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Reply to Winter's "Vertical Restraints and Antitrust Policy: A Reaction to Cooper, Froeb, O'Brien, and Vita"

James Cooper, Luke Froeb, Daniel O'Brien, and Michael Vita

In the Autumn 2005 issue of *Competition Policy International*, we published an article on the antitrust policy implications of the theoretical and empirical literature on vertical restraints.[1] In an accompanying comment,[2] Professor Ralph Winter claims that we are advocating an enforcement standard that in any particular case would ignore case-specific evidence of the restraint's effects. He also claims that we commit an "analytical error"[3] in our discussion of how distortions in promotional incentives may motivate the use of resale price maintenance (RPM).

1 J. Cooper, L. Froeb, D. O'Brien, & M. Vita, *Vertical Restrictions and Antitrust Policy: What About the Evidence*, 1(2) COMPETITION POL'Y INT'L 45–63 (2005).

2 R. Winter, *Vertical Restraints and Antitrust Policy: A Reaction to Cooper, Froeb, O'Brien, and Vita,* 1(2) COMPETITION POL'Y INT'L 75–88 (2005). A comment was also published in the same issue by F.M Scherer (*Comment on Cooper et al.'s Vertical Restrictions and Antitrust Policy,* 1(2) COMPETITION POL'Y INT'L 65–74 (2005). We respond to many of the points raised by Professor Scherer *in* J. Cooper, L. Froeb, D. O'Brien & M. Vita, *Vertical Antitrust Policy as a Problem of Inference*, U.S. Federal Trade Commission (Feb. 18, 2005), *available at* http://www.ftc.gov/speeches/froeb/050218verticalecon_respcrit.pdf.

3 Winter, *supra* note 2, at 82.

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Neither criticism is accurate. We agree with Professor Winter that individual cases should be judged "on their own merits." We do argue, however, that the plaintiff's burden in vertical restraints case should be high, and we place significant weight on both historical and case-specific empirical evidence.[4]

His claim that we commit an analytical error in our discussion of promotional incentives also is incorrect. We clarify this point below.

I. On Using Case-Specific Evidence in Antitrust Investigations

Our article observed that economic theory provides ambiguous predictions about the welfare effects of vertical restraints. Moreover, we explained that when practitioners attempt to use theory to help discern the effects of vertical restraints in any particular case, they confront a difficult inferential problem:

> "Not only must they decide which model best applies to the particular factual circumstances in which the restraint has been adopted, they also must then determine whether the model chosen has the particular combination of parameters that would result in an anticompetitive equilibrium."[5]

We pointed out that this is a difficult exercise, given the various uncertainties that are involved, and concluded that the ability of theory to guide practitioners is "quite limited,"[6] and that enforcement decisions necessarily will be subject to "substantial uncertainty."[7] Nowhere in this discussion did we say that, in any

4 Remarkably, in earlier academic publications, Professor Winter advocated an explicit policy of per se legality for vertical restraints:

> With a single firm upstream, and therefore no possibility of beneficial effects on interbrand competition, we find that restraints nonetheless generally increase market surplus in our framework. Although examples can be constructed in which welfare decreases with restraints, a rule superior to per se legality of purely vertical restraints has not, in our view, been offered.

See F. Mathewson & R. Winter, *On Vertical Restraints and the Law: A Reply*, 19(2) Rand J. Econ. 300 (1988).

5 Cooper et al., *supra* note 1, at 45.

6 *Id.* at 47.

7 *Id.* at 48.

given instance, the competitive implications of vertical restraints should not be assessed on their own merits. We did say that doing so is typically "difficult"—a point that should be uncontroversial.

Given the significant uncertainty that characterizes the equilibrium consequences of vertical restraints in any particular application, our article went on to discuss how an optimal policy toward vertical restraints "could be modeled as a process whereby decision makers use observed data to update their prior beliefs about the likely efficiency of a given vertical restraint, yielding a posterior belief."[8] We explained that a survey of the empirical literature on vertical restraints shows that, in the cases that have been studied to date, vertical restraints almost always have been found to be pro-competitive or competitively neutral. This suggests that an optimal decision process would start with strong priors that vertical restraints are pro-competitive.[9] With respect to the evidence in a particular case, we noted, "if empirical evidence is difficult to interpret, these observations will cause little, if any, modification to these prior beliefs."[10] This hardly is equivalent to "forcing appropriate antitrust decisions to rely on prior empirical evidence rather than case-specific facts,"[11] as Professor Winter contends.

Finally, we discussed the implications of our analysis for antitrust policy. We noted that "to the extent that theory provides little guidance in classifying evidence beyond allowing us to determine safe harbors, a decision maker's beliefs that a specific vertical practice is pro- or anticompetitive should closely mimic his or her prior beliefs regarding such practices in general."[12] This statement simply is a logical conclusion about the weight that murky evidence should receive when a rational decision maker optimally updates his prior beliefs. It is not a call for case-specific evidence to be ignored. Indeed, in the conclusion, we suggested a case-specific approach in which policymakers "draw inferences about the competitive effects of the restraint by comparing markets with and without the restraint to determine the effect of the restraint."[13] We noted that this approach could involve a comparison of the same market before and after adoption of the constraint, or a comparison of a cross-section of markets in different geographic areas. Obviously, the quality of the experiment, and how closely it mimics the

8 *Id*.

9 Of course, the strength of these priors may vary by the type of restraint at issue because not all vertical practices have been subject to the same level of empirical research.

10 Cooper et al., *supra* note 1, at 48.

11 Winter, *supra* note 2, at 87.

12 Cooper et al., *supra* note 1, at 61.

13 *Id.* at 63.

effect of the restraint, will affect the weight that a decision maker should attach to such evidence.

II. Professor Winter's Critique of Our Discussion of RPM

In our discussion of the various possible motivations for vertical restraints, we observed that, in numerous models, RPM induces retailers to spend more on promotion than they would without RPM. In his comment, Professor Winter claims that our discussion of this issue commits "an analytical error."[14] We stated, "[i]f the manufacturer's profit margin for additional sales is large in relation to the retailer's . . . the retailer rationally will provide a lower level of promotion than is optimal for the manufacturer."[15]

Referencing this passage, Professor Winter states, "the authors err . . . in stating that inadequate retailer incentives can be traced to differences between the wholesale margin and the retail margin."[16] Professor Winter's criticism, however, ascribes greater precision to our statement than is warranted. Note that our statement does not say how large the manufacturer's margin must be relative to the retailer's margin for the retailer to choose less promotion than is optimal for the manufacturer. The statement, therefore, is quite weak and is true across a wide range of imperfectly competitive environments. It holds, for example, in the environment examined in Mathewson and Winter's seminal analysis (1984) of vertical restraints by a manufacturer that charges two-part tariffs to imperfectly competitive retailers engaged in promotion that may or may not spillover to their rivals.[17] It also holds in the same environment when firms restrict attention to linear input prices.[18] One can imagine theoretical environments in which our

14 Winter, *supra* note 2, at 82.

15 Cooper et al., *supra* note 1, at 49.

16 Winter, *supra* note 2, at 84.

17 *See* F. Mathewson & R. Winter, *An Economic Theory of Vertical Restraints*, 15(1) RAND J. ECON. 27-38 (1984). Since the manufacturer can employ two-part tariff contracts in this model, its optimal level of promotion is the same as that of a fully integrated firm. Absent vertical restraints, it turns out that any positive margin for the manufacturer is large enough relative to the retail margin to cause retailers to choose less promotion than is optimal for the manufacturer.

18 Under linear input pricing, if the retailer's margin is sufficiently small relative to the manufacturer's margin at the chosen wholesale price, the retailer will select a level of promotion lower than the manufacturer would choose if the latter could establish the level of promotion at the time the wholesale price is set. If the manufacturer and retailer cannot agree on the level of retail promotion in advance (an assumption required for retail promotional incentives to motivate RPM in the first place), then they may turn to resale price maintenance to improve the retailer's incentives.

statement is too strong.[19] However, our statement is weak enough to cover most cases of interest. More precise statements about the relationship between margins and promotional incentives would require detailed assumptions, which would go well beyond the appropriate scope of a policy journal.

III. Conclusion

We do not advocate a standard of per se legality for vertical restraints. We believe that case-specific evidence is relevant to determining the legality of any particular use of a vertical restraint, and our article suggested a number of ways that such evidence could be brought to bear by antitrust investigators. That said, we defend unapologetically a vertical restraints enforcement standard that forces plaintiffs to bear a high burden of proof. Theory tells us that vertical restraints can be good or bad, but the weight of the best available empirical evidence comes down overwhelmingly on the "good" side of the scale.

19 For example, in a private conversation, Professor Winter pointed out that an exception occurs when perfectly competitive retailers sell to customers with identical preferences over quality. In that special case, retailers choose the manufacturer's preferred level of promotion even when their margins are zero.