Institute of Channel Management

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Avoiding Corrosive Price Competition

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Although many suppliers seek a balance between conventional channel members and Internet resellers, corrosive price competition between these two types of intermediaries remains one of the most common causes of channel conflict. At the same time, there are a number of lawful approaches that a supplier can take to avoid or control it.

The Problem

When certain resellers of products (Internet based or otherwise) substantially undercut the prices charged by competing resellers of the same brands, at least some of the latter react by no longer doing certain things that suppliers value to help differentiate their products from those of competitive brands. To cope with diminished margins, intermediaries subject to intense price competition often drop services, limit inventories or otherwise cut costs. Alternatively, they look to the supplier for extra financial subsidies. Unless managed carefully, corrosive price competition not only can erode supplier margins, but also can jeopardize brand value, resulting in commoditization.

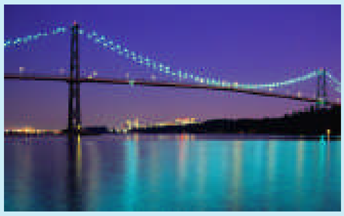
Underlying this problem may be the "free-rider effect," where some resellers that have not invested services or inventories take a free ride on those that do. So, for example, an end-user works with a full-service reseller that has technical expertise to determine what it needs for a particular application, but then goes to an Internet reseller to make the buy on price. While the pricing of full-service reseller usually reflects its higher costs, the discounting reseller takes a free ride on these services.

Non-Price Vertical Restrictions

Sometimes, suppliers are their own worst enemies because they sell to anyone and everyone with no post-sale controls. Vertical non-price restrictions can be used to manage channel conflict by controlling the nature and extent of the competition among the supplier's resellers, regardless whether this control is exercised using incentives (carrots) or by contracts (sticks). For the last 30 years, this approach has been commonly used with considerable success and little legal risk in the United States and Canada, as it is judged under the legal standard known as the "rule of reason," where such restrictions are presumed reasonable and lawful until proven otherwise.

One type of vertical non-price restriction is customer restraints that permit the supplier to allocate customers among its resellers, effectively telling them to whom they may or may not sell. Another kind is territorial or market restrictions, which designate a geographic area or market for the intermediary and encourage or require it to stay there or stay out. The third type is product restrictions that can: (1) limit the products made available to competing sellers (in general, the supplier does not have to sell all products to all customers), (2) require that resellers buy the whole line or at least certain core products to avoid cherry picking or (3) exclude the sale of competitive products.

As a result, a reseller can be prohibited from selling over the Internet or even confined to only that type of selling. Of course, customer and market restrictions can be combined to allocate only particular types of end-users to Internet sales. Moreover, the Internet intermediary can be provided with only certain products to further reduce conflict.



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Account-Specific Marketing

Suppliers often exacerbate channel conflict by assuming they must treat all conventional and Internet channel members the same or on a "fair and equitable" basis—unrealistic standards that have never been part of the law. Instead, the requirement in the United States under the Robinson-Patman Act is that only competing customers must be treated more or less alike, unless there is a good reason to differentiate.

So, another strategy to cope with Internet pricing and distribution issues is to develop or refine account-specific marketing programs to compensate resellers for their efforts which are consistent with the supplier's goals. In addition, non-price vertical restrictions can be used to control the amount of overlap so that competing customers are treated appropriately.

Careful design of pricing programs can avoid Robinson-Patman issues, as can the use of certain defenses like availability, cost justification and meeting competition. So, for example, if the supplier values technical support or depth and breath of inventory, the conventional reseller providing it may receive a better price than the Internet reseller that does not. Moreover, the supplier can re-allocate its trade spending to deliver the appropriate rewards without an increase in aggregate spending.

Setting or Encouraging Resale Prices

Through account-specific marketing or otherwise, suppliers long have influenced resale prices through the prices they charge to their customers, something that may be useful to address corrosive price competition by affecting the minimum resale prices for both conventional and Internet resellers. However, the U.S. Supreme Court has made it clear that it can be lawful for the supplier to go beyond this to actually specify the resale price by either contract or policy in order to level the playing field.

Based on recent decisions, the law currently applies the rule of reason to maximum, minimum or exact resale prices set by contract and permits them, unless they are shown to be unreasonably anticompetitive. This standard is the same one that applies to commonly used vertical non-price restrictions with minimal legal risk, but has been much more controversial in the pricing context.

An even safer approach is to set such prices by unilateral policy, a practice allowed in the United States for 90 years. Here, the supplier typically announces a floor, ceiling or exact price and refuses to do sell to anyone that does not follow it—a practice that is entirely lawful, provided there is no agreement between the supplier and the customer on resale price levels. Interestingly, a reseller that complies is considered not to have made an illegal agreement. As result of this freedom, many suppliers of attractive branded products have successfully implemented resale price policies to tackle corrosive price competition in the business-to-business context for such diverse products as electronic test equipment, power tools, agricultural supplies and automotive replacement parts.

Another method to control resale prices is for the supplier to negotiate the sale directly with the end-user. Here, the supplier may establish a contract price with the ultimate customer and make it available to an internet or other reseller to implement. The voluntary nature of the reseller's participation subjects this arrangement to the rule of reason. Alternatively, the intermediary can be used as an agent for the sale or for order fulfillment.

Rather than control resale prices, some suppliers prefer to encourage certain pricing behavior, usually by providing some form of discount or allowance. One common version is the Minimum Advertised Price (MAP) program, which pays an advertising allowance to those resellers that do not advertise below the floor price, although they remain free to sell at any price they please. Another variant is the target price rebate, which gives intermediaries rebates for following target prices set by the supplier. Here too, the voluntary nature of these approaches results in rule-of-reason treatment.

Summary

While channel conflict caused by corrosive price competition between conventional and Internet resellers remains a problem for many suppliers, there are a variety of lawful ways to avoid or manage it, including non-price vertical restrictions, account-specific marketing and resale price setting or encouragement.

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