The Regional Competition Center for Latin America Presents:

White Paper on Vertical Restraints

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Vertical restraints are one of the most difficult areas of antitrust law. Theories exist for how vertical restraints can be either procompetitive or anticompetitive. Ideally, policy makers would like a set of empirical methods to distinguish between the competing hypotheses on a case-by-case basis, but the empirical tools to do so are not as well developed with respect to vertical restraints as they are, say, for market definition in merger analysis.

Without such tools, policy-makers would like a reliable body of evidence about the relative frequency of procompetitive and anticompetitive uses of different vertical restraints. While some evidence is available, it is highly imperfect. But policy makers have to make decisions in real time. Recognizing the limitations of our current knowledge is an important step in formulating a rational policy toward vertical restraints.

This white paper seeks to distill the insights from the academic literature and the experience in other jurisdictions, both to suggest what constitutes current best practices with respect to vertical restraints and to explain areas of disagreements where controversy remains about what constitutes best practices.

Vertical restraints are one component of a multifaceted contract. The assessment of likely effects of vertical restraints on competition requires an analysis of the entire vertical relationship as well as the market setting under which it occurs. Because the restraints are often with respect to behavior that would be a form of competition, they often appear to be restraints on competition.

Notwithstanding imperfections of our current knowledge of the competitive effect of vertical restraints, consensus exists on some basic principles. Most notably, when interbrand competition is vigorous, there are likely no anticompetitive effects from vertical restraints that restrict only intrabrand competition. As a result, vertical restraints can only substantially lessen competition when they might restrict interbrand competition and/or interbrand competition is not vigorous. The debates over what policy should be focuses on these latter hard cases.

In focusing on these harder cases (or even in deciding which cases fall into the subset of hard cases), it is useful to keep in mind the proper use and potential abuse of competition statutes. Ultimately, harm to competition is the result of either collusion or the exclusion of rivals through means other than simply offering a better product and/or price. In considering an action against a vertical restraint, it is important for a competition authority to be clear on which of these effects it is

alleging. Doing so can help avoid the fallacy of using the competition statutes to address what are more properly understood as contract disputes.

In this white paper, we discuss both competitive and anticompetitive effects of vertical restraints. Ideal antitrust enforcement would distinguish perfectly between the two. The tools to implement ideal antitrust policy with respect to vertical restraints do not exist, however, so the challenge for antitrust authorities is to formulate an enforcement strategy that minimizes error costs.

Arguably, the most important point to help antitrust enforcers avoid error is to recognize that vertical restraints are distinct from horizontal restraints. They are not agreements among competitors. They are agreements between firms at different stages of a vertical chain that, for a variety of reasons, have decided not to integrate vertically. In general, vertically situated firms have a mutual interest in coordinating their behavior so as to compete more effectively in the market for sales to final consumers. There are many reasons to believe that simple sales contracts will coordinate vertically related firms imperfectly. A firm at one stage might wish to charge too high a price or skimp on quality from the standpoint of the system as a whole. To the extent that vertical restraints coordinate competitive behavior, antitrust challenges to them can be anticompetitive.

Ultimately, all legitimate antitrust concerns come down to either collusion or monopolization. Some vertical restraints can result in collusion. Others can result in monopolization. Antitrust enforcers considering intervention against vertical restraints should be clear on which of these problems they believe they are attacking. Doing so will weed out many illegitimate complaints because there are many complaints about vertical restraints that do not plausibly reflect either collusion or monopolization.

This white paper was organized as follows: Section II discusses different types of vertical restraints. Section III describes the evolution of academic analysis of vertical restraints, starting with the Chicago School critique of early legal hostility to vertical restraints and the Post-Chicago response. This historical development brings out the fundamental economic dilemma in vertical restraint policy of preventing uses that harm competition while not standing in the way of those that promote competition. Section IV covers a general framework based on decision theory for formulating policy. Section V reviews the empirical evidence about the competitive effects of different vertical restraints. Sections VI and VII describe the continuing evolution of vertical restraints policy in the US and the EU. Section

VIII discusses the different approaches in Latin America. Section IX contains conclusions.