

CHAPTER 1
CHANNEL ORGANIZATION AND ANTITRUST

Conventional marketing channels comprised of independent agencies and institutions are on the decline. Centrally programmed vertical marketing systems have emerged as the significant form of channel organization in the modern marketplace. Some observers estimate that these contractual and corporate vertical marketing systems now account for as much as 85% of total retail sales.ⁱ

Implicit in this concept of a vertical market system is the notion that the entire channel, rather than each constituent firm, is the meaningful unit of competition. Consequently, the modern channel of distribution must be formally managed from top to bottom if it is to be maximally competitive. Unfortunately, this practice of centralized channel management is directly at odds with the view of channel-member independence implicit in the antitrust laws.

Traditional Channels

The traditional marketing channel, which is envisioned by the antitrust laws, is a "provisional coalition of independently owned and managed institutions," each of which follows its own interests with little concern about what goes on before or after it in the distributive sequence.ⁱⁱ It is a fragmented network in which loosely aligned manufacturers, wholesalers and retailers bargain with each other at arms length, negotiate aggressively over terms of sale, and otherwise behave autonomously.ⁱⁱⁱ

Moreover, the autonomy of these operating units in conventional marketing channels often results in wasteful duplication, scheduling inefficiencies, and high intra-channel selling costs. In addition, the fragmentation of the system into coalitions of small self-sufficient firms frequently results in the sacrifice of potential scale economies that could be achieved by the realignment of the activities within the

network. Consequently, it is not at all surprising that planned vertical marketing systems are rapidly displacing conventional marketing channels as the dominant mode of distribution. ^{iv}

Vertical Marketing Systems

Vertical marketing systems seek to overcome the inherent disadvantages of autonomy. They are centrally programmed to achieve both operating efficiencies and maximum market impact. In addition, the entire system is carefully rationalized to achieve managerial and promotional economies through the integration and coordination of system-wide marketing activities. ^v

Channel members are coordinated in detail; suboptimization is checked; and entry is rigorously controlled. In the case of contractual systems, membership loyalty is assured through the use of specific agreements, and in the case of corporate systems, by the authority of ownership. As a result, the vertical networks tend to be relatively stable. Marketing functions and tasks are routinized. Detailed negotiations are radically reduced and are treated as part of a long range plan. Movement of goods is automatic. Activities are standardized, and service and sales quality is carefully controlled. In short the modern distribution channel is now centrally managed as a whole.

Obviously, the comparative advantage of the modern vertical marketing system lies in its ability to capitalize on centrally programmed operations and scale economies in both logistical operations and marketing. While the traditional channel has the advantage of adopting to heterogeneous market opportunity, the cost advantages work in favor of the centrally programmed vertical marketing system. And where uniformity is preferred, or at least not undesirable, the standardized level of performance and heightened impact achieved within vertical marketing systems is rarely achieved in conventional channels.

Corporate Systems

Corporate systems are often the byproduct of a general policy of vertical integration followed by many

firms who are trying to free themselves from the limitations and uncertainties of their environment. Here, integrated marketing is merely part of a broad program of vertical and horizontal integration and control. Most major oil refiners, for example, develop and protect their retail markets by integrating and controlling retail marketing, just as they protect and develop their sources of supply by integrating and controlling production.

Corporate systems also emerge as a consequence of the special distribution needs of new hi-tech products. The last fifty years have seen the introduction of many complex products which require intensive pre-purchase sales effort, and after-purchase support. Unless these functions are fully integrated into a product's distribution, it will be difficult for it to compete with products so distributed.

On the other hand, corporate systems are not always the best answer to the problem of coordination and control. When the assortment of products required at the retail level is radically different from the assortment that make sense at the manufacturing level, vertical integration may be impossible without completely changing the nature of the business. For example, oil companies and tire companies have integrated forward into retailing because the "discrepancy of assortments" is not great. However, it would not be easy for a firm like Gates Rubber Company to integrate forward. Even though Gates makes a full line of belts and hoses, they would have to completely change their business were they to do so. Their customers expect to buy hoses and belts in an auto parts store, not a "Gates Hose and Belt Store." And of course the typical auto parts store carries a radically different assortment from the line Gates now makes and sells--say 20,000 stock-keeping units (sku's) versus 1,000 sku's in Gates' assortment.

There are other reasons why corporate systems are not always the best answer to the problem of coordination and control. Because certain intermediaries specialize in one or more of the marketing flows such as selling, physical possession, negotiation etc., their use often boils down to an economic decision to exploit their superior efficiency or scale economies in the performance of these basic marketing tasks and functions. Various independent marketing intermediaries, through their experience, their

specialization, their contacts, and their scale, can often offer other channel members more than they can achieve on their own. In such cases, the channel decision is a "make -or-buy" decision. Should the firm do its own distribution or should it sacrifice some control in order to realize these efficiencies? This is the trade-off: cost versus control.

This "make or buy" decision is never completely resolved. The fact is that there seems to be a continuous process of divesting and reintegrating marketing functions by manufacturers or other channel leaders. For example, in recent years, there has been a tendency for certain of the oil companies to eliminate independent jobbers and dealers, and to do their own wholesaling and retailing in certain key urban markets. At the same time, B.F. Goodrich has announced that it is spinning off its 500 company owned and operated service centers, and soon will discontinue operating retail stores entirely.^{vi} The reason given for both decisions is profitability. The oil companies say that they can deal directly with the motorist through self-serve, express outlets at less cost than the combined functional discount they were giving dealers and jobbers. Goodrich said that they felt that smaller companies and individual operators could operate these "local" businesses more profitably than a large company such as Goodrich.^{vii}

Contractual Systems

Because integration through common ownership is not always the best way to achieve coordination and control, independent firms at different levels often seek to integrate their programs on a contractual basis in order to realize the systemic economies and increased market impact enjoyed by corporate systems. Contractual integration occurs where the various stages of distribution are independently owned, but where the relationships between vertically adjacent firms are covered by a contractual arrangement.^{viii}

Contractual integration is by far the most important form of integration. In many lines of business it is the dominant form of channel organization. It is also the form of channel organization that is most likely to be subjected to antitrust attack.

Contractual integration takes a variety of forms: voluntary groups, cooperative groups, franchise systems, etc. To a significant extent, channel members in such systems are willing to trade off some degree of autonomy in order to gain scale economies and other efficiencies, and to increase market impact.^{ix}

While the overhead control that can be exercised over channel members is reduced, there are many offsetting advantages to the contractual system. The financing advantage is of course obvious. In many lines of business, the investment at the distributive level equals or exceeds that at the manufacturing level. In addition, the initiative that individual owners at different levels are likely to exercise can be especially important where the sale is complex as in the case of life insurance, or where the sale involves a trade-in as in the case of an automobile. In other cases, the escape from union labor or chain store taxes can be an incentive to utilize locally owned channel members. In still other cases, channel members are willing to work much longer hours and for less return when they are in business for themselves, than when they are merely employees.

Contractual Systems as Complex Organizations

It is now widely accepted by students of complex organizations that a manufacturer and his associated wholesalers and dealers make up a loose-knit organization which is in need some degree of interorganizational administration, much as is a single corporate system. Moreover, as in all organizations, some activities can best be performed centrally, while others are best carried out on a decentralized, though carefully coordinated basis.

Few would dispute that any given channel of distribution can improve its competitive viability if the activities and flows within it are coordinated in an effective manner. Although it is conceivable in certain situations that free market forces could approximate the same result, it is more often the case that the free functioning of markets would entail considerable wasted effort, needless duplication, and reduced marketing impact. Therefore, most manufacturers understand that they can often improve their market

performance by recognizing their vertical interdependence with their retailers and wholesalers, and by coordinating the system's activities accordingly.

Interorganization Management

Among all of the members of the channel, the manufacturer is most often, though not always, in the best position to perform this administrative function for the contractual system. This is true not only because of the manufacturer's proprietary position and technical knowledge with respect to the product, but also because of the scope of his knowledge of the larger market, and because he is the only actor in the system legally permitted to coordinate all of the others. Thus, despite the separation of the ownership of the intermediate facilities, the manufacturer will often feel compelled to develop a series of sanctions and controls which will allow the loose-knit system to rival the efficiencies of the vertically integrated corporate system, and to gain an advantage over competing systems that lack this coordination. ^x

Also, just as a high degree of interorganizational coordination is required within a marketing channel if it is going to have any long-run impact on the markets it serves, so too, functional specialization is a prerequisite for achieving efficient channel performance. It is the way that scale economies and expertise are brought to bear on the distribution process. The other side of the coin, however, is that this functional specialization results in even greater operational interdependence. And of course, this functional interdependence increases still further the need for centralized coordination and administration. It is a chain reaction.

Moreover, in order to institute effective interorganization management, and to exploit the advantages of functional specialization, the exercise of power is a necessary predicate. Without power, few of the advantages of the corporate system could be captured by the contractual system. And yet, there are significant constraints in place which limit the manner in which power may be employed in the contractual marketing system. Some of the constraints are legal while others derive from the fact that a heavy handed exercise of power can cause channel members to withdraw from the system or to withhold

their full and enthusiastic participation in the joint enterprise. Long ago, McVey noted that independent middlemen are in business for themselves, not for manufacturers. They do not function solely as member components of a distribution system, but rather they act in their own interest -- each one choosing those products and suppliers that best help him serve the target groups for whom he acts as a "purchasing agent."^{xi}

Interdependency and Conflict

Anytime there is an interdependency relationship, the seeds of conflict are ever present. And of course, conflicts can and do take place within distribution channels over how much inventory should be carried by various members, who has the right to represent a particular product within a given territory, whether prices are being maintained at reasonable levels, why distributors and dealers are sometimes bypassed via direct selling, etc.^{xii} In fact, most of the antitrust activity directed at contractual channels arises from these internal channel conflicts. This is true of public as well as private cases. Thus a central task in interorganization management is to seek ways to manage conflict... to keep conflict from becoming dysfunctional, to keep it from going public or destroying the system.

Inherent in all channels comprised of independently owned members is the problem of suboptimization. As the McVey article quoted above notes, there is a tendency for intermediaries to pursue their own interests, even at the expense of system interests. The resulting suboptimizing behavior serves to undermine the competitive viability of the total interorganization network. Thus, the problem for the actors within any distribution network is to develop a set of arrangements that will minimize suboptimization by individual channel members. Only then will it behave as a vertical system. This is the function of the various vertical marketing restrictions imposed on channel members by the system "administrator." It is also a source of much antitrust litigation.

In all systems in which the parties must cooperate in order to achieve a common end, it is imperative for the effective functioning of the system that the role which each party is to play within the system be

well understood and clearly defined. In fact, within any distribution system, channel members must come to some agreement on the "domain" of each. This "domain agreement" includes all of those mutual understandings regarding the customers to be served, the territories to be covered, and the functions or activities to be performed by each component of the system. ^{xiii}

Channels as Organizations

Although channels are not often as "formalized" as other complex organizations, they approach such formalization through the adoption of rules and the specification of duties. In fact, within any formal contractual channel system, positions and duties must be fairly well ordered and defined, and relationships must be institutionalized. These explicit rules and policies regarding delivery, billing, order size, standardization, customer care, and the like are the critical vehicles that permit routinization and lead to the formation of what Alderson has termed "organized behavior systems." ^{xiv}

To summarize, if these contractual marketing systems follow the usual dictates of organization theory, one would expect them to develop systems of authority which will allow them to assign roles and domains, and to resolve conflicts. Thus, in order to organize and manage the resources of a distribution channel, it may be necessary to develop power centers within the system. But, at the same time, this essential power remains anathema to the antitrust laws. This is the core of the policy dilemma.

In all channels comprised of independent firms, the strain toward autonomy must always be juxtaposed to the need to cooperate. It is unnatural, and perhaps even undesirable, for the law to expect the highly interdependent firms in a vertical marketing system to act independently. Hence, the problem for public policy is to accommodate this interdependence while preserving those areas of independence that keep the marketing system vital and responsive to the consumer interest.

Channels of Distribution as Markets

Antitrust law is explicitly based on an economic view of market behavior. It uses economic analysis, as opposed to organization theory, to determine whether, and how various structures and arrangements will affect the public interest. There are other interests present, but the overriding purpose of antitrust enforcement is to maintain competition as the principal regulator of business behavior, channels of distribution included. The sections of the Sherman and Clayton Acts dealing with vertical channel relationships clearly reflect this tradition. The key sections are concerned with "restraints of trade" and the "lessening of competition." The difficulty is that this "economic" view is dramatically at odds with the organizational imperatives just discussed. Effective vertical marketing systems require that competition between individual channel members be restrained for the good of the whole system.

Economic theory views the relationships between levels of distribution primarily as relationships between buyers and sellers, i.e., as market relationships. And of course in a competitive market, these vertical relationships should be governed by the interaction of supply and demand. Moreover, if one assumes that these vertical markets are competitive, or should be, no single buyer or seller should be able to influence price. No participant should stand in any significant relationship to any other. Relationships should be arms-length. Power is to be completely absent. Each participant is to be free from the power or influence of any other.^{xv} No one should be compelled to act against his own self interest, narrowly defined.

Power and Dependency

Of course, we know this to be an unrealistic view of the modern channel situation. It completely ignores the near universal conditions of mutual dependency and concomitant power relations, which severely limit and possibly even disqualifies the market mechanism as the appropriate model for guiding public policy in this area. The typical distributive market is clearly imperfectly competitive. Each

imperfection partially frees distributors and manufacturers from market constraints. To the extent that they are thus freed, they will have bargaining power over those with whom they deal. Thus, a manufacturer who has created consumer preference for his brands enjoys a bargaining advantage in his dealings with distributors. A dealer who benefits from consumer habit and from location is strengthened in his relations with wholesalers. And so it goes. Even, monopolistic and oligopolistic elements in horizontal competition add uncertainties to vertical relationships and cause their outcome to rest in part on relative bargaining strength.^{xvi} Furthermore, the increase in size associated with mass distribution adds to the importance of bargaining power.

These conditions of dependency and control, so characteristic of modern distribution, vitiate much of the economic analysis of the vertical relationships in a vertical marketing system. Power is essential for vertical marketing systems to function effectively, but power is incompatible with traditional economic analysis. There never was absolute equality of bargaining power on opposite sides of vertical markets, but great increase in the size of either manufacturers or retailers, and the attraction of mass markets, have changed much of modern distribution from a flow through a series of largely autonomous markets to a single movement dominated by either manufacturer or mass retailers.

Often, dominance by a manufacturer reflects a calculated strategy on his part to shift the selective function to the consumer or end user and away from intermediate markets. Many manufacturers now compete more for the patronage of the final buyer than for that of the wholesaler. In such cases, the bargaining position of the independent wholesaler or distributor is weakened still further since he stands between the manufacturer and the retail level where the competitive success of the "pull" strategy is determined. Such manufacturers must, and do, control both the wholesale and the retail level. Texaco or General Motors cannot afford to let their retail dealers operate at arms length. If the pull strategy is to work, the retail presentation must be carefully orchestrated. The wholesaler either integrates into the manufacturer's system or he is by-passed. There are situations where it may not be possible to bypass the

independent retailer, but often, the independent retailer can be reached directly. And if this is the case, the wholesaler has to sing from the manufacturer's hymnbook if he wants to be part of the chorus.

The net result of all of these developments in contemporary distribution is that power has come to rival economic factors as the governing element in the vertical relationships in a channel of distribution. And yet, our mode for analyzing antitrust issues in the channel area either assume power does not exist, or that when it does, that it is an "imperfection" and must be corrected.

Channels as Competitors

As already noted, competition is no longer simply defined by horizontal relationships. Economic battles involving distributors or dealers versus other distributors or dealers marketing the same brand, will not in the long run determine the ultimate victors in the contemporary marketplace. Rather, the relevant unit of competition is now the entire network of interrelated institutions and agencies versus other networks of institutions and agencies. This turns out to be true even when network members in any geographic territory handle the product lines of more than one manufacturer. Today, it is the effectiveness of the means by which various individual manufacturers coordinate their activities with their distributors', and vice versa, that determines the viability of one type of channel alignment versus others.

In the meantime, antitrust policy is still trying to maintain the autonomy of independent decision-makers at all levels of the distribution channel. As a consequence, manufacturers and franchisers are finding it increasingly difficult, short of integration by common ownership, to exert the needed influence on the independent businessmen who deal in their products, and on the markets in which their products are sold. At the same time, public policy is making it easier for distributors to choose alternative suppliers and to establish their own geographic markets, to do business with whom they choose, and to establish their own prices. And the more the supplier or franchiser attempts to resist these trends by making it difficult for franchisees to exert their independence in legally permissible ways, the harder it becomes to terminate the franchise relationship without inviting a law-suit.^{xvii}

Distributor Interest and the Public Interest

The key question to ask is where the public interest lies --in more freedom for channel members or less? One group, basing their conclusion on economic efficiency, holds that marketers should be able to achieve through contract, what can be achieved through ownership. They view it as illogical to allow close-knit corporate systems under common ownership to act in concert while loose-knit contractual systems engaging in the same behavior, and seeking the same ends are, prosecuted under the Sherman and Clayton Acts. Distinctions of title are seen as irrelevant in this instance.

On the other hand, others argue that there is real social value in the decentralization of economic and marketing decision making, even if it must be gained at the expense to economic efficiency. They note that large vertical systems often become rigid and resistant to change. In addition, these integrated systems are hard to challenge since new competitors with new ideas or marketing methods must enter as full-blown systems, or else they are foreclosed. Consequently, barriers to entry are increased and responses are blunted and tempered by bureaucratic inertia. The end result could easily be groups of relatively inefficient competing systems, offering largely homogeneous offers, while protecting the status quo. To some extent, the history of innovation in marketing supports this view, since it is typically a history of outsiders challenging existing arrangements which have outlived their time. ^{xviii}

There are also troublesome issues of equity and power that must be faced. When options are limited and dependence is great, the tendency is to convert economic and marketing disputes into political issues and to seek to resolve them through political means. And of course, the politicization of marketing may completely undermine the justification for allowing the marketing structure to emerge in the first place. Joseph Palamountain's classic study of the New Deal marketing reforms bears witness to this process. ^{xix} It is the old issue of hierarchies versus markets that has long troubled us in economic and political affairs. Edward Mason once phrased the issue as a search for "that degree of market power which is necessary to an efficient conduct of business, but beyond which there is an inevitable divergence between the particular and the general interest. ^{xx} The search for that "optimal degree of market power" in vertical

marketing systems is what this this study is about. Moreover, this search will differ from studies such as Robert Bork's The Antitrust Paradox^{xxi} in that we will use a compass pointing to the consumer interest, as opposed to economic efficiency.

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End Notes--Chapter 1

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ⁱⁱ Bert C. McCammon, "Perspectives for Distribution Programming," in Louis P. Bucklin, ed. Vertical Marketing Systems (Glenview, IL: Scott, Foresman and Company, 1970), p.43.

ⁱⁱⁱ Bert C. McCammon, "Perspectives for Distribution Programming," in Louis P. Bucklin, ed. Vertical Marketing Systems (Glenview, IL: Scott, Foresman and Company, 1970), p.43.

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- ^{iv} Bert C. McCammon, "Perspectives for Distribution Programming," in Louis P. Bucklin, ed. Vertical Marketing Systems (Glenview, IL: Scott, Foresman and Company, 1970), p.43.
- ^v Bert C. McCammon, "Perspectives for Distribution Programming," in Louis P. Bucklin, ed. Vertical Marketing Systems (Glenview, IL: Scott, Foresman and Company, 1970), p.43.
- ^{vi} The Wall Street Journal, October 15, 1985, p.
- ^{vii} The Wall Street Journal, October 15, 1985, p.
- ^{viii} Donald N. Thompson, "Contractual Marketing Systems: An Overview," in D. N. Thompson (ed.), Contractual Marketing Systems (Lexington, MA: Heath Lexington Books, 1971), p. 5.
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- ^{xiv} Wroe Alderson, Dynamic Marketing Behavior (Homewood, IL: Richard D. Irwin, Inc., 1965), p 37 and 43-45.
- ^{xv} Joseph C. Palamountain, Jr., "Vertical Conflict," in Louis W. Stern, Distribution Channels: Behavioral Dimensions (Boston: Houghton Mifflin Company, 1969), p.134.
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^{xx} Edward S. Mason (ed), The Corporation in Modern Society (Cambridge, MA: Harvard University Press, 1961) p. 7.

^{xxi} Robert H. Bork, The Antitrust Paradox: A Policy at War with Itself (New York: Basic Books, Inc., 1978).