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Antitrust Policy, Restricted Distribution,
and the Market for Exclusionary Rights

Herbert Hovenkamp*

In a recent article,1 Professors Thomas G. Krattenmaker
and Steven C. Salop attempt to demonstrate that in appropriate
circumstances, certain strategizing firms can obtain monopoly
pricing power by entering into exclusionary arrangements with
their suppliers that raise the costs of the strategizers’ rivals.
The authors propose a two-part inquiry and related tests for
identifying exclusionary arrangements that are anticompetitive
because they facilitate monopoly pricing by raising rivals’ costs.
This essay analyzes Krattenmaker’s and Salop’s proposals and
suggests some problems and alternative solutions. It concludes
that although firms may sometimes use vertical restrictions to
raise rivals’ costs, Krattenmaker’s and Salop’s tests are often
inadequate to determine whether such practices are occurring
in a particular case or to measure their effect if they are
occurring.

I. RAISING RIVALS’ COSTS AND THE MARKET
FOR COMPETITION

A. A NEW THEORY, OR A NEW NAME?

A rapidly growing literature discusses strategies by firms
seeking profits called “raising rivals’ costs.”2 Firms employing

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presented at the antitrust conference of the American Association of Law
1. Krattenmaker & Salop, Anticompetitive Exclusion: Raising Rivals’
Costs To Achieve Power over Price, 96 YALE L.J. 209 (1986).
2. E.g., CAMPBELL, SPATIAL PREDATION AND COMPETITION IN ANTITRUST
(Stanford Law & Economics Program Working Paper No. 27, 1986); SALOP &
SCHEFFMAN, COST-RAISING STRATEGIES (Federal Trade Commission Bureau of
Economics, Working Paper No. 146, 1986); Gilbert & Newbery, Preemptive
Patenting and the Persistence of Monopoly, 72 AM. ECON. REV. 514 (1982);
Hovenkamp, Antitrust Policy After Chicago, 84 MICH. L. REV. 213, 274-83
(1986); Krattenmaker & Salop, Competition and Cooperation in the Market
for Exclusionary Rights, 76 AM. ECON. REV. 109 (1986) (papers and proceed-
ings); Lewis, Preemption, Divestiture and Forward Contracting in a Market
such strategies seek to increase their profits not by reducing their own costs, which is competitive; nor by excluding rivals from a market altogether, which is often anticompetitive; nor by convincing rivals to engage in price fixing, also anticompetitive; but rather by increasing the costs of rivals while imposing smaller or no price increases on the strategizing firm. Many hypothesized strategies of raising rivals’ costs are anticompetitive; they result in lower total market output and higher consumer prices.3

The postulated strategies for raising rivals’ costs vary from quite simple to extremely complex. They also vary in other important ways. Some strategies require concerted behavior by firms collectively controlling a significant market share.4 Others require not market dominance but rather success in convincing a legislative or administrative body to impose cost-raising regulations.5 Still others can be effected by single, perhaps even nondominant, firms.6 Some hypothesized strategies are clearly anticompetitive, because the only plausible explanation for them is that they impose cost increases on rivals.7 These strategies generally fall into a category of behavior that the antitrust laws have treated as illegal per se.8 Other strate-

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3. For some generalizations about when strategies of raising rivals’ costs reduce market output and increase price, see Salop & Scheffman, supra note 2, at 269.

4. See Hovenkamp, supra note 2, at 274-80; Williamson, supra note 2, at 108-10.


6. See Krattenmaker & Salop, supra note 1, at 251-52.

7. For example, the “naked” agreements between Alcoa and electric utilities not to sell to Alcoa’s competitors are clearly anticompetitive. See United States v. Aluminum Co. of Am., 148 F.2d 416, 422 (2d Cir. 1943).

8. That is, because no one has made a plausible argument that the action
gies may produce efficiency gains while they impose cost increases on rivals. Under traditional antitrust analysis requiring an assessment of overall impact, these strategies must be treated under a rule of reason.9

Strategies for raising rivals' costs are not new, and antitrust tribunals have recognized them for some time. As early as 1904 in Montague & Co. v. Lowry10 the defendant association of tile manufacturers and dealers was accused of requiring members to sell to nonmembers at the full list price, while members could sell to other members at any price.11 As a result the plaintiff nonmember had to pay much more for tile than did his member competitors.12 Likewise, in the well-known Alcoa monopolization case, the government discovered that Alcoa had negotiated contracts with electric companies providing that the companies would not supply electricity to any of Alcoa's competitors.13 At least some of these agreements between Alcoa and its competitors appear to have been "naked"; Alcoa purchased nothing from the utility in question except a promise that the utility would not sell electricity to Alcoa's competitors.14 Other well known antitrust cases in-

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9. Because they involve vertical integration, most of the strategies discussed in Krattenmaker & Salop, supra note 1, fall into this category. Because they involve horizontal integration or joint ventures of competitors, many of the strategies discussed in Hovenkamp, supra note 2, at 274-83, receive rule-of-reason treatment as well. See also P. Areeda, supra note 8, ¶¶ 1500-1508 (addressing rationale for and application of the rule of reason).

10. Montague & Co., 193 U.S. 38 (1904); see also United States v. American Can Co., 230 F. 859 (D. Md. 1916), appeal dismissed, 256 U.S. 706 (1921). In American Can Co., the defendant was accused of raising its rivals' costs by entering into exclusive dealing contracts with suppliers of new, low-cost canning machinery. Under the contracts the suppliers could sell the new machinery to American Can and no one else. Id. at 874-75. The scheme apparently failed because as soon as American Can acquired a large share of the current market it increased its price so dramatically that it again became profitable to manufacture cans with older, higher-cost machinery. Id. at 879-80.


12. Id. The "cartel ringmaster" theory offered by Krattenmaker & Salop, supra note 1, at 238-40, differs from the Montague & Co. situation principally in that the underlying agreement is vertical rather than horizontal. See infra text accompanying notes 41, 70-73.


volved strategies of raising rivals' costs, but in these cases the challenged activities simultaneously reduced the defendants' costs as well or improved the quality of their products.\footnote{15}

The new literature on raising rivals' costs tries to improve on our former perceptions by providing a more rigorous theory for predicting when such cost-raising strategies are likely to occur and when they will be anticompetitive. This literature is generally critical of the antitrust policy of former eras for imagining anticompetitive effects where none existed and where such effects were frequently implausible.\footnote{16} At the same time, the literature on raising rivals' costs is "expansionist" in that it would assign liability in areas where the dominant antitrust theory today finds little or no danger to competition.\footnote{17} For example, the literature on raising rivals' costs treats practices like exclusive dealing or other vertical restraints somewhere between the Chicago School notion that all such restraints are harmless and ought to be legal\footnote{18} and the notion that prevailed in the 1960s that all such restraints are suspect and should either be illegal per se or else be analyzed under very strict

\footnote{15} See, e.g., United States v. Terminal R.R. Ass'n, 224 U.S. 383 (1912). In Terminal R.R. Ass'n, the Court analyzed a joint venture operating a railroad bridge and cargo transfer system. The venture reduced the members' costs by permitting them to share facilities subject to very substantial economies of scale. \textit{id.} at 386-90. The costs to those not wishing to use the facilities were prohibitive because alternative shipping facilities were much more expensive and single-firm use of such facilities would not have permitted achievement of available scale economies. Similarly, the Supreme Court's concern in Associated Press v. United States, 326 U.S. 1 (1945), was with Associated Press's by-laws which prohibited the dissemination of AP news to nonmember publishers. In both cases, the Supreme Court adopted the efficient solution: it permitted the efficiency-creating joint ventures to continue, but required the venturers to open themselves to all competitors on nondiscriminatory terms. See H. HOVENKAMP, ECONOMICS AND FEDERAL ANTITRUST LAW § 10.3 (1985). Although it involved single-firm behavior, the more recent decision of the Supreme Court in Aspen Skiing Co. v. Aspen Highlands Skiing Corp., 472 U.S. 585, 610-11 (1985) (requiring that Aspen Skiing cooperate with Highlands on skiing packages) can be defended on the same grounds.

\footnote{16} See, e.g., Krattenmaker & Salop, supra note 1, at 215-22.


\footnote{18} See R. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH IT-SELF 281-82 (1978) (commenting on the inflexibility of the per se rule regarding vertical price fixing); Easterbrook, \textit{Vertical Arrangements and the Rule of Reason}, 53 ANTITRUST L.J. 135, 158-59 (1984) (suggesting that vertical arrangements are often procompetitive and outlining factors to consider in determining whether they should be lawful); Posner, \textit{The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality}, 43 U. CHI. L. REV. 6, 9 (1981) (suggesting that resale price maintenance should not be treated as per se illegal by the court).
In spite of a substantial literature, many things are not known about the strategies of raising rivals’ costs, including whether and how often firms employ such strategies, whether and when the strategies are anticompetitive, and how courts can identify when the strategies are being employed anticompetitively. Krattenmaker and Salop make the important point that our theory-making concerning exclusionary behavior has fallen behind our theory-making concerning cartelization and its equivalents. In large part this seems to be true because so much of our recent theory of firm behavior comes from the Chicago School, whose members indulge in almost unlimited skepticism about the effectiveness of anticompetitive exclusionary practices.

We know the least about cost-raising exclusionary strategies when they involve vertical restrictions on distribution. Analysis of vertical integration invariably seems more complex and controversial than analysis in other areas of antitrust law. Analysis of the relationship between restricted distribution and the raising of rivals’ costs is no exception.

B. COMPETITION AS A PUBLIC GOOD

If markets functioned perfectly no vertical arrangements would be anticompetitive. Such arrangements injure competition only in the presence of high entry barriers, high transaction costs, imperfect information, externalities, or other failures that prevent markets from performing efficiently. If real world competition is generally robust—if every attempt to charge monopoly prices is disciplined by new entry or increased output by competitors—then there is little cause for concern about vertical restraints. As a result, antitrust policy concerning vertical restraints has been determined in large part by the dominant perception of how well markets in the real world perform.


20. Krattenmaker & Salop, supra note 1, at 211 (noting that the “state of antitrust law governing exclusion” is in “substantial disarray”).


22. In fact, policy concerning most other antitrust violations also has been determined by perceptions of market performance. For a brief historical over-
The Warren Court’s lack of hospitality toward vertical restrictions was based on an economic theory that emphasized imperfections in real world markets.\textsuperscript{23} The theory particularly emphasized the perceived ability of manufacturers of differentiated products to “manipulate” the demand for their products by controlling the distribution system.\textsuperscript{24} Conversely, the Chicago School’s extreme position that nearly all vertical restraints should be legal is based on a judgment that market imperfections have been greatly exaggerated,\textsuperscript{25} or else that competition is powerful enough to overcome them.\textsuperscript{26} In return, new theories under which vertical restrictions can be anticompetitive are based on new perceptions that markets do not perform as effectively as Chicago School economists presume.\textsuperscript{27}

The Chicago School competitive model is predicated on the assumption that the welfare of society will be maximized when the amount of competition is maximized. Although this may be true, it does not necessarily follow that the unregulated market will maximize competition. One of the most important contributions of the academic literature on raising rivals’ costs is the observation that competition itself is a “public good”\textsuperscript{28}—that is, a good that benefits society as a whole that cannot be fully accounted for by market processes. If a good is truly public, it is practically impossible to organize a market transaction in that

\textsuperscript{23} View of the dominant economic theories guiding antitrust policy, see Hovenkamp, \textit{supra} note 2, at 213-26.

\textsuperscript{24} The leading case is United States v. Arnold, Schwinn & Co., 388 U.S. 365, 382 (1967), declaring vertical nonprice restraints illegal per se.


\textsuperscript{26} For example, the belief that market imperfections have been exaggerated is the thrust of the Chicago School’s relentless—and for the most part well-founded—criticism of the “monopoly leverage” theory of vertical integration. As Louis Kaplow notes, however, the Chicago School critique of the theory assumes away many imperfections that might permit anticompetitive leverage to be used. See Kaplow, \textit{Extension of Monopoly Power Through Leverage}, 85 \textit{Colum. L. Rev.} 515, 520-39 (1985).


\textsuperscript{28} Krattenmaker & Salop, \textit{supra} note 1, at 110.
good so that all those who benefit from the transaction can be forced to pay their share, or all those injured can be compensated, or both.\textsuperscript{29} To illustrate, one can easily demonstrate that suppliers are best off if the retailers to whom they sell charge competitive prices. In fact, as a general rule firms are best off when vertically related firms behave competitively.\textsuperscript{30} A supplier therefore may be willing to pay for a guarantee from a retailer that it will charge only competitive prices. To view the relationship from the other side, however, a supplier might be willing for a certain payment to permit one or more of its retailers to charge monopoly prices. For example, a supplier might be tempted for a sum to join or acquiesce in a cartel of its retailers in exchange for some of the cartel’s monopoly profits.\textsuperscript{31} By such participation the supplier effectively “sells” to the retailer’s cartel whatever benefits he might otherwise obtain from competition in the retail market.

In the real world competition produces net wealth. As a result, if all those benefitted or injured by competition were able to participate in the bargaining process in this illustration, the resulting market would be competitive.\textsuperscript{32} Not all the beneficiaries of competition participated in the transaction described above, however. Although the supplier benefits from competition in the retailers’ market, dozens of others—principally consumers—benefit as well. Far from inviting consumers to participate in this bargaining process, the supplier and retailers intentionally kept it secret from them. Importantly, although retailer competition is valuable to the supplier, it is not as valuable to the supplier alone as it is to the supplier plus the retailers’ customers. As Krattenmaker and Salop note, several people have suggested that markets could perform quite competitively if all those affected by competition were invited into

\textsuperscript{29} For an excellent, brief, and not too technical discussion of the economics of public goods, see E. Mansfield, Microeconomics: Theory and Applications 489-518 (1985).

\textsuperscript{30} See H. Hovenkamp, supra note 15, § 9.2, at 249.

\textsuperscript{31} This is not likely to happen unless market failures are so substantial that the value to the dealer from participating in the cartel is large enough to compensate the supplier for all its losses, with a surplus remaining. It is most likely to occur if the wealth transfer that results from price fixing is large in proportion to the deadweight loss—most generally, when the consumers’ price elasticity of demand is very low. See generally Hovenkamp, Vertical Restrictions and Monopoly Power, 64 B.U.L. Rev. 521, 529-34 (1984) (discussing vertical restrictions and supplier participation in retailer cartels).

\textsuperscript{32} That is, because the gainers from competition stand to gain more than the losers stand to lose, the potential gainers would outbid the potential losers and purchase the competitively structured market.
the bidding process; nevertheless, we have not figured out any practicable way to do this, particularly in those situations where the purchase and sale of competition is kept a secret from an important class of affected market participants.

That competition is a public good makes an anticompetitive exclusionary rights theory plausible. If competition is bought and sold in a market that denies access to interested bidders, the sale of exclusionary rights will not necessarily be welfare maximizing and may be anticompetitive. That a market for anticompetitive exclusionary rights thus exists does not tell us, however, whether vertical contracts as a class or even any specific vertical arrangements are anticompetitive. It may tell us only that firms can use exclusionary rights to eliminate competition among themselves, or that competitors acting in concert can impose higher costs on new entrants or other rivals. An "exclusionary rights" theory that explained only that certain

33. For example, if a supplier were offered a sum by a dealers' cartel to participate in it, perhaps by "imposing" resale price maintenance on the dealers or providing legally enforceable vertical restraints to enforce their horizontal territorial division scheme, the supplier might ask the dealers' customers to bid against the cartel for the preservation of competition. In a perfectly-functioning market the customers would be willing to bid enough to win, because the amount by which the supplier plus the customers value competition will be greater, by the amount of deadweight loss created by the cartel, than the amount by which the dealers value the monopoly profits from cartelization. See H. HOVENKAMP, supra note 15, § 2.3, at 49 ("[T]he consumer welfare principle is predicated on the observation that everyone is a consumer.").

Nevertheless, there are two important, and quite different, objections to using this argument to justify abandoning the antitrust concern with price fixing: 1) an empirical, economic judgment that, even disregarding the antitrust enforcement consequences, in the real world this bidding process would not occur because the consumers could not be identified and organized so as to bring it about; and 2) a political, or distributive, judgment that people are entitled to a competitive market without having to "pay" for it.

In fact, in this case (2) collapses into (1). Even if consumers bid more for competition than the cartelizing dealers would bid for supplier participation in the cartel, the final outcome—at least as far as consumers are concerned—would be the same. Their bid for a competitive market would effectively raise their price of the product, and demand would be reduced to below the competitive level; as a result, the suppliers (rather than the dealer) would earn monopoly returns in the form of the bid payments themselves.

34. Consumer preferences other than competition might also be public goods—for example, the preference for a regime of small businesses. Because each consumer believes her own purchase choice has an insignificant impact on the structure of the economy, she purchases where the price is lowest in spite of a preference for a world of higher-priced smaller firms. See Hovenkamp, supra note 2, at 243-44.

horizontal restraints are harmful would be neither very revolution-ary nor very helpful. All but the most radical right in anti-
trust policy think that some agreements among competitors are bad and should be condemned.

II. THE MARKET FOR COMPETITION AND THE EXCLUSIONARY RIGHTS DOCTRINE

A. IDENTIFYING A MARKET FOR EXCLUSIONARY RIGHTS

The insight that competition itself can be bought and sold in a market that performs poorly is helpful if it explains trans-
actions that were previously considered obscure or controver-
sial. In Anticompetitive Exclusion: Raising Rivals’ Costs To
Achieve Power over Price,\(^{36}\) Krattenmaker and Salop attempt
to do exactly that. They look at various kinds of vertical re-
strictions as the product of a market for “exclusionary rights”—that is, as contracts in which one or both of the parties
promises to refrain from entering some segment of the market
that they might otherwise enter. For example, an exclusive
dealing contract is a sale by one of the parties of the right to
shop elsewhere for part of his requirements, as is a tying ar-
rangement. A vertical territorial or customer arrangement is a
sale by one of the parties of the right to sell in a certain region
or to a certain class of customers. In short, a sale of an exclu-
sionary right is the sale of the right to compete in a way that
the seller might wish absent the arrangement. Because compe-
tition is a public good, the sale of such a right can be anticompe-
titive; it can impose larger losses than gains on all those
affected by the transaction.

Krattenmaker and Salop suggest that the sale of exclusion-
ary rights can be anticompetitive when a well-placed firm\(^{37}\) im-
poses higher costs on rivals than the strategizing firm faces
itself. This analysis is consistent with the consumer welfare
principle; Krattenmaker and Salop believe that preservation of
competition, economically defined, should be the goal of the an-

\(^{36}\) Krattenmaker & Salop, supra note 1, at 223-27.

\(^{37}\) A “well-placed” firm could be the dominant firm in the market, but it
could also be a group of established firms explicitly or tacitly colluding. Ordin-
arily it could not be a nondominant firm acting alone, because the strategies
generally require arrangements that cover a large percentage of a relevant
market, unless they are achieved by governmental intervention into the mar-
ket. Governmental intervention might occur, for example, if one taxicab firm
convinced the sovereign to give it a monopoly of a certain class of business.
1986) (suit by cab drivers over city ordinances regulating taxicab licenses).
titrust laws.  

Krattenmaker and Salop argue that vertical restraints might be anticompetitive in this way under a number of theories. For example, a dominant firm might: 1) use exclusive dealing or similar arrangements to tie up competitors' access to low-cost inputs, leaving the competitors with only higher-cost inputs; 2) use exclusive dealing or similar arrangements to tie up so much of an input that competitors bid up the price for the input that remains; 3) obtain agreements from a large number of suppliers that they will impose resale price maintenance or other price-raising distribution restrictions on competitors; or 4) use exclusive dealing or similar arrangements to alter the structure of the market remaining available to competitors in such a way as to facilitate collusion there.

Krattenmaker and Salop accept what has become the dominant view today that vertical restrictions are generally competitive and beneficial to society. Consistent with their analysis, vertical restrictions imposed by a single nondominant firm in a competitively structured market would appear to be harmless. As a general rule, only restrictions that foreclose a large share of a market will permit the two inferences necessary for concluding that a vertical restriction is anticompetitive—namely, that 1) the restrictions do indeed raise the costs of rivals; and 2) as a result, the strategizing firm is able to raise its own prices and earn monopoly returns. Thus, determination of market structure and of the strategizing firm's relative position in the market become essential.

39. Id. at 234-35. Krattenmaker and Salop characterize this as the "bottleneck" theory. Id. at 234.
40. Id. at 236-38. Krattenmaker and Salop describe this as the "real foreclosure" strategy. Id. at 236.
41. Id. at 238-40. Krattenmaker and Salop dub this the "cartel ringmaster" strategy. Id. at 238.
42. Id. at 240-42. Krattenmaker and Salop call this the "Frankenstein monster" strategy. Id. at 240-41.
43. Id. at 228-29.
44. Such vertical restrictions would be harmless unless a nondominant firm should somehow succeed in tying up a source of supply that gave it a significant cost advantage over all other firms. This might happen, for example, if a nondominant firm was the successful bidder for a government monopoly franchise that gave the franchisee distinct advantages over all competitors. See Campbell v. City of Chicago, 639 F. Supp. 1501, 1504 (N.D. Ill. 1986) (Yellow and Checker cab companies reached an agreement with the City of Chicago giving the two companies a perpetual right to 80% of the taxicab licenses).
45. This position has been argued many times before. See H. Hovenkamp, supra note 15, § 9.2; see also U.S. Dep't of Justice, Vertical Distributions Re-
Krattenmaker and Salop argue that a tribunal assessing whether a particular vertical restraint is anticompetitive must make the following determinations:

First, one should ask whether the conduct of the challenged firm unavoidably and significantly increases the costs of its competitors. If so, one then should ask whether raising rivals' costs enables the excluding firm to exercise monopoly power—that is, to raise its price above the competitive level.\footnote{Krattenmaker & Salop, supra note 1, at 214.}

B. AMBIGUITY AND CONFLICT IN THE USE OF SURROGATES

It is well known that the behavior antitrust policy is most concerned about—persistent sales at a price higher than marginal cost—cannot generally be measured directly, certainly not in a courtroom.\footnote{See Landes & Posner, Market Power in Antitrust Cases, 94 HARV. L. REV. 937, 939-41 (1981). Courts cannot measure this behavior because they cannot compute marginal cost, and most practical measures of market power, such as the Lerner Index, require knowledge of marginal cost. Id. at 941.} Antitrust analysis addresses this problem by using a variety of substitutes and simplifying assumptions to estimate a firm's ability to charge prices higher than marginal cost, or to evaluate a charge that some practice increases a firm's ability to charge such a price.\footnote{The ability to charge prices higher than marginal cost can be inferred, under appropriate circumstances, from high market share, persistent supernormal profits, or the ability to price discriminate. See H. HOVENKAMP, supra note 15, §§ 3.1-7.}

Krattenmaker and Salop propose some tests for identifying practices that facilitate monopoly pricing by raising rivals' costs. They suggest that these tests measure whether a rival's costs are "unavoidably and significantly" increased as a result of such practices, and whether this in turn permits the strategizing firm to charge monopoly prices.\footnote{Krattenmaker & Salop, supra note 1, at 214.} The tests that Krattenmaker and Salop propose, however, are in most instances proxies for the true object of their measurement.\footnote{Krattenmaker & Salop note an exception. Under their "bottleneck" theory there might be direct evidence that rivals' costs have been raised—such as empirical evidence that all input sources not controlled by the supplier are more expensive than those that are. See id. at 258-59.} The tests generally measure, using objective criteria, whether the market structure suggests that the rivals' costs are increased.\footnote{See id. at 253 ("objective measures for estimating the likelihood and magnitude of anticompetitive effects").} Frequently, Krat-
tenmaker and Salop condemn practices on the basis of market structure tests analogous to those used in the Justice Department's Merger Guidelines\textsuperscript{52} or its Vertical Restraints Guidelines.\textsuperscript{53}

A proposed test for antitrust liability should not be faulted because it fails to measure directly the improper exercise or increase of market power. Such a criticism would apply to nearly every test the courts currently use. In this case, however, the proposed tests are subject to two objections, one quite specific but which does not apply to all of Krattenmaker's and Salop's postulated strategies, the other broader but more difficult to state. The first objection is that anticompetitive results under Krattenmaker's and Salop's cost-increasing strategies cannot always be attributed to a particular vertical arrangement on the basis of proxy evidence alone. In that case, the arrangements should not be condemned under these theories on the basis of such proxy evidence, because the efficiency-creating potential of vertical restrictions is present in \textit{all} markets, concentrated as well as unconcentrated.

The second objection is that Krattenmaker's and Salop's proposed tests require the use of competing proxies in evaluating vertical restraints.\textsuperscript{54} Under well-developed economic theories vertical restraints can increase a firm's efficiency by lowering its distribution costs or reducing the risk of entry into a market.\textsuperscript{55} These cost decreases, however, cannot be measured and frequently cannot be identified in a particular case. Nevertheless, such cost decreases are reasonably presumed to explain most vertical restrictions. Under the theories proposed by Krattenmaker and Salop the same restrictions might raise the costs of rivals. Once again, however, in most cases the existence or degree of these cost increases cannot be determined in a particular case. Importantly, in most of the cases that Krattenmaker and Salop describe, a vertical restraint could \textit{simultaneously} lower the costs of the firm imposing the restraint while


\textsuperscript{53} See \textit{supra} note 45.

\textsuperscript{54} The government's VRGs, \textit{supra} note 45, are subject to the same criticism, particularly if—as is widely believed—vertical restrictions are not used very often to facilitate horizontal collusion. The theory of the VRGs is not that vertical restraints might raise rivals' costs, but rather that they may facilitate tacit or express collusion in one of the markets covered by the restraint.

\textsuperscript{55} For a summary of the theories, see H. HOVENKAMP, \textit{supra} note 15, §§ 9.2, 9.4.
it increases the costs of rivals. In such cases any assessment of the competitive consequences of the restraint requires some kind of balancing of the two effects against each other.\textsuperscript{56} When neither effect can be measured directly, this balancing problem is intractable.\textsuperscript{57}

1. Proxy Evidence of Cost-increasing Vertical Strategies

A vertical restriction’s impact on rivals’ costs might be estimated in at least three different ways. First, the impact might be estimated directly, by proof taken from a rival’s cost figures or some equivalent source.\textsuperscript{58} Alternatively, the impact might be estimated indirectly, for example, by evidence that the market shares of rivals decreased while the share of the strategizing firm increased. Finally, the impact might be estimated by examining changes in market structure that result from the challenged practice and that suggest that rivals’ costs have increased.

At a minimum, the selected measuring tool will be useful only if it can distinguish cost increases to the rival from cost decreases to the strategizing firm. Although condemnation of practices that raise rivals’ costs is an eminently worthwhile goal, condemnation of practices that simply lower the strategizer’s costs is not, even if the effect is to make rivals worse off. Thus, evidence that the strategizer’s market share increased while that of its rivals decreased is generally useless because it is absolutely consistent with both an increase in rivals’ costs and a decrease in the strategizer’s costs.\textsuperscript{59} Likewise, evidence that the strategizer’s profits or margins increased

\textsuperscript{56} In most cases, the relevant question is whether total market output increased or decreased as a result of the restraint. This would be a function of: 1) the amount by which the restraint reduced the strategizing firm’s costs; 2) the amount by which the restraint increased the costs of rivals; and 3) the strategizing firm’s market share. As Krattenmaker and Salop are well aware, output tests will not work in antitrust litigation because the relevant “output” is too difficult to define and, in any event, incapable of measurement in real world markets. See Krattenmaker & Salop, supra note 1, at 283-84; Hovenkamp, supra note 2, at 256-60.

As noted infra text accompanying notes 78-80, although the anticompetitive threat posed by vertical restraints increases as a firm’s market share rises, so too does the efficiency-creating potential of the restraint.

\textsuperscript{57} See infra text accompanying notes 76-87.

\textsuperscript{58} Such direct proof might be supplied, for example, by the price figures of those supplying inputs.

\textsuperscript{59} This is the fallacy commonly committed by Chicago School scholars who suggest “output” tests for measuring the competitive impact of vertical restraints. See, e.g., Easterbrook, supra note 18, at 163-64 (proposing an output
while those of its rivals decreased is equally consistent with both increases in rivals’ costs and decreases in the strategizer’s costs.

Krattenmaker and Salop generally rely on information about market structure to estimate a vertical restriction’s impact on rivals’ costs. Because of the state of our knowledge about markets, however, facts about market structure are at best circumstantial evidence of impact on rivals’ costs, and may be far less. On the one hand, Krattenmaker and Salop suggest that their tests measure “whether the [challenged] conduct . . . unavoidably and significantly increases the costs of . . . competitors.” On the other hand, they describe their procedures for making this measurement as developing “objective measures for estimating the likelihood and magnitude of anticompetitive effects.” Clearly, however, measuring likely effects is not the same as discovering that a practice “unavoidably and significantly” increases costs. Evidence drawn from market structure generally tells us only that such cost increases are plausible.

I use the word “plausible” here rather than the word “likely” because indirect evidence drawn from data about market structure is much better at telling us whether certain kinds of conduct (such as collusion) are possible than at predicting that they will actually occur. Often the statement that conditions, objectively measured, are conducive to the occurrence of some event tells us little about whether the event will actually occur. More accurately, it tells us that conditions inconsistent with its occurrence are not present. Thus, we can be more certain that collusion will not occur in an unconcentrated market with negligible entry barriers than that it will occur in a concentrated market with high entry barriers.

Knowing that a market is conducive to cartelization or secret purchases of exclusionary rights or even strategic manipulation of supply of inputs is not the same as knowing that these practices will really occur or measuring what their magnitude

test); Posner, supra note 18, at 21-22 (restating his output test to focus on market share).

60. Krattenmaker & Salop, supra note 1, at 214.
61. Id. at 253.
62. For example, the statement that certain weather conditions are conducive to tornadoes may not tell us that a tornado is highly likely or even that there is a better than 50% chance that a tornado will occur. It tells us only that, based on the measurement capabilities we have, tornadoes have frequently occurred under similar conditions and have seldom or never occurred under other conditions. That is, certain weather conditions are a prerequisite to the occurrence of tornadoes.
will be. With respect to some of Krattenmaker's and Salop's proposed strategies, actual measurement of increases in rivals' costs seems to be absolutely essential, because no amount of market structure data is likely to tell us whether the hypothesized cost increases are "likely."

For example, the strategy for raising rivals' costs that Krattenmaker and Salop call the "Frankenstein monster" theory\(^3\) will not likely succeed no matter what the market structure, because the situation that it creates is extremely unstable. The "Frankenstein monster" theory posits that a supplier enters into exclusive dealing contracts with many dealers, thus causing the market for dealing services available to rival suppliers to become much more concentrated.\(^4\) These remaining dealers are much more likely to engage in tacit or express collusion. The tests proposed by Krattenmaker and Salop for evaluating and eventually condemning this behavior do not require proof that such collusion is actually occurring, but only that the new "market" structure facilitates it. Importantly, the rivals' costs will not be raised at all unless the collusion actually occurs.

In this case, however, there is one important impediment to the occurrence of such collusion. If the independent dealers collude it will be more profitable for a dealer to be independent than to be committed to an exclusive dealing agreement with the strategizing firm, because the collusion gives the independent dealers higher profits than the committed dealers are earning. In fact, the strategy is profitable only if the independent dealers exact a higher markup than do the committed dealers. We would therefore expect a mad rush of dealers to evade the exclusive dealing contracts.\(^5\) Conceivably, the arrangement

\(^3\) Krattenmaker & Salop, supra note 1, at 240-42; see also supra text accompanying note 42.

\(^4\) As a matter of convention, the word "supplier" here refers to an upstream participant in a transaction while the word "dealer" refers to a downstream participant.

\(^5\) For example, suppose that a market contains 100 dealers and that other preconditions for cartelization are present, so that if five dealers were left free in the market they could successfully raise prices from a competitive dealer markup of 10 cents to a markup of 13 cents. As the theory goes, a dominant supplier engages 95 of the dealers in exclusive-dealing contracts, thus denying them to competing suppliers; as a result, the remaining five dealers will cartelize the market and raise the markup to 13 cents. Thus the dominant supplier's rivals will face distribution costs of 13 cents while the dominant firm has distribution costs of only 10 cents.

This strategy successfully raises rivals' costs only as long as the cartelizing dealers—those not involved in exclusive dealing with the dominant firm—charge a higher markup than the dealers subject to the dominant firm's exclu-
might be made more stable, perhaps by long term exclusive dealing contracts coupled with rigorous enforcement by the supplier;\textsuperscript{66} the strategizing firm nevertheless will find it difficult to maintain its hold over all these retailers if it is more profitable to be independent.\textsuperscript{67}

Even if the strategizing firm entered into exclusive dealing contracts with ninety-nine percent of the dealers in a market with high entry barriers and obviously conducive to collusion, the strategizer would still not be able reliably to earn monopoly profits by collusion among the remaining one percent of the dealers because as soon as the independent dealers’ profits went up, the strategizer’s dealers would begin defecting. In that case no amount of data drawn from market structure could tell us that increases in a rival’s costs are likely to result from the “Frankenstein monster” strategy.\textsuperscript{68} As a result, it would never be efficient to condemn exclusive dealing under this theory. This is doubly true in light of the widely-known efficiency of exclusive dealing.\textsuperscript{69}

...
Krattenmaker's and Salop's "cartel ringmaster" theory\textsuperscript{70} likewise leaves some unanswered questions. The situation Krattenmaker and Salop posit could raise rivals' costs should it ever arise: if a firm could convince its suppliers to charge higher prices to the firm's rivals or discriminate against them in some other way, the firm could itself charge higher prices. Krattenmaker and Salop even suggest that this may explain what happened in \textit{Interstate Circuit, Inc. v. United States}\textsuperscript{71} without the need to infer an agreement among the defendant distributors.\textsuperscript{72} Critical questions remain unanswered, however: why will the scheme work, absent an agreement among the suppliers,\textsuperscript{73} and why would it be stable if it were initiated? A unilateral price increase by a supplier would have yielded only lost sales and profits; the price increase, whether initiated by a powerful buyer or not, works only if the other suppliers do it as well.

2. Efficiencies and Competitive Harm: Balancing by Proxy

That vertical restrictions can enable manufacturers to reduce their costs of distribution is relatively uncontroversial. As a result most vertical restraints are analyzed under a rule of

\textit{Exclusive Dealing}, 25 J.L. & ECON. 1, 3 (1982) (stating that "[t]he most commonly expressed view of exclusive dealing in the literature portrays it as a device to obtain increased dealer promotional effort").

\textsuperscript{70} Krattenmaker & Salop, \textit{supra} note 1, at 238-40; see also \textit{supra} text accompanying note 41.

\textsuperscript{71} 306 U.S. 208 (1939).

\textsuperscript{72} Krattenmaker & Salop, \textit{supra} note 1, at 238-39. Professor Phillip Areeda also believes an antitrust violation could be found in \textit{Interstate Circuit, Inc.} without inferring an agreement among the distributors. The violation, however, was the unreasonable vertical arrangements themselves. In that case, of course, that the arrangements were solicited by a dominant exhibitor as a device to raise rivals' costs would be irrelevant. It would appear that the exhibitor itself did not even violate the antitrust laws, but merely requested others to do so. See 6 P. AREEDA, \textit{supra} note 8, ¶ 1426, at 158 (1986).

\textsuperscript{73} One could postulate that the agreement was tacit, but nevertheless each firm would agree to depart from a competitive strategy only if it had some faith that other firms would behave in the same manner. Of course, one might take the approach that the restriction should be condemned as a device for facilitating tacit collusion, particularly given that the Sherman Act does not reach tacit collusion directly. In that case, however, the added wrinkle that the device is being used by one firm vertically related to the colluders to raise rivals' costs becomes superfluous. Under relatively orthodox theory, vertical restraints can be condemned when they facilitate tacit or express collusion. For example, this is the principal theory of the VRGs, \textit{supra} note 45, at 6268 (recommending that vertical restraints unlikely to cause collusion not be challenged).
and most of the restraints analyzed in this way are upheld. Quantifying the magnitude of such efficiencies in general, or even determining whether they actually obtain in a particular case, however, is generally beyond the courts’ capacity. Courts, therefore, seldom consider how a particular restraint might reduce the defendant’s costs or increase the quality of its product. Rather, the theory that vertical restraints are generally efficient is part of the “background” information that induces courts to be hospitable toward the restraints. The theory thus forces the plaintiff to provide a good explanation why the restraint in a particular case is anticompetitive.

If a vertical restraint can simultaneously reduce the costs of the strategizing firm and increase the costs of rivals, determining the “net” efficiency of the restraint may require the court to quantify these two phenomena and balance them in some way. As noted above, a court will rarely be able to conclude that a restraint has in fact raised rivals’ costs, and it will almost never be able to quantify such a cost increase were it to find one, unless there is direct evidence. Likewise, a court would seldom or never be able to quantify the efficiency gains that result from a particular practice.

Under Krattenmaker’s and Salop’s theory, as under the theory of the Justice Department’s Vertical Restraints Guidelines, vertical restraints are most likely to be anticompetitive when markets are concentrated and the firm or firms imposing the restraints have a large market share. This theory repre-

74. The outstanding exception is resale price maintenance, which is illegal per se. See H. HOVENKAMP, supra note 15, § 9.1, at 247.
75. For example, it is now commonplace that the effect of adopting rule-of-reason analysis of vertical nonprice restraints has been judicial approval of the vast majority of them. See Kaplow, Antitrust, Law & Economics, and the Courts, supra note 27.
76. See supra text accompanying notes 54-57.
77. See Krattenmaker & Salop, supra note 1, at 275. “[T]he larger the purchaser’s market share, the greater its reward for achieving power over price, hence the greater its willingness to pay to achieve anticompetitive exclusion.” Id.
78. See VRGs, supra note 45, at 6257. Anticompetitive effects are very unlikely when “the firms using the restraints have small market shares, . . . the restraints are not widely used, or . . . the restraints are used in markets too unconcentrated for the exercise of market power.” Id.
79. Many courts also have adopted this reasoning and assess a market-power requirement in vertical restraints cases. See, e.g., Assam Drug Co. v. Miller Brewing Co., 798 F.2d 311, 316-17 (8th Cir. 1986) (adopting a “market power approach” in a case applying state antitrust law similar to federal law); Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698, 702 (7th Cir.)
resents significant progress from earlier analysis, which often saw little connection between market power and the legality of vertical restraints. Importantly, however, the larger the strategizing firm’s market share, the larger the impact of any efficiency-creating restraint on total market output.\footnote{Likewise, the larger the market share held by a group of firms imposing the restraint, whether unilaterally or in concert, the larger the impact of the restraint.} For example, if a firm with a ninety percent market share reduces its costs the impact on the market will be much greater than if a firm with a ten percent market share reduces its costs. Thus, although the potential danger from anticompetitive vertical restraints increases as the market share of the strategizing firm increases, so also does the potential for efficiency gains. As a result we cannot say that a particular restraint is likely to be anticompetitive on balance simply because the firm imposing the restraint has a large market share.

Krattenmaker and Salop acknowledge that a complex rule for analyzing vertical restrictions is necessary because the restrictions at least plausibly create efficiencies at the same time that they may raise rivals’ costs.\footnote{Krattenmaker & Salop, supra note 1, at 228-29, 277-78.} Nevertheless, they tentatively propose that most claims of substantial efficiencies be ignored if the evidence also indicates that the practice confers substantial power over price upon the defendant.\footnote{Id. at 280.} In reaching this conclusion Krattenmaker and Salop distinguish between hard, empirical evidence that a particular practice actually produces efficiencies, and evidence that establishes “only the logical possibility that such efficiencies will be realized.”\footnote{Id. at 281.} They would require those relying on efficiencies as a defense to “develop standards for estimating the magnitude of those efficiencies.”\footnote{Id. at 219-23.}

Krattenmaker and Salop nevertheless are willing to permit purely theoretical evidence, drawn from the structure of the market, that a practice raises rivals’ costs. They are willing to condemn a practice on the basis of indirect, generally conjectural evidence that a particular practice creates efficiencies.\footnote{Id. at 281.} (stating that “plaintiff must show that the defendant has market power”), \textit{cert. denied}, 469 U.S. 1018 (1984); \textit{Graphic Prods. Distribs. v. Itek Corp.}, 717 F.2d 1560, 1568-69 (11th Cir. 1983) (requiring proof of market power).

\footnote{80.}
tural evidence of its harmful potential, while they ignore equally convincing theoretical evidence that the practice is efficiency producing. Such a position is defensible only if a vertical restraint is less likely to be efficient on balance than anticompetitive. As noted earlier, the observation that market conditions are “conducive” to a certain practice tells us very little about the likelihood that the practice will actually occur. If on the basis of purely theoretical evidence we conclude that a certain practice is “conducive” to the raising of rivals’ costs but that it may also produce substantial efficiencies, we still know very little about whether neither or both of these things will occur, or about what their magnitude will be if they do occur.

Consider Krattenmaker’s and Salop’s illustration drawn from the facts of *Klor’s Inc. v. Broadway-Hale Stores, Inc.* Klor’s alleged that defendant Broadway-Hale (BH) purchased promises from one or more manufacturers that they would not deal with Klor’s. Krattenmaker and Salop note that Klor’s would have to show, “as a threshold matter,” that the arrangement raised its costs, which requires a showing that one of Klor’s inputs is now more expensive and that this higher ex-

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85. More accurately, this position is defensible only if anticipated productive efficiency gains to the strategizing firm are less than anticipated losses in allocative and productive efficiency caused by the restraint’s tendency to raise rivals’ costs. These anticipated losses include losses both in allocative efficiency, in that they facilitate monopoly pricing, and in productive efficiency, in that they raise the production or distribution costs of rivals.

86. See supra text accompanying note 62.

87. Krattenmaker and Salop address but do not resolve the dilemma of which efficiency claims are relevant—all efficiencies, or only those that yield lower consumer prices in the short run. They conclude: 1) the antitrust laws at least arguably say something about how wealth should be distributed between consumers and sellers, as well as about efficiencies; and 2) historically, efficiency claims have been ignored, and thus the burden is on those arguing for the defendants to show why the claims should be considered, unless they are very strong. See id. at 278-82.

88. See id. at 268-69, 289-91.

89. 359 U.S. 207 (1959).

90. Id. at 209. The illustration fits Krattenmaker’s and Salop’s description of an exclusionary rights strategy that is more likely to be successful because it raises the rival’s variable, and thus its marginal, costs much more than it raises the rival’s fixed costs. The item in which cost is raised is inventory for resale, which is a variable cost. Krattenmaker and Salop posit that strategies that raise rivals’ fixed costs by relatively more and marginal costs by relatively less will be less successful because 1) they will have a smaller effect on rivals’ prices, which are computed on the basis of marginal cost, and 2) their impact on rivals’ profits is nevertheless sufficiently substantial that rivals will be inclined to take countermeasures. Krattenmaker & Salop, supra note 1, at 266, 271.
pense contributed significantly to Klor’s cost of doing business.\textsuperscript{91} Klor’s can establish this by showing that all remaining appliance manufacturers were less efficient, had very limited capacity, or were so concentrated that they would collude—in short, that one of the four theories of raising rivals’ costs\textsuperscript{92} could apply. In any of these cases Klor’s would have to pay more for inventory than it had paid previously. Krattenmaker and Salop observe\textsuperscript{93} that one could infer this by examining concentration in the supply market before and after the agreement, using a concentration measure such as the Herfindahl-Hirschman Index;\textsuperscript{94} combined with the conclusions about permissible concentration levels contained in the 1984 Justice Department Merger Guidelines.\textsuperscript{95}

Klor’s would next have to show that the exclusionary rights agreement permits BH to raise prices profitably.\textsuperscript{96} This would additionally require an analysis of the retail market in which BH and Klor’s sell. Klor’s could prevail, for example, by showing that BH is the only firm in that market that is unaffected by the vertical restraint, or perhaps by showing that BH is a dominant firm, or else that other firms operating in the market that are unaffected by the restraint are likely to collude with BH.\textsuperscript{97} Krattenmaker and Salop suggest that such inferences could be drawn by the objective method of examining the structure of the “unaffected” market—that is, the market consisting of those firms whose costs are not raised by the vertical restraint. If the “unaffected” market data support the requisite inference, Klor’s thus would have succeeded in showing that the restraint was anticompetitive.\textsuperscript{98}

At this point it is important to consider two additional factors: counterstrategies that might be available to Klor’s\textsuperscript{99} and the cost to BH of purchasing the exclusionary rights. As Krattenmaker and Salop note, Klor’s could bid against BH and might be willing to pay more than BH for the exclusionary right at issue.\textsuperscript{100} Krattenmaker and Salop respond that this

\textsuperscript{91} Id. at 289.
\textsuperscript{92} See supra text accompanying notes 39-42.
\textsuperscript{93} Krattenmaker & Salop, supra note 1, at 290.
\textsuperscript{94} See P. Areeda & H. Hovenkamp, supra note 52, ¶ 913.1.
\textsuperscript{95} Supra note 52.
\textsuperscript{96} Krattenmaker & Salop, supra note 1, at 290.
\textsuperscript{97} Id.
\textsuperscript{98} See id.
\textsuperscript{99} See id. at 269.
\textsuperscript{100} Id. That is, Klor’s might offer the appliance manufacturers more to continue selling to Klor’s than BH would offer them to stop selling to Klor’s.
possibility is not relevant because the "admission fees" themselves raise the rivals' costs by the amount of their bids. The other side of that coin, however, is that if BH purchases the exclusionary right it will raise its own costs as well as those of rival Klor's.

For example, suppose the appliance market has two suppliers, A with costs of $100 and B with costs of $105. BH would like to purchase an exclusionary right from A in the form of a contract that A will not sell to Klor's. As a result Klor’s must purchase from B, and its costs will increase by $5. BH’s costs, however, will also increase by the price of the exclusionary rights contract. BH’s strategy, we presume, will be effective if the price of the exclusionary right amounts to less than $5 per unit sold by BH. If the strategy is to be successful the price to A will have to be substantially greater than A’s foregone profits from sales to Klor's. It will have to be substantially greater, rather than merely equal, to A’s foregone profits, because if the strategy is successful A will lose on two fronts: 1) the profits that A would have earned from its sales to Klor's; and 2) the profits it will lose when BH itself raises its price to monopoly levels, thus reducing its sales volume. That the market is highly concentrated at both the supply and retail level does not

101. Id.
102. Krattenmaker and Salop consider whether the excluded rival will be able to outbid the strategizing firm for the exclusionary right. Id. at 273. They give less thought to whether the strategist's reservation price for the exclusionary right will be profitable to the supplier of the right. They conclude without proof that "[f]requently, suppliers will have alternative outlets for their goods at little loss in revenue," if they reduce their market by selling an exclusionary right. Id. "Thus, little additional compensation would be needed to cover the suppliers' revenue shortfall." Id.; see also id. at 273 n.199 (giving an example). An alternative hypothesis—that good retailers of appliances are hard to find—seems equally plausible.

The same criticism applies to Krattenmaker's and Salop's illustration of Alcoa's contracts with electric utilities not to sell to Alcoa's competitors. See id. at 227. One can hardly conclude that the utility can costlessly give up a substantial customer. Power companies do not have the unlimited ability to expand into new geographic areas, particularly if those areas are already controlled by others. Moreover, if overall capacity in the industry is sufficient or excess, it is not at all clear that a lost customer can easily be replaced.

103. Actually, the analysis is more complicated. If the agreement between BH and A were "naked"—that is, if BH were not buying appliances from A anyway, A would simply lose all of its sales to Klor's. In the much more likely situation where A was selling to BH and BH and Klor's were competitors, the effect of the agreement would be to either force Klor's out of business or else to switch to a different supplier of appliances. In either case, many customers who would otherwise go to Klor's to purchase A's appliances would now go to BH. Thus BH's sales might actually rise. Importantly, however, if BH raises
ensure that this strategy will be profitable to BH. For example, if A forgoes profits of $20 per unit on its sales to Klor's and if BH is four times as big as Klor's (that is, sold four times as many units before the exclusionary rights contract took effect) it would cost BH $5 per unit of its own sales to raise Klor's costs by $5 per unit. In that case both firms would experience the same cost increase and one would normally expect that neither firm would find that profitable.\textsuperscript{104}

Although Krattenmaker and Salop acknowledge that such problems may prevent the exclusionary rights contract from being negotiated, they do not incorporate discounting for such likelihood into their objective test, which considers only the structure of the market. The result, once again, is that a market that appears to be “conducive” to cost-raising strategies on the basis of concentration information alone, is in fact not necessarily conducive to them. In that case, condemnation of a vertical restraint capable of substantial efficiencies is manifestly contrary to the consumer welfare principle.

Consider this in a context in which it is likely to arise in litigation. Unless BH is quite ill advised it will not leave behind a distinct contract under which it purchases from A a naked promise not to deal with Klor's. Rather, the agreement will be disguised from authorities, perhaps as an exclusive dealing contract or arrangement in which A designates BH as its “exclusive” distributor in a certain city or area, effectively preventing itself from selling to Klor's. Klor's alleges that the arrangement is in fact BH's purchase of an anticompetitive exclusionary right from A.\textsuperscript{105} I suggest that no matter how concentrated the appliance manufacturing market and the appliance retailing market, the court will not be able to conclude that this arrangement is anticompetitive in the way that Krattenmaker and Salop suggest. Most importantly, it does not follow from the market structure that A would be willing to accept any offer that BH would be willing to make for the purchase of this monopoly.

\textsuperscript{104} That is, each firm would experience a loss of volume but no increase in profits per units sold.

\textsuperscript{105} Although A would ordinarily be willing to sell appliances to BH for, say, $100, the parties have negotiated a contract calling for a sale price of $100 + X, where X equals the price of the exclusionary right that BH is purchasing. X could also be the provision of sales services that BH would not otherwise provide to A.
Add an additional factor into the calculus: BH alleges that Kor's was engaged in persistent free riding of point-of-sale services offered by BH. As a result, BH argues, it was in A's best interest that Kor's be terminated, and total market output will actually rise as a result.

Now the court faces a problem of a different order of magnitude than that described by Krattenmaker and Salop. First, using their test, the court would inquire whether the market structure is such that an exclusionary rights strategy is plausible. If the answer is no, the exclusive dealership agreement is legal. If the answer is yes, the court must next consider whether the arrangement in this case is efficient or else is a device for raising Kor's costs disproportionately to BH's so that BH can charge monopoly prices. To answer this question the court must look beyond the structure of the market. The court must also determine: 1) the amount of profits A would forego by not selling to Kor's; 2) the amount of profits A would forego when BH subsequently raises its own prices; and 3) the amount of profits that BH could be expected to earn from this strategy. If (3) is greater than the sums of (1) and (2), it is plausible that BH has purchased an anticompetitive exclusionary rights contract from A. The court must still determine, however, whether the exclusive dealership arrangement is efficient because Kor's has been engaged in free riding and A anticipates that it will sell more appliances, not fewer, under the new arrangement. It will be some time before courts or even strategizing firms will be able to manage all these calculations in real world markets.

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106. For a summary of the traditional economic analysis of free riding and its impact on supplier output, see H. HOVENKAMP, supra note 15, § 9.2. Under that analysis, a vertical restriction that eliminates free riding will increase the supplier's sales, at least in the long run. Id. One prominent scholar, it should be noted, has argued that the fact that a vertical arrangement increases output is not dispositive of its efficiency. Scherer, supra note 27, at 697-704. In that event even a measurement of the restriction's effect on output would not determine whether it is efficient. Id.

107. In their analysis of efficiency and how it should be accounted for, Krattenmaker and Salop observe that one consequence of efficiency is reduced costs for the purchaser of the exclusionary right; as a result, he is willing to pay more for the exclusionary right. This may be true, but it does little to help distinguish between a vertical arrangement that is on balance anticompetitive and one that is competitive.
CONCLUSION: ALTERNATIVE, ADMINISTRABLE SOLUTIONS

The preceding comments do not reflect substantial doubts on my part that vertical restrictions can be used to raise rivals' costs. I believe that firms do employ cost-increasing strategies anticompetitively and that vertical restrictions may be one such strategy.\(^{108}\) The problem is to devise a set of rules that increases social welfare enough to be worth the costs of antitrust enforcement. At this stage, the tests Krattenmaker and Salop propose do not seem to be well designed to do that.

On the other hand, there may be alternative routes to the same destination, or at least one that is relatively close. This essay does not propose a comprehensive set of enforcement rules, as Krattenmaker and Salop have done, but rather makes a few suggestions, some drawn from Krattenmaker's and Salop's own analysis.

First, no policy is served by considering either strategy or structure in cases involving truly "naked" restraints. The purchase from a vertically related firm of nothing but a promise not to deal with a rival is classic material for the per se rule. Granted, the anticompetitive consequences of such a purchase may be open to doubt,\(^{109}\) but it is equally clear that such a purchase produces no cost savings for anyone and thus must be anticompetitive in its motive if not its effect. If a practice obviously has no efficiency value whatsoever, then any reasonable possibility for harm makes condemnation appropriate as soon as the tribunal is able to place the restraint in this category.\(^{110}\)

Provisionally at least, other activities that Krattenmaker and Salop describe should also be placed in this per se classification. For example, as far as I know no one has ever provided a rational efficiency explanation for contracts in which a supplier promises to charge higher prices to the contracting firm's competitors than it charges to the contracting firm.\(^{111}\) Once

\(^{108}\) On the other hand, I am far more confident that competitors acting in concert use such strategies. See Hovenkamp, \textit{supra} note 2, at 276-78.

\(^{109}\) For example, it is difficult to see how such a purchase would permit supracompetitive pricing if both vertically related markets are competitive.

\(^{110}\) That is, costs of determining the competitive consequences of the restraint must also be considered. See K. Elzinga & W. Breit, \textit{The Antitrust Penalties: A Study in Law and Economics} 9-12 (1976); H. Hovenkamp, \textit{supra} note 15, §§ 10.1-4; Schwartz, \textit{An Overview of the Economics of Antitrust Enforcement}, 68 GEO. L.J. 1075 (1980).

\(^{111}\) Krattenmaker and Salop deal with this under their "cartel ringmaster" theory. See Krattenmaker & Salop, \textit{supra} note 1, at 238-40.
again, if efficiency claims are so weak that not even a theoretical case for efficiency can be made, per se condemnation is appropriate if there is any reasonable possibility of competitive harm.

Additionally, any rule of reason evaluation of a vertical restraint should assess the impact of the restraint on rivals' costs, particularly if there is empirical evidence of actual cost increases to rivals flowing from the restraint. If the evidence is good enough that the court can estimate these cost increases, closer scrutiny of any claimed efficiencies is then in order. The burden should then be shifted to the defendant to provide evidence of the magnitude of claimed efficiencies. Likewise, there may be direct evidence that a vertical restraint facilitates a particular antitrust violation such as collusion. In that case, however, the proper course for the court would be to condemn the facilitated violation.

Finally, Krattenmaker and Salop are correct to conclude that judicial supervision of vertical arrangements is more appropriate if the cost-saving effects and the exclusionary effects can be disaggregated, even if they cannot be measured. Under the "less restrictive alternative" analysis appropriately applied in rule-of-reason cases a court might be quite willing to concede that an arrangement creates efficiencies, but nevertheless require that the arrangement be restructured in such a way as to preserve the efficiencies while eliminating or reducing the potential for harm to competition. Several Supreme Court cases involving horizontal agreements fall into this category, and there is no theoretical reason why the same rule should not apply to vertical arrangements.

112. The "Frankenstein monster" theory, supra text accompanying notes 63-69, is the theory under which this is most likely to occur.
113. See 7 P. Areeda, supra note 8, ¶ 1505 (1985).
114. See, e.g., National Collegiate Athletic Ass'n v. Board of Regents, 468 U.S. 85 (1984); Associated Press v. United States, 326 U.S. 1, 13 n.10, 21 (1945); United States v. Terminal R.R. Ass'n, 224 U.S. 383 (1912). In each of these cases, the Court recognized efficiencies in joint ventures of competitors, but condemned various restrictions on entry or output. See H. Hovenkamp, supra note 15, § 10.3.