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Vertical Restraints: A Historical Comparative Perspective Between Brazil and the United States of America.

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1) Introduction

This paper has the main purpose of serving as a reflection about the way of analyzing vertical restraints in Brazil. The topic is of particular interest because of the confusion surrounding these types of practices, since they jointly reveal anticompetitive and procomeptitive aspects. As a result, the analysis of the subject has no pre-determined pattern and has to de done on a case-by-case basis. Nevertheless, it is possible to point some common examination perspectives involving these conducts, which are essential to permit a sound and robust study. With the main goal of attaining a set of orderly concepts and steps of approach for the study of vertical restraints in Brazil, the paper will propose an initial outline of a guide for antitrust decision-making.

Before, notwithstanding, a brief description of the Brazilian Competition System will be made, stressing the main problems for an effective antitrust enforcement policy in Brazil and, consequently, for enhancing the quality of the decisions involving vertical restraints. A comparative exam of the analysis of vertical restrictions in the North American jurisdiction will constitute part of the work, mainly aiming at providing a brief view of the recent developments in a more advanced competition system. This particular endeavor will be important to pinpoint the areas in which the Brazilian antitrust system still needs to improve.

The paper is divided into five parts. The first one is the introduction. The second defines vertical restraints distinguishing them from other types of anticompetitive practices. The third part provides a historical comparative perspective between Brazil and the United States of America. An exam of specific problems arising in the Brazilian approach to vertical restraints, comes next, suggesting some basic steps of analysis and outlining the main procedures of a guideline. The last and fifth part concludes the paper.

2) Vertical Restraints' Definition

Vertical restraints are defined as restrictions or limitations imposed by firms located in the upstream of the production chain on firms in the downstream market. Vertical restraints are normally divided into two types: the price restraints and the non price restraints.

Price restraints are price limitations applied by one firm in the upstream market to another one situated in the downstream market. Non-price restraints comprise all other restraints not involving prices such as exclusive purchasing, distribution agreements, refusals to deal, territorial and customer restrictions.

Another common classification of vertical restraints divides it into two groups according to the scope of the pursued restriction and its effects to competitors. The first one are the restraints that foreclose a competitor from selling its products, called foreclosure or interbrand restraints. The second are those vertical restrictions that limit the reseller's possibilities of selling the good, known as intrabrand restraints.

Taking into account these divisions, we specify next the practices known as vertical conducts, giving a brief explanation of each one and their most common anticompetitive and procompetitive effects.

a) Resale Price Maintenance (RPM).

This conduct is characterized by the imposition of a resale price by the producer or seller to its resellers. It is important to depict that the simple suggestion of prices does not constitute an antitrust violation. Even though the boundary line between the simple suggestion and the actual imposition of a resale price is rather tenuous and imprecise, there has been a common understanding among specialists that the existence of a punishment for non compliance is sufficient to define the infraction.

RPM’s can occur in three different forms: by the imposition of a maximum, a minimum or a fixed price, which will be here addressed as respectively, maximum, minimum and fixed RPM.

A maximum RPM does not represent significant concerns to consumer’s welfare. This practice is plausible whenever the firm located in the upper stream of the production chain wishes to constrain the prices set by firms with market power situated in the lower production chain. This conduct is justifiable since the retail price represents a cost for the producers or original sellers. An excessively high cost can lead to a shift in the demanded quantity with repercussions to the suppliers of the good.

A minimum RPM, on the other hand, does have some potential negative consequences to consumers. Two possible anticompetitive effects can be pointed out as eventual results of a minimum RPM:

i) the consolidation of a cartel among the distributors of a given good, and,

ii) the creation of facilities for the establishment of a cartel among suppliers.

The first effect only occurs in industries where the bargaining power of resellers is sufficiently large. Since there is no aparent advantage for suppliers in establishing a minimum resale price, as lower retail prices actually benefit them through the increase of the demanded quantity, only resellers with high bargaining power can impose a minimum RPM.

The second effect mainly represents a way of guaranteeing the stability of an agreement of prices at the supply level, reducing the incentives of cheating through concession of price reductions to distributors. In a competitive distribution market, resellers are led to pressure their suppliers for lowering their prices so they can resale at a lower price, maintaining their mark-up. For the suppliers, this is also interesting, since a reduced price at the retail level will increase the demanded quantity and, consequently, promote higher purchases of their products from the distributors.

By setting a minimum RPM, even if a supplier lowers his prices to its resellers, disobeying the cartel agreement, his net benefit will be limited since the resellers will only be able to reduce the retail price to a certain level (the minimum RPM). If that had not been the case, there would be a higher incentive for the supplier to give a price reduction to its resellers, upon their request, since their would be no limit for a price reduction at the retail level, and, as a result, more space for an increase in the demanded quantity. We can thus conclude that in cartelized sectors in the supply side, where distributors represent an important means of attaining the final consumer, the establishment of minimum RPM assures greater stability for the cartel.

Turning now to fixed RPM, the focus of analysis must converge to the answering of the following question: what were the price levels before the settlement of the price constraint? If the prices were lower then the ones actually fixed, the situation will be analogous to a maximum RPM, in the opposite case, a minimum RPM will represent the similar situation.

Regarding the possible procompetitive effects of RPM's we can point-out at least two:

i) in cases of existence of two successive monopolies in the distribution chain, or, accordingly, two agents with high market power, the settlement of a maximum RPM can reduce double mark-ups, promoting a higher surplus to suppliers and consumers by reducing the distributor's surplus. As a result, an increased social welfare in comparison to the precedent case can arise; and,

ii) the establishment of a RPM can eliminate or reduce the free-rider problem, particularly important in products in which informational and pre-sale services are often present. Given that certain products often enclose information asymmetries, potential buyers will certainly value whatever endeavors to reduce this situation. Consequently, they will look for pre sale and informational services before acquiring their products. The free-rider problem arises when consumers get these services in a particular seller while buying the product in another one that does not provide the same services. This situation is very likely to occur since pre sale and informational efforts presume a cost to the firm offering it, which reflects in its prices. As a result, firms not providing these services generally have a lower price, while they benefit from the positive externalities of the firms providing it. Since property rights are not well determined, in these cases, some firms are allowed to free ride on the efforts of others, creating a disincentive for pre-sale and informational services and an indirect harm for suppliers. To correct this economic distortion, the supplier can fix a minimum RPM to distributors to guarantee an adequate compensation for the effort made by firms that provide pre sale and informational services.

b) Exclusivity Agreements

This conduct consists in agreements established between buyers and sellers to exclusively negotiate among them, excluding, consequently, other economic agents. In order to more effectively assure the imposition of this practice, it is commonly applied with other vertical restraints as price discrimination or refusal to deal, for example.

This particular conduct can be associated to an informal vertical integration, since its effects to the market are similar to this kind of merger.

Two negative effects are associated to exclusive agreements: i) the possibility of foreclosing the market to competitors through the increase of the barriers to entry, and, ii) the possibility of ensuring a market division agreement among competitors.

The first effect occurs whenever one firm implements one exclusive agreement to hinder its rival's access to essential inputs or to significant distribution facilities. In some cases one of the markets vertically linked is foreclosed in such a manner that potential competitors willing to enter one of the markets are required to provide an entrance in both of the markets. The second effect represents the enforcement practice resulting from a previous conspiracy of a market division. In other words, when two suppliers divide a certain market they can establish exclusivity agreements with the respective consumers to assure the maintenance of the agreement.

Two additional costs for competing firms result from the first effect: i) integration costs due to the necessity of establishing a distribution or supplier chain to adequately compete in the market, and, ii) search and co-ordination costs with alternative distributors and suppliers not engaged in the exclusivity agreements.

However, for the effects to take place, two conditions are necessary: i) the firm responsible for the practice must have market power, and ii) the market portion attained by the conduct must be relatively significant;

Among the possible efficiencies deriving from an exclusivity agreement two can be pin pointed:

(i) the observation of significant economies of scale as a result of an increasing distributor specialization, and,
(ii) the reduction of transaction costs among suppliers and distributors.

With respect to the second efficiency, there are three possibilities in which an exclusive agreement can reduce transaction costs:

(i) when distributors are able to opportunistically benefit from the supplier's specific assets, leading, consequently, to a lower investment appropriation from the producer.

(ii) when they serve as a stimulus for distributors to supply the adequate effort desired by the supplier; and,

(iii) when it is possible for the distributor of a particular product to substitute it for other similar goods of inferior quality.

Regarding the first case, the asset's specificity is defined in broad terms and can be associated to marketing and learning investments, for example. These are considered specific since they generally have an application that is limited to a particular firm. With respect to marketing, this kind of investment can lead consumers to search for a particular kind of product in one distributor, but the distributor might offer a different kind of brand to obtain a larger profit. An exclusive agreement can eliminate this opportunistic behavior. Accordingly, a distributor might also be able to take advantage of training courses, particular secret technical information or specific assets from a producer firms if an exclusivity agreement is not set.

With respect to the second case, sometimes the effort to sell products to marginal consumers tends to increase, what may cause the distributors to shift their selling to products that present a better cost/benefit relationship to marginal consumers. By setting an exclusivity contract the supplier firm can guarantee that the sales effort of distributors will be maximized.

The third case occurs whenever opportunistic distributors are able to sell to consumers inferior quality products leading them to think they are consuming a higher quality good supplied by a well known producer in the market. The imposition of an exclusivity agreement can deter this behavior. However, two conditions must be observed for the opportunistic behavior to happen and the exclusivity agreement to be effective impeding it to happen: i) information asymmetries must impede consumers to distinguish the products, and, ii) the distribution chain must be widespread, increasing, consequently, the monitoring costs for suppliers to stop distributors from their opportunistic behavior.

c) Price Discrimination

Price Discrimination occurs when a supplier sells the same product charging different prices, discriminating the consumers. The discrimination can be set individually or in groups. The main objective of this practice is to allow the producer to appropriate part of the consumer's wellfare, what increases, consequently, his profit. For a price discrimination to occur and be profitable, three conditions must be met:

i) the seller must have a certain control of the price, i.e., he must have market power,

ii) the agent involved in the practice must be able to accurately differentiate the consumers according to the price elasticities of their demands, and,

iii) the arbitrage opportunities must be limited, otherwise, the price discrimination would be eliminated.

There are three different types of price discrimination: the first type, the second type and the third type price discriminations.

In the first type price discrimination, also called perfect price discrimination, the vendor sells each unit for a different price, extracting in each transaction the highest price for that unit. This practice is seldom observed in practice and rather represents a theoretical abstraction. If a seller is able to perfectly price discriminate, he will attain the highest possible profit while all the consumers will be satisfied. Thus, in a first degree price dscrimination, we have an efficient outcome.

In the second degree price discrimination the vendor charges different prices to the same consumer according to the quantity he buys, while in the third degree price discrimination the vendor separates the consumers in different groups, based upon their price elasticities of demand and charges them different prices.

Price discrimination is not necessarily an anticompetitive practice, soemtimes it can even increase the amount of transactions in the market.

Price Discriminations can present the following efficiencies:

i) in certain industries the existence of significant economies of scale and consumers with substantial diferences in their consumption, it normaly is more efficient to charge less for those who consume more, and,

ii) when the marginal cost of supplying a good or service is substantially increased in certain periods of time, normaly known as peak hours, it can be efficient to charge more.

A very normal anticompetitive outcome resulting from price discrimination conducts is the one observed in markets where a vertically integrated firm controls an essential input in the production chain and charges different values to its rivals to increase their costs. Apart from that, the drawbacks associated to price discrimination represent, in fact, a variation of other anticompetitive practices, for example, refusal to deal, tying, or market division. Two competing firms allocating the market among them can agree to always charge higher prices or simply refuse to sell to the consumer of the other one. The price discrimination will serve as a means of assuring the existence of a cartel in these cases.

d) Tying Practices

Tying practices are conducts in which the supplier of a certain good or service imposes the acquisition of another one as a condition to sell the first good or service.

Two are the possible efficiencies of tying practices:

i) the sale of various products reduces the transaction costs related to gathering information, contract negotiation, logistics and stock management, and,

ii) it permits to protect the seller's image and/or reputation against the sale of a complementary product of inferior quality (this effect is only possible when the consumer is unable to clearly and separately identify the two complementary goods).

The anticompetive effects of tying are the following:

i) it can promote a market foreclosure for competitors by conditioning the acquisition of one product to the other[1];

ii) it can lead to a substantial raise of the barriers to entry, since a potential entrant could be forced to invest in the joint production of two different goods;

iii) it can create a monopolistic position in the post sale service market of a ceratin product due to the extreme dependence of these clients to the service provided[2]. This is the case, for example, when the vendor of a certain machine requires the joint purchase of the product and its maintenance services. Three conditions must be met for a monopolist benefit to occur as a result of a tying practice:

? the existence of substantial *switching costs* that hinder the substitution of the acquired product,

? the relative difficulty for the buyer to accurately evaluate the post sale service costs before purchasing the product, and,

? a low level of competition in the market of the product.

iii) A tying practice can serve as a mechanism to mislead government officials from price fixing determinations in regulated industries, or as a veil of predatory pricing.

e) Customer and Territorial Restraints

[1] For example, if the profits of one certain supermarket is extremely dependent upon the sale of good A, that only firm 1 produces. Firm 1 can condition the sale of good A to the purchase of good B. Firm 2, that sells good B at a lower price, will be impeded to comercialize with the supermarkets because of the tying practice of firm 1.

[2] This phenomenon is known in the literature as lock-in effect.

In this practice, the supplier of a certain good establishes certain restraints with respect to the area in which his distributors and resellers can act, limiting the competition and the entry.

Basically, the procompetitive effect of customer and territorial restraints can be resumed to the argument that they can reduce the opportunistic behavior of certain distributor/reseller, in detriment of others, leading, consequently to a reduction of quality of the goods and services sold.

Two are the anticompetitive aspects of this practice:

i) the facilitation of collusive practices by the downstream firms, and,

ii) the increase of the market power of the supplier.

f) Refusals to Deal

Refusals to deal are practices of not commercializing with a certain agent without a legal motive for doing so. This conduct almost always represents a mean of assuring the compliance of other anticompetitive practices such as exclusivity agreements, RPMs, cartels or price discrimination. With respect to cartels there is no possible efficiency.

Regarding the other conducts the anticompetitive and procompetitive aspects have been already previously outlined.

3) A Historical Comparative Perspective of Vertical Agreements

3.1 United States of America

North American antitrust legal provisions find its origins in the Sherman Act of 1890, the Clayton and Federal Trade Commissions acts of 1914, as well as several posterior amendments. Section 1 of the Sherman Act posits, *"Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade, or commerce among the several States, or with foreign nations, is hereby declared to be illegal."* Section 2 stipulates that *"Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize in any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor."* According to the Sherman Act, violations will be punished to a maximum fine of \$ 5,000, and/or by imprisonment not exceeding one year. Section 7 of the Sherman Act also allows treble damages pleads to private parties. In 1974 the fines were substantially increased to a maximum of \$ 1 million for corporations and \$ 100,000 for individuals while violations of the Sherman Act became a felony, carrying a maximum prison term of three years.

In its early years of existence the impact of the Sherman Act was quite limited, due, essentially, to its ambiguous provisions. The courts had to intervene by determining when restraints of trade could be considered reasonable. However, this interference narrowed the scope of the act. In the beginning of the 20th. Century most observers agreed upon the need of a complementary legal provision since the Sherman Act had proven to be quite ineffective.

In 1914, the Clayton Act was enacted. The act provided greater specificity to antitrust by enumerating the forms of corporate activity that were subject to prosecution. Some vague prohibitions of the Sherman Act were supplemented and the following conducts were deemed illegal once the effects *may be to substantially lessen competition or tend to create a monopoly in any line of commerce*: I) *the use of discriminatory prices in the sale of commodities of like grade and quality,* ii) *exclusive dealing and tying contracts,* iii) *the acquisition of the stock or other share capital of another corporation.*

The Clayton Act has been amended several times aiming at strengthening the prohibitions and expanding the authority of the antitrust agencies. Its two main amendments were the Robinson-Patman Act, in 1936, and the Celler-Kefauver Act, in 1950.

The first act had the main objective of protecting small businesses by preventing large buyers from securing unwarranted cost advantages when dealing with suppliers. Provisions and acceptance of price discounts were forbidden when no explanation related to cost differentials was provided. These costs were deemed unlawful, even upon justification, whenever they undermined competition or contributed to the creation of monopoly. The reasonableness of the procedures was left to the analysis of the Federal Trade Commission - FTC.

The second act actually established the basis of merger analysis in the U.S that was reinforced in 1976, through the creation of a pre-merger notification program.

Two agencies are responsible for the enforcement of the antitrust laws in the United States, the Justice Department's Antitrust Division and the Federal Trade Commission[3].

The Antitrust Division emerged as the embodiment of the Sherman Act, at the moment of its creation. Nonetheless, the Justice Department was not sufficiently equipped to face the increasing enforcement demands of a rapidly expanding economy. To address these increasing demands the FTC was created in 1914, with the main goal of applying expert knowledge and flexible procedures to regulate the economy.

The Antitrust Division is responsible for enforcing the Sherman Act, while the enforcement of the Clayton Act is shared with the FTC. However, the FTC also brings cases that could be prosecuted under the Sherman Act. This overlapping jurisdiction has led some specialists to suggest the centralization of antitrust activities in the Antitrust Division, with the FTC mainly responsible for consumer protection. With the main objective of addressing jurisdictional conflicts a Liaison Arrangement was created in 1948. A division of powers among the agencies, based on their respective experience and expertise, established duties allocations based on the type of violation and economic sector.

[3] FTC from now on.

Antitrust Division is led by an assistant attorney general and several deputy assistant attorneys generals. All formal investigations and case fillings must be approved by the assistant attorney general. Before, nonetheless, the Division’s attorneys, jointly working with staff economists, decide if the potential cases have the required legal and economic merits to warrant a formal investigation.

The Antitrust Division has substantial investigative powers. Whenever it decides to initiate a formal investigation, it must decide if it will de conducted on the criminal or on the civil level, or in both. Criminal proceedings are usually filed in practices considered illegal *perse,* while civil proceedings often occur when the conduct involves an analysis based on the rule of reason[4]. In civil cases, the division can issue civil investigative demands (CIDs), the equivalent of administrative subpoenas. The CIDs can be issued to a corporation, corporate officials, or third parties, when there is reason to believe that the party possesses necessary information or relevant documentary material. In criminal cases, the investigations are commonly conducted through the grand jury system. Grand jury investigations represent a significant threat to corporations due to the unlimited scope of the investigations. Previously unrecognized violations may be revealed and documentary evidence derived from grand jury subpoenas may be acquired by private parties and used for treble damage suits. Nevertheless, once criminal charges are filed, the accused party rarely prepares a defense. Instead it prefers to enter a a plea of

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[4] The analysis of antitrust practices can be done according to 2 different approaches: the rule of reason or the analysis *per se.* The first one analyzes the pro and anticompetitive effects of a particular conduct before deeming it illegal. The second only requires the adequate proof of the practice to consider it a law violation.

nolo contendere. This choice proves to be quite beneficial for the firms entering it, since it minimizes the costs of a lengthy and expensive trial and prevents its use in private antitrust cases because it is not an admission of guilt. Civil cases can also be settled out of court through the negotiation of a Consent Decree with the Division. Apart from being inadmissible as prima facie evidence of an antitrust violation in private suits, consent decrees allow for relief eliminating expenses, delays and disclosures associated with a trial.

The Federal Trade Commission's enforcement power is derived from the Federal Trade Commission Act of 1914. According to Section 5 of the FTC Act, the agency has the power to bring proceeding against *unfair method of competition in commerce*. FTC is headed by a five-member commission with a chair. It is presently composed by two bureaus, the *Bureau of Competition* and the *Bureau of Consumer Protection.*

Cases in the FTC as well as in the Antitrust Division may be originated by industry complaints, referrals from the other antitrust agency, businesses publications and economic market studies. In the past, most cases were generated from formal complaints. In the recent years, however, an increasingly number of cases was started through economic analysis. This trend diminished the excessive reliance on complaints inaugurating a pro-active posture of the competition enforcement agencies.

Nevertheless, among all the cases filed in both agencies, few are actually litigated to a conclusion. Great part of them are settled by the negotiation of Consent Orders or

Consent Decrees. A Consent Order gives the offended party the opportunity of negotiating a settlement with the FTC, while a Consent Decree allows a negotiation at the civil level with the Antitrust Division. These two dispute settlements have the advantages of avoiding a costly and time consuming litigation as well as eliminating the risk of subsequent treble damages suits.

Regarding specifically the issue of vertical restraints, however, the most important cases have gone to court, mainly due to the inherent difficulty of determination of the positive and negative aspects of these practices.

Until the 1970's the US courts had been rendering decisions condemning vertical restraints based on the rationale that they reduced the seller's independence and foreclosed their access to customers. These decisions had been facing blatant opposition of the *Chicago School*, which argued that one of the reasons for a manufacturer to restrict its distributor's actions would be to benefit the consumers.

The *Chicago School* claimed that the main variable to be analyzed in vertical restraint case was the effect in output. Whenever the effect of the restraint was the increase of output they would argue that the practice was pro-competitive. Whenever the effect was the reduction of output they would deem it anticompetitive. In other words, this school concluded that the interests of manufacturers and consumers are often coincident and result in mutually beneficial vertical rulings. By imposing some restrictions in market procedures the manufacturers could avoid opportunistic behaviours in the productive chain, assuring a more efficient outcome. As an example, we can allude to an example of a distributor undertaking great efforts to promote its product, facing, as a consequence, a cost for these efforts. Another distributor not undergoing the same actions could have a lower cost, being able to sell to consumers that have got to know the product of the first distributor due to his efforts. The second distributor would be free-riding on the first one. A vertical restraint such as a resale price maintenance or the concession of an exclusivity distribution right could eliminate this inefficiency. Thus, vertical restraints are commonly employed when markets fail to allow for the efficient supply of inputs and distributions of outputs. Non market contracting arrangements are used not to eliminate competition and create monopoly power but to overcome the financial costs and uncertainties that accompany certain types of market transactions.

The critics of the *Chicago School* posit, nevertheless, that opportunistic behaviors can be suppressed by a separate service charge by their respective deliverers, or, by the elimination of information asymmetries existent in the market. Besides, they tend to give more importance to the increasing market power resulting from vertical restraints than the *Chicago followers.* Vertical restraints, according to them, may be used as part of a strategy to eliminate competitors.

In general terms, the *Chicago School* argues that competition agencies should have a minimal interference in the market with respect to anticompetitive practices, while their opposers claim for a necessary and active regulation. David S. Evans[5] separate these two approaches in the *hands-off* and *hands-on* schools. The first one views the courts and

[5] *Regulation, National Economic Research Associates,* Fall 2001.

competition enforcers as having a limited ability to accurately differentiate anticompetitive and procompetitive practices. As a result, their interference contributes for enhancing any eventual market inefficiency, instead of eliminating or diminishing it. The *followers* of the second school claim that a separation of the practices according to their positive or negative effects in competition terms is possible. While the *hands-on* thinkers believe that the cost of a government action deterring pro-competitive conducts is lower than the benefits of reducing anticompetitive practices, the *hands-off* theorists have the opposite view.

Regarding more specifically the court's views on vertical restraints, they have been changing quite often. Since 1911, most North-American courts ruled these practices unlawful according to a *per-se* analysis. The paradigmatic case which settled this point of view was the case *Dr. Miles Medical Co. v. John D. Park & Sons Co. US. 373 (1911).*

In 1977, the Supreme Court's decision on the case *Continental T.V., Inc., et al. GTE Sylvania Inc.*, changes the approach of non price vertical restraints in the United States, establishing an analytical perspective according to the *Rule of Reason.* In this case, GTE Sylvania was restraining the sales of Continental T.V., its franchisee, in a specific area. The U.S. Supreme Court concluded that a *Rule of Reason* should be applied to any intrabrand non-price vertical restraint[6]. The Supreme Court claimed that despite the fact that these restraints limit intrabrand competition, they can promote substantial interbrand competition, since they enhance distribution efficiencies. Thus, this decision meant the acceptance of the argument that vertical restraints can be an efficient means of

[6] See first paragraphs of topic 2.

eliminating or diminishing opportunistic behaviors of firms vertically related in the production chain.

Since the case *Continental T.V., Inc., et al. GTE Sylvania Inc* most court decisions in the United States have followed an analysis based upon the net competitive effects of the practice. A specific restraint vertically imposed by one agent to another can de deemed lawful if the pro-competitive aspects of this restriction are greater than its anticompetitive effects. Among the accepted pro-competitive aspects of a vertical restraint accepted by the courts we can point out:

i) the competition enhancement with other producers,
ii) the increase in the distributive efficiency,
iii) the stimulus for the protection of property rights,
iv) the incentive to attain more adequate amounts of pre-sale and post-sale services,
vi) the avoidance of opportunistic behaviors (free rider problem) to stimulate the reseller's investment in technical and commercial capacitating.

The analysis basically focuses on the effect on one market to the restriction imposed on the other market. In other words, it results from the comparison of the effect of a decrease of the intrabrand competition with respect to the consequences of the increase in the interbrand competition. If one particular restraint imposed by manufacturer firms to its distributors raises the competition with its rivals more than it promotes a diminishing competition at the distribution level, it can be considered legal.

Nevertheless, North-American courts are also aware of anticompetitive concerns present in vertical restraints, such as market foreclosure or raising rivals costs. Thus, the most common approach in the U.S. is a sequential analytical framework based on:

1) the relevant market definition,

2) the calculation of the market shares,

3) the analysis of the market power of the firms engaged in the practice,

4) the exam of the negative aspects of the conduct,

5) the exam of its positive effects,

6) the analysis of the extent to which the restraints are necessary for the achievement of the positive effects.

Most of the North-American courts have understood that a net negative effect of a practice is only possible when the agent imposing it has significant market power in the concerned relevant market. In the case *Tampa Electric Co. V. Nashville Coal Co.,* for example, the North- American Supreme Court concluded that the market share of the defendant of 0.77% was insufficient to promote competitive concerns in the defined relevant market.

During the 1980's very few vertical restraint cases were analyzed by antitrust agencies and US courts. More recently, the number of cases have increased. Apart from the abovementioned cases we can point out other two paradigmatic cases in the U.S.: *United States vs. Sealy Inc.* and *Eastman Kodak Co. Vs. Image Technical Services Inc.*

In the first one, *Sealy Inc.*, a mattress producer, was granting territorial exclusivity to 29 licensed firms to produce its brand. It specified, moreover, technical required standards and the sale price to be established. The Supreme Court concluded that the concession of territorial exclusivity reduced the competition among rivals and had resulted from an agreement between the licensed companies and *Sealy Inc.* The case illustrates how a vertical restraint can conceal a horizontal agreement among competing firms.

In the case *Eastman Kodak Co. Vs. Image Technical Services Inc.* the accused company, a maintenance company of Kodak products, claimed that Kodak had been refusing to sell replacement parts to companies that were competing with them in the maintenance business. The plaintiff argued, moreover, that the accused company had changed its selling policies and had been jointly offering the product and the maintenance service. The major issue in this case was whether a company without market power in the upstream market was able to impose an anticompetitive practice in the downstream market. The U.S. Supreme Court considered the conduct unlawful because the high exchange costs and information asymmetries related to the maintenance costs faced by the buyers of Kodak products actually gave market power to the plaintiff with respect to this specific market segment. According to the Supreme Court, the consumers of Kodak equipment were tied to the service market associated to them, an effect known as *lock in*. This effect enabled the producer company to have market power.

3.2 Brazil

The Brazilian Antitrust system is composed by three governmental entities. The Secretariat for Economic Monitoring - Seae, the Secretariat for Economic Law - SDE and the Administrative Council for Economic Defense - CADE. The first agency is administratively linked to the Ministry of Finance, while the others are subordinated to the Ministry of Justice.

Antitrust cases are presented to SDE, which, jointly with Seae, conducts antitrust investigations. SDE concludes its technical report enforcing legal aspects, while Seae mainly approaches economic issues. Seae´s report is only mandatory in merger cases; with respect to anticompetitive conducts it is not. CADE, an administrative tribunal, renders the judgment on the cases after analyzing the technical opinions of the other agencies.

Brazilian Competition Policy Enforcement was inaugurated in 1962, with the creation of CADE. Notwithstanding, only after 1994 an effective competition policy enforcement has been possible. The implementation of the "Real Plan", in this year, yielded inflation control through the functioning of free market forces, gradual opening of the economy and privatization of state owned assets, in opposition to the scenario of price control, trade barriers, and government enterprises, which hindered competition enforcement in the past. A new competition law, law n. 8.884/94, which transformed CADE into an independent agency, was also enacted in 1994, within the scope of the economic reforms. All these changes significantly enhanced Brazilian Competition System's effectiveness, establishing the Real Plan as an important milestone in competition policy, and, consequently, the year of 1994, as a turn point date.

In this context, the analysis of vertical restraints of trade within the Brazilian economy was only seriously dealt after 1994.

Law no. 8.884/94's approach to vertical restraints is mainly addressed in articles 20 and 21. Some analysts claim that article 54 is also oriented towards antitrust practices, while others affirm that it is mainly directed to mergers, acquisitions and joint ventures. The law, in fact, is not clear since article 54 stipulates: *any acts that may limit or otherwise restrain open competition, or that result in the control of relevant markets for certain products or services, shall be submitted to CADE for review.*

CADE's view, however, is that article 54 is exclusively related to the notification of mergers, acquisitions and joint ventures. In fact, any other interpretation would lead to the obligation of notification to CADE of any acts that possibly might *limit or otherwise restrain open competition*, according to the provisions of article 54. Actually, the interpretations opposed from CADE's view are misleading and, if applied, they could impose a significant burden to the system, since companies would be expected to infer all the possible and imaginable consequences of any of their practices and submit the anticompetitive ones to CADE. The resulting lack of legal certainty, and the posture of law offices trying to avoid eventual unpleasant surprises could lead to the submission of a significant number of unnecessary cases, substantially increasing the slowness of the already sluggish Brazilian Competition System. The European Commission Competition Law requires mandatory submission of all vertical agreements among firms. The Commission, however, issued block exemptions regulations for some specific type of agreements to diminish the number of notifications. Thus, even in the European Community, the multiplication of irrelevant cases submitted to the competition authorities represented a serious concern. CADE's interpretation seems to be aware of this problem setting a correct understanding in this particular issue.

According to article 20 *Notwithstanding malicious intent, any act in any way intended or otherwise able to produce the effects listed below, even if such effects are not achieved, shall be deemed a violation of the economic order:*

I- to limit, restrain or in any way injure competition or free enterprise;

II- to control a relevant market of a certain product or service;

III- to arbitrary increase profits; and

IV- to abuse one's market control.

Article 21, on the other hand, non-exhaustively enumerates a set of practices that constitute antitrust infractions. The article has mainly the objective of listing a set of potentially illegal conducts. To conclude whether the practices constitute or not legal breaches, article 20 must be examined. If at least one of the potential effects stipulated in the article is attained, the conduct will be deemed illegal. In other words, article 21 has rather a didactic function, serving mainly as a preliminary infraction qualifier that should be verified through the analysis outlined in article 20.

As previously stated, practices listed in article 21 are not exhaustive. This means that other conducts may be considered infractions of the economic order without any particular provision in this article. The possibility of reaching at least one of the results pointed in article 20 is whatsoever mandatory.

By simply enumerating infractions that potentially can constitute breaches of the economic order, while maintaining the illegality of article 20 restricted to its effects on the market structure, the Brazilian law privileged its flexibility in detriment of legal certainty. At the moment of its creation, in 1962, competition enforcement was a recently new area. Its severe application, to a large extent, conflicted with the main political economic goals of the government. Having a flexible law in these occasions, actually represented an advantage in political terms.

In fact, CADE, in its early years, had mainly a fictitious role. During the creation of the Brazilian competition system, the country was experiencing a period of political and economic crisis. Economically, Brazil had been growing until the early 60's at a phenomenal rate, due to the nationalism pro-development strategies of President

Juscelino Kubistchek. The strategy was based on a wide range of sectored economic goals expressed in the “Target Plan”[7]. This development strategy elected industrialization as a national goal to be reached, and privileged producers in detriment of consumers. The industrial policy promoted state interventionism, import substitution and even price controls of essential goods and services. As a result, competition policy, in the early sixties, actually conflicted with the main governmental objectives. These conflicting goals explain, in a great portion, the flexibility of the Brazilian Competition Law.

From 1964 on, the political economic scenario became increasingly opposed to competition concerns. The military government assumed control of the country and encouraged even more the entry of high technology modern firms in Brazil. These companies had been built to operate in developed countries with a large market of high purchasing power. Their operation in Brazil actually led to a high market concentration protected by the imposition of tariffs. To curb inflation, moreover, price controls were undertook by the government. Consequently, there wasn’t space for competition enforcement in this context.

Federal intervention to establish price controls to hinder inflation encouraged, in fact, the development of trade associations to defend sectored interests while establishing, jointly with the government, the prices to be followed. Since the prices were determined by federal entities through the analysis of cost structures and comparative exams of

[7] A triple economic expansion path plan was elaborated. The government would participate in the long run mature investments associated to the infrastructure. The foreign enterprises would be concentrated in the highly capital and technology intensive sectors associated to the durable consumer goods, while the national private sector would be responsible for the production of non durable consumer goods.

similar products, the organization of firms in associations meant the capacity of reaching a more profitable decision to its interests. These groups were actually called by government officials to negotiate a commonly reasonable price to be followed. These federal actions had the purpose of stabilizing the market, which is, in fact, the final goal of cartels. As a consequence, price control in Brazil led to the organization of institutional structures for cartel functioning, developing, consequently, a corporate culture of market information interchange among industrialists. At this period it was common for competitors to talk about costs and prices.

In this scenario, the existence of a flexible legislation allowed authorities to overlook some basic competition problems, concentrating the application of the law to the concerns elected by them. Some theorists argue that the Brazilian Competition law had the main objective of protecting the economy from abusive price raises, regardless of competition concerns. The law's ultimate custody target was, according to these specialists, worker's budgets, and not competition itself or freedom of economic activity.

Interestingly, this rationale explains some law provisions that apparently may seem contradictory to provide an environment of free competition. As an example we can point item iii of article 20, which prohibits *"any act in any way intended or otherwise able to produce the increase of profits on a discretionary basis"*. It seems clear that the seek of increasing profits represents the essence of free competition. Thus, the search of the possibility of raising profits represents a legitimate goal to firms. Prohibiting acts with this specific goal undermines attempts to reach a more competitive market. It is, in fact, the capacity of discretionary increases in profits that signals to competing firms that the profit rate of a certain industry is exceedingly high, allowing, through subsequent entry of firms, the price to attain a competitive level. As a consequence, the prohibition of *increase in profits on a discretionary basis* represents a competition paradox. Only the explanation of price protection concerns can elucidate the rationale of forbidding this specific practice.

Recent government measures of price controls as the one recently undertaken in the Brazilian pharmaceutical industry, for example, can also be explained by this reasoning. These initiatives actually conflict with competition enforcement and represent a residual interference of this approach even nowadays.

As we have seen, it is true that, on one hand, the historical political and economic context of the creation of a certain law substantially shapes its contents. On the other hand, apart from this passive influence, laws also have an active role of modifying the reality in which they act. Thus, legislations have a symbiotic relationship of mutual interference with their respective social, political and economic environment. They must imperatively bound individual and social actions to their determinations, without, however, excessively impairing evolutions. Consequently, a constant trade-off between legal enforcement certainty and social economic policy flexibility remains inherent to all laws. Some, as the criminal laws, sacrifice, to a great extent, the latter in detriment to the former. In these cases, the balance tends to the legal enforcement side, while political and social evolutionary aspects tend to be residual. Others, as the competition law, have a somewhat distinct point of equilibrium, rather pending to the flexibility side.

In Brazil, the flexibility in the Competition Law is expressed by an excessively generic and imprecise legislation. In article 20, for example, infractions are vaguely determined and are associated to their potential market effects. The market effect is a concept that can easily be questioned and undermined, especially when the law does not provide a clear definition. Accordingly, article 21 stresses the law's elasticity by establishing a set of non-exhaustive exemplary practices with no self-enforcement power.

In this context, vertical restraint cases presented to competition authorities in Brazil actually suffer the abovementioned effects of lack of precision. Companies when entering complaints, as well as the Secretariat for Economic Law when filing administrative proceedings and preliminary investigations, tend to provide an inaccurate listing of breaches. This procedure can be explained by the intention of maximizing the probability of condemnation when faced to an imprecise and inaccurate legislation.

The scenario is even worsened considering that CADE has failed to give, through its decisions, a clear set of common principle of analysis. The cases submitted to the council reveal that there is a substantial lack of uniformity and coherence throughout the decisions, which vary in a great deal.

As the analysis of some of CADE's recent decisions regarding vertical restraints will demonstrate, the council's approach to the subject cannot be easily apprehended. This difficulty is partly the result of the absence of a common set of systemized principles of analysis, which leaves the decisions excessively based on superficial perceptions of the commissioners, and, consequently, more susceptible to political influence. Most of the conclusions derived from the cases are driven by assumptions often not proved, and, in various cases, a thorough investigation of the anticompetitive and procompetitive effects of verticals restraints is completely neglected.

While examining the Xerox and Sharp cases[8], for example, CADE did not account for the positive and negative effects of the practices pointed in the complaints, in accordance to the rule of reason approach set forth in the Brazilian Legislation[9].

In the first case, the complaint was filed by one of the companies that rented Xerox's photocopying machines. It basically alleged that Xerox was tying the provision of maintenance services to the purchase of other materials it produced. Thus, according to an agreement signed between the companies, Xerox would only provide maintenance services if the other firm bought developer, photo receiver and other materials from it. CADE defined three relevant markets, the photocopying machines market, the maintenance services market and the materials market, in which Xerox had shares

[8] Respectively, Administrative Proceeding (PA) 23/91 and Administrative Proceeding 01/91.

[9] Resolution 20/99 issued by CADE posits in its appendix *The analysis of anticompetitive practices requires a discerning examination of the practices' effects on its respective markets, according to articles 20 and 21 of law no. 8.884/94. The national and international experience reveals the importance of analyzing each practice in its particular context, as well as its economic reasonableness. It is thus necessary to consider not only the costs associated to a certain practice but also all the benefits stemming from it, in a way to carefully investigate its net impacts in the market and with respect to consumers.*

varying from 74 to 100%. The Council concluded that Xerox had been, through its tying practices, erecting barriers to eliminate its competitors, by hindering the utilization of its rivals' products by hirer companies, without providing sufficient evidence that these products were prejudicial to the photocopying machines. CADE, however, restricted its analysis to the proof of the tying practice and the calculation of the market power, neglecting any eventual inherent efficiencies of the conduct.

In the Sharp case, accordingly, CADE also examined a complaint of the conditioning of maintenance services of a photocopying machine producer - Sharp - to the acquisition of other materials it produced. The council deemed the practice unlawful despite the fact that the producer only had a share of 3,5% of the relevant market. Once again, analyses of eventual efficiencies associated to the conduct were totally ignored. The decision stated that competition in the market of the tied good had been "inevitably" impaired, eliminating actual or potential competitors due to difficulties created for the performance or development of companies in that market. The council's conclusion in this case, paradoxically, converged to a *per se* approach, in opposition to the widespread view that the Brazilian Competition Law only accepts an analysis based on the "Rule of reason".

It must be however stated that these two decisions were undertook before the enactment of law no. 8.884/94.

While examining a merger involving a tying practice, known as the Vesuvius case, CADE's approach seemed to have converged towards the perspective of more developed jurisdictions, through the analysis of the extension of the market power in one market to the other one. In this case, the council considered that, despite of Vesuvius' high market share, its competitors were able to supply similar products at similar prices and quality. Based on this consideration, the practice was considered legal.

In other decisions, such as the Valers case[10], the council's exam seemed excessively focused on the firm's anticompetitive intentions, while ignoring other important objective elements. In this Administrative Proceeding, Valer, a meal voucher company, entered in an exclusivity agreement with some supermarkets. Valer would reduce the period for which they had to wait to get cash for the meal vouchers they received from customers if the supermarkets agreed to accept only Valer meal vouchers. CADE concluded that Valer did not have market power because of its reduced market share. Nevertheless, the Council stated "Valer's clear intention to injure competition would suffice to condemn it". The analysis based upon a subjective consideration of an abstract entity, such as a firm, represents an inconsideration of the competition law. Law no. 8.884/94 states: *Notwithstanding malicious intent, any act in any way intended or otherwise able to produce the effects listed below, even if such effects are not achieved, shall be deemed a violation of the economic order"*[11]. As can be seen, the competition legislation tries to focus on objective observable elements to the relevant market, avoiding individualized, subjective considerations.

[10] Administrative Proceeding (PA) 32/92.
[11] Article 20.

In the analysis of the Kibon case[12], filed by SDE upon the observation that the company had been releasing price lists to its distributors, CADE deemed the conduct legal. The council concluded that an offence of the economic order was impossible since the market was characterized by a high level of interbrand competition, low barriers to entry and a scattered retail market. Opposing to other administrative proceedings, in this one, CADE examined a set of relevant economic variables to the imposed vertical restraint. However, the council's relevant market definition was not established in a rigorous way. Throughout the analysis persisted a confusion regarding which exact products were included in it. Moreover, the market share of 15%, held by Kibon, the accused company, was considered to be low, without a commonly established comparison reference[13].

While examining a set of accusations in the cement industry consistent in: 1) tying the acquisition of the product to the freight and 2) the establishment of discriminatory pricing among consumers, CADE ignored, once again, the effects of the alleged practices. The council's decision was based on a report issued by SUNAB - National Provisions Superintendence - a former governmental agency specialized on price enforcement. Notwithstanding SUNAB's experience in monitoring and enforcing price ordinances, its expertise in antitrust was nil. Despite the fact that contradictions of

[12] Administrative Proceeding (PA) 148/94.

[13] The U.S. Vertical Restraints Guidelines followed until the Clinton Administration considered the market share of 10% or less as a safe harbor for the use of vertical restraints. Brazilian Competition Law does not have a market share threshold considered as a safe harbor. In spite of this fact, CADE considered the market share of 15% as low, without pointing the reasons for such a conclusion.

the reports of SUNAB were pointed in the commissioner's votes, they were not elucidated. Paradoxically, even though CADE's conclusion was based on SUNAB's analysis, it deemed the conduct lawful while SUNAB considered it unlawful. Particularly intriguing was the justification given for the legality of the price discrimination practices. According to the vote of commissioner Lucia Helena Salgado e Silva they *consisted in current commercial practices in the sector*[14]. In other words, the simple consolidation of a practice in the market would suffice to deem it legal.

Finally, in the Administrative Proceeding No. 08012.003303/98-25, filed against Souza Cruz S/A, a cigarette producer company, by Philip Morris, some inconsistencies were also observed. In this case, Phillip Morris accused Souza Cruz to have been establishing exclusivity agreements with some dealers. The arrangements located in some particular places, such as airports and shopping centers, raised increasing competition concerns due to the higher market power of the accused firm at these locations.

First of all, one interesting problem due to the overlapping analyses among agencies in the Brazilian Competition System arose in this case. The relevant markets were differently defined by SDE and SEAE. This difference led to a different recommendation to CADE with respect to the practice. The divergences seemed to have complicated the council's decision, since its consideration of the relevant market was not clearly established. In fact, the reporter commissioner's vote simply described SDE and SEAE's definition without specifically pointing out the most adequate one. CADE decided in this case to sign a "Cease of Practice Commitment" with Souza Cruz.

[14] Our translation.

According to Brazilian Competition Law, the signature of a Cease of Practice Commitment by SDE or CADE with the supposed violator of the law is possible. This will not deem the practice illegal, whatsoever, nor imply confession by the accused party. Nevertheless, CADE's decision interpreted the possibility, expressed in the law, as an obligation of the regulatory institution. In other words, whenever the possibility of signing a Cease of Practice Commitment existed, CADE judged that it had to be done. In this specific case, however, CADE's decision of signing a cease of practice commitment with the accused company seemed to have been a second best response to avoid a decision while confronted to an ambiguous interpretation of the analyzed practice. By doing so, CADE lost the opportunity of clearly defining its view of a particularly important market practice, adding, instead, further uncertainty to the subject. Moreover, by stating that a Cease of Practice Commitment could be always granted, it gave incentive for the widespread use of anticompetitive practices by firms, since the possibility of this ultimate concession would guarantee condemnation exemptions. Consequently, this decision created a serious moral hazard problem involving all antitrust conducts.

4) Specific Problems of the Brazilian Approach to Vertical Restraints – A Proposed Framework for Antitrust Decision Making

A wide range of factors that can be classified as institutional, legislative and analytical factors has substantially impaired the Brazilian antitrust decision making related to vertical restraints.

Among the worth mentioning institutional elements are the problems related to the overlapping tasks of the three agencies and the lack of judicial decisions regarding antitrust cases. These two factors inflict a substantial uncertainty to investment decision making, acting as a deterrent element of trade relationships.

With respect to the first one, there is a draft bill prepared by a working group, composed at the request of President Fernando Henrique Cardoso, which proposed a new structure for the Brazilian Competition System. The new model gathers SEAE, SDE and CADE into the National Agency for Competition. The agency will be an independent body, either linked to the Ministry of Finance or to the Ministry of Justice. CADE will maintain its financial independence and its tribunal duties within the agency. Its decisions will be mandatory, unless one of the parties appeals to court. The main advantage that the creation of this agency can bring is the decrease in the analytical time of cases submitted to the system, due to the synergies of the joint analysis of legal and economic aspects[15].

Nevertheless, even though this structure solves various existent problems, some of them still remain. The proposed agency will still serve as a tribunal at the administrative level, always subject to revisions at the courts. Thus, any case will potentially be able to pass through two judgments, one at the administrative level, and another one at the courts. This represents a very time consuming and uncertain process that can refrain

[15] As stated previously, nowadays SEAE elaborates its technical report with emphasis in the economic aspects of a particular practice while SDE examines primarily the legal aspects of the conduct. CADE, then, judges the case. Most of the times, however, it elaborates its own technical report, besides from the reports presented by the other agencies. Great part of the slowness in the review of anticompetitive cases is attributed to this composition of the Brazilian Competition System.

investments and hinder business predictability. To substantially enhance the system’s effectiveness and agility it would be more adequate to concentrate the agency’s effort in the investigations of cases, not in the whole process of investigation and judgment. The simplest cases could be solved by a common understanding between the agency and the accused party. The most complicated ones, subject to a greater dispute, could be directly sent to the courts. There is no need for a judgment at the administrative level. The agency could act similarly to the Federal Trade Commission - FTC, in the United States, focusing primarily on cases with complicated economic effects. On the other hand, with respect to cases involving a rather criminal approach, the federal and state prosecutors could act. This idea, however, depends on the improvement of the expertise and expediency of the Brazilian courts related to antitrust cases. If this does not happen, its benefit will be almost nil.

Until now, antitrust decision making has remained concentrated at the administrative level, in the three agencies that form the Brazilian Competition System. Nevertheless, since an appeal to the courts is always possible, all administrative decisions can be subject to change. Very few decisions have been sent to courts in Brazil. This on one hand denotes the lack of major disputes related to the subject, but, on the other hand, also reflects the recentness of the subject. It is expected, with the progressive development of antitrust, that increasing cases will be presented to the courts. One of the main queries faced by antitrust enforcers is the response of the courts to competition cases. By endorsing or rejecting administrative decisions, they will play an essential role in shaping antitrust policy. John R. Commons once described the Supreme Court as *the* *first authoritative faculty of political economy*. His statement couldn't be more applicable to the present case. In the U.S., as we have seen, the most complicated cases go to court, which posit their consent or dissent to a specific out coming. Even though the courts express their views with respect to policy makers on a case-by-case basis, their doctrine relies on an implicit logic and coherence as well as on precedent decisions. Thus, in Brazil, only consistent decisions over time will serve as endorsements or reprovals of antitrust decision making at the administrative level. The final judgment of the courts can seal the legitimate acceptance of a decision, since their insulating from electoral pressures grants them reliance, exemption and respect for the check and balances system. As stated Marc Allen Eisner in his book *Antitrust and the Triumph of Economics, The Network of relationships that connect the antitrust agencies with other institutional actors within the policy process structures their evolution and, in doing so, shapes policy as well.*

The second set of elements that act as deterrents to an effective antitrust enforcement policy are the legislative ones. As has been previously stated, the Brazilian Competition Law is unspecific, imprecise and gives rise to different interpretations. This lack of precision has been complicating law enforcers, specially the SDE. To file administrative proceedings and preliminary investigations, SDE often lists a whole set of articles breached by one specific practice, without a particular care of compatibility between the practice and the law provision. By doing so, it seems to try to avoid the risk of not considering one particular law article as well as to eliminate the possibility of subsequent filings related to the same practice. The latter reason is, with no doubt, an important concern, especially if we take into account the sluggishness of the Brazilian

Competition System. Nevertheless, SDE's posture has two immediate negative aspects. First, it confuses CADE, when it is judging the cases. CADE often files cases due to an imprecise or confused investigation undertaken by SDE, which does not pinpoint some nuances that are frequently overlooked by the council. The second negative aspect is that firms are misguided in their right to defend themselves. They are not able to present their reasons for a certain practice if it has not been defined in a proper manner. Consequently, the accused companies have to defend themselves against a wide ray of all imaginable practices to avoid penalties.

The last set of elements are the analytical ones. These problems have been carefully dealt in topic 3.2. They basically are: i) the lack of a common set of principle of analysis, ii) the often absence of a thorough analysis of the net benefits of a certain practice, and iii) the examination of one case without observing precedent similar cases, i. e. , the lack of analytical coherence.

This paper essentially focused on the analytical problems of the Brazilian Competition System for practical reasons. Since the other previously mentioned factors involve changes that are beyond the scope of the entities comprehended in the System, the study converged to the elements that can be changed by the competition agencies to enhance the system' s effectiveness regarding the analysis of vertical restraints.

With this main goal in mind, a standardized analysis framework of vertical restraints, based on a sequential step approach is suggested. The steps are to be implemented according to an algorithmic eliminatory approach, i.e., if a criteria is met in one of the steps the practice will be deemed legal. It will only be deemed illegal if none of the criteria is met. This perspective, on one hand, aims at reducing the time of analysis, applying an early termination strategy to cases that meet the criteria and concentrating the efforts of the competition agencies on the cases that can effectively represent an economic harm. On the other hand, the approach tries to incentive business creativity to implement whichever practice is more adequate for its purposes, as long as it does not represent an offence to the principles set forth. In other words, the general rule is that all vertical conducts are legal, as long as they do not fail to meet all the mentioned criteria. The analysis, thus, pends towards recognizing that vertical restraints are eminently procompetitive.

The **first step** is to define the upstream and downstream relevant markets. The accurate definition of the market is essential to characterize a certain conduct. A certain practice can be neglected if the market is not properly defined. Another possible consequence of an improper market definition is an inaccurate measurement of the market shares. For example, a firm that produces soft drinks and beer might have a market share of 90% if the definition considers only soft drinks, but this participation can be reduced if beers are considered part of the relevant market. The key issue while defining the relevant market is the substitutability of the products. Starting from the product involved in the practices, all its substitute goods must be included in the market. Of course, this analysis involves the definition of a degree to which goods can be considered substitutes, since, in the limit, all goods are substitutes because they dispute consumer's income[16].

The **second step** is to calculate the market share of the firms involved in the restraint. Firms with small market shares, operating in non concentrated structures, as well as those that do not cover a substantial share of the sales or capacity in the downstream market, are unlikely to facilitate collusion or to foreclose competitors from the market. Likewise, a firm with low market share or operating in a non concentrated structure cannot normally use vertical restraints to accomplish an anticompetitive practice. For calculating market shares and to what extent they can represent a menace to competition, two indexes are suggested.

The first index is the market participation of the firms engaged in the practice. A reasonable threshold for this index is 20%[17], in the upstream and downstream market. The second index is called the *vertical restraint index (VRI).* The VRI is calculated by squaring the market share of each firm in the market involved in the restraint and then summing the values obtained. For example, if only two firms employ a restraint one with a 10% and one with a 20% market share, the market VRI for the upstream firms will be $10^2 + 20^2 = 100 + 400 = 500$. If four suppliers, each with a 25% market share employ the restraint, the market VRI will be equal to $25^2 + 25^2 + 25^2 + 25^2 = 625 + 625 + 625 + 625 = 2500$. If all firms in the relevant market use the restraint the VRI will be equal to the

[16] For a thorough analysis of this issue see *Giua para Analise Economica de Atos de Concentracao - Ministaerio da Fazenda - Secretaria de acompanhamento Economico.*
[17] The definition of thresholds is a complicated task and involves a separate study. Thresholds can vary according to differences among industries, countries and other elements.

HHI (Herfindahl Hirschmann Index)[18]. The VRI when there is only one firm in the market, and that firm employs a vertical restraint, is 10000, its maximum possible value. A reasonable threshold for this index is 1200, in both markets. If the threshold is reached in at least one of the markets (upstream or downstream), the conduct will be deemed legal. Otherwise, the analysis will proceed to the **third step.**

The **third step** involves the analysis of ease of entry in the relevant markets previously defined. For the examination of the conduct to continue to the **fourth step,** at least one of the defined markets (upstream or downstream) has to present a difficult entry, otherwise, the practice will be deemed legal. If ease of entry is observed on the secondary market and exclusion is the only possible anticompetitive effect, the practice will be considered lawful. The same thing applies when collusion is the only anticompetitive effect in the primary market and entry is easy in this specific market.

To conclude whether entry is easy, one should pose the question if it is likely to occur within a relatively short time in the event of a significant and non transitory increase of price. Several factors can be analyzed to answer this question. Entry is relatively difficult, for example, if it requires a costly investment in specialized production or distribution facilities or if it can only be accomplished aver a long period of time. In other words, whenever substantial sunk costs and economies of scale are present in the industry. Some other aspects observed in the market can give a hint with respect to the ease of entry, they are:

[18] See Resolution 20/99 issued by CADE, for a precise definition.

i) the existence of regulatory or legal barriers,

ii) the existence of economies of scope,

iii) the degree of integration of the productive chain,

iv) the consumer loyalty to the existing brands,

v) the threat of reaction of the incumbent firms.

In the **fourth step** the range of the restraint will be examined. To do so, it is appropriate to use the coverage ratio. The coverage ratio calculates the percent of each market involved in the restraint. For example, if 5 suppliers with 10% of market share employ the restraint, the coverage ratio will equal 50%. The coverage ratio of 60% in both markets is considered to be a fairly adequate threshold. Thus, if at least one of the markets does not present a coverage ratio of 60%, the analysis will continue to the last step.

In the **fifth and last step** an analysis of the anticompetitive and procompetive elements of the practice will be done. To accept a certain result as procompetitive, however, certain elements must be observed. First, it is required for the restrain to be the only way of attaining the procompetitive effect. Second, a considerable connection between the vertical conduct and the procompetitive aspect must be present. The examination of the anticompetitive and procompetitive elements of vertical restraints, done in section 2, can serve as a guide to which are the plausible effects of each practice. If the anticompetitive effects of a certain vertical restraint are higher than its procompetitive aspects, it must be considered unlawful, otherwise, it must be deemed lawful. In other words, the net benefit of a certain practice must be considered.

5) Conclusion

As was showed in the precedent pages, the Brazilian Competition System has substantial problems that hinder the application of an effective antitrust enforcement and reflects more directly in the analysis of vertical restraints. These problems are institutional, legislative and analytical. This paper represented an effort to pinpoint the main drawbacks of our competition system, showing how they can reflect in the analytical work of the agencies, particularly with respect to vertical restraints. The description of the North American experience served as an important point of comparison in this endeavor. For the enhancement of the analysis of vertical restraint within the Brazilian Competition System, the paper suggested an analytical framework to be applied. The observation of a common standard of analysis based on orderly concepts and principles to be applied to vertical restraints can help to solve part of the problems of the Brazilian system. Among the main advantages that a guideline can provide are, i) the increase in outcome predictability, ii) the decrease in the analysis subjectivity, and iii) a higher transparency. In this context, the guideline has an important didactic role of expressing the main concerns while dealing with vertical restraints.

Nonetheless, one main challenge remains in the horizon, still threatening any effort undergone to improve antitrust enforcement in Brazil: the courts. Only the judgments of the courts, done in a rapid, effective and systematically robust way can assure the establishment of a real and representative competition culture among the Brazilian society. Until the response of the courts to antitrust cases has not been systematically established, competition enforcement will continue to be uncertain, imprecise and questionable. Thus, the discussion of the establishment of an outline of a guide must be extended to the judges and public prosecutors. This effort could approximate administrative competition agencies to the courts, helping to consolidate a joint effort towards competition enforcement.

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