

Chapter 2

The Myth that Welfare is Promoted by Prohibiting Vertical Price and Brand Maintenance

The misconception that it is only necessary to fight price maintenance in order to guarantee the supply at favourable prices to consumers of the desired branded goods is widespread among the public and, surprisingly, also among students of economics. For example, a snap poll involving 193 participants, (mainly students aged between 20 and 36 years) by the Muenster Institute of Retailing and Network Marketing in 2010 revealed a considerable lack of knowledge of the topic of vertical price management (cf. Fig. 2.1).

If the advocates of cartel-law practice had to present themselves for public election at regular intervals, they would be well advised to adhere to strict RPM prohibition. The year-long discussion on price maintenance has obviously caused the subject of price-maintenance prohibition to become taboo and any attempt to change the situation is doomed to failure.

2.1 Starting Point: What Gives Rise to Optimum Consumer Welfare?

In our view, consumers experience the *greatest conceivable degree of welfare* when the effectiveness of competition is permanently guaranteed. Undisputed is the fact that this refers to competition *between* different supply concepts and brands. It is, therefore, a matter of the *effectiveness of inter-brand competition*. This presupposes supply diversity. Well-proven and innovative selling efforts compete with each other for the favour of consumers. Value systems in the consumer-goods sector normally have multiple levels with manufacturers and distributors being involved in marketing efforts. The most attractive supply concepts usually feature a harmonious combination of excellent services from both manufacturers and distributors. Conflicts *within* such service combinations, no matter

- More than 55% of respondents believed that manufacturers themselves set the selling prices of their products in retailing.
- On average, those asked estimate that 40–60 per cent of the products available in the most important consumer-goods sectors are price-maintained.
- 50 per cent regard a controlling influence of the manufacturer on the price structure of the distributor as negative.
- More than 54 per cent consider that price maintenance is disadvantageous to consumers.
- 60 per cent support a strict prohibition of every form of price fixing between manufacturing and retailing.
- 35 per cent subscribe to the theory that manufacturers and distributors increasingly conspire against consumers. In many cases, stricter action against value-adding partnerships is even welcomed, because it is widely believed that the strict prohibition of price and brand care leads to falling prices and, therefore, raises consumer welfare.

Fig. 2.1 Results from a poll by University of Muenster, 2010

whether they concern brand communications or strategic price positioning, may confuse the consumer and impair his faith in the quality.¹

Therefore: Diversity presupposes freedom of contract and of action in sales channels.

However, if industrial and commercial enterprises are increasingly prohibited by cartel law from avoiding consumer confusion by undertaking the necessary price and brand care, this may endanger strong brands and destroy incentives to innovate.

2.2 How do Strong Brands Arise and How do They Raise Welfare?

In order to justify for the above-mentioned theories, it is necessary to make a brief *excursion into the more modern theory of the formation of strong brands*.² Brands are created inside human minds; they cannot be ‘made’. Anyone attempting to burn his brand onto peoples minds by force ‘cowboy-style’ is certainly destined to fail. These are the results of our neuroscientific research at the University of Muenster. Strong brands are based on myths. A particularly graphic example of this is Red Bull, one of the few products that became a strong brand within a truly short period

¹ Cf. also the detailed article of Kenning and Wobker (2012).

² Cf. for the overview Ahlert (2004); Ahlert et al. (2006b) and Zernisch (2004).

27 guests attending a birthday party and aged between 23 and 68 participated in a blind test. In two experiments, the guests sampled two glasses each of sparkling wine (so called 'Sekt') in direct comparison and then immediately attempted to name the 'Sekt' that they personally found tasted best. The test persons were not told what brand they were just drinking. In casual conversation with the host, however, they were informed of the (alleged) price for the bottle of the relevant sparkling wine purchased from a distributor. What the participants did not know: all glasses contained the same brand of sparkling wine.

Results:

Experiment (1)

7 participants selected the 'Sekt' for € 2.99, 15 participants the 'Sekt' for € 4.99, 5 were undecided

Experiment (2)

10 participants chose the 'Sekt' for € 6.99, 10 participants the 'Sekt' for € 10.95, 7 were undecided

A similar result was obtained in a comparable experiment performed with wine (cf. Plassmann et al. 2008, p. 1050 ff.). The researchers explained it with the aid of a brain scan of the participating test persons (the exact method is called functional magnetic resonance imaging: see Ahlert/Hubert 2010, p. 47ff. for further details).

It could be proven that the change in price influences neural correlates of taste processing. In other words, the test persons did not merely think that the more expensive wine tasted better to them, this was really the case.

Fig. 2.2 Blind test with sparkling wine (University of Muenster 2010) [Cf. Schefer (2013) (forthcoming)]

of time. Red Bull is not a product essential to life. The consumer can avoid the product if he is confused by the consistently high price. After all, there are many alternative cult products and the consumer can also refrain from buying altogether.

But what would happen in the consumer's mind if the price of Red Bull was suddenly radically reduced?

A 'magic potion' for a discount price? 'Supernatural powers' for the same price as still mineral water? Price destruction would result in people ceasing to appreciate Red Bull and it would no longer have the effects attributed to it for the well-being of the consumer. This is demonstrated by brain research with the aid of magnetic resonance imaging³ as well as blind tests with consumers (cf. Fig. 2.2).

Efficient vertical price care is indispensable, not only for cult products like this fizzy drink, but for (almost) all branded articles. Strong brands are created in peoples' minds through their own experiences and beliefs, and these are influenced, firstly, by 'storytelling' in the media and, secondly, and in particular, by personal communication at sales outlets. Discord between manufacturers and sales agents would upset the brand community.

It is generally the case that unbridled price destruction and uncoordinated brand management can damage strong brands or even destroy them.

³ More information on this in Ahlert and Hubert (2010, pp. 59ff) and Kenning (2010, pp. 31ff).

The legal system does not currently offer any effective protection against these processes. If the individual supplier is then also prohibited from taking action himself to protect his brand against such impairments, he may lose customers. The product pales into insignificance. Diversity and, consequently, welfare, are lost if the consumer is unnecessarily forced to forego consumption. Without strong brands, consumer welfare is diminished.⁴ In the case of the cult beverage, Red Bull, some would perhaps say: ‘Just as well that we have got rid of this useless beverage. Young people should go back to drinking mineral water, milk or beer.’ The market has been cleaned up. In the words of Josef Schumpeter: the brand has been creatively destroyed, space has been created for the invention and marketing of new products. Or, as Friedrich Nietzsche said: ‘...and he who would be a creator in good and evil—truly he must first be a destroyer and break values.’ (Zarathustra 1928).

2.3 How Does Vertically Coordinated Price Management Affect the Dynamics of Innovation in Manufacturing and Retailing?

The above consideration is based on a fatal misunderstanding of industrial processes of innovation in connection with price maintenance. The argument repeatedly raised that price maintenance leads to *lethargy in competition* and diminishes willingness to innovate and the force of innovation in a sector is untenable in its claim of general validity. It can claim validity only in the extreme scenario of insurmountable barriers to market entry (i.e. high protective fences for obsolete products). In the normal case, the *interdependency between vertical price management and the dynamics of innovation* is precisely reversed. What entrepreneur would invest in complex processes of innovation if he expected that his supply concept could not reach the consumer in unadulterated form, because it would be immediately caught up in price wars? Who would invest in innovative supply concepts if the development of a strong brand was doomed to failure from the outset, because of the legal prohibition of concerted practices in the sales channel? All the more so if this led to a situation in which distributors who had been willing to cooperate were to lose interest in the transaction because of inadequate margins and the necessary enthusiasm for storytelling could not even arise.

In order to provide sound answers in terms of the theory of competition to the questions raised above, a brief *excursion into competition as a process of discovery* is required. The processes of progress can be described as the most important sub-processes of effective competition, but also as those most susceptible to disruption.

⁴ Cf. the article by Mocken (2012).

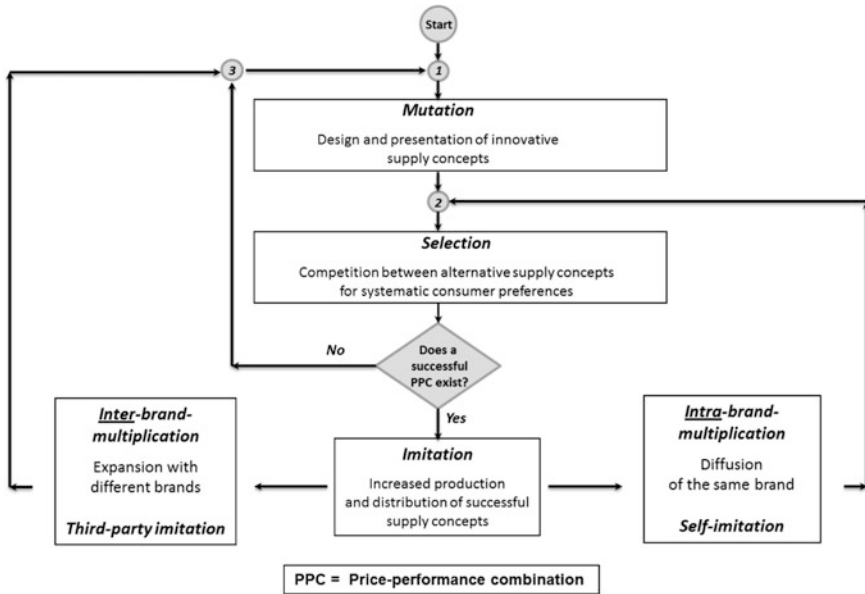


Fig. 2.3 Competition as a process of discovery (following Grossekkettler)

According to the economist, Heinz Grossekkettler, they can be presented as follows⁵:

Even consumers do not generally know exactly what their preferences will be before new goods emerge. Needs for ‘unborn’ goods exist latently at best. In this situation, it is important for consumers to be presented with the *widest possible range of alternative problem solutions* (items satisfying needs) in the course of a market experiment. Through their purchasing decisions, consumers determine the chances of survival of the individual supply concepts and, therefore, the possible returns to the supplying companies. This is how *consumer sovereignty* finds expression.

The process of innovation and diffusion is divided schematically into four subprocesses: mutation, selection, self-imitation and third-party imitation (cf. Fig. 2.3). In the consumer-goods sector, innovative supply concepts normally arise through a division of labour by the interaction of manufacturer and distributors (*mutation*). Value systems which prove to have greater than average success, owing to a high degree of consumer acceptance (*selection*) expand by increasing their capacities and consolidating their position with proven means. We refer to this process of *self-imitation* within the value system as *intra-brand multiplication*. Success motivates competing value systems to disseminate ‘me-too products’ or

⁵ Cf. Grossekkettler (1981, p. 255ff), (2009, p. 139ff).

even wholly innovative variations of the successful concept under alternative labels (manufacturer brands or trademarks). The process of *third-party imitation* may, therefore, be called *inter-brand* multiplication.

2.4 Why can the Prohibition of Vertical Price and Brand Maintenance Disrupt the Processes of Progress and, Therefore, the Effectiveness of Inter-Brand Competition?

Potential for disruption can be located in all four sub-processes of competition as a process of discovery and they are also closely related to each other. For example, foreseeable future difficulties in the diffusion of an innovative product, possibly based on a lack of cooperation on the part of the trade target group, may negatively affect *industry willingness mutate*. A distributor's lack of will to cooperate may, in turn, be traced back to his experiences with his distributor colleagues within the same value system. Loss-leader offers, confusing signals from sales personnel, inadequate goods presentation etc. can cause *consumers to doubt the quality*, so that the selection process is disrupted. Consequently, no strong brand even develops in the minds of customers (distributors and consumers). Ultimately, the chain reaction of mutually propagating effects that are possible and already foreseeable ex ante discourages manufacturers from investing in complex innovation processes.

This is made clear here again taking the selection process as an example. For the consumer to have any *opportunity of 'sovereign selection'*, the supplier (e.g. a branded-article manufacturer) must present his supply concept at all levels in an *unadulterated* manner as far as possible. It would have to be classified as market distortion if brand positioning within the value system intended by the producer was systematically thwarted. This would deny the innovative service opportunity to gain the favour of consumers in the course of the 'market experiment'. Reference is repeatedly made in this context to the risk potential for luxury, prestige or cult goods, but also for high-quality gift articles where, for example, an aggressive low-price policy or loss-leader policy of the distributor or a disharmonious brand communication would run counter to the intended brand launch concept of the manufacturer.

It is the task of competition policy to create suitable underlying conditions that enable innovators to ensure *for themselves* that the supply concepts regarded by them as promising reach the consumer level.

Coordination processes within value systems, explicitly also measures of *vertical brand protection and inter-level price care*, should be admissible in principle, to the extent that they promote the efficient operation of processes of progress. If, on the contrary, an efficient influence by innovators on *intra-brand* multiplication is not legally admissible, there is a risk that no processes of mutation take place, because entrepreneurs assign more importance to the risk of losing the necessary ‘return on investment’ than to the opportunities associated with innovation. This creates a serious defect in *inter-brand* competition, a deficit which would normally have to be eliminated by competition-policy intervention, but which in fact is caused by the cartel-law regulation of vertical marketing.

Not only the permanent *discovery and diffusion of new products*, but also the stabilisation and, if consumers demonstrate a desire for them by their selection behaviour, possibly also the *expansion of the pre-existing range of services and strong brands* could be the result of competition as a process of discovery. There are close interdependencies between these two processes, the introduction of *new products* and the undistorted marketing of *proven* supply concepts. This is because the *high risk of subsequent brand erosion* can stifle innovation efforts from the outset. Furthermore, the impairment of ongoing business success can prevent the release of investment funds urgently needed for innovation. Such destruction of innovation incentives constitutes *one of the most dangerous distortions of markets*.

2.5 Are Price Reductions a Valid Indicator of Increased Welfare?

The conviction that allowing vertical price coordination would cause higher prices for desired branded goods and that these higher prices would inevitably reduce consumer welfare is apparently widespread in cartel-law practice.⁶ In fact, price

⁶ Simon (2012) warns urgently against the admissibility of RPM by reference to the *Loi Galland* passed in France: “This is a statute from 1996 whose real purpose was to prohibit major supermarket chains from selling below cost price. Instead the statute operated like price maintenance in the form of minimum prices where suppliers defined high selling prices and granted year-end discounts that were not allowed to influence the retail price. The result of this was a decline in both inter-brand and intra-brand competition. The prices that customers had to pay after the *Loi Galland* were almost 10 % higher in 2002 (1 January 1997 = 100) than in Germany and at least 3 % higher than the average in the remainder of the Eurozone. After it was realized that this statute had negative effects on consumer welfare, it was amended in 2005. Prices fell by four per cent within a period of 14 months.” In fact, there is no plausible explanation for the chain of effects ‘admissible price restraints >> higher price >> diminution of consumer welfare’. Because the *Loi Galland* had a serious defect: it intervened with a further restraint (it imposed a prohibition of less-than-cost price on all participants) in the value chains and, as a result, it stifled effective competition instead of giving back participants their individual freedom of action. If the statute had instead allowed different forms of vertical price coordination, then, with (sufficiently) effective competition, lasting market results would have been seen that would be described as optimum from the point of view of consumer welfare. Should price increases occur as a result of effective

reductions can definitely *not* be regarded as a valid indicator of greater welfare. Welfare is not primarily concerned with—possibly only temporary—price reductions, but instead with the *diverse options facing consumers among various different supply concepts characterised by different prices*. Moreover, the following fact may not be ignored: in the absence of mutation, even the most efficient processes of selection and imitation come to nothing. Destroying incentives to innovate does not lead to cost-effective supplies of attractive products in the long term.

How can a legal system which explicitly allows patents in order to promote innovation, and which has done so for more than 100 years, deny vertical brand protection to an innovative supply concept? If no essential goods are involved, in which case competition policy must naturally prevent extortionate prices, but the free appropriation of income by consumers, the following question arises: why should the State interfere in value processes and limit diversity? This would be according to the motto: ‘Unless all consumers can afford to buy expensive cult lemonade, nobody should be allowed to have it.’

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(Footnote 6 continued)

competition—as reasoned in detail in the present article—there would be no doubt as to their economic justification from a welfare point of view (translated from German).

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