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Refining its Tool Kit – The ACCC's decision to authorise RPM in the Tooltechnic case

In December 2014 Australia's Competition and Consumer Commission ("the ACCC") granted conditional authorisation to Tooltechnic Systems (Australia) Pty Ltd ("Tooltechnic") to engage in minimum resale price maintenance ("RPM") in marketing its premium Festool brand of power tools.[1]

RPM is subject to a *per se* prohibition under Australia's competition laws, but can be allowed if a firm applies to the ACCC to have the conduct authorised. Although this option has been available since 1995, Tooltechnic was the first firm to successfully apply to the ACCC for authorisation.

The ACCC recognised that RPM would eliminate price competition between dealers for Festool products, and thus increase retail prices to some customers, but judged that the pro-competitive benefits of eliminating the free rider problem would outweigh this adverse effect. It imposed conditions that require Tooltechnic to provide pricing and other operational information to allow the ACCC to successfully monitor the impact of the conduct over the four year period of the authorisation.

This Brief considers the analysis undertaken by the ACCC and explores the implications for other firms that might seek to emulate Tooltechnic's attempts to gain authorisation for RPM.

The commercial rationale for RPM

In the simplest model of competition, suppliers have no reason to want their retailers to earn large retail margins and would prefer to see those high margins being passed on to consumers through lower prices in order to boost sales of their products. There is no need for suppliers to protect retailers from price competition by imposing minimum resale prices if retail price competition generates economic efficiency and increased consumer welfare.

But it is well known that this very simple model of competition can break down when dealing with complex and differentiated products that require high levels of pre- and post-sales services. In this situation, instead of relying on retailers to increase sales by trying to undercut each other on price, suppliers might prefer retailers to invest time and resources to demonstrate the benefits of their products to customers.

Problems can arise when not all retailers play by the same rules. Rather than invest in retail services (such as product displays or other information services) that help to expand consumer demand for the brand, some retailers may instead choose to undercut the retailers that do offer the full range of retail services. Consumers can take advantage of the services offered by full service retailers, but then purchase the product at a lower retail price from a retailer that can afford to undercut full service retailers because it does not bear the costs associated with providing those services.

This "free rider" problem creates a distortion that can lead to the market providing a lower level of retail service and support than would be best for suppliers, consumers and overall economic efficiency. Consequently, manufacturers may prefer to suppress intra-brand competition in order to provide a material degree of protection to retailers that will in turn fund the provision of retailer services that consumers value. RPM is one way of achieving this.

Nevertheless, the world's leading competition law regimes have been predominantly hostile to RPM. The approach in Australia broadly mirrors the European provisions, applying a presumption that RPM is anti-competitive that can be rebutted only by a specific exemption.[2] In the US, a long period of outright prohibition of RPM was ended in 2007 with the Supreme Court Judgment in the Leegin case, which instead established that a more open-minded rule of reason test should be applied.[3]

1. ACCC Determination, authorisation number A91433, 5 December 2014. RBB Economics advised Tooltechnic and its legal advisers, Minter Ellison, on this application.

2. In the EU, Article 101(3) of the TFEU provides an efficiency defence for RPM if the agreement contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit without imposing on the undertakings concerned restrictions which are not indispensable to the attainment of those objectives; and without affording such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.

3. See Filippo Amato, "RPM in the European Union: Any Developments Since Leegin?" CPI Antitrust Chronicle November 2013 (1).

Since few firms have chosen to challenge the presumption of illegality, the default position amongst enforcers has been that RPM is essentially a hard core infringement. The adoption of labels for RPM such as "vertical price-fixing" has tended to reinforce this notion of RPM being synonymous with horizontal cartel activity even though vertical and horizontal price restrictions are fundamentally distinct and deserve a completely separate analysis.

Tooltechnic's own rationale for RPM followed the classic free rider story. It acts as an importer and wholesaler of various power tools and related products in Australia, although the RPM arrangements were intended for the premium Festool brand only, which accounts for a very small share of the power tools segment.[4] Tooltechnic's products are supplied through more than 200 multi-brand dealers in Australia, many of whom also sell online.[5]

Festool products are complex, with a high level of features and functions, and are aimed predominantly at professional users. Tooltechnic believed that provision of retail services such as pre-sales technical advice, product demonstrations, and "try-before-you-buy" arrangements, as well as post-sales services such as customer training and provision of consumables and accessories, would help to expand demand for the brand even if retail prices included a margin sufficient to fund those services.[6]

However, retailers who provided these services were increasingly losing out to competitors who chose a simpler no-frills model, and the problem of free-riding was exacerbated by the increased accessibility of on-line sales. Tooltechnic chose RPM as a solution after judging that other approaches, such as imposing detailed contractual obligations on retailers, granting exclusive retailer territories, or restricting on-line sales permissions, would be unworkable or less effective as a means of boosting sales.

The ACCC's assessment – theories of harm

Due to the novelty of the case and the deep suspicion with which competition authorities treat any conduct that resembles RPM, the ACCC approached its assessment with caution. It considered two theories of consumer harm: first, the concern that some consumers (those who placed little/no value on the retailer services and would purchase from discounters) would be worse off under RPM; and second, the concern that RPM arrangements can facilitate collusion or otherwise reduce competition, resulting in higher prices, lower output and diminished innovation at either the upstream or downstream levels.[7]

In principle, the latter (collusive) set of concerns carries far greater substantive risk of adverse welfare effects, but the ACCC was able to dismiss these coordinated conduct concerns quite quickly. It found none of the market characteristics that may facilitate coordinated conduct – a high degree of market concentration, high barriers to entry and expansion, homogeneous products, and an absence of maverick firms – either amongst power tool suppliers or retailers.[8]

In contrast, the ACCC agonised far more over the adverse impact on those customers (for example experienced repeat buyers) who placed little or no value on retailer advice and service, and who would accordingly be worse off in a world in which Festool products were not available from discount retailers. It saw the policy choice as a trade-off between the identifiable harm to such customers and the (perhaps less tangible) benefits to consumers whose product choices and experience with the Festool brand would be enhanced by the higher quality of retail service that is financed by the margin protection provided by RPM.

Against the context of a generally hostile enforcement stance against RPM, it took courage for the ACCC to adopt a decision that explicitly accepts an increase in the retail prices paid by the disadvantaged customer group. But this is clearly shown to be the right outcome when the incentives and competitive constraints acting on Tooltechnic are appreciated.

As regards incentives, Tooltechnic has no commercial interest in providing retailers with higher retail margins than are necessary to fund the levels of retail service that it considers

4. Para 47 of the Determination suggests that the five brands sold by Tooltechnic in aggregate accounted for around 10% of the Australian market.

5. Dealers are categorised as either "premium", "partner" or "specialist" dealers depending on their commitment to the Festool range in terms of a variety of requirements including floor space, product range, product demonstration facilities and other services provided to the customer.

6. See Determination, para 16. Paras 113-114 specifically highlight how retail discounting poses a threat to the provision of post-sales service.

7. See Determination paras 86 and 93 respectively.

8. Determination, para 99.

9. See Determination, para 109.

10. In para 125 of the Determination, the ACCC noted that Festool full-service dealers report spending up to an hour with a customer, only to have the customer leave and purchase the product from an online discount dealer (or demand that the full-service dealer match the price of the discounter). Full-service dealers also report having to deal with customers who have already bought products from online discounters.

11. See Determination, para 74.

are optimal for the distribution of the Festool products. More importantly, in a context where the brand faces tough inter-brand competition (and consumers have an effective choice between brands) any commercial errors made by Tooltechnic in this regard would be readily punished by consumers simply switching their demand towards competing tool brands that do not choose to suppress retail discounts. The ACCC Determination acknowledges these points but, perhaps understandably given the unusual nature of the authorisation decision, does not give them the weight they deserve.

In reality, the same kind of trade-off exists across many other dimensions of competition in a market such as this without any need for regulatory approval. For example, consider a commercial decision by Festool to incorporate a high cost component in one of its tools that would increase its reliability for heavy duty uses, instead of a lower cost alternative component that would be reliable only for less intensive use. This component choice would mean that all Festool customers would face a higher product price, but some (e.g. those who planned to make only light use of the tool and would be perfectly happy with the low cost component) would be "denied" the choice to enjoy a lower priced product. This is a substantively similar trade-off to that identified by the ACCC in the Tooltechnic case, but absent serious market power there would be no question that regulatory intervention is required to second-guess the merits of any such commercial decision. Inter-brand choices by consumers provide the mechanism to punish the supplier with lost sales if it misjudges consumer preferences.

The pro-competitive story, and alternatives to RPM

Of course, the ACCC assessment also scrutinised the free rider claims made by Tooltechnic, and evaluated the pro-competitive story. The ACCC's market inquiries established that Festool products are complex and positioned at a high quality/high price point. They also confirmed that demand for Festool products clearly did benefit from services at the point of sale due to their complexity and the general lack of customer awareness regarding the potential uses and benefits of the products.[9]

Consequently, the ACCC accepted Tooltechnic's claim that free riding was impacting many of Festool's full-service retailers, and that the distortions arising from this problem were likely to result in an increasing problem of under-provision of retail services for Festool products.[10]

However, the ACCC remained unwilling to authorise the RPM arrangements until it assessed whether there were alternative means for dealing with the distortions that arise from this free riding. It examined two such alternatives – the use of contractual arrangements, and non-price vertical restraints. On the former, the ACCC indicated that while Tooltechnic could continue to impose, monitor and enforce retail service standards contained in any agreements with retailers it would be difficult to specify in a contract what constitutes a high level of service and to monitor compliance with any such requirements effectively. Crucially, and correctly, it also noted that retailers would usually be best placed to know what services are most valued by their customers.[11]

The ACCC also considered whether non-price vertical restraints such as territorial restrictions and a ban on internet sales (except through Tooltechnic's corporate website) might be an effective way of dealing with the free-riding problem. However, it acknowledged that these options would likely reduce the availability of Festool products and harm its overall sales. That outcome would neither be beneficial to consumers nor commercially viable for Tooltechnic in the medium to long term.

But rather than authorise RPM unconditionally, the ACCC decided to impose a number of conditions on Tooltechnic to allow the impact of the proposed conduct over the four year period of authorisation to be evaluated. Those conditions require Tooltechnic to provide information on an annual basis on minimum retail prices, average wholesale prices, overall value of sales, changes in the number (and classes) of Festool dealers, plus details of the changes in the floor space that dealers dedicate to Festool products, and of any customer or dealer complaints.

Opening the floodgates?

Having challenged the RPM taboo in Australia with the first successful application, it will be interesting to see if other suppliers seek to follow Tooltechnic's lead. While the ACCC's effects-based assessment of Tooltechnic's application got the right result in this case, there are reasons to suspect others might find it harder to win authorisation for RPM.

First, future applicants might find it harder to dismiss the concern that RPM contributes to coordinated effects. Tooltechnic was able to satisfy the ACCC on each and every item on its "checklist" approach to assessing such concerns, but it remains to be seen how these risks would be assessed in the face of a more complex factual background. Ideally, the ACCC would adopt a robust stance and raise collusion concerns only where a clear link can be drawn to an identified theory of coordination, but it is quite possible that a more cautious stance would be adopted in the presence of higher market shares in either the upstream or downstream markets, or where multiple RPM applications come from the same industry sector.

Second, the high weight placed by the ACCC on the potential detriment faced by customers who currently buy from discount retailers, and its caution in relying on the constraints provided by inter-brand competition, gives a cautious indicator for future cases. Time will tell whether the ACCC becomes more confident in accepting the effectiveness of inter-brand competition as an antidote to adverse effects in any future authorisation requests.

Third, and more worrying, the ACCC's decision to impose ongoing conditions on Tooltechnic could raise the spectre of increased regulatory cost and uncertainty that might deter valid pro-competitive RPM applications. There is a risk that such costs could neutralise the efficiency-enhancing benefits that RPM is able to achieve, and the spotlight will be on the ACCC to assess whether its regulatory oversight on Tooltechnic is applied in a proportionate manner that avoids such chilling effects. The irony here is that if Tooltechnic felt that it could impose, monitor and enforce retail service standards in the way envisaged by the ACCC, it would probably have implemented these through contracts with its dealers instead of choosing RPM.

Having taken a stance on RPM that sets it apart from other major competition authorities, it is perhaps understandable that the ACCC made its grant of authorisation conditional on ongoing regulatory scrutiny. In future cases, once collusion concerns are dismissed, more faith in the power of effective inter-brand competition to better regulate any adverse effects from RPM might make it possible for authorisations to dispense with these potentially onerous reporting requirements.

Using the right tools from the toolkit

It is easy to see why competition authorities dislike RPM. A minimum retail price imposed by a supplier on the retailers of its product clearly limits the freedom of retailers to set their own prices and to offer discounts to end customers.

Although competition authorities are likely to remain inherently suspicious of RPM, the ACCC's approach in the Tooltechnic case offers a sound template for assessing the pro-and anti-competitive effects of RPM, both in Australia and in other jurisdictions. In this instance, a sensible effects-based assessment clearly showed that where the parties concerned have no market power, a vertical pricing agreement does not create or enhance market power. Under these conditions, many of the concerns associated with RPM simply cannot arise, and effective inter-brand competition can protect consumer welfare much more effectively than regulatory intervention.

Ultimately, the ACCC showed commendable intellectual independence in the Tooltechnic case, showing that it had the tools to handle a dispassionate examination of this controversial subject.