-matching through the MFN contract is automatic we can rule this out.

<sup>19</sup> For reference see footnote 11.

behalf of their suppliers, in which case the law on RPM would again not apply, at least in the EU.<sup>20</sup>

There are three further possible reasons why we primarily observe Retail Price MFNs in an online environment. First, established retail platforms often have substantial negotiating power vis-à-vis the suppliers they deal with, since they provide crucial customer access. In some markets, there may well be rather more customer loyalty to the retail platform than there is to any individual supplier on that platform such that, if a given supplier were to cease supplying through that retail platform, the vast majority of customers would stick with the retail platform rather than moving to retain the supplier. This negotiating power is enhanced by the fact that there are typically few major retail platforms in any given online market, perhaps due to network effects. The strong negotiating position of the retail platforms is important because it means that they are able to insist on Retail Price MFN clauses as a condition of service, in the form of a ‘take it or leave it’ offer, even if such clauses are not necessarily in the interest of suppliers.

Second, an important characteristic of the online environment is that it is far easier than in an offline environment to monitor adherence to a contractual condition of this sort, since online retailers are able to track the prices of their competitors electronically, more or less costlessly, on an ongoing basis in real time.

Third, and potentially at odds with the first rationale, in some online markets we might expect to see low search and switching costs, combined with relatively little loyalty to particular retail platforms and minimal capacity constraints. In this case, we may be more likely to observe vigorous Bertrand (price-based) competition occur between retail platforms than between offline retailers. In this context, a combination of RPM and Retail Price MFNs may appear especially attractive (and worth taking a legal risk on) so as to limit, or even eliminate, competition at the retail level.

Nevertheless, these clauses could potentially also apply also in any offline environment where suppliers set retail prices (that is, effectively engage in RPM). As such, we have chosen in this paper to use the more generic term ‘Retail Price MFNs’ rather than the more specific ‘Platform MFNs’. From an economic perspective, these clauses are identical.

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<sup>20</sup> See para 18 of European Commission (2010) “Guidelines on Vertical Restraints”, [http://ec.europa.eu/competition/antitrust/legislation/guidelines\\_vertical\\_en.pdf](http://ec.europa.eu/competition/antitrust/legislation/guidelines_vertical_en.pdf). For a discussion of the economics of online platforms, and the application of the genuine agency provisions, see Bennett, M. (2013) “Online Platforms: Retailers, Genuine Agents or None of the Above?”, Competition Policy International, <https://www.competitionpolicyinternational.com/assets/Uploads/EuropeJune.pdf>.

### 3. The Economics of Retail Price MFNs

The economic literature on Retail Price MFNs is still nascent. While there have been a number of contributions<sup>21</sup>, the key potential anticompetitive effects so far identified are well captured in Boik and Corts (2013) and Foros, Kind and Shaffer (2013).<sup>22</sup> These papers identify three key forms of anti-competitive effect potentially arising from these clauses:<sup>23</sup>

- i. They act to *soften competition* between retailers on the fees they charge to suppliers for their retail services. A retailer with a Retail Price MFN will have an enhanced incentive to raise its fees to suppliers, because it knows that it won't thereby be disadvantaged, in terms of retail prices, relative to other platforms. In equilibrium, these higher fees will lead to higher retail prices.
- ii. They can act to *restrict entry* at the retail level. Specifically, they can disadvantage potential retail competitors with low-end business models by eliminating such an entrant's ability to win customers away from the incumbent through cutting its own margin and offering lower prices.
- iii. In a market with asymmetric business formats where some retailers are able to set their own prices, Retail Price MFNs can act to *eliminate price competition at the retail level* and so lead to prices being set as if there were industry-wide RPM. This effect relates to the narrow variant of Retail Price MFN<sup>24</sup>, where the supplier does not control all prices but is required to monitor and match any that it does not control. This price-matching commitment can eliminate competition at the retail level by removing any incentive for the retailer which is potentially able to set its own prices to undercut its rival. This in turn means that suppliers effectively set prices across all retailers, as though there were industry-wide RPM.

Each of these potential effects is discussed in more detail below.

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<sup>21</sup> These also include Johnson, J. P. (2013) The Agency Model and MFN Clauses, mimeo. Available at SSRN: <http://ssrn.com/abstract=2217849> and Gans, J. (2012): "Mobile Application Pricing," Information Economics and Policy, 24, pp. 52-59.

<sup>22</sup> See references at footnote 10. Boik and Corts (2013) use the term Platform MFNs, but (as discussed above) their results are not restricted to an online setting.

<sup>23</sup> These first of these effects was identified, albeit in an alternative context, in Shaffer, G. (2012) The Economics of Parities and Differentials, paper presented at the University of East Anglia and at the UK Office of Fair Trading (OFT) to be included in a forthcoming publication by the OFT,. As is discussed in section 4 below, there is formal mathematical equivalence between relative parities (the subject of Shaffer (2012)) and Retail Price MFNs (the subject of Boik and Corts (2013)).

<sup>24</sup> See footnote 16.

*i. Retail Price MFNs act to soften competition*

To understand the softening of competition effect, it is first important to remember that we are in a market context where suppliers, not retailers, set prices, and in which retailers are then paid a fee for their services. This can be characterised as ‘effective RPM’ (whether or not it would be found to be RPM under the law).<sup>25</sup>

Given this context, it is assumed that retailers set their fees first, and suppliers then set their final retail prices, taking these fees into account. Absent Retail Price MFNs, these suppliers would have the potential to set different retail prices across different retailers. This may seem slightly counter-intuitive in a situation with effective RPM, but it is important to recall that RPM is intrinsically a purely vertical arrangement; it involves nothing more than an upstream supplier setting a downstream retail price. There is nothing explicitly within RPM which means that the supplier has to set an identical price in every retailer, and we may well indeed expect to observe a profit-maximising supplier setting different prices across retailers if these retailers were to charge the supplier different fees.

How does this feed into the setting of fees by retailers? Consider the decision from Retailer A’s perspective. Retailer A will set its own fees with consideration for how any increase in its own fees is expected to reduce its sales. This mechanism underlying this sales effect is an indirect one. If Retailer A increases its own fees, then this will tend to increase the retail prices chosen by suppliers selling through Retailer A relative to the retail prices they choose for their sales through other retailers. This will in turn make Retailer A relatively less attractive than its competitors from a consumer perspective, and this will in turn lead to Retailer A losing sales to competing retailers.

The power of this indirect mechanism in constraining prices will clearly depend on a number of factors, such as the extent to which suppliers pass through an increase in fees as higher retail prices and the extent to which consumers switch between retailers on the basis of price. In general, however, this mechanism means that there will typically be at least some competitive constraint on the fees charged by retailers.

What is the impact of Retail Price MFNs in this context? Effectively these clauses undermine the mechanism outlined above by restricting the extent to which suppliers can price

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<sup>25</sup> This ‘retailer fee’ may be set explicitly, or it may be simply the difference between the retail price and wholesale price. For simplicity, Boik and Corts (2013) assume that this fee is a fixed charge per unit, as does Shaffer (2012) in the context of formally equivalent price relativity clauses, but the general findings in these models should carry over to situations in which the fee is charged as a commission set proportional to retail price (see also Johnson (2013)).

differently across retailers. With such an MFN clause in place, Retailer A can raise its fee rate to the supplier knowing that there is no consequent risk of the supplier setting retail prices higher for Retailer A than for its competitors. For the supplier to do so would be in breach of the Retail Price MFN. This in turn means that Retailer A will expect to lose far fewer sales as a result of a fee rate increase, and this of course greatly reduces (or even eliminates) the indirect competitive constraint on Retailer A's fee rates. As a result, we would expect Retail Price MFN clauses to lead to higher retailer fee rates, and consequently higher retail prices.

More formally, within a theoretical model, the inclusion of a Retail Price MFN means that suppliers no longer set prices through each retailer on the basis of that retailer's fees. Rather they now set prices across retailers, based on average retailer fees. As Boik and Corts (2013) highlight, two different effects can in fact be identified as emerging from this:<sup>26,27</sup>

- A 'squeezing the supplier' effect. As Retailer A raises its own fee, this raises average retailer fees by a lesser amount (for example, in a symmetric two retailer model, average fees will increase by half as much as Retailer A's own fees). Given that there is no reason to expect any change in the supplier's pass through rate, this clearly means that final retail prices charged through Retailer A will increase by less as a result than they would absent the Retail Price MFNs. As such, Retailer A has a greater incentive to raise its own fees with Retail Price MFNs than without. It is noteworthy that this result occurs even where there is no demand interaction (ie competition) between downstream retailers.
- A 'softening competition' effect. As Retailer A raises its own fee, this raises average retailer fees as before. Because the supplier is required under the Retail Price MFN to price the same across retailers, this increase in average retailer fees will also increase the prices it charges through competing retailers. This in turn directly reduces the competitive constraint faced by Retailer A from these retailers, again incentivising it to set higher prices than it would absent the Retail Price MFN.

Boik and Corts (2013) also consider the situation in which retailers can choose whether or not to impose Retail Price MFNs. Shaffer (2012) also considers the same issue in the context

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<sup>26</sup> The same effects were identified by Shaffer (2012) in the context of formally equivalent price relativity agreements (see section 4 and footnote 23).

<sup>27</sup> It is noteworthy that these effects would occur even with perfect competition upstream between suppliers. As such, the existence of vigorous competition upstream – as might reasonably be assumed to exist between suppliers to platforms such as Amazon Marketplace for example – does not in itself imply that we can be sanguine about Retail Price MFNs.

of formally identical price relativity clauses.<sup>28</sup> These papers show first that, under fairly general conditions, Retail Price MFNs will typically raise fees and prices to above the level that would arise through collusive fee-setting by retailers. As such, it is not immediately obvious that retailers will wish to adopt MFNs. They also find that, for the special case of linear demand, retailers' profits can be either higher or lower following the imposition of Retail Price MFNs, depending on their own and cross-price elasticities of demand. Introducing Retail Price MFNs is more likely to increase retailers' profits where the retailers are closer substitutes, but more likely to reduce them where the retailers face more independent demand and where demand is sufficiently inelastic in own-price.

The question of whether retailers will adopt Retail Price MFNs is, however, more complex than simply looking at whether they raise profits. It is necessary also to look at the unilateral incentives of each retailer to adopt them, taking the other retailers' choices as given. It is shown in these papers that they will sometimes be adopted even when they are not profitable overall, and sometimes not adopted when they are profitable overall.

A natural question to ask here is why suppliers would ever sign up to such clauses, since retailers seem to get the upside in terms of higher retailer fee rates. In fact, within these models, the suppliers may find Retail Price MFNs to be profitable, depending on the parameters. Likewise, if lumpsum transfers are possible, we should expect the retailers to be able to induce participation through these. But what if neither of these hold? The existing literature does not examine the incentives of suppliers to engage in Retail Price MFNs; it simply assumes a game structure in which it is the retailers that decide this question.

It could be argued that this is a reasonable approach in the case of retail platforms, given that they have a strong negotiating position relative to suppliers, since they deliver them much-needed customer access. As such, if Retail Price MFN clauses are offered by retail platforms as part of a 'take it or leave it' offer, suppliers may sign up to them in order to gain the benefit of dealing with the retail platform. Their preference may be to deal with the retail platform without Retail Price MFN clause, but this option is not on offer. In a more general context, however, where bargaining power is more evenly distributed between suppliers and retailers, it may be necessary to consider the participation constraint of the suppliers.<sup>29</sup>

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<sup>29</sup> It is worth noting that Retail Price MFNs may well still be acceptable to suppliers if lump-sum payments are possible, since suppliers may then receive a share of any additional rents in the form of such a payment.

**ii. Retail Price MFNs can restrict entry at the retailer level**

The effect of Retail Price MFNs on entry is more subtle. Boik and Corts (2013) consider a situation in which an incumbent faces an entrant which is somewhat less attractive to consumers (their term is 'downward-differentiated'). For example, this may simply be because of customer loyalty to the existing player or because the entrant offers more of a 'no frills' service. This is modelled as the entrant gaining less demand than the incumbent would at comparable prices. The entrant may also have lower costs.

They find that the imposition of a Retail Price MFN by an incumbent can deter entry by a potential competitor that is more strongly downward-differentiated. The Retail Price MFN clause prevents such a competitor from offering lower retail prices (through offering lower fees to suppliers) in order to win customers. This effectively has the effect of augmenting the entrant's demand disadvantage. If the potential competitor's fixed costs are sufficiently high, the Retail Price MFN will act to deter entry which would have otherwise occurred.

On the other hand, Retail Price MFN clauses can actively encourage entry by retailers with less differentiated, higher cost business models, because of its potential effect of softening competition and increasing the profits available for retailers. Perhaps unsurprisingly, given these findings, Boik and Corts also find that, where potential entrants are able to choose their business model, they will be more likely to choose a higher cost, less downward-differentiated business model where they face Retail MFNs, thus limiting the extent of competition between business models.

**iii. In a market with asymmetric business formats, Retail Price MFNs can act to eliminate price competition at the retail level and so replicate RPM**

Foros, Kind and Shaffer (2013) provide a further insight into the economics of Retail Price MFNs, in a paper inspired by the US ebooks case. They note that, prior to Apple's entry into the ebooks market, Amazon had effectively been a monopoly retailer of ebooks. At that time, Amazon employed a standard retail model, whereby it paid upstream publishers a wholesale price for ebooks, and then set retail prices itself. The book publishers were unhappy with Amazon's strong position in retail and were keen for Apple to enter. Apple agreed to do so, but only on condition that the publishers switched to an agency model, whereby the upstream publishers set final retail prices, not Apple. As discussed above, Apple also imposed a Retail Price MFN on the publishers.

Foros, Kind and Shaffer (2013) then consider the impact of this narrow variant of Retail Price MFN<sup>30</sup> within a hypothetical mixed business format situation where publishers sell through Apple on an agency basis but continue to sell through Amazon on a wholesale price basis. They find that the imposition by Apple of a Retail Price MFN will tend to raise final retail prices to the level which would be observed with industry-wide adoption of the agency model. That is, market prices will be set by suppliers *as if* there is industry-wide RPM. The underlying driver for their finding is that any reduction of prices by Amazon to below this level would, under the MFN agreement, be immediately and automatically be matched by the publishers on Apple's iBooks platform. The Retail Price MFN therefore means that Amazon cannot hope to profit by such a price reduction.

In practice, Amazon itself switched to an agency model very quickly after Apple, thereby giving up its own pricing flexibility. There was some suggestion that this indicated that Amazon's change of approach was forced upon it by the publishers? Foros, Kind and Shaffer argue that this need not have been the case. Absent any Retail Price MFN, they show that, under certain assumptions, Amazon might have done better by not itself adopting the agency model, even in the face of Apple's doing so. However, in the face of the Retail Price MFNs, Amazon was effectively prevented from competing on price. At this point Amazon would have had nothing to gain from not adopting the agency model too. The authors conclude therefore that Amazon would not have required any forcing.<sup>31</sup>

#### 4. Relationship to alternative price relativity clauses

In terms of economic analysis, it is noteworthy that Retail Price MFN clauses can be viewed as formally identical to another type of price relativity clause which does not require RPM. Under this alternative price relativity clause, retailers set final retail prices but are required to set these retail prices such that the product covered by the clause is priced no higher than are competing products.<sup>32</sup> This is broadly the same constraint but 'upside down'.

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<sup>30</sup> See footnote 16.

<sup>31</sup> That said, it is worth noting that the strategy could have backfired for Apple and the publishers if Amazon had countered entry by vigorous price-cutting to below marginal costs. Unlike standard predation models, where the predator pays the full cost of predation through much higher sales at below cost in the predation phase, with Retail Price MFNs the victim of predation is forced to match and hence potentially sell significant volumes at below cost prices too. It seems that pricing in this market was linear and that revenues were intended to be split between the publishers and Apple on a 70:30 basis. As such, the publishers would have borne the brunt of any continued price-cutting by Amazon since they retain the larger share of the revenues. It is therefore probably fair to say that they would have had a strong incentive to persuade Amazon to adopt the agency model, even if it had not otherwise wished to do so.

<sup>32</sup> Note that this form of price relativity clause can appear similar to, but have rather different effects from, an alternative form of restriction which limits relative retail margins across suppliers' products. In assessing the

The simple example in Table 1 below demonstrates this formal identity. In both models, players A and B set intermediate fees/prices and choose whether to adopt a Retail MFN/price relativity clause, and then players x and y set final retail prices. The inequalities arising from the contractual clauses are then identical. What differs between the models is that the identities of players A, B, x and y are different. Effectively the second model is an ‘upside down’ version of the first, in that players A and B switch from being retailers to suppliers while players x and y switch from being suppliers to retailers. In the first, each retailer is effectively asking its suppliers to ‘promise not to make me uncompetitive relative to competing retailers’. In the second, each supplier is effectively asking its retailers to ‘promise not to make me uncompetitive relative to competing suppliers’.

**Table 1: Comparing Retail Price MFNs and Price relativity clauses**

<b>Retail Price MFNs: A simple example</b>	<b>Price relativity clauses: A simple example</b>
Consider supplier x and supplier y, who are selling through retailer A and retailer B	Consider a supplier A and supplier B selling through a retailer x and retailer y
Retailers A and B set distribution fees and decide whether or not to impose Retail Price MFNs.	Supplier A and B set wholesale prices and decide whether or not to impose price relativity clauses.
Suppliers x and y set final retail prices	Retailers x and y set final retail prices
Under retailer A’s Retail Price MFNs:	Under supplier A’s price relativity clauses:
$p^x_A \leq p^x_B$ and $p^y_A \leq p^y_B$	$p^x_A \leq p^x_B$ and $p^y_A \leq p^y_B$
Under retailer B’s Retail Price MFNs:	Under supplier B’s price relativity clause:
$p^x_B \leq p^x_A$ and $p^y_B \leq p^y_A$	$p^x_B \leq p^x_A$ and $p^y_B \leq p^y_A$

The formal identity between these two forms of clause is noteworthy because this type of price relativity clause has been analysed formally in Shaffer (2012).<sup>33</sup> Such clauses have been investigated in the UK Monopolies and Mergers Commission (MMC) investigation into tour

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economic impact of such clauses, it is important to be clear whether the restriction relates to end retail prices (irrespective of wholesale prices), or to retail margins (which are in turn affected by wholesale prices).

<sup>33</sup> See footnote 23.

operators (1997).<sup>34</sup> Akman and Hviid (2006) provide a useful perspective on this case by linking the effect directly to the adverse effects from standard price-matching guarantees.<sup>35</sup> Price relativity clauses of a similar sort were also alleged in the UK OFT decision on tobacco (2010).<sup>36</sup> Although this decision has since been overturned, it is notable that the Competition Appeals Tribunal's judgment was not based on an assessment of the economic theory, but rather on the facts of the case. Similar price relativity clauses are also allegedly under review in an ongoing European Investigation into Apple's distribution practices for its iPhone, under which distributors are said to be required to offer consumers no better discounts (ie no lower relative prices) on rivals' products than they do on the iPhone.<sup>37</sup>

In acknowledging this formal identity, one important further factor should not be overlooked. As mentioned above, the incentives of the suppliers to accept Retail Price MFNs are not examined in detail in the models which exist to date. In the case of price relativity clauses, the analogous question would be is whether retailers have an incentive to accept them. As before, this may depend on whether lump sum transfers are possible, or if not whether the clauses are offered by the supplier as part of a 'take it or leave it' offer.

## **5. The Relationship between Retail Price MFNs and RPM**

As is clear from the above, one important linkage between Retail Price MFNs and effective RPM is obvious: the former can only exist in the presence of the latter, that is where a supplier controls retail prices. Our key observation in this paper, however, relates to an alternative linkage. We believe it is possible, and useful, to distinguish two separate elements of RPM, as it is standardly analysed in much of the economic literature and case law:

- First there is the vertical element, whereby an upstream firm sets final downstream retail prices. This is the explicit element of RPM, which is intrinsic to its very concept.
- Second, there is a horizontal element more implicitly incorporated within RPM as we typically know it, whereby each upstream firm sets identical retail prices across all of

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<sup>34</sup> See footnote 13.

<sup>35</sup> See Akman P. and M. Hviid (2006) "A Most-Favoured-Customer Guarantee with a Twist". European Competition Journal, Vol. 2, No. 1, pp. 57-86. Available at SSRN: <http://ssrn.com/abstract=911580>.

<sup>36</sup> See footnote 14.

<sup>37</sup> See reference at footnote 15.

its downstream intermediaries/retailers. This horizontal element of RPM is highly relevant here because it functions in a very similar way to Retail Price MFNs.<sup>38</sup>

This distinction is important from an economic perspective, but it is one that has hitherto been given only limited focus in the academic economic literature on RPM. To see this note that where we observe only the purely vertical element of RPM, the ability of the supplier to set differing prices across retailers can act as a crucial indirect competitive constraint on the fee rate charged by retailers to the supplier for using their retail services. If a retailer expects an increase in its fee rate to be passed on by the supplier in the form of a higher retail price at that retailer, relative to other retailers, then the retailer will typically expect to lose sales to these competing retailers as a result. This threat of lost sales will in turn act as a competitive constraint on the retailer when setting its fee rates, and will act to keep these rates down.

In this section, we briefly review this literature, distinguishing three broad groups of RPM effect, those where the primary anti-competitive effects are downstream, those where they are upstream and those where competition is harmed at both levels. We find that much of the literature within the first two groups standardly assumes, either implicitly or explicitly, that each supplier ensures price parity across retailers. As such, they effectively combine both the explicit vertical and the implicit horizontal elements. Since the horizontal element of RPM is closely associated with Retail Price MFNs, this wider literature may provide a useful guide to further anti-competitive effects that might be expected to arise from Retail Price MFNs, although they have not yet been analysed formally in this context.

We then examine, albeit without engaging in formal modelling, the relative importance of the assumed horizontal element of RPM in driving the key anticompetitive effects identified in the literature. We find that in the much of the literature, the horizontal element of RPM is crucial or, at the least, likely to substantially exacerbate concerns. We then examine the relevance of this horizontal element within competition cases, focussing on three UK RPM cases, drawing on analysis by Giovannetti and Stallibrass (2009),<sup>39</sup> as well as a more recent, and ongoing, UK RPM case. We find that the likely anticompetitive harm in all four cases depends crucially on this horizontal element.

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<sup>38</sup> In what follows, we simplify slightly by equating the horizontal element of RPM to setting an identical price across retailers. However, it should be noted that a variant, whereby fixed price relativities are preserved across retailers, would be expected to have the same effects.

<sup>39</sup> Giovannetti, E. and D. Stallibrass (2009) "Three cases in search of a theory: Resale Price Maintenance in the UK", *European Competition Journal*, Vol.5, N.3, pp 641-654.

### ***The horizontal element of RPM: Anticompetitive effects***

While there is an extensive literature on the economics of RPM, it is possible to distinguish seven key categories of anticompetitive harm.<sup>40</sup>

- a) RPM to facilitate collusion downstream
- b) RPM to restrict entry or expansion downstream
- c) RPM to soften competition downstream
- d) RPM to facilitate collusion upstream
- e) RPM to restrict entry or expansion upstream
- f) RPM as a commitment device to protect monopoly rents upstream
- g) RPM to soften or eliminate competition both upstream and downstream

The first three of these relate primarily to competition at the downstream level, the next three primarily to competition at the upstream level and the final one relates to competition more generally across the system, upstream and downstream. We group them in this way in the discussion below.

### ***Anticompetitive effects of RPM at the downstream level***

Where the anticompetitive effects of RPM are primarily downstream, and where these effects provide the anticompetitive rationale for the RPM, we would expect to observe the RPM being instigated by retailers, rather than by their suppliers. It turns out that the horizontal element of RPM is crucial for both the first two categories of anti-competitive effect discussed below. These in turn seem to be the most likely forms of RPM to gain attention from the antitrust authorities. It is not, however, an element in the third category.

#### *a) RPM to facilitate collusion downstream*

RPM agreements can be a very powerful means for achieving downstream collusion, indirectly, especially in a situation where explicit direct collusion is prohibited.<sup>41</sup> Retailers

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<sup>40</sup> Several of these are usefully summarised in Bennett, M., A. Fletcher, E. Giovannetti and D. Stallibrass (2010), see reference at footnote 12. The remaining type - RPM to restrict entry upstream – was first identified as a possibility in Marvel, H. P. and S. McCafferty (1985) “The Welfare Effects of Resale Price Maintenance”. *Journal of Law & Economics* 28(2):363-70. However, the idea has only recently been developed further and modelled, in Asker, J. and H. Bar-Isaac (forthcoming) “Raising Retailers’ Profits: On Vertical Practices and the Exclusion of Rivals.” Forthcoming in *American Economic Review*.

<sup>41</sup> This theory of harm does not appear to have been modelled formally, perhaps because it is actually too obvious. It is, though, well-recognised as a theory of harm and much referred to in the literature. For an early example, see Overstreet, T. (1983). *Resale Price Maintenance: Economic Theories and Empirical Evidence*, Bureau of Economics Staff Report to the U.S. Federal Trade Commission.

can effectively delegate to common suppliers the role of setting collusive prices, monitoring adherence to these prices, and even punishing cheating. Any such collusion is likely to be of particular concern for antitrust authorities.

Whilst the vertical element of RPM is clearly required here, it is the horizontal element of RPM that really drives the collusive outcome. If suppliers were to retain the flexibility to set different retail prices in different retailers, it is far from clear that the retailers would achieve their end of downstream collusion.

*b) RPM to restrict entry or expansion downstream*

RPM can benefit downstream incumbent firms by making it harder for entrants or smaller rivals to steal business through undercutting them, thereby restricting their ability to gain share in the market.<sup>42</sup> For example, RPM could potentially be used to restrict the growth of new business models such as ‘no frills’ bricks and mortar outlets or low cost internet retailers if they are restricted to charge the same price as the incumbent retailers.

Clearly the horizontal element of RPM is crucial for this effect.

*c) RPM to soften competition downstream*

Shaffer (1991) shows that RPM can be used to raise prices when retailers have buyer power.<sup>43</sup> Within this model, there are two differentiated retailers, each with limited shelf space. There is perfect competition between manufacturers, who compete to get their products onto these shelves. Absent RPM, manufacturers will compete on wholesale price to get onto the shelves, and this will tend to drive down wholesale prices. Because retailers then face competitors in the downstream market, they end up passing such lower wholesale prices onto consumers.

Shaffer then considers the situation with RPM. In this case, retailers allocate shelf-space on the basis of which manufacturers offer them the highest total profits, taking both the wholesale price and the retail price into account. In this particular paper, if RPM is adopted by both retailers it has no overall effect. Effectively the manufacturers face the same pricing incentives as the retailers had previously and the same equilibrium is reached. If just one

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<sup>42</sup> Again this theory of harm does not appear to have been modelled formally. It is very similar, though, to the entry restriction story described above for Retail Price MFNs by Boik and Corts (2013), which clearly requires pricing equality across retailers.

<sup>43</sup> See Shaffer, G., (1991) “Slotting Allowances and Resale Price Maintenance: A Comparison of Facilitating Practices” *Rand Journal of Economics*, 22. 120-136.

retailer adopts RPM, however, this works as a commitment device for that retailer not to compete prices down in response to the pricing of the other retailer. Overall, prices rise.<sup>44</sup>

This is an interesting finding, in the current context, in that it very specifically only relates to the vertical element of RPM. Indeed, the result disappears if there is a horizontal element to the RPM. However, the model relates to fairly specific circumstances and no such case appears to have raised antitrust concerns to date.

### ***Anticompetitive effects of RPM at the upstream level***

Where the anticompetitive effects of RPM are primarily upstream, and where these effects provide the anticompetitive rationale for the RPM, we would expect to observe the RPM being instigated by the upstream firms, rather than by the retailers. In the first two categories, while it may be the vertical element of RPM which drives the effect, it is clear that the horizontal element also plays an important role. In the third category, the horizontal element turns out to be crucial for the anticompetitive effect.

#### *d) RPM to facilitate collusion upstream*

In a standard retail model, if upstream firms wish to collude, but negotiate contracts with retailers in private, it can be hard for them to spot deviations from any collusive agreement. Their wholesale prices cannot be monitored and enforced directly and, if there is the potential for either demand shocks or retail cost shocks, changes in retail prices will be only an imperfect guide to changes in wholesale prices. This imperfect ability to detect deviations makes collusion more difficult to sustain.

Jullien and Rey (2007) have shown that, in this context, upstream firms can use RPM as a facilitating practice for upstream collusion since it brings the publicly observable element of price under the control of the upstream firms.<sup>45</sup> This paper, however, simply assumes identical retailers and prices that are identical across retailers. This is true both when prices are set by the retailers (absent RPM) and when they are set by the upstream firms (under RPM). As such, it implicitly incorporates both the vertical and horizontal elements of RPM. Jullien and Rey then assume that, because RPM involves upstream firms directly setting

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<sup>44</sup> Similar results have recently been founded in a variant of this model by Foros, Kind and Shaffer (2011) in which there are several manufacturers, each using its own dedicated retailer network. In this model, prices will be higher if a subset of retailers adopt RPM, but not if they all do. See Foros, Ø., H.J. Kind and G. Shaffer (2011), "Resale Price Maintenance and Restrictions on Dominant Firm and Industry-Wide Adoption", *International Journal of Industrial Organization*, vol. 29, pp. 179-186.

<sup>45</sup> Jullien, B. and P. Rey (2007) "Resale Price Maintenance and Collusion" *Rand Journal of Economics*, 38-4, pp. 983-1001.

retail prices, which are then uniform across retailers, it will become straightforward to spot deviations from a collusive agreement under RPM. In fact, they assume that, under RPM, the likelihood of detecting deviations rises to 100%. This improved detection rate makes collusion substantially easier to sustain.

Suppose, however, that we now allow for retailers facing different costs and demand, and individualised demand and cost shocks. Absent any intent to collude, the profit-maximising form of RPM for suppliers may well then involve their setting differentiated prices across retailers. In such a situation, it is far from obvious that the likelihood of detection will be 100%. Indeed, it may be relatively hard to collude. Where optimal collusion would entail different prices across retailers, this would likely require extensive contacts between upstream firms. Hence while RPM can again help monitoring price movements, the need for extensive contact would bring the firm into contact with much more serious infringements of competition law, much more likely to lead to high fines and even imprisonment.

This does not mean that the effect identified by Jullien and Rey would not exist without the horizontal element of RPM; clearly if upstream firms are intent on colluding they can always choose to set uniform prices across the market to facilitate this. It does highlight, however, that RPM can have two distinct effects on how easy it is to detect deviations from a collusive agreement, and therefore on the ability to sustain such an agreement. The vertical element of RPM – the fact that upstream firms control retail prices – clearly helps. However, we might expect the horizontal element of RPM (whereby the supplier sets identical prices across retailers) to significantly strengthen this effect.

*e) RPM to restrict entry or expansion upstream*

A second theory, which has gained attention recently, is that RPM can potentially be used to restrict entry or expansion by upstream rivals. This idea has recently been formalized by Asker and Bar-Isaac (forthcoming).<sup>46</sup> RPM allows incumbent manufacturers, with market power, effectively to align retailer incentives with their own incentives to deter entry or expansion by smaller rivals. So long as they can preserve their market position, incumbent manufacturers have super-normal profit and they share some of this with retailers through setting retail prices and wholesale prices to give them a super-normal margin. If, however, a retailer decides to stock a rival product, and thereby facilitates the expansion of that rival,

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<sup>46</sup> See reference at footnote 40.

the manufacturer's profits will be reduced and this will be reflected in lower margin for the retailers.

The model in Asker and Bar-Isaac (forthcoming) assumes, for simplicity, that all retailers are identical and charge the same price. Thus the horizontal element of RPM is included implicitly in the model. It is, however, probable that the horizontal element of RPM would be required for this result, even in a more sophisticated model. It is important for the result that all retailers have incentives to exclude entry, and it is not obvious that it would be possible to ensure that each retailer had super-normal profit if prices were set differently in different retailers. There will be little benefit to a retailer from receiving a super-normal profit margin from each sale made if it in fact makes no sales because other retailers have cheaper prices.

*f) RPM as a commitment device to protect monopoly rents upstream*

This effect relates to a now well-known monopoly commitment problem, originally identified in Hart and Tirole (1990) and first considered in relation to RPM by O'Brien and Shaffer (1992).<sup>47</sup> In this latter model, a monopoly supplier sells to a number of differentiated downstream retailers. The first retailer is willing to pay more for the product if it does not face any competition. However, the upstream monopolist cannot credibly commit to this because *ex post* it would have an incentive to supply a second retailer, since this increases its profit at the margin. This in turn reduces the payment that the first retailer is willing to make. The overall effect is that, absent a commitment device, the upstream firm is unable to extract the full rent associated with its market power, because it cannot commit itself to not cutting prices on later contracts. O'Brien and Shaffer (1992) show that RPM can solve this problem by allowing the upstream firm to commit to the monopoly price and extract its full monopoly rents. Rey and Vergé (2004) find the same result, albeit under different conditions.<sup>48</sup>

Here, it is specifically the horizontal element of RPM which is really driving this effect, at least in the case of minimum RPM. As is highlighted by O'Brien and Shaffer (1992), the effect relies upon minimum RPM implying uniform prices across retailers. If retailers were able to

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<sup>47</sup> Hart, O. and J. Tirole (1990) "Vertical Integration and Market Foreclosure", *Brookings Papers on Economic Activity: Microeconomics*, pp. 205-276; O'Brien, D. and G. Shaffer (1992) "Vertical Control with Bilateral Contracts", *Rand Journal of Economics*, 23, pp. 299-308.

<sup>48</sup> Rey, P. and T. Vergé (2004) "Bilateral Control with Vertical Contracts", *Rand Journal of Economics*, 35, pp. 728-46.

set prices at different levels across retailers (as would be feasible under the pure vertical element of RPM) then the monopoly commitment problem would not be solved.

### ***RPM to soften or eliminate competition both upstream and downstream***

Finally, in this section we briefly describe three models which consider the effects of RPM at both the upstream and downstream levels. In contrast with the majority of papers described above, these models rely purely on the vertical element of RPM for their findings of anti-competitive effect. However, it is also worth noting that at least two of the three models have somewhat ambiguous effects, with RPM potentially having a positive effect rather than a negative effect. As such, while RPM can still be harmful – and potentially very harmful – in these models, it is probably reasonable to say that, on balance and in comparison with the theories of harm already discussed above, these models do not comprise the ‘worst of RPM’.

*Dobson and Waterson (2007)* have shown that in a bargaining framework, RPM can act to reduce retailers’ incentives to negotiate on wholesale prices upstream by restricting downstream competition.<sup>49</sup> Thus, in this model, RPM affects both levels of the market. When retailers are able to price freely, within a competitive downstream market, their competitive position will depend heavily on the wholesale prices they face. The retailer will seek to win business from its retail competitors by passing on (to a greater or lesser extent) any reduction in wholesale prices in the form of lower retail prices. This competitive dynamic in turn provides retailers with a strong incentive to bargain hard on wholesale prices.

The imposition of RPM clearly upsets this process. If retailers are not able to set their own retail prices, they have less ability to win new business through achieving lower wholesale prices. This reduces their incentives to bargain toughly on wholesale prices, which in turn softens competition at the upstream level. The overall result will be higher wholesale prices and higher retail prices, to the detriment of consumers.

However, RPM has ambiguous implications in this model. As might be expected from the description above, the anticompetitive effect of RPM is strongest where retailers, not

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<sup>49</sup> Similar results are found, albeit in a somewhat different modelling framework, in Shaffer, G. (2013) Anti-Competitive Effects of RPM (Resale Price Maintenance) Agreements in Fragmented Markets, OFT. In this paper, the author extends the model of O’Brien and Shaffer (1992) (discussed above) to a multi-supplier context and allowing for a more even distribution of bargaining power between upstream firms. Unlike the Dobson and Waterson (2007) paper, it allows for non-linear wholesale contracts (that is, there can be a fixed fee payment as well as a wholesale price). It also assumes that each retailer deals with just one upstream firm.

suppliers, have most of the bargaining power and would (absent RPM) compete vigorously in the downstream retail market. If, by contrast, the suppliers have most of the bargaining power, and are relatively differentiated, then this effect will be reduced and RPM may even lower prices within this model.<sup>50</sup>

A similar result is derived in *Foros, Kind and Shaffer (2013)* in a context where retailers receive a share of retail price, rather than paying a wholesale price per unit. They find that RPM will tend to raise prices if there is less substitution between upstream suppliers than there is between downstream retailers but that it will otherwise lower prices. As they state in the paper: “Transferring control of retail pricing to the level where the degree of competition is lowest [...] brings prices closer to the ones that maximize total profit”. Again, this result is driven entirely by the vertical element of RPM.<sup>51</sup>

Finally, *Rey and Vergé (2010)* have shown that RPM can soften, and potentially eliminate, effective competition — at the inter-brand level between suppliers as well as at the intra-brand level between retailers — if used jointly with franchise fees.<sup>52</sup> This model is based on a system of ‘common agency’ whereby all upstream suppliers are stocked by all downstream retailers. This model again does not require that each supplier set the same prices across all of its retailers. However, and unlike the other models discussed in this subsection, in this model all the bargaining power is assumed to sit with the manufacturers, who make ‘take it or leave it’ offers to the retailers.

While this assumption is not crucial for the findings in the model<sup>53</sup>, it should be noted that the model has multiple equilibria, some of which may be more competitive than the situation absent RPM. Where upstream firms have all the bargaining power it is not unreasonable to assume that they would opt for the monopoly equilibrium, under which all competition is eliminated. However, given that upstream and downstream firms may have differing preferences over these various possible equilibria, it becomes more ambiguous which (if any) equilibrium would in fact emerge if downstream firms were to have some

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<sup>50</sup> It should be noted that, in this model, the positive effect derives from the role of RPM in removing an element of double marginalisation. As such, it could potentially also be achieved by maximum RPM, without the need for minimum RPM.

<sup>51</sup> This ambiguity result is arguably stronger than that in the Dobson and Waterson model, in that the positive effect cannot simply be achieved through maximum RPM.

<sup>52</sup> Rey, P. and T. Vergé (2010). “Resale Price Maintenance and Interlocking Relationships”, *Journal of Industrial Economics*, vol. 58, pp. 928-961.

<sup>53</sup> For a discussion, see Shaffer, G. (2013) *Anti-Competitive Effects of RPM (Resale Price Maintenance) Agreements in Fragmented Markets*, OFT, Chapter 5.

bargaining power. Certainly, we may not observe the monopoly equilibrium in this circumstance.

***Summary of findings from the economic literature***

Table 2 below sets out in summary form the key results from the above discussion. It is clear that the horizontal element of RPM plays a key role in the vast majority.

<b>Table 2: Summary of findings from literature: Role of horizontal element of RPM</b>		
<b>Anti-competitive effect</b>	<b>Horizontal element of RPM assumed?</b>	<b>Horizontal element of RPM required?</b>
a) RPM to facilitate collusion downstream	Yes	Yes
b) RPM to restrict entry or expansion downstream	Yes	Yes
c) RPM to soften competition downstream	No	No
d) RPM to facilitate collusion upstream	Yes	No, but strengthens effect
e) RPM to restrict entry or expansion upstream	Yes	Probably
f) RPM as a commitment device to protect monopoly rents upstream	Yes	Yes
g) RPM to soften or eliminate competition both upstream and downstream	No – but results are ambiguous (at least with retailer bargaining power)	No – but results are ambiguous (at least with retailer bargaining power)

***The horizontal element of RPM and UK case law***

The distinction between the vertical and horizontal elements of RPM has also been ignored in the existing case law on RPM, with decisions typically assuming that RPM incorporates both elements. Indeed, many (if not all) RPM cases involve evidence of one or more retailers complaining to their supplier when they observe other retailers undercutting their prices.

Giovanetti and Stallibrass (2009) analyse the likely theory of harm in three UK RPM cases.<sup>54</sup> First, they review the OFT's case against RPM in the UK book market. From 1901 until 1997, the Net Book Agreement (NBA) allowed publishers to set the retail prices of books. Any retailer that deviated from the agreement could be refused future supply of books. The agreement was dropped in the face of investigation by the OFT. The consequences of removing RPM from this market were reviewed by Ball et al (2008) in a report for the OFT.<sup>55</sup> They find that removing the NBA allowed the development of new low price business models, such as sales of books through supermarkets and the internet. At the time of this review, these new routes to market had expanded availability and total book sales. On this basis, Giovanetti and Stallibrass conclude that the key anticompetitive effect of the NBA had been in *restricting downstream entry of new business models*. The horizontal element of RPM would have been key to such an effect.

Second, they examine the OFT's *toys* decision (2003). This decision found that Hasbro, one of the largest toys and games suppliers in the UK, had entered into vertical agreements with Argos and Littlewoods, the two largest catalogue-based retail chains, to fix the price of certain Hasbro toys and games at the recommended retail price (RRP). Prior to these agreements there had been very strong competition between Argos and Littlewoods, who also had substantial buyer power vis-à-vis Hasbro since between them they were its primary distribution channel for the toys involved. This case seems to have been a clear case of RPM *facilitating downstream collusion*, and indeed the UK Competition Appeals Tribunal, when reviewing the OFT's decision on appeal, stated that a finding of horizontal tripartite concerted practice (effectively horizontal collusion facilitated through a third party) would also have been sustainable given the facts of the case.<sup>56</sup> Again the horizontal element of RPM was clearly intrinsic to this finding.

Third, they review the OFT's case on *replica football kits* (2003). Umbro, a manufacturer of replica football kits, had agreements with downstream retailers to fix the price of England, Manchester United, Chelsea and Nottingham Forest replica kits at the same retail price. The decision found that the network of agreements constituted a horizontal concerted practice between the retailers, a theory that was endorsed and expanded by the UK Competition

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<sup>54</sup> See footnote 39 for reference. Because RPM is an infringement of EU and UK competition law *by object*, the OFT was not required to provide any analysis of likely anticompetitive effect within its work. This paper therefore reviews the facts of the cases, rather than any legal conclusions of the OFT, in order to identify the likely harm occurring.

<sup>55</sup> Ball, C., S. Davies, M. Olczak and C. Wilson (2008) An evaluation of the impact upon productivity of ending resale price maintenance on books. OFT, London.

<sup>56</sup> CAT 24/2004 *Argos Limited & Littlewoods Limited v Office of Fair Trading*, para 790.

Appeal Tribunal (and the Court of Appeal) on appeal. The decision did not, however, include any clear theory of harm. Giovannetti and Stallibrass (2009) suggest four possible alternative explanations, and consider that it might well have been difficult for the OFT to identify which of these was the most likely to obtain on the basis of the evidence provided. What seems clear, however, is that the horizontal element of RPM would have been crucial for any of them.

A further OFT case, still currently ongoing, provides further support for RPM as a way of *restricting downstream entry or expansion* by new business models.<sup>57</sup> The investigation into RPM in the mobility scooters sector relates to a very specific form of restriction. The OFT is investigating the allegation that scooter manufacturer Pride has imposed a ban on its retailers advertising at below its Recommended Retail Price on the internet. Such a restriction might reasonably be expected to restrict downstream entry or expansion of internet sales (as well as limiting the extent to which consumers can shop around between retailers from the comfort of their own home). As the OFT states in its press release: *'If retailers are prevented from advertising their discounts online, consumers are significantly restricted from identifying and obtaining lower prices, and it is harder for innovative and efficient retailers to win new customers.'*

On the basis of this admittedly limited selection of cases, then, it seems that the horizontal element of RPM plays a very important role in actual antitrust actions. The problem is not usually that the supplier sets downstream prices, or even that it sets downstream prices across a variety of different retailers, but rather that it sets these downstream prices at the same level across retailers.

## **6. Efficiency benefits from RPM**

We have argued above that RPM effectively comprises two elements. The first, the purely vertical element, is clearly core to any finding of RPM. However, it is the horizontal element of RPM which is crucial for many of the most likely anticompetitive effects of RPM, and seems to be an important factor within actual antitrust cases.

The literature has, of course, also discussed a number of efficiency benefits potentially arising from RPM. The most well-recognised of these can be broadly summarised as follows:

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<sup>57</sup> OFT Press Release "OFT issues statement of objections in mobility scooters sector" 24 September 2013. <http://www.of.gov.uk/news-and-updates/press/2013/66-13#.UnNPVlcWcC>.

- i. RPM to reduce free-riding at the retail level on aspects such as service provision (Telser, 1960)<sup>58</sup>
- ii. RPM to maintain retailers' margins to ensure that retailers are willing to stock and promote products (Deneckere et al, 1996)<sup>59</sup>
- iii. RPM to promote inter-brand competition between suppliers by providing quality certification (Marvel and McCafferty, 1984).<sup>60</sup>

As was the case for the economic literature on the anti-competitive effects of RPM, much of the literature on its potential efficiency benefits has typically simply assumed that RPM comprises both vertical and horizontal elements. Reviewing the theory, however, it appears that the horizontal element is important for the key efficiency benefits identified above.

However, there are also important benefits arising purely from the vertical element of RPM. Apart from the elimination of double marginalisation, these are perhaps less well understood than those arising from the horizontal element, partly because they have been less fully modelled in the academic literature, and partly (where they have) because the relevant papers have been seen as falling under a different area of the literature, such as agency.

In the remainder of this section, we describe briefly the key benefits we see as arising from the vertical element of RPM:

- *Benefits from RPM if upstream competition is more vigorous than downstream:* As discussed above, Foros, Kind and Shaffer (2013) find that RPM will tend to reduce prices if competition upstream is more vigorous than it is downstream, by putting price-setting in the hands of the level that has the greatest incentives to compete aggressively. This may be especially relevant in the case on online retail platforms, and especially price comparison websites, which are specifically designed to facilitate shopping around between upstream suppliers by consumers. Indeed, and while this is clearly an empirical question, it may be that consumers do relatively less shopping around between online retail platforms and price comparison websites, than they do within them, perhaps assuming that prices will not vary substantially between them. Some consumers may even perceive such platforms effectively as simple advertising

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<sup>58</sup> Telser, L. (1960) "Why Should Manufacturers Want Fair Trade", *Journal of Law and Economics*, vol. 3, pp. 86-105.

<sup>59</sup> Deneckere, R., Marvel, H. and Peck, J. (1996), "Demand Uncertainty, Inventories, and Resale Price Maintenance", *Quarterly Journal of Economics*, vol. 111, pp. 885-914.

<sup>60</sup> Marvel, H. and McCafferty, S. (1984), "Resale Price Maintenance and Quality Certification", *Rand Journal of Economics*, vol. 15, pp. 346-359.

media, which provide a useful window on the 'true prices' set by suppliers, which they expect to be identical everywhere.<sup>61,62,63</sup>

- *Benefits from enhanced upstream competition through increased platform participation:* In the context of some of the cases described above, it has been argued that competition is overall increased by RPM in the following way. Supplier participation on platforms increases the degree of competition between suppliers, because consumer search becomes easier, but suppliers may not be willing to participate in such platforms absent price protection through RPM. Thus, RPM may enhance competition between suppliers by incentivising their increased platform participation. This effect is especially likely to occur where suppliers have alternative effective proprietary routes to market, in the form of their own websites, on which they have full control over prices. We are not aware of any academic papers which model this possible platform participation effect, but we should expect the supplier participation decision to be at least partly driven by how much extra custom it feels it would gain access to through participating in the platform, which it would not otherwise easily be able to access.<sup>64</sup>
- *Benefits from RPM where upstream firms have better information on demand or marketing strategy:* Hagiu and Wright (2013) examine the relative benefits of an online platform being a reseller (which sets prices) versus a being a marketplace (on which suppliers set prices) in a context where suppliers and resellers may both have

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<sup>61</sup> Johnson (2013) provides a further argument for why it may be better for upstream suppliers to set prices when there is limited competition downstream due to customer switching costs across retail platforms. Under a standard retail model, retail platforms will seek to exploit customer switching costs by offering low initial prices to win customers but then high prices thereafter once they are 'locked in'. In doing so, they raise overall retail mark-ups and create consumer harm. By contrast, under an agency model, suppliers compete directly, on an ongoing basis and there is no harm from consumer lock-in. See Johnson, J.P. (2013), "The Agency and Wholesale Models in Electronic Content Markets", mimeo, available at SSRN: <http://ssrn.com/abstract=2126808> or <http://dx.doi.org/10.2139/ssrn.2126808>.

<sup>62</sup> We are not aware of empirical research into consumers' perceptions of the relative prices on internet retail platforms and price comparison websites, but there is some evidence that consumers do shop around between (as opposed to within) such platforms, albeit not on a large scale. For example, a consumer survey carried out by IFF for the Competition Commission in the context of its ongoing Private Motor Insurance Market Investigation found that 24% of consumers checked two or more price comparison websites before purchase, and that this figure rose to 46% amongst 17-34 year olds. See page 6, [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/130816\\_customer\\_survey\\_tables.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/130816_customer_survey_tables.pdf).

<sup>63</sup> It should be noted that Foros, Kind and Shaffer

<sup>64</sup> In the context of its investigation into Private Motor Insurance, the Competition Commission has considered - using a channel optimisation model - a closely related question of when would a supplier prefer not to list on a platform rather than submit to an MFN. See [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131219\\_appendices\\_and\\_glossary.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/private-motor-insurance-market-investigation/131219_appendices_and_glossary.pdf), A9(3)-28.

private information about the optimal level of marketing effort/spend to employ on each product.<sup>65</sup> They find that the marketplace approach should be preferred when the upstream suppliers have the greater degree of private information, and conversely that the reselling approach should be preferred when the downstream retailers have the greater degree of private information. While this paper looks at private information on marketing strategy, the same argument could potentially be made in respect of private information on product demand, which affects its optimal pricing.<sup>66</sup> This may provide a rationale for why it is the traders on Amazon marketplace, rather than Amazon marketplace itself, that set retail prices. Amazon marketplace is simply not in a good position to set such prices for the myriad of relatively low demand products that are sold on its platform. The benefits of suppliers controlling prices directly may also be important where the optimal pricing structure is relatively complex, as with the yield management pricing used in the airline sector, for instance.

The strength of the above efficiency arguments, which derive from the purely vertical element of RPM, will clearly depend on the facts of any market under investigation. It is noteworthy, however, that these vertical benefits from RPM seem to have received rather less focus in the literature than the benefits arising from the horizontal element of RPM.

In respect of the standard set of potential benefits, which arise from the horizontal element of RPM, it should be noted that there has been much debate around the extent to which RPM is likely to be indispensable for any identified efficiency benefits, or whether they might be achieved in a less anti-competitive way. There is much scepticism on this point and

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<sup>65</sup> Hagiu, A. and J. Wright (2013) "Marketplace or Reseller?", Harvard Business School Working Paper, No. 13-092, <http://www.hbs.edu/faculty/Pages/item.aspx?num=44784>.

<sup>66</sup> There is an analogy here with the activity of category management. Category management involves a retailer allowing a given upstream firm to choose price, range and shelf positioning for a particular category of product within the store. While there is recognition that category management can be anti-competitive, there are also a number of efficiency rationales for it, which have led antitrust authorities to take a relatively hands-off approach to it thus far. One such rationale is that the upstream firm knows more about customer demand for the product, not least because it sees details on sales across retailers, whereas the individual retailer only sees its own sales. This can, in turn, lead the upstream supplier to set prices more efficiently. For this point, albeit made informally, see Wright, J.D. (2009) "Antitrust Analysis of Category Management: *Conwood v. United States Tobacco Co.* Supreme Court", *Economic Review* 17, pp.311-336. We are not aware of any papers that explicitly model this point. The key existing papers on delegation of price-setting under asymmetric information about demand make the contrary assumption that retailers know more about demand than suppliers. (See Gal-Or, E. (1991) 'Optimal Franchising in Oligopolistic Markets with Uncertain Demand', *International Journal of Industrial Organization*, Vol. 9, pp. 343-364; and Nariu, T. and D. Lee (2013) "Resale Price Maintenance versus Delegation, Under Asymmetric Information", *The Manchester School* 81(3), pp. 401-419.) However, the point made non-formally in the category management literature appears plausible, and fits with the conclusions in respect of private information on optimal marketing levels in Hagiu and Wright (2013).

as a result, in Europe at least, these benefits have not been considered sufficient to alter the strong presumption against RPM that is embedded in its being an infringement of Article 101 TFEU *by object*, albeit they could potentially be drawn upon to justify individual instances of RPM (under Article 101(3)).<sup>67</sup>

We have not carried out an exercise to consider the extent to which the benefits identified above as arising from the vertical element of RPM might be achieved through other means. However, it far from obvious that they could be. As such, once the indispensability question is taken into account, it may well be that the efficiency benefits arising from the vertical element of RPM are more likely to be compelling, just as the anti-competitive effects arising from this element are likely to be rather less serious.

## **7. Policy conclusions**

On the basis of the above discussion, it is possible to consider the relative pros and cons of the vertical and horizontal elements of RPM separately. We find that many of the more serious anti-competitive effects diagnosed as potentially arising from RPM, as well as the actual enforcement cases, depend on the horizontal element of RPM, and not just the vertical element. At the same time, while the most well-recognised efficiency benefits of RPM do require the horizontal element, it is far from clear that RPM is indispensable for achieving these benefits. In addition, the vertical element of RPM may give rise to some additional and potentially significant efficiency benefits of its own.

On balance, then, it seems that it is the horizontal element of RPM which has really driven thinking on the appropriate approach to RPM under antitrust law. That is, this horizontal element can be viewed as RPM 'at its worst'.

So what are the implications for the core subject of this paper, Retail Price MFNs? There is a nascent literature on these clauses, which highlights their potential effect in softening competition and foreclosing downstream entry, but we have noted that Retail Price MFNs have a very strong resemblance to the horizontal element of RPM. This means we might expect Retail Price MFNs to have similar anti-competitive effects and also similar potential efficiency benefits, at least in respect of those effects that incorporate this horizontal

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<sup>67</sup> Bennett, M., A. Fletcher, E. Giovannetti and D. Stallibrass (2010) provide a description of the distinction between *object* and *effect* cases in EU competition law, and a discussion of the appropriate treatment of RPM in this context. See reference at footnote 12.

element. It also means, however, that Retail Price MFN clauses can be characterised as roughly equivalent to RPM ‘at its worst’.<sup>68</sup>

What then does this mean for policy? It would seem reasonable to conclude that Retail Price MFNs are no less likely than RPM to have an anti-competitive effect and no more likely to have efficiency benefits. There is an ongoing policy debate about the appropriate legal treatment of RPM. In Europe, it is seen as an infringement of Article 101 TFEU *by object*, which essentially means it can be presumed harmful, without any anticompetitive effect needing to be shown. In the US, RPM was viewed as a *per se* infringement until the well-known *Leegin* case. While RPM is now subject to the rule of reason approach in the US, many still consider that there should be a strong presumption that RPM is harmful.

It is beyond the scope of this particular paper to opine on where the appropriate policy line should be drawn on RPM. However, on the basis of the above, we would argue that – wherever this policy line is drawn – Retail Price MFNs should not be treated any less harshly. That is, if RPM is to be seen as an infringement *by object* under EU competition law, then so should Retail Price MFNs. This is our key conclusion in this paper and it is driven by the fact that Retail Price MFNs work so very similarly to the more problematic horizontal element of RPM.

Finally, and as discussed above, there is also an ongoing debate about whether or not internet retail platforms should be viewed as retailers at all, and therefore whether they are actually covered by the law on RPM. Again, without opining on this issue, the analysis in this paper suggests that there is likely to be significant economic harm deriving from Retail Price MFNs, irrespective of whether RPM law is triggered.

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<sup>68</sup> There is an additional argument that could be drawn on to support this point. Many of the more significant anti-competitive effects arise when RPM is instigated by the retailers, rather than the suppliers. Given that Retail Price MFNs are typically instigated by retailers, this is a further reason why they might reasonably be viewed as mimicking the ‘worst of RPM’.