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SOFT DRINK INTERBRAND COMPETITION ACT



HEARINGS

BEFORE THE

MMITTEE ON ANTITRUST, MONOPOLY AND BUSINESS RIGHTS

OF THE

MITTEE ON THE JUDICIARY UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 598

A BILL TO CLARIFY THE CIRCUMSTANCES UNDER WHICH TERRITORIAL PROVISIONS IN LICENSES TO MANUFACTURE, DISTRIBUTE, AND SELL TRADEMARKED SOFT DRINK PRODUCTS ARE LAWFUL UNDER THE ANTITRUST LAWS

JUNE 4 AND SEPTEMBER 26, 1979

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SOFT DRINK INTERBRAND COMPETITION ACT

MONDAY, JUNE 4, 1979

U.S. SENATE,
SUBCOMMITTEE ON ANTITRUST,
MONOPOLY AND BUSINESS RIGHTS
OF THE COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met at 10:15 a.m., in room 457, Russell Senate Office Building, Hon. Birch Bayh (member of the subcommittee) presiding.

Present: Senators Bayh, Baucus, Thurmond, Cochran, and Dole.

Staff present: Mike Cooper, counsel to the subcommittee; Bob Levitt, research assistant; Nels Ackerson, chief counsel to Senator Bayh; Kevin O. Faley, general counsel to Senator Bayh; Mary K. Jolly, staff director to Senator Bayh; Linda Rogers-Kingsbury, chief clerk to Senator Bayh; Louise Milone, legislative assistant to Senator Bayh; Christie Johnson, assistant clerk to Senator Bayh; Steve Holley, staff assistant to Senator Bayh; Pete N. Chumbris, chief counsel to the minority antitrust subcommittee; Henry Ruempler, counsel to Senator Cochran; Tom Parry, counsel to Senator Hatch.

Senator BAYH. We will ask for our hearings to be called to order.

OPENING STATEMENT OF HON. BIRCH BAYH, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator BAYH. Today, as you all know, we begin hearings on the Soft Drink Interbrand Competition Act. It has been numbered S. 598. It is legislation designed to clarify the circumstances under which territorial license provisions are lawful in the soft drink industry.

This legislation is in response to a Federal Trade Commission instituted proceeding to bar as unlawful territorial franchise agreements with bottlers by soft drink sirup companies.

On March 8 of this year, S. 598 was introduced by myself and my distinguished colleague from Mississippi, Senator Cochran, the Senator from South Carolina, and many others. In fact, we have some 75 other colleagues. So there is a rather significant amount of support in the Senate cosponsoring this legislation.

This legislation, just briefly, for those present who may not be familiar with it, is designed to preserve a unique industry practice, the manufacturing, bottling, and distribution, of trademarked soft drinks by local companies operating under territorial licenses. Under our proposal, the local man would continue to rely on this territorial license as long as there is substantial and effective interbrand competi-

tion. I want to emphasize that provision of the bill—as long as there is substantial and effective interbrand competition.

For over 75 years the soft drink industry has used territorial franchise agreements with smaller bottlers to provide services to a wide variety of its customers and to insure the future of the returnable bottle, as will be explained by some of our witnesses here today. These restrictions limit the geographical territory in which a bottler may manufacture and distribute soft drink products and have been the basis of the industry's structure.

These contracts in no way prevent one brand from being in competition with another. In fact, many people whom I have discussed this matter with believe that franchise contracts help promote competition among brands of soft drinks.

Those of us cosponsoring the legislation believe that antitrust laws should not be used to restructure an industry, especially where there is an acknowledged high-level of interbrand competition. Such a restructuring might change the nature of an industry in which many of the franchises are small family owned businesses.

We are concerned that should territorial licenses be prohibited, we would find these small businesses swallowed up by large bottlers. In the longrun, the FTC ruling would, therefore, be anticompetitive instead of competitive. The industry will be transformed from one with many components—small businesses, community businesses—to an oligarchical industry.

I know I have looked at this situation in Indiana. There is great fear among some 50 small businesses that they would be gobbled up by a few larger bottlers.

In 1979, over 2,000 bottling plants were operating throughout the United States. Over 1,500 of these plants employ fewer than 50 employees. Although the distribution of bottling plants tends to parallel the distribution of population, many of these plants are located in small cities. The end result of the FTC ruling will be not only detrimental to the industry, but costly to the communities and the consumers as well.

We in Government find ourselves treading many fine lines and the regulation of business is certainly one of them. We must constantly be watchful not to permit the stamping out of competition through monopolistic practices that endanger the small businessman.

At the same time we must be even more vigilant in our scrutiny of what we here in Washington do about business regulation lest we endanger the existence of the very people we are trying to protect by in fact regulating them out of business.

It is my judgment that the FTC opinion, let me say, has created just such a situation.

By attempting to protect the consumer from a suspected antitrust violation, we may well be hurting the consumer and destroying the business of the smaller bottlers who are unable to compete with larger bottlers who can ship farther in greater quantities.

It is clear that if the over 2,000 plant industry becomes an industry dominated by only a handful of bottling companies, those companies can set any price they wish and there will be no smaller competing bottlers to provide local competition. Further, the service from the soft

drink industry that we have all come to enjoy and take for granted, the soda machine in the local garage or in our office buildings, may well become a thing of the past.

We must continue to be aware of the needs of the small businessman in America and to protect the invaluable contribution he or she makes to our economy and our way of life, and the people of our country. I do not believe Government plays a helpful or even proper role when its bureaucrats, even with the best of intentions, burden the American businessman with ill-conceived regulations which ultimately cannot assist either business or consumers.

We have enough real problems in this country for Government to solve without creating new ones.

In summary, let me conclude by saying, I believe this legislation is vital to the survival of the small bottler and the returnable bottle and to the maintenance of a high level of service we have come to expect from the soft drink industry.

[The text of S. 598 follows:]

96TH CONGRESS
1ST SESSION

S. 598

To clarify the circumstances under which territorial provisions in licenses to manufacture, distribute, and sell trademarked soft drink products are lawful under the antitrust laws.

IN THE SENATE OF THE UNITED STATES

MARCH 8 (legislative day, FEBRUARY 22), 1979

Mr. BAYH (for himself, Mr. COCHRAN, Mr. ARMSTRONG, Mr. BAKER, Mr. BAUCUS, Mr. BELLMON, Mr. BENTSEN, Mr. BOREN, Mr. BOSCHWITZ, Mr. BURDICK, Mr. CANNON, Mr. CHILES, Mr. CRANSTON, Mr. DANFORTH, Mr. DECONCINI, Mr. DOMENICI, Mr. EAGLETON, Mr. FORD, Mr. GARN, Mr. GOLDWATER, Mr. GRAVEL, Mr. HART, Mr. HATCH, Mr. HAYAKAWA, Mr. HEFLIN, Mr. HELMS, Mr. HOLLINGS, Mr. HUDDLESTON, Mr. HUMPHREY, Mr. INOUYE, Mr. JACKSON, Mr. JEPSEN, Mrs. KASSEBAUM, Mr. LEAHY, Mr. LUGAR, Mr. MAGNUSON, Mr. LAXALT, Mr. MATHIAS, Mr. MATSUNAGA, Mr. MCCLURE, Mr. MCGOVERN, Mr. MELCHER, Mr. MORGAN, Mr. MOYNIHAN, Mr. NUNN, Mr. PERCY, Mr. PRESSLER, Mr. PRYOR, Mr. RANDOLPH, Mr. RIEGLE, Mr. ROTH, Mr. SCHMITT, Mr. SIMPSON, Mr. STENNIS, Mr. STEVENS, Mr. STEWART, Mr. STONE, Mr. TALMADGE, Mr. THURMOND, Mr. TOWER, Mr. WARNER, Mr. WILLIAMS, and Mr. YOUNG) introduced the following bill; which was read twice and referred to the Committee on the Judiciary

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A BILL

To clarify the circumstances under which territorial provisions in licenses to manufacture, distribute, and sell trademarked soft drink products are lawful under the antitrust laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Soft Drink Interbrand Competition Act".

SEC. 2. Nothing contained in any antitrust law shall render unlawful the inclusion and enforcement in any trademark licensing contract or agreement, pursuant to which the licensee engages in the manufacture (including manufacture by a sublicensee, agent, or subcontractor), distribution, and sale of a trademarked soft drink product, of provisions granting the licensee the sole and exclusive right to manufacture, distribute, and sell such product in a defined geographic area or limiting the licensee, directly or indirectly, to the manufacture, distribution, and sale of such product only for ultimate resale to consumers within a defined geographic area: *Provided,* That such product is in substantial and effective competition with other products of the same general class.

SEC. 3. The existence or enforcement of territorial provisions in a trademark licensing agreement for the manufacture, distribution, and sale of a trademarked soft drink product prior to any final determination that such provisions are unlawful shall not be the basis for recovery under section 4 of the Act entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes", approved October 15, 1914.

3

SEC. 4. As used in this Act, the term "antitrust law" means the Act entitled "An Act to protect trade and commerce against unlawful restraints and monopolies" (the Sherman Act), approved July 2, 1890, the Federal Trade Commission Act, approved September 26, 1914, and the Act entitled "An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes" (the Clayton Act), approved October 15, 1914, and all amendments to such Acts and any other Acts in pari materia.

Senator BAYH. I will yield to our distinguished ranking minority member, Senator Thurmond.

OPENING STATEMENT OF HON. STROM THURMOND, A U.S. SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator THURMOND. Thank you, Mr. Chairman.

The Federal Trade Commission in 1971 initiated a number of cases challenging the territorial provisions in bottlers' trademark licenses as unfair methods of competition in violation of section 5 of the Federal Trade Commission Act.

After a prolonged hearing, a ruling by the administrative law judge stated that the franchise system was lawful. The Federal Trade Commission overruled the decision and created an issue that 36 Senators considered important enough to introduce legislation to clarify the conflicting issues of contract obligations among the various interests affected by the FTC decision.

The Senate has enacted in a previous Congress such a bill and sent it to the House of Representatives, which could not fully resolve the issue in time before that Congress ended. It has been stated that neither the courts nor the FTC will consider several pertinent factors which only the Congress can resolve because the Congress is better equipped to cope with the range of issues and interests which are involved in the soft drink franchise matter.

For the above reasons, I have again cosponsored such a bill, S. 598, with the hope that a full record will be recorded. Briefly, the territorial franchise system for soft drinks has been in effect for over 78 years, with over 2,000 large and small bottlers making capital investments to billions of dollars in reliance on such territorial agreements.

A few years ago, in South Carolina, my home State, we had 44 soft drink plants and 36 soft drink firms. The great majority are

domestically owned. They employed approximately 2,800 people with an annual payroll over $18 million.

Without territorial restrictions, without corrective legislation, we shall see the larger bottlers with great capital capture the warehouse business and we shall see the small, independent bottler go broke. With concentration achieved by the large bottlers, there will be truly a lack of competition in this field.

For these reasons, I am favoring this bill and hope that the Senate will seek to pass it. Thank you, Mr. Chairman.

Senator BAYH. Thank you, Senator.

Next, our colleague from Mississippi who was supporting this legislation before he became one of our colleagues.

Senator COCHRAN. Thank you, Mr. Chairman.

OPENING STATEMENT OF HON. THAD COCHRAN, A U.S. SENATOR FROM THE STATE OF MISSISSIPPI

Senator COCHRAN. Mr. Chairman, I have joined with you in introducing this legislation because I believe it is essential to protect the livelihood of the small, independent bottlers, as well as the interests of the customers they serve.

Having worked on the issue, as you pointed out, during my tenure in the other body, and here, I have reviewed the points in controversy very carefully. It is inconceivable to me that the FTC could find any lack of competition or consumer choice in the soft drink industry which results from the franchise system.

According to all the key indicators of competition, there is today intense competition in the soft drink industry. Prices are low. Variety is high. Concentration is low. Local service is strong. All of these elements exist in part because of the territorial licenses under which the local bottlers have operated for the last 75 years.

The FTC ruling against territorial licenses would disrupt all of this. Indeed, the FTC ruling will actually be anticompetitive, causing greater concentration, reducing consumer choices, reducing local service, and conceivably raising prices in the longrun.

Moreover, if the ruling causes the demise of the returnable bottle, which is likely, there will be significant ecological consequences.

For these reasons, Mr. Chairman, I strongly support the legislation and am pleased to join you in welcoming the witnesses who have come today to testify concerning their views and opinions on this legislation.

Senator BAYH. Thank you, Senator Cochran.

We have as our first group of witnesses a panel of bottlers. If they would come to the witness table, we would appreciate it. Mr. Sidney P. Mudd, Seven-Up Bottling Corp. of New York, New Rochelle, N.Y.; Mr. Robert Delauter, Coca-Cola Bottling Corp. of Portland, Ind.; Mr. J. Peter Moore, Pepsi-Cola Bottling Corp. of Bend, Oreg.; and Mr. Charles Moak of the Moak Bottling Corp. of Indianola, Miss. We appreciate all of you being here.

I know Mr. Delauter. Could the rest of you identify yourselves for all of us here, please?

TESTIMONY OF SIDNEY P. MUDD, SEVEN-UP BOTTLING CORP. OF NEW YORK, NEW ROCHELLE, N.Y.; J. PETER MOORE, PEPSI-COLA BOTTLING CORP. OF BEND, OREG.; BOB DELAUTER, COCA-COLA BOTTLING CORP. OF PORTLAND, IND.; AND CHARLES MOAK, MOAK BOTTLING CORP., INC., INDIANOLA, MISS.

Mr. MUDD. Sir, if I may begin. I will identify everyone for the subcommittee.

Senator BAYH. Fine. Are you Mr. Mudd?

Mr. MUDD. Yes, sir.

Senator BAYH. Good. You can be the ring leader.

Mr. MUDD. Mr. Chairman, my name is Sidney P. Mudd. I am past president of the National Soft Drink Association, the organization representing soft drink bottlers throughout the country.

I am currently chairman of that association's special franchise committee. This committee is concerned with the implications of the Federal Trade Commission's challenge to the soft drink industry's territorial system, and with the proposed remedial legislation now pending before this subcommittee. I am also a Seven-Up soft drink bottler in New Rochelle, N.Y.

I appreciate, as do all of us, this opportunity to appear here today in order to present the subcommittee with whatever information it desires regarding the structure and performance of the soft drink industry and with regard to the need for enactment of S. 598.

I will briefly summarize the prepared statement I have submitted to the subcommittee. I request that my prepared statement be reprinted in the record of these proceedings.

In order to give the subcommittee an opportunity to become acquainted with the tremendous diversity in the soft drink industry and the range of factors that confront bottlers in various parts of the country, I am accompanied by a panel of bottlers whose operations vary widely and who come from different sections of the country. With me are Mr. Bob Delauter, president of the Coca-Cola Bottling Co. of Indiana, who is on my far right; Mr. Charles E. Moak, president of the Moak Bottling Co. in Mississippi, on my immediate right; and Mr. J. Peter Moore, vice president and manager of the Pepsi-Cola Bottling Co. of Bend, Oreg., on my left.

Each of these bottlers will make a brief statement describing his operation and the market within which he competes. Thereafter, we will be happy to respond to any questions you may have with regard to our knowledge of the operation of the soft drink industry, the effect of the territorial franchise system, and the impact of the Federal Trade Commission proceedings on our businesses.

My company, Joyce Beverages, Inc., is a large bottler. Nevertheless, like the vast majority of bottlers, large and small, I fully support S. 598. There are basically two reasons why I support the bill.

First, I firmly believe that the elimination of soft drink territories would have profoundly unfortunate effects upon the industry and upon the consuming public. The soft drink territorial system has served the consumer extremely well, has functioned in a truly competitive way, and the system should not be changed unless it can clearly

be shown that the use of territories has an adverse effect on interbrand competition.

My second reason for supporting the bill concerns the effect of elimination of territories upon my company. Obviously the effect of the elimination of territories would be felt initially by small bottlers. But there is a real possibility, as I explain in greater detail in my written statement, that franchise companies, food chains and other large marketing corporations will move into the bottling industry with dire effects upon all industry members.

My written statement briefly describes the structure and operation of the soft drink industry and its history of adapting to the natural competitive flux of the marketplace.

I also discuss the damaging effects on the health of the industry created by the 8 years of proceedings before the Federal Trade Commission and the courts.

In supporting S. 598, we are not asking for an antitrust exemption. Rather, S. 598 is remedial in scope and fully consistent with traditional antitrust statutes. What it does is to require the Commission and the courts to test soft drink industry territorial franchises in terms of the extent of interbrand competition in the market. Section 3 of S. 598 would free the industry from treble damage exposure for enforcing exclusive territorial provisions in trademark soft drink agreements prior to the date when and if a final determination is made that such products are not in substantial and effective interbrand competition. Territorial provisions have been in effect for more than 75 years.

Prior to the FTC ruling, every court which examined the soft drink territorial provisions held them to be lawful, beginning with the *Coca-Cola* case in 1920.

In light of the industry's good faith reliance on these precedents and the competitive nature of the soft drink industry, Congress should relieve the industry from treble damage exposure for having territories before a possible finding of illegality under S. 598.

In summary, let me briefly state my principal points. First, the soft drink industry is populated by local independent bottlers who face intense interbrand competition and who provide the consumer with a wide range of soft drink choices.

Second, the territorial limitations have provided incentives to bottlers to make investments for production, distribution, and marketing which have resulted in substantial and effective interbrand competition.

At the same time, the territorial system has not prevented adaptation to changing economic and demographic factors.

And third, and finally, S. 598 does not confer an antitrust exemption. It merely clarifies the competitive standard under which exclusive territories are to be judged.

Mr. Chairman, with your permission, I would like to introduce Mr. Bob Delauter, from the Coca-Cola Bottling Corp. of Portland, Ind.

Senator BAYH. Thank you, Mr. Mudd.

We appreciate Mr. Delauter being here.

Mr. DELAUTER. Mr. Chairman, I am Bob Delauter, a Coca-Cola bottler from Portland, Ind. I serve all of Jay and Blackford and Randolph Counties in Indiana and most of Darke and Mercer Counties in Ohio and parts of three other counties in Indiana and Ohio.

My franchise area covers 128,960 people, in which the largest town is Greenville, Ohio, with 13,800 people.

My wife and I own 95 percent of our company and the other 5 percent is held in a trust set up by a previous stockholder. I have managed the company since 1956. The history of our plant is one of hope and progress and development.

On November 20, 1917, Orien E. Holsapple and his uncle, Jim Isenhart, launched themselves into a new enterprise. On that date they became the sole owners of the Portland Bottling Works at 317 West Main Street in Portland.

That start was important because their new soda pop business brought them into contact with a Mr. Luther Carson of Paducah, Ky., who was the owner of the Coca-Cola bottling franchise in Fort Wayne, Ind., which included Portland and the surrounding area.

Although the soda water business flourished, Mr. Holsapple was impressed with the growth of Coca-Cola on a national basis and for 6 long years sought a subcontract from Mr. Carson authorizing him to bottle and sell Coca-Cola in Portland. Finally, an agreement was reached between the parties in February 1923 and the production facilities were moved from Hartford City, Ind., to 317 West Main Street in Portland. Mr. Holsapple tried to borrow money locally but was turned down because it was considered a bad risk. Because the previous owner owed money to the Hartford City Bank and was in poor financial shape, his bank agreed to lend Mr. Holsapple the money to buy and move the company out of Hartford City to Portland. The purchase price was a total of $2,200.

That first year in business, they sold a total of 240 cases of Coca-Cola. That was less than the amount of lemon pop we sold around the square in Hartford City. At 80 cents a case, this amounted to a grand total of $192 or $3.70 a week. At that time, Coca-Cola retailed at 5 cents a bottle or 0.77 cent per ounce. Today in the Ludwig's IGA Store in Portland, Coca-Cola can be purchased for less than 1 cent per ounce.

In September 1938 we moved into a new modern building at 510 East Arch Street. I have here a souvenir copy which I will present to you. It is 41 years old. It tells our story pretty well. It commemorates the big day for our company in 1938. On that day we had 265 customers. They are all listed on the back. They were all invited to our open house. We employed eight people and we were very proud of our contribution to them and to our hometown. In 1961 we found it necessary to enlarge our facilities and added some 40 percent to our space.

In 1969 we purchased the adjoining franchise for Coca-Cola at Union City, Ind., and invested hundreds of thousands of dollars in new bottles, coolers, and trucks. On that day we were selling 611,391 cases. Coca-Cola was selling at 0.75 cent per ounce. By promotion and hard work and the efforts of loyal employees and customers, we grew at a rate of 35 percent that first year. We purchased thousands of dollars in coolers over the next several years and are now in the process of trying to build a new plant to service our 2,200 customers. Our employment has grown to 83 people, and we sell 10 times as much Coca-Cola per day now as we did in our entire first year in 1923.

Now I would like to retrace my steps to about July 15, 1971, the day the Federal Trade Commission sued the soft drink franchise companies and several bottlers. I had just purchased the Union City

Coca-Cola Bottling Co. I owed over a half million dollars and had just been told, in effect, by the FTC that my purchase was practically worthless, because without franchise lines I could not afford to invest in coolers, signs, trucks, and bottling equipment necessary to serve my customers. Although we are in a small country area, we border some very large bottlers with much deeper pockets than mine, and in a price battle for customers I simply could not survive.

Remember, in 1969 Coca-Cola was selling for 0.75 cent an ounce, slightly less than when our company started in 1923. So you see, the FTC attempt to assure competition between bottlers of Coca-Cola had a very hollow ring to me.

What other product in the world was selling cheaper in 1969 than it was in 1923? Where else could the consumer go and find such a bargain?

In Portland, Ind., we are about 65 percent returnable bottle sales and the balance is in nonreturnable bottles and cans. I am unable to produce some of these nonreturnable bottles and cans so I buy these in packages from another source. I need to install new and faster equipment. However, to do this would require investing about $1 million in new equipment. The uncertainty of the FTC ruling over the last 8 years has caused us to delay this investment at an increase in cost to me of about 10 percent per year. Even if I were to convert to 100 percent returnables, I would still need to enlarge my plant to take care of the 35 percent of the people who are now drinking from convenience packaging.

The results of delay, inflation, and uncertain legal prospects caused by the FTC ruling has been a major factor in the increased cost of my product to the consumer in Portland, Ind., since 1972. Actually, our price has increased as much since 1972 as it did in the first 40 years of our business.

Now the FTC is not the sole cause of this, obviously, but certainly they were a major cause. Senate bill 598 will give me a clear understanding of the future where I can plan, build new efficient production, and continue to provide soft drinks at a price still available at about a cent an ounce in my territory. In today's world, that is still the best bargain in town.

It was made possible by the wisdom of my predecessors who designed the franchise system to assure a quality product with wide availability at a fair price. It was this system that has taken the life's work of several families, a system that has created the most widely known, widely available, and widely enjoyed product in the world.

In January we went out to a supermarket in Indianapolis and purchased one each of every type, size, flavor, and brand of refreshment available. It filled a pickup truck. We were shocked to find that over 395 different competing products and packages were available for refreshment in that area—not including milk, tea, coffee, beer, or water.

We were trying to convey the tremendous competition for our customers' refreshment dollar. Some of those soft drink products on that day were for sale at less than 0.77 cent per ounce. Although I don't have a picture with me today, I would be glad to furnish the committee a photograph of that display and document any of the prices or any of the other information.

The point of my story is this. Our system works honestly, fairly, and efficiently to the benefit of the consumer, the bottlers, and the marketplace. I think this is obvious, as evidenced by the fact that 395 different entries exist in that refreshment market. I honestly know of no other business where the consumer has such a wide choice at such bargain prices.

The average soft drink bottler, like myself, cannot survive without the franchise system. We are a unique industry with a different delivery system than anyone else, a returnable package system, and a multitude of package sizes to satisfy any customer's needs. Our products are available in every place we can find, big or small, wherever thirst might exist.

In today's real world the franchise territories determine whether hundreds of local bottlers like myself will continue to insure availability of hundreds of products to thousands of dealers, or whether the soft drink industry will become a few national corporations shipping a few major brands to supermarkets only.

Thank you for the opportunity to tell my story. I urge you to please consider this bill and pass it. Eight years is long enough. We need your help now. Thank you, sir.

Senator BAYH. Thank you, Mr. Delauter.

Mr. MUDD. Mr. Chairman, with your permission, may I present to you Mr. Peter Moore, the Pepsi-Cola Bottling Co. of Bend, Oreg.

Mr. MOORE. My name is Peter Moore and I am a resident of Bend, Oreg., where my family has owned the Pepsi-Cola Bottling Co., since July 1969. The stock of the company is held in trust by the U.S. National Bank of Oregon for the estate of my deceased father, William R. Moore. The beneficiary of the trust is my mother, Helen Moore, and upon her death the business will pass to my two brothers and me. My younger brother, Craig, has worked with me since 1975 and is currently our marketing manager.

The involvement of our family in the soft drink industry began in 1938 when my father went to work as a route salesman for Pacific Coca-Cola Bottling Co. in Portland, an operating division of Coca-Cola USA. During the next 13 years, he progressed in the organization from route salesman to route supervisor to advertising manager and finally sales manager.

In 1951 he left Coca-Cola to become general manager of the Seven-Up Bottling Co. in Portland, a locally owned independent franchise operation. During the 21 years in which my father worked at Portland Seven-Up, my two brothers and I completed our high school and college educations. All of us earned our way doing the various jobs around the company, such as truck washing, janitorial work, working on the production line, and ultimately having our own sales routes.

In 1974 my father left the very successful Seven-Up plant to become president of Alpac Corp. in Seattle, Wash., a much larger organization with plants in Seattle, Hawaii, and Alaska. At the time of his death in 1976, he was on the board of directors of the National Soft Drink Association and a leader in the industry.

In 1969 my family and I moved to Bend to manage the Pepsi-Cola Bottling Co. in Bend. At that time the franchise population included 55,000 people. The territorial boundaries are the sparsely populated

Jefferson, Crook, Deschutes, and Harney Counties and a portion of Klamath County, which today have 80,000 people. These boundaries include an area of 18,000 square miles.

In 1969 our company employed 12 people and had an annual volume of about $500,000. In 1978 we employed about 35 people and had sales of $2 million. Our payroll was $456,000. This year our $520,000 payroll includes 38 people, and we will have a sales volume around $2.5 million.

Our physical plant, which is a producing facility, is located at 2440 Northeast Fourth Street in the Bend Industrial Park on 2¾ acres of land. The plant consists of 40,000 square feet of warehouse and offices, 20,000 square feet of which was completed in mid-1978 at a cost of $330,000. The philosophy of our family has always been to reinvest heavily in our enterprise, and during 1978 we reinvested $130,000 in capital equipment.

In 1979 we will reinvest nearly $200,000 in production equipment, trucks, vendors, dispensing equipment, et cetera.

The book value of our capital equipment as of March 1979 is nearly $400.000, and our land and buildings have an assessed value of $770-000. This year we will contribute nearly $100,000 in corporate income tax and property taxes.

On the strength of our Pepsi franchise, we have been able to piggyback Seven-Up, Dr. Pepper, Squirt, Hires, Sunkist, Hawaiian Punch, Welch's Grape, Country Time Lemon Ade, and Great Waters of France Perrier, and create additional competition.

In the 10 years which I have worked in Bend, I have competed against three Coca-Cola bottlers. The first one sold out after a strike in 1971. The second one got into financial difficulty in 1974 and sold out to the bottler in Eugene, which is an adjacent territory. In addition to all the products of Coca-Cola USA, it also sells Canada Dry, Crush products, Frostie Root Beer, and Nestea. Royal Crown in Bend sells Royal Crown, Diet Rite Cola, Sugar Free RC, Dad's Root Beer, and Nehi flavors.

In addition to these and other national brands, we also compete with the private label warehouse brands such as Shasta, Western Family, Tastewell, Cragmont, Happy Time, et cetera. In a recent survey of one of our supermarkets, there were 131 different items directly competing for shelf space with the product which our firm sells, not counting coffee, tea, powdered soft drinks, beer, and other beverages which compete for the consumer dollar.

Our market consists of approximately 600 different customers. We service 18 supermarket chainstores, which account for about 25 percent of our total volume. None of these chainstores are serviced by warehouses located in my territory.

In addition to the 18 supermarkets, we serve another 15 independents and 10 convenience stores. We have nearly 250 vending accounts, 100 postmix accounts and 130 premix accounts. Our product mix is divided as follows: 60 percent returnable bottles, 25 percent cans, 7 percent plastic, 3 percent postmix, and 5 percent premix. In Oregon all containers are subject to our mandatory refund law, and, therefore, are returned to retail outlets.

Competition for business in our territory is intense. This past Memorial Day weekend, every chainstore in our market had Pepsi or Coke

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16-ounce returnable bottles or 12-ounce cans on sale. The low price for 16 ounces was 0.92 cent per ounce, and the price for cans was 1.64 cents per ounce.

The consumer is offered a choice, and in our market today the returnable container is definitely the value package. Without exclusive territories, many small bottlers like myself believe that we would lose the 25 to 30 percent of our business we do with chainstores, where returnables today obviously compete directly with cans and 2-liter plastic.

Chains would rather deal in cans than returnable bottles, since they are the only containers compatible with the one-way system of warehouse distribution. Our market would be particularly vulnerable to transshipping through chain warehouses, since the chainstore distribution centers are located only 160 miles away in Portland, Oreg. Unrestrained by the territorial system outside bottlers could easily expand into my market, using such inducements as the convenience of one centralized seller and participation in joint national or regional advertising.

Exclusive territories do not guarantee that returnable bottles will continue to be sold in every territory because that depends on whether both the chainstores and the ultimate consumers continue to purchase them. As long as demand for returnables exists, exclusive territories permit that demand to be satisfied.

The same cannot be said for the warehouse delivery system that would occur without franchise boundaries. Even under the store-door delivery system, chains have tried to reject returnables because they are a nuisance and are more competitive pricewise with the private labels of the chainstores.

Therefore, I feel we would lose this very important 25 to 30 percent of our business. With the loss of this chainstore volume, the small bottler would have his back to the wall and delivery of soft drinks to smaller accounts would cease altogether or could continue only with a substantial increase in price.

With us out of business, the small retail outlets would be deprived of regular service and in-store sales assistance, and the consumer would be deprived of the economical returnable bottle. It is also unlikely that the big operator would care about servicing the vending unit at a service station or a small resort operator up in the mountains.

The fact is the breakup of the franchise system would be hurtful to many businesses who have depended on the store-door delivery sysstem for decades as well as to the consumer. The consumer will be forced ultimately to pay higher prices for national brand soft drinks because returnables will disappear as the major national shippers take over the entire soft drink industry.

If exclusive territories are prohibited, the small soft drink bottler will be forced out of business and his employees will lose their jobs. The chainstores will get stronger at the expense of small stores and the soft drink industry will become concentrated in the hands of the few giant franchise companies.

With the present system of exclusive territories, the consumer has unparalleled choice as to what soft drinks he will buy, where he will go to buy them, and in what sizes and packages he will purchase them. Most of these choices would not be available if the franchise bottlers

of national brands did not have exclusive manufacturing and marketing territories.

Senator BAYH. Thank you, Mr. Moore.

Mr. MUDD. Finally Mr. Chairman, may I present Mr. Charles Moak, the Moak Bottling Corp., Inc., of Indianola, Miss.?

Mr. MOAK. Mr. Chairman, my name is Charles Moak and I am the owner of the Royal Crown, Dr Pepper, Seven-Up Bottling Co. of Indianola, Miss., a town of 10,000 people located in the Mississippi Delta, midway between Memphis, Tenn., and Jackson, Miss.

In addition to RC, Dr Pepper, and Seven-Up, I produce Nehi flavors, Frostie Root Beer, Diet Rite Cola, and Sugar-Free Dr Pepper.

My first contact with the soft drink business was in June 1937 when at the age of 13 I worked during the summer for Richard Bottling Works of Tunica, Miss., a small, independent operation with no national franchise, belonging to mother's youngest brother. I worked in this plant every summer until I finished high school, doing every job in the plant, beginning with sorting bottles to production to route sales. After 3 years of college, I worked full time as a production and plant manager.

In 1953 my wife and I purchased a small, independent plant at Indianola, Miss. In our first year, we operated two full-time route trucks. I worked in the plant 3 days a week and drove a third truck 3 days and my wife kept the books. We employed six people with a payroll of $12,000 to $15,000 and a total dollar volume of about $75,000. We produced a line of flavored drinks consisting of orange, grape, strawberry, peach, root beer, lemon, and cola. We covered a six-county area and our customers were the farm and country store, a market that disappeared with the advance of farm mechanization.

In 1968 a fire destroyed the rear of our building and we moved to a new 60 by 100 building out of the downtown area.

In 1969 the opportunity to obtain RC Cola and Dr Pepper franchises came to us, and believing that our future lay in the franchise system and national brands, we acquired a franchise covering a 2½-county area with a population of 109,000 people.

In our first year as a franchised bottler, we operated 3 full-time route trucks and employed 12 people with a payroll of $38,518. We had sales of $115,000. I supervised the production and worked nights and Saturdays on vending machines which were acquired in the purchase of the franchise territory.

In 1971 we purchased a part of the territory of the Seven-Up Bottling Co. of Leland, Miss. We hired a production manager, operated four route trucks, and I concentrated on sales and vending.

Three years ago my youngest son joined me in the business as sales manager for postmix and premix fountain sirup and took over the vending operation and service. My oldest son joined us 1½ years ago and heads our sales force. Both of these young men have worked in the business during their school years, as I did. I might add, my wife still keeps the books.

In 1978 we employed 19 people in the plant and owned 3 route trucks. In addition we had 3 independent distributors with 4 employees, for a total of 28 people. Our payroll was $150,753 and discount commissions to the distributors came to $68,451, for a total of $219,204. Our sales rose to 256,000 cases.

The city of Indianola received 1 percent of the sales tax collected from our sales, in addition to property taxes and license fees we paid. In order to serve the public with the variety of packages they choose, we have expanded our building from its original 6,000 square feet to its present 15,000 square feet. We produce 20 different packages and purchase 20 from other bottlers. A check of the local supermarket shows that we compete with 62 different companies producing 231 beverage products.

As a result of our location, we compete with four different Coke plants and three Pepsi plants. The Coke bottler that serves Indianola is Mississippi's largest bottler and another that serves our largest town, Greenville, Miss., is Memphis Coke, one of the South's largest bottlers. The Coca-Cola Bottling Co. of Vicksburg, Miss., serves the area 9 miles southwest of Indianola. Both Memphis Coke and Vicksburg Coke have Dr Pepper franchises, and Vicksburg Coke also has Seven-Up.

Without the exclusive territory, I believe these two plants would sell Dr Pepper and Seven-Up at least as far as their Coke franchise, which covers two-thirds of my territory. If we compete with these bottlers selling these products, there is no way we can keep our bottles and cases separated.

While the deposit on a case of bottles is $2.40 and the shell is $1, the bottles cost $3.98 and the shell $2.72 for a total of $6.70. Bottlers picking up the empties of other bottlers could inflict severe damage to competition.

Those of us who are too small to afford hundreds of thousands of dollars of investment for can production have to purchase from contract canners and have to pay a higher price for the products. As a result, we would be at a price disadvantage and would be forced to rely on returnable containers at reduced volume. Without an exclusive territory, I could no longer afford to engage in local advertising because I would simply be advertising for my competition.

Without exclusive territories we would probably lose those retail stores in our territory serviced by warehouses outside our territory. Sixty-five percent of our volume is with the supermarket and convenience store. In the Memphis, Tenn., metropolitan area, there are five wholesale grocers, and chain store warehouses, and two discount store warehouses, which service stores located in my area as well as stores in Memphis.

The same situation exists in the Jackson, Miss., area where there are three grocery warehouses and one chain service station warehouse which supply stores in my area.

The obvious advantage from the closeness to these warehouses enjoyed by the Memphis and Jackson based bottlers would exclude me from competing with these bottlers. They also have advantages in large production capacity, can production facilities, volume purchasing power, and capital.

Our other accounts are garages, offices, service stations, beauty parlors, and shops where we stop a truck costing $20,000 or more with a salesman and his helper to service the account with one to three or four or five cases.

Our route salesmen not only deliver the product to the store, pick up the empties, stock the shelves, and plead for space; they perform

the one service the value of which I cannot calculate. They keep our products displayed and placed at point of purchase advertising. This is important because if any soft drink is left off the shelf a short time, the purchaser substitutes some other product a few times and may switch brands. Warehouse deliveries make no provision for this valuable service.

As I understand it, this subcommittee is concerned with the extent of competition in local soft drink markets. Let me say that in my market price competition is intense. To see the extent of competition between franchise bottlers one has only to visit a supermarket in our area on any weekend and check the prices of RC against Coke, Dr Pepper against Mr. Pibbs, and Seven-Up against Sprite and Pepsi. One thing you would notice is frequent discounts and promotions. You would also see specials offered on private label brands. You will find the price of franchise beverages at 6 quarts for $1 or 8 quarts for $1 is not unusual. The cost to the consumer for 8 quarts for $1 is 1 cent for 2½ ounces and 6 quarts for $1 is 1 cent for 1.9 ounces. The regular price for quart beverages is 3 quarts for $1 or 1.04 ounces for 1 cent. The price of a soft drink in 1937 was 1 cent for 1.1 ounces. I know of no other present product on the American market where competition has resulted in such a bargain for the consumer.

In order to maintain the market share for our beverages, we have to meet these prices and use every promotional device at our command and hope that if the shopper tries the product once and likes it, she will buy it again at regular prices.

I have no idea what I can do if warehouse delivery puts these products on the shelf and I am no longer in the store. I cannot survive the loss of this portion of my business.

When I close my plant and these jobs and revenues and money spent with local people for services are lost, will they be missed by our community? Obviously they will. There is a far greater number of small family-owned-and-operated bottling plants in our country than large corporate companies. Each of these small businessmen has supported his community just as I have. We have put our every effort into our business, building for ourselves and our family. Are we now to be told that all of those efforts that have produced competition and prices to the consumer equaled by no other business is no longer needed?

All we would have left is secondhand machinery, equipment, bottles, and cases which will be worthless. We will be forced out of business, not by our business mistakes or lack of competitive effort but because we happen to be small and not located near any warehouses.

Once these small plants are closed, a few large corporate plants will be all that remain, and the American people in the end will pay the resulting high prices and be the losers.

Mr. MUDD. Mr. Chairman, that completes the formal statements of the bottler panel. We would be hopeful we could answer questions that might be in the minds of the subcommittee.

Senator BAYH. I am sure we will all have some questions. I appreciate your testimony.

I would like to just take a moment to lay again the background for my support of this legislation, and the kind of testimony you have given tends to support my original judgment, but I want to proceed further to examine where we are on this.

It seems to me we have a question, as described by all of you, that is one of survival for a large number of small businesses. We have to also, I believe, at the same time we think of small businesses, think of the consuming public.

I have seen a couple of newspaper articles that describe all of the bottlers as some big pressure operation, and described recently, this morning, as a big soda pop battle, and that this effort is being orchestrated by the major soda pop national corporations.

This is not the way it had been described to me by the constituents I represent in Indiana.

Mr. Delauter, what is the Indiana picture as far as your industry is concerned?

Mr. DELAUTER. Under the present system, we are in pretty good shape. It is very competitive.

Senator BAYH. I mean the breakdown sizewise.

Mr. DELAUTER. The largest plant in the State, I am sure, would be Speedway Coca-Cola. There are some 29 other small Coca-Cola bottling plants, 5 Pepsi-Cola bottling plants, and 1 Seven-Up plant. I am sorry; there are more plants, but one corporation owns the Seven-Up plants in the State of Indiana.

There are very few independent bottlers left. I think there are three Royal Crown bottling plants in the State.

Our per capita is very high. The sales volume of soft drinks in Indiana is very high for a northern State.

Senator BAYH. It is fair to say, at least as I have heard it described to me by those people in Indiana, as I recall, the last total was about 51 total bottling plants, and a big percentage of those, well over half, were small plants that employed less than 50 people. Is that accurate?

Mr. DELAUTER. Yes. That is true. That is accurate.

Senator BAYH. In fact, I see here in a recapitulation of this, 34 out of 51 bottling plants in Indiana hire under 50 people. Is that correct?

Mr. DELAUTER. Yes, sir; that is correct.

Senator BAYH. Only 7 of the 51 have over 100 employees.

Mr. DELAUTER. It sounds right.

Senator BAYH. So we are basically talking about a lot of community-sized, small business operations.

Mr. DELAUTER. Most of these plants are in towns of 8,000 to 15,000.

Mr. MUDD. May I add something on the national figures for you? There are approximately 2,000 bottlers in the United States. Approximately 1,800 of them have less than 100 employees. So I think that might give you the flavor of the industry on a nationwide basis.

Senator BAYH. Is that general picture described in Indiana the same in Mississippi and Oregon?

Mr. MOORE. Yes.

Mr. MOAK. Yes.

Senator BAYH. I see here in this one article, and I just bring this article to your attention because I just read it this morning.

The big bottlers and their subsidiaries argue that dozens of small bottlers would be wiped out if the small franchises are limited. These crocodile tears are unconvincing to many small bottlers.

Mr. Delauter, is somebody pulling the wool over my eyes in Indiana? Of those many small bottlers, I have not had a single small bottler

who feels there is a cabal where the big national corporations are really trying to use the appeal of the small community bottlers. They sort of look at this as you have described it, as sort of a matter of survival to them.

Mr. DELAUTER. Yes, sir. It is a matter of survival. I think some people misunderstand us. I am an independent bottler. I am not a part of the Coca-Cola Co. What appears in the paper on the Coca-Cola Co. in Atlanta, Ga., has absolutely nothing to do with how much money I make or how much I invest in Portland, Ind. That is my business. If I go broke, that is my loss.

Senator BAYH. Can you give us an idea, if you compare the recent profit figures of Coca-Cola in Atlanta compared with the Delauter operation in Portland? I don't want to get into your finances.

Mr. DELAUTER. I don't know much about the profit of the Coca-Cola Co. in Atlanta, Ga. What I read in the paper is that they have had an increase. In my 25 years in Portland, Ind., I have never earned more than 5 percent on dollar sales. I have never earned more than 5 percent. Last year it was less than 2 percent. In 2 of those 25 years I lost money.

As a matter of fact, I can very recently recall having carried a couple of checks in my pocket for a few weeks to make certain that we weren't overdrawn at the bank, Senator.

Senator BAYH. Many of us can sympathize with that. In fact, maybe a few of us have let those checks slip out in cases. [Laughter.]

Let me ask you now, as I perceive this, quite the contrary to a couple of articles I have seen—and I think here again the folks just had some bad information. Where that is coming from, I don't know. I am sure it is well-intentioned.

If you put a lot of small businesses out of the picture and a few large bottlers get into the picture, it would seem to me that the chance to manipulate the price to the disadvantage of the consumer would be significantly increased, and the willingness to buy the kind of personalized service from local vending machines would go down.

Give us a picture, a succinct picture, Mr. Delauter, of what happens to your business if the FTC ruling stands.

Mr. DELAUTER. Senator, if the FTC is successful in their suit, I will lose most of my take-home market. It will go to NR's and cans.

Senator BAYH. The take-home market from where?

Mr. DELAUTER. From chainstores, independent grocery stores, big accounts in all the counties that I serve. That will leave me with a lot of small accounts, with too little volume to survive. The returnable bottle will disappear. Let me explain why that will happen. It is very obvious to a small bottler.

I would have to compete in my home market against giant bottlers who could sell Coca-Cola in cans and large non-returnable bottles. These are packages which I cannot now produce. I now buy these packages from the very bottlers who would be my main competitors. They could come in and would in fact, offer lower prices temporarily to eliminate me from those big stores.

After I am out of the business, retail prices will be raised, in my opinion, by the big grocers and the chains who at least in the past have always priced national brands above their private labels to assure that those private labels do in fact sell.

The large bottler would then increase his wholesale price to whatever price he could negotiate with those stores, because he controls my territory and there is no guy who is there willing to work 75 hours a week to compete with him.

Senator BAYH. Can you tell me how a big bottler in Indianapolis, Dayton, Chicago, wherever they might be, Cincinnati, wherever it might be, how they could afford to ship Cola into the local supermarket at a price that would be competitive with you right there in the community?

Mr. DELAUTER. Most of these chainstores have warehouses, and the warehouse centers are in the large cities, most of them; for example, Indianapolis. They would simply sell to the warehouse and it would be shipped into my territory at a price that I really couldn't compete with, with returnable bottles.

They are already in business. They have the equipment and it is paid for. It is true that if I could go out and borrow $1 million, put in the equipment, and they would stand back for 12 months until I got the building up and ready to compete, I think I could compete with anybody. But on an overnight basis, I wouldn't last 3 months.

Senator BAYH. Just what persuaded me to support this legislation is the impact that this kind of financial distress would have, not just on the individuals involved—although I sympathize with them—but on the community.

How many people do you employ? Give us some idea of what the payroll is in your community, the taxes you support locally, and this kind of thing.

Mr. DELAUTER. We employ 83 people. They would be out of a job. That is $1 million in wages. Local taxes are $15,000 which would be lost to Portland. State taxes are $39,000. We might not lose all of those because some of those might just transfer to another city. That would be the net result of it.

Senator BAYH. Have you figured out what this impact would be on Indiana as far as lost jobs?

Mr. DELAUTER. No; I know what it would be on our hometown. The unemployment rate would go up 3 percent in Portland if all of my people were out of a job.

Senator BAYH. Mr. Mudd, let me ask you a question. It seems to me you come into this discussion from a little different perspective as far as size is concerned.

Mr. MUDD. Yes, sir.

Senator BAYH. How many people do you employ?

Mr. MUDD. In all of our operations, we are close to 2,000. It is about 700 in New York.

Senator BAYH. It would seem to me that you would probably be one of the people who would be in a position to sort of buy out my constituent in Portland, or other places. If that is the case, why do you support this bill?

Mr. MUDD. Senator, I have spent about 8 years of my life supporting it, so I think my sincerity can't be questioned.

Senator BAYH. I am not asking it because I doubt your sincerity. I want to know what your economics are.

Mr. MUDD. All right. If we go back to the example of the 2,000 bottlers across the United States and think of them as being 1,800 small

bottlers and a couple hundred large bottlers, my operation certainly falls in the 200 or so that are considered to be large bottlers. I always remember the cartoon of three fish swimming in order in the ocean, with the little one first then a middle-sized one and then a large one. The middle-sized one and the large one are just about to swallow the one ahead of them.

There isn't any surety that we as a large bottler won't be attacked in very much the same way as most of the small bottlers in the United States will be attacked and swallowed. You have to remember that, in a condition in which there are no boundaries, we become a target for every franchise company whose brands we handle. We become a target of every large chainstore operation to whom we have sold in the past, or to whom we have not sold in the past, under our contract. And we become the prime target of any other entity in American business that wants to buy a small franchise someplace or what used to be a franchise and then go into the business of competing with us. Let me give you an example.

If the Seven-Up Co. is not content with the way I might respond in any given market to the challenge of others and they are not seeing their brand represented adequately in Washington, which is one of our operations, or in Chicago or New York, they have every opportunity to ship into that territory and ultimately take the same chainstore portion of the business that Bob Delauter described. In Washington, for example, our chainstore business is about 60 percent of our business.

The Seven-Up Co. could sell, or any other bottler around who was endowed with enough resources could sell to those chainstores and, in effect, regardless of size, put us in a position of not being able to operate the rest of the territory.

If you look at our operation, you think of us as large, and we are. But compared to a Philip Morris, or compared to a Westinghouse, or compared to an A&P, our best customer, who could take us over, or at least could take the chainstore portion away from us, we are in similar jeopardy.

I don't believe and I don't think any of you should think I am in the same jeopardy that the smaller bottler is. But we are in what I consider to be grave jeopardy.

For that reason, I have worried over this since 1971, and given every ounce of energy I was asked to give to it to try to preserve this industry. We are not safe, sir.

Senator BAYH. Thank you.

Senator Cochran?

Senator COCHRAN. An observation, Mr. Mudd, just following up on the question Senator Bayh asked you. Because of the threat from the larger companies to your business, you would actually be forced to protect yourself by acquiring bottlers which are smaller than you.

Mr. MUDD. I would hate to think I was ending my career as a predator. But I would be absolutely certain to be the predator because that would be the only way I could defend myself against Phillip Morris breathing down my neck saying, "You are not doing it, and out you go. We have the resource to own this market, and we are going to own it."

They didn't come into this market to be second to Pepsi or Coke or anyone else in this industry. I am not trying to damn them in any

way. I am trying to state the worries I have when I go to sleep at night; am I going to be here if those territories come down.

Senator COCHRAN. There was comment earlier about the personalized service of small operations and the flexibility of bottlers in rural or sparsely populated areas of the country.

I would like to ask Mr. Moak, for instance, in the territory you serve in the Mississippi Delta, what if I owned a small service station or a country store and wanted to have a sales operation, a vending machine or just over-the-counter soft drinks there, but I only required about two cases a week? Would that be an account that would be large enough for your operation to serve?

Mr. MOAK. As long as I am there you will get served.

Senator COCHRAN. What if you weren't there? I understand from your testimony that you have a territory that is served by Memphis Coke, which overlaps in some respects in that area, and also Vicksburg, which is a larger bottling operation to the south of you. Would that same customer be able to have that kind of service from a distant bottler if you weren't there to provide it?

Mr. MOAK. I can't see where he would. The cost of the truck operation for the very small store off the beaten path is such that they can't hardly afford it. I make that a part of my business because he is in my territory and I feel that if I sell this small store and you drink my product there, you come down to the supermarket and buy it, or if you go to some other place you buy it, it is a cold bottle sample. I think if we cover every place and make our product just as available as we can, I don't think anybody else could do that.

Senator COCHRAN. The Federal Trade Commission in its ruling permits exclusive territories for returnable bottles. But if the ruling stands and you lose most or all of your nonreturnable business, could you stay in business, meet your payroll, with the returnable bottle part of the business you have now?

Mr. MOAK. No, sir; 50 percent of my present volume is in nonreturnable packages. It is a growing segment of the business. The consumer prefers the conveniences of nonreturnable containers. If I lost that portion of my business, I would be forced to operate covering the same territory with 50 percent of the volume, which means higher trucking expenses, higher salaries for the people per casewise they deliver. It would just be impossible to do it.

Senator COCHRAN. If you were able, for instance, to make the investment into the production of cans or nonreturnable packages, would the cost of the product go up or go down?

Mr. MOAK. If I were able to make the investment in the—I don't have the financial resources to make this investment. That is a question I can't answer. I can't see where the cost would—well, I guess if I owned the facility, I might be able to produce it cheaper. What I am doing now is purchasing from another supplier. He, of course, makes a profit. I have to pay freight from the place of production up to my business.

If I had hundreds of thousands of dollars to invest, it might be cheaper to produce.

Senator COCHRAN. If this is not prying into personal economic secrets, I was curious whether or not you had others make offers to purchase your business. If so, when is the last offer you had?

Mr. MOAK. Just prior to the FTC challenge I had an offer to sell my business. Since then I have had no offer. These particular people that made the offer haven't been back to see me.

Senator COCHRAN. Have you had any offers, or any indication anybody wanted your business, since the FTC action began?

Mr. MOAK. No, sir.

Senator COCHRAN. One last question. There is an argument in the FTC opinion that small bottlers are inefficient and charge higher prices. What do you charge for your product?

Mr. MOAK. I charge in the marketplace what I feel is a reasonable profit to recover my investment. We compete with every special promotion that we can.

In fact, I brought several tear sheets out of newspapers which will show what our prices are in the supermarket. Here is one for Piggly Wiggly, which happens to be my competition. It is 1 quart of Coke, 6 for 88 cents. I don't think you will get much cheaper. There are others showing 1 quart of Dr Pepper, Seven-Up, Nehi, and RC, 8 for 99 cents.

Senator COCHRAN. That is 8 quarts for 99 cents?

Mr. MOAK. That is right. The competition does the same thing. I have some of their ads here. I would like to pass these around, if you would like to look at them.

Senator COCHRAN. Senator Dole just observed you can't get water that cheap up here. [Laughter.]

On the other hand, if the exclusive franchise is destroyed, could your prospective competitors for Coke sell it down there in the Indianola area at 8 quarts for 99 cents?

Mr. MOAK. No, sir; they would have to freight it to Indianola. Of course, where they would do me such tremendous damage is to sell it to the wholesale warehouses located in Memphis. Then the wholesale warehouse would deliver it to the stores. They, of course, would deliver in trailer/truckload lots, which is the way groceries are now delivered. That would be a part of their delivery. The Memphis operation I can't conceive of running trucks down in my area to just work those sales.

Senator COCHRAN. Thank you very much, Mr. Moak. I think the testimony that you and Mr. Mudd and other members of the panel have offered to the subcommittee this morning is very enlightening. I think it should serve to dispel whatever doubts there may be about the fact that this legislation would in fact serve the interests of customers, consumers, and the independence of businesses which provide that unusual and important service in this country. So, I thank you all very, very much for being here.

Senator BAYH. The Senator from Kansas?

Senator DOLE. I have a little different position than most of the members of this group. I have to go home at night. [Laughter.]

Senator BAYH. Take this bargain with you when you go. [Laughter.]

Senator DOLE. I am just sort of here as a nervous observer. I have a lot of bottlers in my State of Kansas, and others I met from time to time. It is no secret my wife wrote the opinion. I guess. Most people know that. I am not here to check on what you said about her, but I am interested in trying to figure out some way to come to grips with it.

I hadn't seen the Jack Anderson column this morning, but I am just trying to satisfy some of us. Of course, you have probably an adequate number of cosponsors, I would think, to do most anything. [Laughter.] But when you get into the general philosophical question of deregulation and decontrol and free competition, maybe there are answers to all of those questions that are consistent with the present arrangement prior to the FTC decision. Of course, this has been around, as you said, for what, 7 or 8 years. So it is not something that just happened. I haven't tried to address all the philosophical questions.

Do you think the present arrangement is consistent with efforts of those who seek to lessen regulation and lessen control and free up competition?

Mr. MUDD. Senator, I would like to just respond first to that, and certainly others may want to.

I think the real difficulty with the Commission and with those who might write columns is that they really don't understand the industry. Here you have an industry that is presently fragmented into more than 2,000 parts. It used to be fragmented into maybe 4,000 parts, or higher. So there has been a natural response to the changes in demographics or the changes in the marketplace which have caused a normal marketplace procedure for efficiency of operation. Charlie Moak's example in his ad there is a perfect reason to believe what I am saying here.

If the Federal Trade Commission is really successful, if it does tear down the boundaries of these territories, we are absolutely convinced that we will see a reduction in the number of these 2,000 bottlers steadily downward until perhaps there are 100 major left. I don't even think that 100 would hold after a while. If you look at the brewing industry, which is not totally parallel to ours but somewhat parallel to it, I think you see an example of it. You have what, 27 breweries left. You have really two big ones now: Anheuser-Busch and Miller. The others are struggling to make a profit.

I think you will find a condition which will exist in a year or two in this industry which will be very, very parallel to that.

We don't look at this as asking for an exemption from the antitrust laws of the land. We simply want an opportunity to prove in court, if challenged, that we have substantial and effective interbrand competition.

With all due respect to Mrs. Dole and others, we do not believe that the Commission understood or took a hard look at interbrand competition. They were obsessed with the idea of—maybe that is too strong a word, sir; forgive me for that—but they were concerned with the intrabrand angle of the competition. They completely overlooked, in our judgment, the intensity of the interbrand competition which we have tried to explain today.

Where in God's name can you find a product that sells as cheap as it did 20 or 30 years ago? You just can't do it, sir. So we think we have the most complete competitive structure in American industry today. We feel, as well intentioned as the Federal Trade Commission decision is, that it overlooks the fact that it will destroy the very competitive situation it seeks to enlarge.

That worries us. How have we failed to present our case properly to you or to Mrs. Dole or to the world? I think it is beginning to emerge

now because there has been enough attention paid to it over the last 8 years to understand it.

We are a very unique industry. There is no way in the world any one of us would have made the investment in this business without a franchise. We started in a little storefront in Joliet in 1935 with absolutely nothing. Now we are providing a livelihood for 2,000 people. We have a payroll of $35 million and are paying $9 million in taxes. It never would have happened, Senator, if we didn't have a franchise.

Senator DOLE. I think the proviso in the legislation that you just referred to that sets up a substantial and effective competition with products of the same general class is certainly a good thing to have in the legislation. You are not objecting to that, as I understand it.

Mr. MUDD. Absolutely not. We are not asking for anything that is in violation of the antitrust laws. We are not asking for any protection. We just want to say we have more competition than we know how to say grace over. Just to put another bottle up there on the table with Bob Delauter's 395, no way.

We checked in New York. We have over 1,000 competitive packages in New York, sir, right now.

Senator DOLE. Of course, you have gone down from 4,000 to about 2,000. I assume whatever happens, you are going to have fewer bottlers one of these days, whether the FTC decision is overturned or whether legislation is passed. In the normal course of events I would assume there would be a gradual decline in numbers, either through economies of scale or something.

Mr. MUDD. I think you are finding it in every industry, sir. I think that is the trend.

Mr. DELAUTER. I wanted to say that there is such intense competition in our territory, it is day by day, route by route, outlet by outlet. Our route men will even try to get to a particular store before a competitor route man to make certain he gets his shelf space filled up. That is a fact. These gentlemen will testify to that. I don't know of any more intense competition than that.

Senator DOLE. I think based on the comments in the column this morning, and I assume there may be some bottlers who are opposed to this legislation—I haven't found any, but there may be some brave soul out there willing to hold up his hand. But the inference Senator Bayh indicated is rather clear. There would be a number of small bottlers who might have a different view.

Have you found that to be the case?

Mr. MOORE. You wouldn't find one in the Northwest, I can tell you that.

Mr. MUDD. Not in the East.

Mr. MOAK. Not in Mississippi.

Mr. DELAUTER. I will testify every bottler in the State of Indiana is in favor of S. 598; without question, everybody.

Senator DOLE. I don't know of any in Kansas. I didn't know we had that many bottlers until later. [Laughter.] I never could find them in my campaign, but they are there now. [Laughter.]

That is all I have.

Senator BAYH. Senator Baucus, do you have questions?

Senator BAUCUS. Thank you, Mr. Chairman. I am basically in support of the legislation. I don't want to burden the committee by repeating questions I am sure have been asked. Thank you very much.

Senator BAYH. Thank you very much, gentlemen. I think you make a very good case here on the economic necessity of this.

I think our distinguished colleague from South Carolina would like to have some questions submitted, as some other colleagues might, for the record, if we might submit them and ask you to respond in writing.

We are between a real rock and a hard place. He is the ranking minority member of the full committee. I am the chairman of one of the subcommittees involved in a couple of amendments on the Justice Department authorization bill. I don't know where that will lead today. We have to be two places at once this morning. We appreciate your being here. Thank you very much.

[The questions and answers previously referred to and Mr. Mudd's prepared statement follow:]

RESPONSES TO SENATOR THURMOND'S WRITTEN QUESTIONS BY SIDNEY P. MUDD

Question 1. Can you estimate how much, if any, of the soft drink product in a particular market was coming from outside of a particular franchised area?

Answer. Sir, in New York there is a very considerable amount being shipped in. The amount of this "bootlegged" product is unknown. I have heard guesses ranging from hundreds of thousands of cases to several million cases. It is important to know, Senator, that these cases are not sold at a lower price to the consumer. The additional profit made on these "bootlegged" cases is shared by the retailer and the "bootlegger" who sells to him.

Question 2. For almost a decade, the legal status of the franchise system of the soft drink industry has been plaguing its franchisees, because of the Federal Trade Commission action. Please comment further how the larger bottling and canning operations can expand quickly to capture the most desirable customers in neighboring territories now served by smaller firms?

Answer. Senator, I'll be happy to comment. Let me use the New York market as an example. There are four Seven-Up bottlers in the greater metropolitan area. My company is one of them. Each company now makes store-door delivery to every chain store in its franchised territory. None of us makes any delivery to a chain store warehouse. While these warehouses are located in the franchise area of any one of the four bottling companies, they would, if they could, buy soft drink products and then ship them to their retail stores, regardless of bottler area.

If the bottler territories are destroyed, a battle to acquire the maximum chain store business throughout a large marketing area will begin. Direct delivery to chain warehouses in trailer-lots, probably at a reduced price, will be the weapon. Eventually, the largest or richest bottler will capture the business by driving the smaller ones out. The rejected bottlers will have only the small accounts left. They can stay in business only by raising prices to their remaining accounts. More than likely they will be forced out of business entirely. You just can't raise the price that much.

There are two important points to be made: the consumer is not likely to benefit from the temporary price reduction to the chain warehouse and no bottler can be sure he will emerge the winner because he is relatively large. He may still be the victim of a larger entity, be it bottler, franchisor, grocery chain or other large marketing concern which secures a franchise without boundaries.

Question 3. Unless Congressional action is quickly accomplished, is there hope for the smaller franchisees?

Answer. If the Federal Trade Commission's order is permitted to stand, I see no hope for the small bottler. I believe he will be driven out of business, with minimal salvage value of once saleable assets. After eight years of uncertainty and strain, it does not seem improper for us to ask Congress, the creator of the Federal Trade Commission, to act in this important matter.

PREPARED STATEMENT OF SIDNEY P. MUDD

Mr. Chairman, my name is Sidney P. Mudd. I am past president of the National Soft Drink Association, the national organization representing soft drink bottlers throughout the country. I am currently Chairman of NSDA's Special Franchise Committee. This Committee is concerned with the implications of the Federal Trade Commission's challenge to the soft drink industry's territorial system and with the proposed remedial legislation now pending before this Subcommittee. I am also a Seven-Up soft drink bottler in New Rochelle, New York.

I appreciate this opportunity to appear here today in order to present the Subcommittee with whatever information it desires regarding the structure and performance of the soft drink industry and with regard to the need for enactment of S. 598.

One thing that becomes immediately clear as one looks at the soft drink industry is its tremendous diversity. While most bottlers are small, some are quite large. Local markets vary greatly in population, in geographic size, in transportation characteristics, and with respect to a host of other factors that determine the competitive nature of the market. In order to give the Subcommittee an opportunity to discuss the range of factors that confront bottlers in various parts of the country, I am accompanied by a panel of bottlers whose operations vary widely and who come from different sections of the country. With me are Mr. Bob Delauter, president of the Coca-Cola Bottling Company of Portland, Indiana, Mr. Charles E. Moak, president of the Moak Bottling Company of Indianola, Mississippi, and Mr. J. Peter Moore, vice- president and manager of the Pepsi-Cola Bottling Company of Bend, Oregon.

Each of these bottlers will make a brief statement describing his operation and the market within which he competes. Thereafter, we will be happy to respond to any questions you may have with regard to our knowledge of the operations of the soft drink industry, the effect of the territorial franchise system and the impact of the Federal Trade Commission proceeding on our businesses.

The company with which I am associated, Joyce Beverages, Inc., is not a small bottler. My company has annual sales approaching $200 million. It serves portions of Connecticut, New York, New Jersey, Illinois, Wisconsin, Maryland, Virginia and all of the District of Columbia. By anybody's reckoning, I am a large bottler. Nevertheless, I fully support S. 598, as do the vast majority of bottlers, large and small.

There are basically two reasons why I, a large bottler, support the bill. The first reason is that I firmly believe that the elimination of soft drink territories would have profoundly unfortunate effects upon the industry and upon the consuming public. I support S. 598 because I believe that the soft drink territorial system has served the consumer extremely well, has functioned in a truly competitive way and that the system should not be changed unless it can clearly be shown that the use of territories has an adverse effect on interbrand competition.

By any of the generally accepted criteria of performance, the industry deserves high marks—widespread, effective distribution; consistent maintenance of quality; development of new flavors and containers; effective price competition; and adaptation to changing commercial realities.

My second reason for supporting the bill concerns the effect of elimination of territories upon my company. Obviously, the effect of the elimination of territories would be felt initially by small bottlers. But there is a real possibility, which I will expand upon later in my statement, that franchise companies, food chains, and other large marketing corporations will move into the bottling industry with dire effects upon all industry members.

I would like first to describe briefly the structure and operation of this industry. The soft drink industry consists of more than 2,000 soft drink manufacturers. Most of these are local bottlers who are licensed by a franchisor to manufacture, distribute and sell a trademarked soft drink product within a specific geographical area. In addition, there are many local and regional bottlers who own their own trademarks and who manufacture, distribute and sell soft drinks under those trademarks, such as Rock Creek in Washington, D.C., as well as national shippers such as Shasta.

The practice of licensing local bottlers to manufacture, distribute and sell soft drinks under a particular trademark in a defined territory began more than seventy-five years ago. The territorial exclusivity of the license agreement is critical to the soft drink franchise system. Because of the substantial capital investment required to manufacture and distribute soft drinks, it was and is

necessary to grant the bottlers exclusivity in order to persuade them to make such investments. It also induces them to develop their territories intensively, with the result that trademarked soft drinks are available in virtually every retail outlet in each territory and are supported by a high degree of customer service.

We believe that the territorial system has performed efficiently and has benefited the consumer. Bottlers are subject to severe interbrand competition. Price reductions and premium promotions are common competitive devices in this industry. Moreover, no other food product is distributed as extensively. Indeed, soft drinks are convenience items which consumers desire and can find available virtually everywhere.

The territorial system has enabled the industry to be broadly responsive to consumer desires for different kinds of containers. Thus, local bottlers respond to the demand for returnable containers, convenience containers, single-service and large economy-size containers. In contrast, soft drink companies without local bottlers—like Shasta—commonly do not offer such a variety of containers. Usually they offer only 12-ounce cans.

Historically the territorial system has adapted to changing economic conditions. Bottlers are able to expand either by further developing their own markets, by adding additional plants or by merger with or acquisition of other bottlers, or by consolidation with other bottlers. Moreover, the territorial system does not maintain the existence of those businesses which fail due to incompetence, undercapitalization or other shortcomings. Instead, the record of mergers and consolidations in this industry is indicative of the adaptability of the industry to the natural competitive flux of the marketplace.

This adaptation through mergers and consolidations is accomplished with much more equity and responsibility under the traditional franchise system than would occur under the FTC order. Instead of having small bottlers simply driven out of business, which is what the FTC order would accomplish, the traditional system permits those bottlers which are undercapitalized or otherise cannot perform effectively to sell their companies and obtain a fair return on their investment. At the same time, the purchaser assumes the seller's franchise responsibilities in the territory. Under the FTC order, on the other hand, there would be no such allocation of responsibility. Distant bottlers would be free to ship soft drinks wherever and whenever they wished with no obligation toward small accounts and no obligation to provide any customer service at all.

Although the number of bottlers has decreased in recent years, the industry remains essentially localized. A breakdown of industry plants by size and by state is attached for your review. This local character of the industry is the result of the exclusive territorial provision. One of the virtues of this provision is that it has limited forward integration into the manufacturing process by the large trademark owners and prevented backward integration by large national retail food chains.

With the elimination of the territorial provisions, the industry would soon be dominated by a handful of giant national companies. In contrast, in local markets a franchised bottler competes with other local bottlers with national brand franchises, as well as with regional brands, private label brands, such as Safeway's Cragmont, and with nationally shipped brands, such as Shasta. In the Washington metropolitan area, for example, there are more than a hundred soft drink products regularly marketed by twenty-five different companies in competition with each other.

Mr. Chairman, the Federal Trade Commission proceedings have hung over the soft drink industry for eight years and are not yet resolved. In 1971 the Federal Trade Commission brought charges against eight industry franchisors, alleging that exclusive territorial provisions in their contracts with local licensees constitute unfair methods of competition. After six weeks of hearings in 1975, Administrative Law Judge Dufresne rule in the *Coca-Cola* case that the territories in the industry fostered, rather than constrained, competition. A similar decision was reached in the *Pepsi-Cola* case on largely the same evidence. In April 1978, the Federal Trade Commission, in a two-to-one decision, rejected all of the Administrative Law Judge's findings and, with very little recognition of the undisputed evidence in the record of substantial and effective interbrand competition, held that the territories are unlawful because they restrain intrabrand competition. The Commission's rulings are on appeal to the United States Court of Appeals for the District of Columbia Circuit.

As you might expect, Mr. Chairman, the pendency of the Federal Trade Commission cases over these many years has been a major impediment to business

decisions within the industry. Bottlers are uncertain as to whether they can justify additional capital expenditures for franchises whose value might suddenly be sharply reduced. For other bottlers who have invested a lifetime of work in their bottling operations, the value of their assets is compromised by the prospect that the market they have cultivated these many years may be taken without payment.

Nor is the uncertainty that has afflicted the industry about to be dissipated. Whatever the Court of Appeals decides, it is probable that the parties before that Court will continue to litigate. In addition, suits against other franchise companies are pending at the Federal Trade Commission. Furthermore, the possibility of treble damage suits is very real. It is time, therefore, that the legal standard for testing these arrangements be clarified.

The operations of the soft drink industry and the merits of the territorial system have been aired extensively over the years. The members of the soft drink industry are proud of the competitive performance of the industry. Industry members presented facts supporting the territorial system in the Federal Trade Commission proceedings, and while the Administrative Law Judge fully agreed with the industry's contentions, the Commission practically ignored them in its ruling. Under the circumstances, we feel it appropriate for us to be here since the futility of dissuading the Federal Trade Commission of their preconceived conclusions is perfectly clear.

I think we should also make it clear that in supporting S. 598 we are not asking for an antitrust exemption. Rather, S. 598 is remedial in scope and fully consistent with traditional antitrust statutes. What it does is to require the Commission and the courts to test soft drink industry territoral franchises in terms of the extent of interbrand competition in the market.

As a layman, I understand that the effect of S. 598 is to test bottlers' territorial provisions by requiring a determination as to whether the bottlers' products are in "substantial and effective competition" with other soft drink products. I am not a lawyer and I leave it to NSDA's attorneys to answer questions about the meaning of that term and of the bill generally. However, to me, that test is one which I believe most bottlers would recognize as fair and understandable.

It also seems to me that passage of S. 598 is in accordance with the public interest. The Administrative Law Judge who heard the evidence in the *Coca-Cola* and *Pepsi-Cola* cases found that the markets examined by him were subject to extensive interbrand competition. Passage of S. 598 would require the FTC and the courts to determine whether such competitive conditions exist in this industry.

This is also a time when Congress is very much concerned about industrial concentration. Retention of the territorial franchises would tend to preserve the local, deconcentrated structure of the soft drink industry. On the other hand, elimination of the soft drink territories would rapidly cause this industry to become highly concentrated. This could happen in a number of ways. The most obvious way would be for large bottlers who have the best access to food chain warehouses to capture these accounts and thereby supply all of the chain stores served by the warehouse, including those in other bottlers' territories. Thus, small bottlers would lose the chain stores which account for a large portion of their sales and profits. This is the first step toward the small bottler's demise.

In addition, all bottlers—large and small—are certain to be jeopardized as a result of vertical integration by the franchise companies and the food store chains. If territories are eliminated, franchise companies can easily integrate forward into the bottling level of the industry by competing with their own bottlers until they capture the market. Food store chains could also integrate backward by either acquiring existing bottlers or by acquiring franchise rights from the syrup manufacturers and then shipping to unlimited areas. Because of the enormous leverage which the franchise companies and the food chains could apply, the soft drink industry would quickly become concentrated.

I do not think that my prediction of rapid industry concentration is fanciful. One need only recall how quickly the brewing industry went from a condition of numerous local and regional brewers throughout the country to an industry dominated by a few large national brewers to know that this can readily happen in the soft drink industry.

Section 3 of S. 598 would free the industry from treble damage exposure for enforcing exclusive territorial provisions in trademarked soft drink agreements prior to the date when, and if, a final determination is made that such products are not in substantial and effective interbrand competition. I think that this is an appropriate provision. As I mentioned earlier, territorial provisions have been in

effect for more than seventy-five years. Indeed, the industry has had abundant reason over the year to believe in their lawfulness. Prior to the FTC ruling, every court which examined the soft drink territorial provisions hald them to be lawful, beginning with the *Coca-Cola* case in 1920. In light of that good faith reliance and of the competitive nature of the soft drink industry, Congress should relieve the industry from treble damage exposure for having territories before a possible finding of illegality under S. 598.

In summary, let me briefly restate the points I have made:

1. The soft drink industry is populated by local independent bottlers who face intense interbrand competition and who provide the consumer with a wide range of soft drink choices.

2. The territorial limitations have provided incentives to bottlers to make investments for production, distribution and marketing, which have resulted in substantial and effective interbrand competition. At the same time, the territorial system has not prevented adaptation to changing economic and demographic factors.

3. S. 598 does not confer an antitrust exemption. It merely clarifies the competitive standard under which exclusive territories are to be judged.

We believe that with the passage of S. 598 the law relating to bottler territories will be clarified; the soft drink industry will continue to serve the public efficiently and competitively; the soft drink industry will be responsive to competitive changes; and the industry will continue to have the local, nonconcentrated structure which for so long has typified this national small business industry.

RESPONSES TO SENATOR THURMOND'S WRITTEN QUESTIONS BY BOB DELAUTER

Question. Who would service the small stores, gas stations, etc., if the franchisee did not have an exclusive territorial franchise?

Answer. In my territory most customers of that size would not be served. I have 2,200 customers in a 9 county area. It's 60 miles to some of my small country dealers. We serve all the people now with a route delivery system that takes our truck close to these dealers as they go from town to town. The volume of a small country dealer might be as low as three or four cases per week. By stopping on the way from our plant to a supermarket in Hartford City, Indiana, we can justify the small stop. We may deliver 100 cases to each of the bigger stores in Hartford City twice a week. Therefore, a three case stop is possible. Without the franchise, I will lose the supermarket takehome business to a chain store warehouse delivery system whose headquarters is not in my locality. There is no way I could afford to deliver these small accounts if they were all I had. Per case manufacturing costs, delivery costs and overhead would make it economically impossible. The chain store warehouse delivery system would deliver to their stores only. Nearly 50 percent of my dealers would be without soft drink service. I have a complete cooler sales and repair department with specialists trained in refrigeration, coin mechanisms and cold drink merchandising. If I go out of business, who would provide this service? Certainly not the chain store systems. Small vendors like candy and tobacco distributors might try, but there is no way they could handle the thousands of cases on their margins. The big surviving bottlers would be so few and far between that they could not afford to sell to these small dealers. Therefore, the FTC action would deteriorate service and concentrate the business in the hands of a few big bottlers selling to a few large chain stores. Price, availability, and service would all be adversely affected. It would be a disaster for over half of the small bottlers and dealers who now bring soft drinks to the American consumer on a reliable and regular basis at competitive prices.

RESPONSE TO SENATOR THURMOND'S WRITTEN QUESTION BY J. PETER MOORE

Question. Would you describe the differences in the price of soft drinks that are in cans, in disposable bottles, and in returnable bottles?

Answer. In the State of Oregon, we conduct business according to the Oregon bottle bill and therefore all containers are returned according to the mandatory refund provision of that law. As a result of the law, soft drinks are no longer sold in non-returnable, disposable glass bottles. However, in addition to selling

returnables, we do market soft drinks in 12 oz. cans and 2-Liter non-refillable plastic bottles, each of which have the 5 cents mandatory refund. The following chart shows that returnables are less expensive than convenience packages on an "everyday price" basis based on our company's regular wholesale price.

Average Retail Cost

	Cents per ounce
12 oz. returnable	2.07
16 oz. returnable	1.78
1-liter returnable	1.63
12 oz. cans	2.76
2-liter plastic	2.20

As I stated in my testimony, we very often have our products on special, in which case the cost per ounce is reduced substantially, whether it be a returnable or a non-refillable container. However, due to the cost of packaging, the returnable container remains the best buy for the consumer.

RESPONSE TO SENATOR THURMOND'S WRITTEN QUESTION BY CHARLES MOAK

Question. Testimony shows that beverages today cost the consumer 1 penny for each 1.04 ounces, while in 1937, it was 1 penny for each 1.10 ounces. How does that compare with your experience in cost per ounce?

Answer. The price of returnable quarters of national franchise brands sold in the supermarkets in our area is 3 quarts for $1.00 which gives a per ounce price of 1.04 ounces for 1 cent. In 1937 the price was 1 cent for 1.1 ounces. The present price is a very slight increase to the consumer in 42 years. It should be remembered that a penny in 1937 had far more value than a penny in 1979. Special promotions in the supermarkets give an even lower price per ounce than the 1937 price. A common weekend sale is 6 quarts for $1.00 or 1.9 ounces for 1 cent. Special discount sales of 8 quarts for $1.00 is a price of 1 cent for 2.5 ounces or more than twice as much for the same money as in 1937.

Senator BAYH. Our next group of witnesses again is a panel. Dr. Victor P. Goldberg, Institute for Advanced Study, Princeton; Dr. Lee Preston, State University of New York, Buffalo; and Prof. Oliver Williamson, University of Pennsylvania, Philadelphia.

Gentlemen, we are anxious to hear your testimony. I understand that you are going to examine in some degree the economics of the situation from your professional backgrounds as special economists. So we appreciate your being with us.

TESTIMONY OF VICTOR P. GOLDBERG, INSTITUTE FOR ADVANCED STUDY, PRINCETON, N.J., LEE PRESTON, STATE UNIVERSITY OF NEW YORK, BUFFALO, N.Y.; AND OLIVER WILLIAMSON, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. PRESTON. Thank you, Senator. We are very happy to be here.

My colleagues and I were invited to participate in these hearings by the National Soft Drink Association because of our prior independent academic work in areas related to the subject matter under consideration here. Although none of this prior work had involved the soft drink industry as such, all of it is related to the basic issues raised by this legislation.

We are going to proceed very briefly and quickly, I hope. We have all filed statements with the committee. Professor Williamson will address the general question in general remarks. Professor Goldberg will turn attention more specifically to the FTC action. I will comment on some general competitive aspects of the soft drink industry.

With that, I will turn it over to Professor Williamson.

Senator BAYH. I may have to step out into the hall just a moment to find out what is happening over on the floor, so I will follow your statements. I don't want to appear rude. I will be back in just a moment. Why don't you just proceed.

Mr. WILLIAMSON. Thank you, Mr. Chairman.

My expertise on this matter is limited to the evaluation of vertical market restrictions in general. Others with more extensive industry-specific background are better qualified to speak to the applications of the analysis to the soft drink industry than I.

My remarks are based in large part on a paper that I presented at a conference on antitrust law and economics that was held at the University of Pennsylvania in November 1978. The paper, which is titled "Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach," appears in the April 1979 issue of the University of Pennsylvania Law Review.

My remarks are organized in three parts. First I examine the inhospitability tradition within antitrust, especially as this approach relates to the evaluation of vertical restrictions. I then turn to an alternate approach, the transaction cost approach, in which efficiency aspects are more prominently featured. While I argue that the inhospitability tradition relies on mistaken premises and that an efficiency presumption is a better guide to sound public policy, the efficiency presumption is subject to challenge in both dominant firm and collusive oligopoly industries. The third part of my remarks elaborates on these qualifications and relates them to S. 598.

The inhospitability approach to antitrust attributes anticompetitive purpose and effect to every novel or nonstandard business practice. Under this approach, there are only two standard, hence acceptable, ways of organizing transactions.

One of these, which is the preferred way, is to rely extensively on market exchange between successive stages of production and distribution. Each successive stage of economic activity is mediated by a contract between autonomous firms on each side of the transaction. A flow of goods and services from raw materials through intermediate product to distribution channels and into the hands of consumers occurs in this way. Autonomous contracting thus proliferates.

An alternative but generally less acceptable way to organize economic activity is by vertical integration. Transactions that might be mediated by markets are here mediated instead by administrative processes; that is, internal organization.

Although the inhospitability tradition recognizes that certain economies sometimes result from vertical integration, it is very inexplicit about the nature of these economies. Market mediated exchange is thus favored.

Modes of organization that fall between fully autonomous contracting on the one hand and complete integration on the other are regarded with hostility. In particular, vertical market restrictions of all kinds—including territorial restrictions—are held to be motivated by anticompetitive purpose.

The ultimate justification for this view is that markets will support all legitimate services that consumers demand. Any service that the market will not support must, perforce, lack legitimacy.

Dr. Comanor's views on vertical restraints are illustrative. His statement ran as follows:

> To the extent that services are demanded by consumers, a market will develop to supply them and a separate price will be charged. To the extent, moreover, that manufacturers have a legitimate interest in having them provided, they should be forced to bear the cost. In either case, no vertically imposed restrictions are required.

Reduced to its rudiments, the inhospitability tradition relies on an assumption of frictionlessness in the operation and organization of markets. Every legitimate economic activity can be organized and priced separately without incurring significant costs. The transaction cost approach, by contrast, recognizes that autonomous contracting can be a costly activity and that, except as special restraints are introduced, market modes of organization can malfunction and will sometimes break down altogether.

The problems with autonomous contracting are essentially of two kinds. First, just as product variety and complexity are costly, so is contractual variety and complexity. Whether valued services can be delivered in the discriminating way contemplated by Dr. Comanor thus depends on the costliness of writing and negotiating comprehensive contracts.

Second, even if comprehensive contracting were attempted, contracts are not self-enforcing. If there are incentives for the parties to cheat, policing costs must be incurred. In consideration of such difficulties, comprehensive contracting is sometimes supplanted by alternative means of organization.

Vertical integration is largely explained as a means by which to economize on complex contracting costs. The same is true of intermediate forms of organization such as franchising, whereby franchisors introduce marketing restraints on franchisees.

The transaction cost approach thus proceeds from very different premises than does the inhospitability tradition. Rather than assume that anticompetitive purposes lie behind and anticompetitive effects will accrue to nonstandard business practices, it assumes instead that new modes of organization reflect an effort to economize on transaction costs. Organizing a transaction this way rather than that, is thus presumed to have the purpose of promoting efficiency and hence benefits society rather than fostering monopoly.

The principal reason for maintaining an efficiency presumption is that this presumption better accords with reality. Not only are transaction costs real, but efforts to economize on them explain a good deal of economic activity within the enterprise system.

Furthermore, monopoly hazards appear only if special structural preconditions are satisfied. The inhospitability tradition ran roughshod over transaction costs and made no effort to delimit the circumstances where monopoly hazards were serious. Maintaining an inhospitability attitude thus encouraged the enforcement agencies to behave in a counterfactual way and interpret innocent and beneficial developments in a suspect and even hostile manner.

Thus consider territorial restrictions. The inhospitability view is that territorial restrictions discourage intrabrand competition and thus must have antisocial consequences. The possibility that there

might be economies is not even considered, and the possibility that interbrand competition is doing the job is held to be irrelevant.

By contrast, the transaction cost approach, which intensifies a line of argument developed in earlier studies of these matters, recognizes that such restraints may be essential to the viability of the franchise system and regards economical modes of distribution as a valued social outcome.

Realization that marketing effectiveness can be contingent on vertical restraints is thus crucial to an accurate assessment of nonstandard modes for organizing markets. Once the relevant transaction cost features are recognized, it becomes clear that what others have characterized as arbitrary or even antisocial restrictions, can and often do serve a useful social purpose. Accordingly, the choice between alternative modes or organization ought not to be artificially foreshortened to polar outcomes.

To the contrary, mixed modes and their transaction cost properties need to be considered. In the degree to which, one, franchising is more viable when accompanied by vertical restraints, and two, such franchising offers the least cost mode of delivery, there are clear social benefits in permitting such restraints.

Whether these benefits are offset by clear social costs, however, must also be considered. Thus, although an efficiency presumption reflects central tendencies, it is also subject to challenge. This brings us to the question of whether interbrand competition is effective.

The presumption that territorial restraints have the purpose of promoting more cost-effective marketing is subject to challenge in industries where interbrand competition is weak. Where this obtains, the possibility must be faced that vertical restraints have the purpose of regularizing distribution, thereby to promote more effective oligopolistic pricing.

Thus a crucial operating concern of a manufacturer's cartel is to devise signals whereby adherence to the cartel pricing policy can be inferred with confidence. The elimination of false moves or ambiguous actions which, if misinterpreted, would cause the cartel to unravel, is of special importance.

Where distributors are owned or extensively controlled by manufacturers, retail price changes can normally be presumed to reflect manufacturers' intent.

By contrast, the responsibility for pricing changes is less clear where distributors are fully autonomous agents. The possibility that territorial restraints serve other than efficiency purposes but promote pricing discipline must thus be faced in industries where interbrand competition is ineffective.

The qualification of S. 598 which stipulates that vertical restraints in the soft drink industry shall be lawful provided that "such product is in substantial and effective competition with other products of the same general class" is thus not only fitting but is an essential safeguard. Checks on effective interbrand competition need to be made and be met.

Thank you.

Senator BAUCUS [presiding]. Thank you very much, Mr. Williamson.

Mr. Goldberg?

Mr. GOLDBERG. Professor Williamson's testimony has described the recent advances in our understanding of the economics of vertical restrictions. In my prepared statement I consider the specific issue of territorial exclusivity in soft drink bottling and the misunderstanding of the issue evidenced in the FTC's *Coca-Cola* decision. I will give an abridged version of my remarks today.

There are two central messages of the approach Professor Williamson has described. First, vertical restrictions have many more desirable features than have generally been recognized. Second, it is extremely difficult for an outsider to determine what the best contract would look like. As a general rule of thumb it would seem reasonable to presume that in the absence of strong reasons to the contrary, the choice of contractual terms should be left to the immediate parties.

In my prepared statement I go into some detail as to how the FTC misunderstood the economies of exclusive territories in the soft drink industry. Today I will restrict my remarks to three issues: the effect on prices and output of the shift to central warehousing; the effect on promotional efforts; and the FTC's argument that the existing system impedes the adjustment to a more efficient territorial system.

The bottlers and the FTC agree that if the exclusive territories were eliminated, chainstores would no longer utilize direct delivery to the stores. Rather, chains would have soft drinks delivered to their own warehouses from which they would then distribute to their own retail stores.

The Commission argued that such a shift would be efficient—exclusive territories prevent adjustment to a system yielding lower wholesale and, therefore, lower retail costs. This conclusion is almost certainly wrong.

Let us assume what both sides accept to be true. The initial effect of "walls down" competition would be price competition and lower prices for the large chain accounts. This would mean that in many regions route delivery systems will lose a significant piece of their volume. The remaining volume will have to be spread over fewer sales. Cost per unit will, therefore, rise. Thus the wholesale price of soft drinks sold through nonchainstore outlets, which currently account for more than half the sales, will rise relative to that in chainstores.

The story is not yet complete, but let us pause to examine the implications thus far. The change in relative prices will alter the mix of sales—a larger share of soft drinks will be sold through chainstores. We cannot be certain as to what will happen to the average price paid, nor to the quantity sold, even if we assume no loss in promotional effort. But the lower chainstore price could be more than offset by the higher prices elsewhere.

There will, however, be additional effects on promotional effort. With the bottler no longer supplying the individual chain outlets, the intensive local selling effort will no longer be provided. The response to this situation is uncertain. The most plausible, I believe, is for the sirup manufacturers to substitute regional and national advertising for the local services formerly provided by the bottlers. The cost of this will be reflected in the price of sirup sold to bottlers and this in turn will have an upward pressure on wholesale prices in the industry.

It is conceivable that the wholesale prices would rise to the point where the cost to chainstores returns to, or even exceeds, its initial level. This is not, I must emphasize, a prediction. It is simply a stark example of how misleading the initial observation of lower prices to chain warehouses can be when assessing the merits of the alternative distribution systems.

An exclusive territories system enables the bottlers to engage in more local promotional activity and it also influences the relative attractiveness of alternative promotional techniques.

Most of the FTC's discussion regarding advertising is concerned with determining when increased local promotion should be reckoned as a desirable feature of a vertical restriction. The Commission's answer seems to be that the justifications are few. Encouraging price advertising is acceptable. Enhancing other forms of advertising is acceptable only for new or faltering firms.

These criteria reflect a skeptical attitude regarding the merits to society of extensive promotional activity. I confess that, to some degree, I share this skepticism. But it does not follow that society should, therefore, come down hard upon vertical restrictions that facilitate local promotional activity. It is not at all clear what the effect of abolishing territories will be on the overall level of promotional activity. The most likely industry response would be a shift to increased advertising by the sirup manufacturers at the national and regional level. Cooperative advertising with certain retailers, especially the larger food chains, is also plausible.

There is no reason to believe, therefore, that there will be less money spent on advertising and other promotional activity. About all we can be certain of is that the industry perceives that the existing mix of promotional activities is a more effective one than that which would exist in the absence of territories.

Turning to the argument that the system does not adjust adequately, it is true that the initial Coca-Cola territories were based on how far a horse and wagon could go in a day. However, the facts do show there has been substantial flexibility in adjusting these boundaries. The number of bottling plants in the United States has fallen from nearly 7,000 in 1949 to about 2,000 today. Output per plant has risen about 700 percent in the last 20 years. That is quite a change.

Now it is quite probably true that if Coke were designing a territorial system from scratch today, it would choose somewhat different territorial boundaries. But we must treat this observation carefully. It is equally true that if one were to build, say, a copper wire plant today, he would use a somewhat different technology than would a firm expanding a plant that had existed for some time.

Past investments determine the relative costs of current investment alternatives. It will generally be cheaper to add on to an existing structure than to tear it down and build a brand new state-of-the-art plant. The firm must determine at what point it is in its financial interest to scrap out-of-date plants. Coke is in precisely the same position regarding its territorial system. It has the appropriate incentives to take into account the costs and benefits of scrapping pieces of the existing territorial system. It will attempt to avoid the costs arising from premature scrapping that would follow from the uncompensated dismantling of the exclusive territory system.

That dismantling would subject a number of the bottlers to substantial, losses, losses which are avoidable. The business that bottlers have built up will not necessarily be well designed to compete in a "walls down" world. This is not an argument in favor of protecting inefficient firms. A firm that is designed to produce and market within an exclusive territory can be efficient for that purpose, yet be a high cost ineffective competitor if the territorial system were voided. Efficiency is contextual. In biology, by analogy, polar bears are efficient in the Arctic, but not in Alabama.

Those bottlers not well-situated to compete for chainstore warehouse accounts are likely to suffer severe losses. Their survival itself is problematic. To be sure, such losses are not uncommon in a capitalist economic system. We cannot protect everyone from the cold realities of the marketplace. But in the current context we should bear in mind that the source of these concentrated losses is the FTC ruling. Absent a strong showing that the decision will have desirable effects, it is hard to justify subjecting this subgroup of bottlers to significant losses.

To conclude, there is little reason to be concerned with intrabrand competition. The FTC opinion, which focused almost exclusively on intrabrand effects, was misinformed. My understanding is that the proposed legislation holds that the effects of territorial restrictions in bottler franchises on intrabrand competition should not be grounds for finding an agreement in violation of the antitrust laws. It does not shield the industry from attack on the grounds that interbrand competition is impaired. The legislation directs the attention of the enforcement agencies in the proper direction and is, I believe, a reasonable and modest addition to the antitrust laws.

Senator BAUCUS. Thank you very much.

Mr. Preston?

Mr. PRESTON. Thank you, Senator. My prepared statement constitutes a kind of summary, although it was written quite in advance, of the presentations you already heard. Therefore, I won't dwell on it at any length at all.

I would simply point out what the summary points are. The summary points are very simple. The first one is that it is my view, and I think it has been amply demonstrated in what you have heard today and in the prepared statements as well, that the existing structure and behavior of the soft drink industry is compatible with competition.

With respect to structure, we see that it is flexible and we see it is varied. There is no tendency for the structure to be frozen into a configuration of small, inefficient firms, as some people have feared; nor is there a tendency for the structure to become completely dominated by a few giant firms, as some other people have feared. Neither phenomenon is present in the industry at the present time.

Similarly, with respect to prices and products, you have heard ample testimony, and my prepared testimony provides additional summary material as well, to indicate the great variety of prices and products that are available in the market, even the same specific products in multiple packs and multiple sizes and at varying prices, even within individual stores. Of course, there are further variations from store to store and type of outlet because there are nonstore outlets as well.

I would also emphasize, as I do in my written statement, that the role of the retailer in determining the final consumer price for soft

drinks must not be overlooked. Retail store margins for soft drinks amount to about 20 percent of the final retail price, typically. There is a great deal of flexibility. In fact, the retailer, of course, is an independent purchaser. He prices the soft drinks any way he chooses once he has purchased them.

The ultimate determiner of the consumer price of soft drinks is the retailer rather than the soft drink bottler, or still less the sirup company.

So, at any rate, when we go out to the market, what we see is a tremendous variety, in fact an incredible variety, of prices, products, and packages of soft drinks. And the notion that that tremendous variety is in some way harmful to consumers or that consumers are being some way disadvantaged by a system that has produced this variety seems to me simply bizarre.

The other aspect of my prepared statement—and again, the points have been well brought out by previous speakers—is to simply draw your attention to what I think are the five significant trends that elimination of the territorial franchise system would produce. I would just like to summarize them quickly.

First: Unequivocally, and perhaps the most important trend, extensive vertical integration by the major brand franchisors; that is, the sirup companies. I think there is no question that is the primary long-term result that would arise from the elimination of the territorial franchises. The bottlers who spoke earlier spoke to that point in detail.

Second: The tendency toward backward integration, either by ownership or buying power pressure by the major chainstores, widening their own margins, but whether producing any price benefits for consumers or not we cannot really anticipate.

Third: Geographic market expansion by the largest and strongest established bottlers, those who were able to survive in this new environment.

Fourth: The disappearance of minor brands from the market. All of the competitive diversity that they bring to the market would simply be gone.

Fifth: Of course, the point that has been strongly stressed, the disappearance or substantial contraction of a large number of smaller, but, currently viable and profitable, bottling firms throughout the country.

Now all of these trends taken together mean increased concentration, very substantially increased concentration. Mr. Mudd has pointed out the analogy of the beer industry. I think it is a very good analogy.

My own experience in studying various industries has been that that kind of increased concentration, the great increase in nationwide concentration by a very few large firms, inevitably results in greater price rigidity and greater market monopoly. The exceptions I think are very rare.

What we see is a present situation in this industry that is completely compatible with competitive conditions in the market and offering consumers a tremendously wide range from which they can make whatever choices they like. The alternative would be a peculiar result from what I think is a misapplication of public policy. The alternative would be a forecast of much higher concentration and would be very unlikely to generate any benefits for consumers.

Thank you.

Senator BAUCUS. Thank you very much, Dr. Preston.

One question I have is the degree to which the present territorial franchises are fixed in stone. That is, to state the question differently, how much competition is there now among franchisees in the bottling industry? Is there any competition among franchisees? Are there attempts by some of the larger franchisees to enlarge their territory?

Mr. PRESTON. The first answer I think is that the bottlers who were here earlier spoke somewhat to that. Of course, under their present contracts, the franchise holding company can only expand geographically by the acquisition of a neighboring franchise.

Senator BAUCUS. I understand that. But the question goes to, are there any pressures to change the territorial contracts with the franchisor? Would some of the larger franchisees pressure their franchisors to change the contract and expand their territories?

Mr. PRESTON. Not to my knowledge, Senator. But the bottlers would be much better qualified to answer the question than I am.

My point is really that the extent of interbrand competition in the soft drink industry is so great that any emphasis on intrabrand competition is simply misplaced. I think we have such a very high rate of interbrand competition and this tremendous variety of prices and packages even for the same brands that you get the kind of alternatives in the store, the kind of alternatives facing the consumer, that you would expect competition from multiple sources to produce.

Since you can buy the same product from a variety of choices, depending on what your choice is——

Senator BAUCUS. I understand your point. I tend to agree with you. I am just trying to test your point. Thank you very much.

Senator BAYH [presiding]. Thank you, Senator Baucus. I appreciate your keeping us moving here.

We have heard from the bottlers and others. We have heard from you about the economics of the situation and what this decision will mean. At least one assumption has been we are going to have massive warehousing. Am I right in assuming this is generally what the experts think will happen? It is certainly what the retailers think will happen.

Senator DOLE. I think he indicated five things probably would happen.

Mr. PRESTON. Yes, sir. From my prepared statement I read the list of five trends, all of which I think add up to a tremendous increase in concentration in the industry. Exactly what technological forms that concentration would produce I don't think we can predict with real certainty.

Senator BAYH. Warehousing as part of vertical integration is one aspect.

Mr. PRESTON. Absolutely.

Mr. WILLIAMSON. In a very general way, I think one can make the proposition that if you have an efficient mode of organization and it is upset by an FTC ruling or otherwise, there is an incentive to put in place another efficient mode of organization that duplicates many of the same features that the original one had.

If there were restraints associated with franchising originally, you would assume that a mode of organization would appear that also involved restraints. Vertical integration certainly has those features.

Senator BAYH. Do you have any additional thoughts?

The article this morning talked about the present relationship, however one might describe that, as costing the consumer 5 cents a can. It would add more than a nickel to every can or bottle of soft drink you buy. The total tab comes to more than $2 billion a year.

One: Is that true in your judgment? Two: If it is true, does that mean then, if we go along with the decision and this bill does not pass, we are going to have a nickel cut off the cost of each soft drink can or bottle we buy?

Mr. PRESTON. Senator, I think that statement is totally without foundation. It is extremely irresponsible. In the first place, I do not know precisely how one would even make an analysis to see what the specific price effects of this particular practice, given all of the circumstances of the soft drink industry, might be.

Senator BAYH. Five cents is a good round number.

Mr. PRESTON. Oh, it is a round number, shockingly round really. I am making a very academic point, but it is a point to ask: How could one ever know the answer to that question? The first point is, one really can't know the answer to that. My second point I think is perhaps more of a commonsense point.

Let's look for the 5 cents. Where is this 5 cents? First we have to know that, of course, only about one-third of all soft drinks are sold in cans. So what this has to do with the general price of soft drinks——

Senator BAYH. It says bottles or cans.

Mr. PRESTON [continuing]. Is another question. At any rate, if we look at a six-pack of cans, say, selling at retail for perhaps a quarter a can——

Senator BAYH. Excuse me. You know so much more about this than I. I want our record to be complete here. The assertion was it was 5 cents for every can or bottle. So if there is a distinction in your answer between cans and bottles, I would like to have them both answered.

Mr. PRESTON. My point really was that the present packaging is divided about one-third returnable bottles and one-third nonreturnable bottles and one-third cans, on a nationwide basis. But as the bottlers speaking here earlier emphasized, it is very different from one market to another. That also raises the question about how this kind of estimate would be made.

Furthermore, of course, the economics of the three containers is very different. That is, the cost of the containers is different and the price to the consumer tends to be different among the three different kinds of containers.

But focusing on cans for the example and using that as a typical figure would be OK.

Let's assume that that retail price is about 25 cents, which has been pointed out here would be, let's say, a high price. It is not a special price. The bottlers who have spoken here this morning have pointed out how important price, especially in large packs, is to the soft drink industry. But let's focus on the higher priced end of the market to make this argument, or at least give it its due.

So assume the retail price is 25 cents and that the retail markup is 20 percent. That gets you down to 20 cents. There is no supposition, as far as I know, that a change in the territorial system is going to make any vast change in the retail markups. It might enlarge them. If the retail-

ers are able to get control over the system, I would expect the margins to widen rather than to narrow.

Now you are down 20 percent. You are talking about a 5-cent reduction on a product from selling for 20 cents. This would imply that somewhere in that 20 cents there is a 25-percent profit margin of some kind that can be eliminated by this territorial change. Now you heard what the bottlers who spoke here said this morning about their profits on sales. There is not any really comprehensive data on profits on sales in the bottling activity. But in all of the information I have, I don't have any indication that profits on sales are even half that in the bottling activity.

The bottlers who spoke here this morning spoke of figures well under half that. I don't know where there is any nickel in the system that could be captured by any change in the system whatsoever.

I think that looking at the economics of it in that way makes that statement seem a very bizarre one.

Mr. GOLDBERG. I would like to add something to that. I am not quite sure where Mr. Anderson got his numbers from, but it is quite probable that what he was looking at was the estimate of how much the price of Coke sold through warehouses only would fall initially. Then he extrapolated from that to say that all Coke prices would fall by this throughout the system.

In my remarks I suggested it is quite possible that the cost of soda sold through the warehouse system might fall initially. However, what also will happen is that the soda sold not through the warehouse system is going to rise in price. That is going to have to figure in this average price the customer is going to pay.

In addition to that, what will happen after the system goes through a new equilibrium is that the sirup companies themselves are going to increase their advertising. This is going to lead to higher wholesale prices. The net effect of this whole thing is not at all clear. Quite probably, the average price paid by consumers is going to end up rising.

One more addition to this point. It is not clear to me at all what the advantage to the Coca-Cola Co. would be to have the price of Coca-Cola high. Coca-Cola really would like the price as low as possible so they would sell more Coke. I could see an advantage to the bottlers. But in this particular case it is the Coca-Cola Co. that was sued for having this arrangement and they also defended themselves very aggressively. So it is a very odd sort of line of logic Mr. Anderson has to have as to why Coke itself would want to have high prices.

Senator BAYH. I assume Mr. Anderson was getting this logic from other people. He probably knows as much about the soft drink industry as I do. It is the logic of other people he is espousing.

I appreciate getting your analysis of it.

Professor Williamson, do you have a comment on that point?

Mr. WILLIAMSON. As I indicated at the outset, I don't have extensive knowledge of the industry, but any time there is a 25-percent margin that represents in some sense inefficiency or waste, the incentives to reorganize this activity along more efficient lines are just enormous. I can't imagine there not being those kinds of reorganizational activities already going on in the industry if such a huge margin of inefficiency did exist. The fact we don't observe it suggests to me that the imagined inefficiency is totally without foundation.

Senator BAYH. One of the alternatives that has been suggested that would happen if this bill does not pass is that there will be a few very large bottlers who will then move on out in various ways and drive the smaller bottlers out of business. Those large bottlers are now in business, operating within their own franchise. Can one tell by looking at the way they operate and the way they price now that there would be any great savings to be passed on if they were to go out and—I don't see how somebody bottling in Chicago could be any more efficient selling in Indianapolis than he now is in Chicago. Can we tell by analyzing what is happening in those areas where the large bottlers are now to tell what would happen if they would move on out beyond their present territories?

Mr. PRESTON. I think Professor Williamson was very responsive to your question, Senator. That is, if there were some kind of big gains to be accomplished, either operating efficiency gains or price control gains or any other kinds of gains to be accomplished by such moves, we would expect to see such moves taking place. We do not see any such moves taking place. Such moves could take place within the present circumstances. If the gains were great enough, it would pay firms to consolidate on a large scale. As the data tabulated in my prepared statement show, we do not see any great wave of large consolidations. What we see is a movement of small firms being consolidated in response to technological changes within local market areas, increasing economies of transportation, and economies of scale in production. But we don't see any tendency toward nationwide increasing concentration at the present time.

Mr. WILLIAMSON. The matter of whether there would be incentives for the large bottlers to make acquisitions, if the bill were not passed and the FTC ruling were to stand, raises a question of how it is that under current circumstances, with territorial restrictions in place, large and small bottlers can coexist in adjacent areas and both be viable and both be efficient, but, if the territorial restrictions were removed, efficient coexistence may no longer be feasible.

I would conjecture that if franchise restraints are removed, competition of a free-rider kind will appear at the boundary where the franchises meet.

There is an incentive then, if territorial integrity no longer exists, to expand each area so as to reduce the number of interfaces and avoid the disincentives of a free-riding type that occur when successive franchises are operating where territorial integrity is no longer subjected to discipline.

So the elimination of territorial restrictions would provide an incentive to erase boundaries, and in the process of erasing boundaries, erase the free-riding effects that would appear wherever the boundaries had previously existed.

But the fact you don't observe efforts to erase those boundaries now doesn't imply that the present system is inefficient. It simply indicates that it is viable, given the territorial restraints.

Senator BAYH. I was out in my State over the Memorial Day recess. On one occasion I had a Tab fit. I raced to the nearest dispensing

machine I could find and I found the price tag was 50 cents. We have talked about 25 cents. That decision, if it is upheld, will that have any impact on the vending machine price? It has raised at a rather astronomical rate over the past relatively short period of time.

Mr. PRESTON. I wouldn't think so, Senator. The vending machine, of course, is the most expensive place to buy anything—not just soft drinks—anything that is involved in a vending machine, because the method of distribution is very expensive and because it offers great convenience to the consumer. But it is a very small volume type of distribution. The machine is small compared to a store.

Great labor costs and transportation costs are involved in servicing that machine, and of course, the price in the vending machine is under the control of the vending machine operator, whoever that may be. There are diverse companies of all kinds involved in the vending machine business, as you know. That price is set by the vending machine operator.

Senator BAYH. You have looked at the bill. You have studied the bill. Is there any course of action when I put two quarters in the machine and it doesn't work? [Laughter.]

Mr. GOLDBERG. Write your Congressman. [Laughter.]

Senator BAYH. I would like to say on the record that was said in jest, at least as of now. [Laughter.]

Does the Senator from Kansas have questions?

Senator DOLE. I don't have any questions. I think it is interesting testimony. I was out of the room part of the time visiting with the champion speller from Kansas. [Laughter.]

Did I understand initially you are here on your own? You don't represent the bottlers or any of the people involved in this hearing? You are all here because you have an academic interest in this case?

Mr. PRESTON. Sir, we all have an academic interest in the subject matter. We have all conducted perfectly independent research, unrelated to this case.

Senator DOLE. You are not being paid to testify by anyone?

Mr. PRESTON. Excuse me, sir. We were invited to come here today by the Soft Drink Association because of our prior work in the field. We have been paid by the Soft Drink Association for coming here today and for preparing this testimony specifically for this purpose. But that is based on our prior independent work in the field. Our work is not only independent of the Soft Drink Association, it is independent of each other. Our original work on this subject has been totally on our own.

Senator DOLE. Does that apply to the other witnesses? You are all being paid to be here by them?

Mr. GOLDBERG. That is correct.

Mr. WILLIAMSON. That is correct.

Senator BAYH. Thank you very much, gentlemen. We appreciate your letting us have your thoughts.

Mr. PRESTON. Thank you, Senator.

Senator BAYH. If you don't mind, I think some of our other members might have questions that we will submit and we could then put them in the record.

[The questions and answers referred to and the prepared statements follow:]

RESPONSES TO SENATOR THURMOND'S WRITTEN QUESTIONS BY LEE PRESTON

Question No. 1. Would the failure of S. 598, or a similar bill, in being enacted have an impact on capital investment that is essential in continuing a successful business?

Answer. Business investment decisions are very strongly affected by uncertainties. The greater the uncertainty, the less the new investment, other things being the same. The soft drink industry, and particularly the independent bottler, faces great uncertainty because of the FTC action. It would be very surprising if this uncertainty did not reduce the bottlers' willingness to make new investments—and their ability to borrow investment capital from banks—since the basic economic and legal structure of their operations may be drastically changed as a result of the FTC proceeding.

Question No. 2. Testimony in previous years shows that an exclusive franchise is necessary for a territory to prevent large franchisees from major cities—Los Angeles, Denver, Chicago, New York City, et al.—to invade a territory in smaller communities. Please comment.

Answer. Many of the major bottlers in large metropolitan areas would undoubtedly like to expand their sales to include the largest and most profitable accounts (e.g., supermarket chains) in nearby territories. It is much less likely that they would wish to establish the necessary delivery routes to serve smaller customers. However, the economics of the typical franchise bottling firm requires a mixture of large and small accounts to provide an adequate overall scale of production and distribution, and a regular pattern of operations, for the firm over time. Hence, loss of the largest accounts to a neighboring "metro bottler" endangers the entire operation of the smaller firm. Furthermore, even if the smaller firm could somehow survive the loss of its largest accounts, because of serving smaller outlets—and therefore the prices charged by them to final consumers—would certainly be substantially increased.

Question No. 3. Would elimination of the territorial franchise system in soft drink industry result in more effective competition or lower prices?

Answer. The precise effects of any one change within a large and complex industry are necessarily difficult to predict. This difficulty is increased when the change will inevitably lead to a process of economic adaption over time, and the ultimate effect will be a major alteration in the basic economic structure of the industry. During the process of adjustment, many cost and price effects might be observed. Some costs might fall, and others rise; prices might fall for some products and customers, and rise for others. These details of the adjustment process cannot be predicted in advance. My own conclusion, however, is that the net long-run impact of the removal of the territorial franchise system would be a substantial increase in concentration in the entire soft drink production and marketing activity. Such an increase in concentration can scarcely be expected to result in more effective competition or lower prices in the long run.

Question No. 4. It is my understanding that the soft drink industry remains relatively unconcentrated on a national basis. Would you comment?

Answer. Soft drink bottling is necessarily a regional economic activity, since the final product is relatively heavy and costly to ship in relation to its value, and also subject to damage in shipment and to deterioration over time. However, production of other similar products, such as beer, have become much more highly concentrated on a national basis, while soft drinks remain the least concentrated of food products industries. Soft drink bottling could become concentrated nationally by the brand name firms, or by large multi-plant bottling organizations. It has not become so concentrated as yet because (a) the territorial franchise protects the economic integrity of the individual bottler, making him less subject to "raids" by other parties, and (b) multi-plant production and marketing by the individual bottler makes his operation efficient, while at the same time discouraging takeovers by other firms (including the franchisors themselves) that do not and could not offer the same combination of brands for the local market. Hence, it seems clear that the relatively low nationwide concentration of soft drink bottling continues because the regional structure of the industry has been economically strengthened and preserved by the territorial franchise system.

PREPARED STATEMENT OF DR. LEE E. PRESTON

BIOGRAPHICAL NOTE

Lee E. Preston is Melvin H. Baker, Professor of American Enterprise in the School of Management and Director of the Center for Policy Studies, State University of New York at Buffalo. He was educated at Vanderbilt University (B.A. 1951) and Harvard University (M.A. 1953; Ph. D. 1958), and was a member of the faculty of the School of Business Administration, University of California, Berkeley (1958–69). He was a Staff Economist with the Council of Economic Advisors, Executive Office of the President (Kennedy) during 1961–62, and a member of the White House Task Force on Antitrust Policy, 1967–68. He has testified frequently before Congressional committees, served as a member of the American Economic Association Advisory Committee to the U.S. Bureau of the Census, and served as a consultant to a number of public agencies and private firms. He is the author of some seventy-five books, monographs and articles dealing with a wide range of subjects in economics, marketing, management and public policy.

Almost seven years have passed since I first had the opportunity to discuss the legal and economic status and consequences of the territorial franchise system, with particular reference to the soft drink industry, before this Committee.[1] Since that time, I have appeared twice before committees of the House of Representatives.[2] And, in the interval, a number of different versions of the proposed legislation have been discussed, and a variety of problems and implications have been investigated. We are, however, once again today focusing on a piece of legislation which has as its purpose, in the words of your Committee, "to make clear that the traditional territorial franchise system under which certain trademark soft drinks have been manufactured, distributed and sold is lawful under the antitrust laws, so long as there is substantial and effective competition among different products and vendors." [3] In other words, if the tests of competitive acceptability normally applied in antitrust matters are satisfied, the territorial franchise system will not be considered in itself an unacceptable arrangement for manufacturing and marketing soft drink products.

It may well be wondered why a matter that has been under consideration for this long a period and that is now in the process of adjudication in the courts requires Congressional action at this time. My own view is that there are sound economic reasons for Congressional action, quite apart from any additional legal considerations that may be involved. Uncertainty with respect to the legal status of the franchise system has now plagued the soft drink industry for almost a decade, and this uncertainty cannot help but affect investment decisions and other business plans. Moreover, if it should appear—either as a result of federal court decisions or simply as a result of further delay—that the present FTC position regarding the franchise system will prevail, then changes in industry structure can be expected to occur which would almost certainly be nonreversible. Thus, if large bottling and canning operations can expend quickly to capture the most desirable customers in neighboring territories now served by smaller firms, subsequent Congressional action confirming the validity of the territorial system would be of little effect. Indeed, the more likely it is that Congress will eventually take such corrective action, the greater incentive large firms would have to invade neighboring territories, even on a break-even or below-cost basis, in order to obtain the permanent advantage of market control. For this reason, I believe we are dealing with a situation that, once substantially altered, cannot be restored to its present condition. If, in fact, it is the intent of the Congress that the historic pattern of manufacturing and marketing arrangements in the soft drink industry shall be permitted to continue, and particularly that the economic values of the smaller firms involved shall be protected, then definitive Congressional action simply cannot come too soon. The

[1] Hearings before the Subcommittee on Antitrust and Monopoly of the Committee on the Judiciary, U.S. Senate, 92d Cong., 2d sess., Aug. 8, 9, 10, and Sept. 12 and 14, 1972, pp. 392–399.

[2] Hearings before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, U.S. House of Representatives, 93rd Cong., 2d sess., June 27, 28, July 1 and 2, 1974, pp. 367–390; and Hearings before the Subcommittee on Monopolies and Commercial Law of the Committee on the Judiciary, U.S. House of Representatives, 94th Cong., 2d sess., June 24 and July 1, 1976, pp. 392–412.

[3] Report from the Committee on the Judiciary, U.S. Senate, 93rd Cong., 1st sess., June 4, 1973, p. 3.

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ultimate impact of the FTC position on this matter will be the destruction of the value of existing small businesses by whatever economic interests—neighboring larger bottlers, chain food stores, or the franchise companies themselves—choose to do so. It will do no good for the Congress to act later to protect those interests; they will simply be gone.

The body of my statement develops two main themes: First, I consider the principal allegations of the critics of the territorial franchise system as revealed in prior Congressional hearings and other discussion, and present a variety of evidence suggesting that their concerns are misplaced and that the soft drink industry as a whole presents ample evidence of competitive structure and behavior. Second, and more briefly, I point out what seem to be the likely effects of the elimination of the territorial system and emphasize that it is by no means clear that these effects would result in more effective competition or lower prices for soft drink products.

COMPETITIVE STRUCTURE WITHIN THE TERRITORIAL FRANCHISE SYSTEM

The impact of any particular business practice, such as the territorial franchise system, in any specific industry depends of course on the larger context of technological and economic conditions under which that industry operates, its pattern of historical development, and the complex of other forces, social as well as economic, that condition its evolution over time. Hence, it is always difficult to isolate the specific effects of any single industry feature considered alone. Critics of the territorial franchise system in the soft drink industry have essentially argued that, given the history and larger operating context of the industry, the system results in (1) an inflexible, inefficient and noncompetitive industry structure, and (2) a pattern of high, stable and uniform consumer prices. My own study of the industry has convinced me that neither of these propositions is correct, that the structure of the industry is both reasonably flexible and acceptably competitive, and that the variety of products and prices available offers ample scope for consumer choice and market competition. If the territorial franchise system has any specific effects on competitive conditions, these would appear to take the form of an increase in the number and variety of competitive forces existing in the marketplace and hence an increase in the opportunities for competitive behavior and adaptation over time.

Overall industry structure

Critics of the territorial franchise system in the soft drink industry have expressed concern that, on one hand, the system may permit the continued operation of small and inefficient, and hence high-cost bottlers; and, simultaneously, that it may also result in increasing domination of soft drink bottling and distribution by giant multi-plant enterprises, and possibly by the franchise companies themselves. Even on the surface, these two possibilities seem somewhat contradictory, since the preservation of inefficient small firms would almost certainly imply limitations on the growth of very large firms, and vice versa. However, it is more important to note that neither of these concerns is supported by the facts. On the contrary, the soft drink industry has adjusted to changing economic and technological conditions by the gradual combination and absorption of smaller bottlers into larger and more efficient enterprises. At the same time, the share of the largest firms, and of the franchise companies themselves, in overall bottling activity has not increased substantially in recent years. The principal trend seems to have been growth in the number and market share of moderately-sized, independent firms, which is precisely the type of adjustment that would be expected to promote efficient economic operations as well as maximum competitive flexibility.

Any fear that the territorial franchise system is resulting in the preservation of large numbers of small and inefficient plants should be laid entirely to rest by the information shown in Table 1, which contains U.S. Census data for the period 1963–72, supplemented by NSDA data for 1972–78. The two data sources are not identical in coverage, but are closely similar as the comparison of data from both sources for 1972 indicates. Almost 2,000 small soft drink bottling plants have disappeared over the period 1963–78, while the number of larger plants has increased substantially. Census data reveal that a predominant share of both employment and value added by manufacturing has correspondingly shifted from smaller to larger plants over the same period. Even in 1972 (the

most recent year for which Census data are available), plants with more than 100 employees accounted for approximately half of all employment and value added in the soft drink bottling industry. These data demonstrate conclusively that the franchise system is not an overwhelming barrier to appropriate economic change; it simply assures that changes will occur in a manner that takes account of the existing equities and interests involved.

TABLE 1.—SOFT DRINK MANUFACTURING

[Number of plants and companies, 1963–78]

Year	Number of companies	Number of plants/employment size			
		Total	1 to 49	50 to 99	100 and over
1963	3,569	3,905	3,408	308	189
1967	3,057	3,400	2,740	386	274
1972	2,271	2,687	1,965	417	305
	[1] 2,205	[1] 2,615	[1] 1,927	[1] 419	[1,2] 269
978	[1] 1,724	[1] 2,048	[1] 1,412	[1] 374	[1,2] 261

[1] NSDA data.
[2] NSDA data apparently do not include some large canning operations covered by census data.

Source: U.S. Census of Manufactures, except as indicated.

The decline in the number of small soft drink bottling firms and plants has not, however, led to the consolidation of the industry into a very small number of large, multi-plant nationwide organizations. On the contrary, as the concentration data shown in Table 2 reveal, the soft drink industry remains relatively unconcentrated on a nationwide basis—in fact, the 14 percent concentration ratio for the four largest firms makes it the least concentrated of all the food products industries—and the slight increases in concentration that have occurred during the period 1963–72 have been fairly evenly distributed among the twenty largest firms in the industry. Nor is it true that the role of the franchise companies themselves in bottling activity has increased. On the contrary, U.S. Department of Commerce data indicate that the number of franchisor-owned bottling plants has actually declined from 100 in 1969 to 70 in 1978, and that their share in the total dollar value of soft drink sales—although, of course, increasing in absolute terms—also declined from 4 percent to 3 percent over the period.[4]

TABLE 2.—SOFT DRINK MANUFACTURING CONCENTRATION RATIOS, 1963 AND 1972

[Based on value of shipments]

Year	Share of N largest companies			
	1 to 4	5 to 8	9 to 20	21 to 50
1963	12	5	7	10
1972	14	7	11	12
Change	+2	+2	+4	+2

Source: U.S. Census of Manufactures.

Structure of geographic markets

An additional aspect of interest has been the number of soft drink firms and brands participating in individual geographic market areas. A survey of the largest metropolitan areas in the country reveals that most of them are served by between six and twelve franchised soft drink bottlers, plus unfranchised operations (e.g., Shasta) and supermarket private labels. Smaller local markets are, of course, typically served by smaller numbers of firms; however, a sampling of smaller metropolitan areas indicates that service by fewer than five or six sources of soft drink supply is relatively rare.

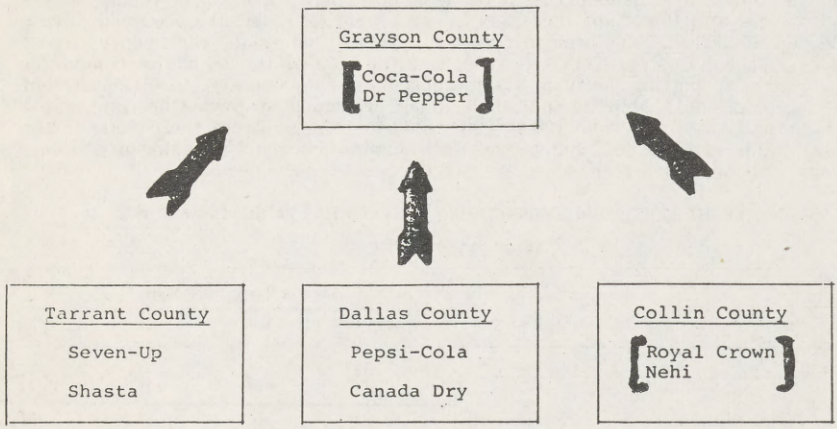
[4] NSDA's "The Soft Drink Industry of the United States, Statistical Profile 1978," Table 22.

Two aspects of local market structure require special emphasis. One is the fact that territorial boundaries for the various franchised brands are rarely identical and often strikingly different. There are, for example, two major Seven-Up bottling operations within the large metropolitan area served by Coca-Cola of New York. Smaller local markets are served by the varying, but overlapping, geographic territories of bottlers in a variety of neighboring locations. For example, consider the sources of major brand soft drinks for consumers in Grayson County, Texas, a market area containing two small cities and a total population just under 100,000 people.[5]

Only one bottler, producing both Coca-Cola and Dr Pepper, is located within the county. However, the situation is far from that of local monopoly. Royal Crown and Nehi beverages are supplied from a bottler in adjacent Collin County; Pepsi and Canada Dry are provided by two different firms, both located in Dallas County; and the Seven-Up franchise bottler is located in Tarrant County, as is the regional manufacturer of Shasta beverages. As a result, six significant bottling operations participate in the Grayson County market, and there are additional sources of minor brands and private labels as well. Moreover, each of these firms will be engaged in competition with the others and/or with other sources of the same brands of soft drinks in other local market locations. The result is a network of interrelated local geographic markets and competitive supply sources that blankets the entire country.

FIGURE 1

SOURCES OF MAJOR SOFT DRINK BRANDS
GRAYSON COUNTY, TEXAS, 1979



The Grayson County example also illustrates a second point, that many bottlers are responsible for providing more than one soft drink brand, although not always within an identical market area. (The Dallas bottler providing Canada Dry for Grayson County, for example, also produces Royal Crown Cola; however, the territories for the two beverages are not identical.) Production of multiple brands, including his own company brands or flavors, is not only a source of economies of scale for the individual bottler, but also a major means of market penetration for new or less popular products. This tendency of new or minor brands to "piggyback" on the production and marketing facilities of local suppliers of major brands has been erroneously criticized by some com-

[5] Example selected because I grew up in the area, but quite typical of smaller market areas nationwide.

mentators as an undesirable limitation on competition. Precisely the opposite, however, is in fact the case. Multiple-brand operations increase the efficiency of the bottler-distributor, and significantly widen the range of final consumer choice. The highly successful nationwide expansion of Dr Pepper during the 1960's was accomplished almost entirely by the addition of that brand to the product lines of established bottlers in areas where Dr Pepper had previously been unknown and unavailable. It would, of course, be undesirable if a single local bottler were to become the sole source of supply for all major brands within his market area. However, the franchising policies of the brand-owning companies are specifically designed to prevent this, and there is no sign of any tendency toward such undesirable local monopoly anywhere in the country, so far as I can discover.

At the same time, the presence of large bottling organizations such as Coca-Cola of New York (which now ranks among the Fortune 500), the substantial bottling subsidiaries of large diversified firms such as Westinghouse and Northwest Industries, and large independent multi-location operations such as Joyce Beverages, constitute important sources of economic power for the entire bottling segment of the industry vis-a-vis the brand-owning franchise companies on one hand and the large supermarket chains on the other. The fact that the bottling industry contains some reasonably large firms, but is by no means dominated by them, seems to me to contribute to the maintenance of a flexible and competitively vigorous economic structure in the vertical as well as horizontal dimensions of the soft drink industry.

Conclusion

The conclusion I draw from inspection of a very wide range of data concerning the structure of the soft drink industry is that there is no tendency either for (1) undesirable preservation of inefficient small operations, or (2) undesirable increases in nationwide concentration or franchise-company dominance, or for the development of local market monopoly, in soft drinks. Hence, it appears to me that the fears of the critics that the territorial franchise system is maintaining or creating an inefficient and uncompetitive industry structure are without any substantial foundation.

PRICING PATTERNS

The tremendous variety of soft drink products, brands and packages makes any analysis of prices and price behavior incredibly complex. However, almost any analysis of pricing patterns that can be undertaken leaves one with an overwhelming impression of variability and diversity—a sharp contrast to the stability and uniformity that one would anticipate under monopolistic conditions. An extremely significant aspect of the situation, of course, is the fact that final consumer prices for soft drinks are established not by the manufacturers (i.e., the bottlers), and still less by the franchisors, but by final retail marketers. Furthermore, between the bottlers and retailers, there are a variety of price-related factors such as advertising allowances, extra-case deliveries, promotional and other services, etc., that make price comparisons alone an incomplete reflection of true market relationships.

Price trends over time

An indication of the change in soft drink prices over time can be obtained from both the wholesale and the consumer price indexes computed by the U.S. Bureau of Labor Statistics. Selected data from this source for the period 1957–78 (Table 3) show that the overall prices of soft drinks, both wholesale and retail, have increased slightly more than those of food products as a whole, but less than the price of cane sugar, the single most important soft drink ingredient cost, and less than an appropriately weighted average of the price indexes for the two types of containers (226). (Increases in labor and transportation costs are, of course, not reflected in these tabulations.) An additional point worth noting from this tabulation is that wholesale and retail prices of cola drinks, the only product for which such price comparisons can be made, have increased at almost precisely the same rates during the period. The entire pattern of price indexes suggests the close relationship between cost movements and price movements that would be expected on the basis of competitive market behavior.

TABLE 3.—*1978 price indexes, soft drinks and related items (1967=100)*

Wholesale Price Index:	
Overall	195.0
Food	207.0
Sugar:	
Cane	221.6
Beet	195.4
Containers:	
Aluminum cans	169.8
Glass containers	244.5
Soft drinks:	
Cola	216.6
Ginger Ale	211.7
Total	211.8
Consumer Price Index:	
Overall	195.0
Food and beverages	209.0
Cola	218.3

SOURCE.—U.S. Bureau of Labor Statistics.

Price/product variety

A second significant aspect of soft drink prices is their geographic variability, and the related fact that the pattern of prices among types of drinks and brands is not the same from one market area to another. This point is illustrated by data in Table 4 which present underlying statistics for two types of soft drink products—colas and fruit drinks—for twenty-three major cities covered by the consumer price index. Not all of the prices in the two columns are directly comparable, since the primary intended coverage is for returnable 12-ounce containers, although other sizes and nonreturnables are also included where necessary. The average price figures recorded reflect, in addition, differences in the brands for which prices were gathered and seasonal and other variations as well. The interesting point to be observed is not simply the variety of prices reported, even where no specific differences in comparability can be identified, but also the variation in price relationships between the cola drinks and the fruit drinks covered by the survey. The two prices are virtually identical in some instances, quite different in others, and the differences go in both directions and are of widely varying magnitudes.

TABLE 4.—SOFT DRINK RETAIL PRICES BY CITY: ANNUAL AVERAGES 1972–77

[Cents per 72-oz. carton]

	1972		1973		1974		1975		1976		1977	
	Cola	Fruit drink	Cola	Fruit drink	Cola	Fruit drink	Cola	Fruit drink	Cola	Fruit drink	Cola	Fruit drink
Atlanta	65.2	65.0	69.4	69.1	92.8	92.6	105.9	104.7	105.1	110.7	106.5	108.3
Baltimore	102.5	[1] 71.2	[2] 103.9	[1] 69.6	[2] 124.6	[1] 85.8	[2] 148.7	[1] 132.0	[2] 139.9	[1] 129.1	[2] 161.3	[1] 118.6
Boston	95.6	[1] 76.0	[2] 97.4	[1] 80.4	[2] 121.1	[1] 107.1	[2] 146.0	[1] 137.4	[2] 144.7	[1] 135.5	[2] 150.2	[1] 129.1
Buffalo	73.0	79.2	72.9	82.6	[3]	95.1	159.3	121.0	[2] 146.1	114.7	[4] 146.6	114.8
Chicago	[5]	[5]	[4] 99.3	[1] 100.7	118.7	[1] 119.4	[2] 163.5	[1] 137.1	[4] 147.3	[1] 133.3	[4] 151.1	[1] 138.8
Cincinnati	73.1	[6] 79.3	77.1	[6] 83.7	93.9	[6] 97.9	100.4	[6] 112.4	104.4	[6] 105.6	[3]	[6] 112.7
Cleveland	78.9	72.5	79.5	79.9	91.5	92.6	113.0	109.7	111.9	117.1	129.2	121.9
Dallas	65.2	68.3	66.6	70.2	82.0	83.8	96.1	100.3	89.5	98.7	98.5	101.9
Detroit	[2] 102.2	[2] 102.2	[2] 101.8	107.0	[2] 123.7	[2] 128.2	[2] 156.9	[2] 162.6	[2] 115.1	[2] 160.4	[2] 162.8	164.4
Honolulu	89.7	85.8	93.4	87.2	101.1	102.7	113.6	[3]	118.7	[3]	120.8	113.7
Houston	63.1	60.2	65.8	63.1	84.0	78.5	101.5	101.9	98.2	91.5	105.6	100.8
Kansas City	84.8	[1] 64.7	87.0	[1] 63.0	99.8	[1] 77.9	117.3	[1] 101.1	116.3	[1] 92.3	[4] 139.8	[1] 91.8
Los Angeles	81.6	78.5	84.4	82.5	[7] 107.2	98.2	[7] 131.2	138.5	[7] 127.8	[6] 135.2	[7] 136.9	[6] 140.5
Milwaukee	[5]	[1] 68.3	[4] 87.4	[1] 69.6	[2] 115.2	[1] 88.0	[4] 142.0	[1] 109.2	[4] 124.4	[1] 108.3	[4] 124.4	[1] 110.2
Minnesota/St. Paul	78.5	83.0	87.8	81.8	101.8	92.5	103.3	[3]	[3]	[3]	[3]	[3]
New York	[2] 112.2	[1] 63.9	[2] 117.8	[1] 63.7	[2] 154.1	[1] 80.4	[2] 188.3	[1] 106.2	[2] 182.1	[1] 101.6	[2] 190.5	[1] 103.7
Philadelphia	[2] 96.8	[1] 58.1	[2] 99.8	[1] 59.3	[2] 122.3	[1] 77.6	[2] 154.4	[1] 104.5	[2] 150.9	[1] 99.3	[2] 158.7	[1] 106.4
Pittsburgh	73.3	74.9	75.5	79.1	93.2	103.0	[3]	[3]	[3]	[3]	[2] 168.9	[1] 138.9
St. Louis	77.2	[1] 58.1	79.0	60.9	92.8	[1] 75.7	123.7	[1] 106.2	122.2	[1] 111.0	126.8	[1] 113.8
San Diego	68.4	75.6	72.9	73.8	87.8	88.5	109.4	104.2	98.1	116.5	[7] 97.3	[3]
San Francisco	[5]	76.1	87.8	77.8	104.7	97.6	[3]	118.3	105.2	149.0	[7] 118.5	[3]
Seattle	[2] 110.2	[2] 106.6	[2] 111.0	[2] 109.8	[2] 132.9	[2] 133.1	[2] 155.1	[2] 157.1	[2] 158.2	[2] 157.1	[2] 170.7	[2] 169.7
Washington, D.C	[2] 110.7	[2] 103.1	[2] 112.9	[2] 102.2	[2] 142.4	[2] 138.3	[2] 174.4	[2] 179.3	[2] 176.7	[2] 177.2	[2] 171.0	[1] 170.0
U.S. average	[8] 83.3	[9] 73.2	[10] 86.1	[10] 75.5	[11] 108.9	[12] 93.7	[13] 132.8	[13] 115.2	[14] 127.2	[15] 116.7	[16] 107.4	[17] 113.8

[1] Cans.
[2] Nonreturnables.
[3] Insufficient quotations to publish average price.
[4] 8 16-oz bottles.
[5] Prices not comparable throughout year.
[6] Bottles are 16 oz; all others are 12 oz.
[7] Price for 6 16-oz returnable bottles.
[8] Based on monthly price for a varying number of cities.
[9] Based on survey of 44 cities.
[10] Based on survey of 43 cities.
[11] Based on survey of 39 cities.
[12] Based on survey of 42 cities.
[13] Based on survey of 36 cities.
[14] Based on survey of 24 cities.
[15] Based on survey of 23 cities.
[16] Based on survey of 27 cities.
[17] Based on survey of 15 cities.

Note: If no container designation, price refers to soft drinks in returnables. U.S. average is the average price for a 72-oz carton weighted by the population of each city from a sample of 56 cities.

Source: "The Soft Drink Industry of the United States, Statistical Profile 1978," table 15, p. 15. U.S. Department of Labor, Bureau of Labor Statistics, Estimated Retail Food Prices by Cities, 1972–77.

More detailed examination of the pattern of soft drink prices requires direct study of local market areas, brands and stores—a fascinating, but extremely time-consuming task. A comprehensive list of the soft drink brands available in the Washington, D.C. market area as of June 1976 was attached to my testimony before the Subcommittee on Monopolies and Commercial Law of the Committee on the Judiciary, U.S. House of Representatives.[6] That survey showed a total of forty-three brands of cola-type drinks (regular and diet), thirty-two full-line brands of flavors and mixers, and twenty-five individual (not full-line) brands and flavors—a total of well over a hundred different products available. In addition, nine different package forms and sizes were represented. At that same time, a more detailed survey of product and price information was made for the smaller market area of Silver Spring, Maryland. This survey was conducted in four leading food chains, four smaller discount food stores, and four drug and convenience store chains. These outlets do not, of course, by any means include the full variety of locations and circumstances under which soft drinks were available within this single community. However, the results do provide a representative indication of the product and price variety available in a single local market.

Results of the brand and package survey are shown in Table 5. Pricing data were gathered in detail for cola-type drinks only, and all prices were converted to a price-per-ounce basis for purposes of analysis. Prices of cola-type drinks varied from a low of .8 cents per ounce to a high of 2.9 cents per ounce, depending on brand and package size. Very wide variations were shown even within individual brands, with Coca-Cola having both the lowest (1.3 cents) and the highest (2.9 cents) price per ounce of any of the major cola brands included. It is also notable that private label brands were not in all cases cheaper on a price-per-ounce basis than major brands.

TABLE 5.—SOFT DRINK BRAND AND PACKAGE SURVEY, SILVER SPRING, MD., AREA, JULY 1976

Store	Brands	Packages
Safeway	36	105
Giant Food	33	88
A & P	44	150
Grand Union	29	91
Pantry Pride	27	79
Jumbo	28	75
Consumer's Co-Op	31	90
Memco	30	85
Drug Fair	17	52
Dart Drug	20	46
People's Drug	18	47
7-Eleven	22	49

Evidence of the variability of retail soft drink prices is also provided by a recent "Inflation Watch Survey" conducted by the New York Daily News in fifty-four supermarkets in the New York/New Jersey metropolitan area. Prices for a six-pack of 12-ounce cans of Coca-Cola varied from $1.29 to $2.19, and the price of a case of twenty-four 12-ounce cans of Diet Pepsi varied from $4.75 to $7.96. Prices of a dozen 32-ounce bottles of Seven-Up ranged from $5.35 to $9.24. These variations of 60 to 70 percent from low to high retail prices for identical products within the same metropolitan market area strongly emphasize the role of the retail outlet in determining final consumer prices for this type of product.[7]

Similar results were obtained from a recent, more comprehensive survey of major types of soft drink outlets in both the New York and Washington, D.C. metropolitan areas. Major food stores were found to carry approximately forty different soft drink brands, with many different package sizes available within each brand. Price-per-ounce comparisons showed variations of as much as 100 percent from low to high on the same brand of merchandise within an individual store (i.e., price variations associated entirely with the form and size of the container). Store-to-store variations in the price of the same brand/pack item were also widely observed, although the range of variation was somewhat narrower. Interbrand price variations (price-per-ounce basis) were observed in all

[6] See footnote 2 supra, pp. 398–404.
[7] New York Daily News, Sunday, May 6, 1979, p. 7.

stores, and again the private label product was not always the cheapest in a price-per-ounce comparison.

Conclusion

My overall conclusion from inspection of a wide variety of available data on soft drink prices is that the range of product, package and price variety available to consumers of soft drinks is probably as great as that available on any moderately priced consumer good in the entire economy. As a result, it would appear that consumers have incredible range of choice of their soft drink purchases, and, hence, a wide range of competitive alternatives to which to respond. If consumers choose to pay higher (per ounce) prices for certain brands and packages when alternative similar products (and often the same brand in alternative packs) are available at considerably lower costs, it seems to me that we are observing the variety of consumer preferences under competitive market conditions rather than the effects of the territorial franchise system.

ALTERNATIVES TO THE TERRITORIAL FRANCHISE SYSTEM

The previous comments describe the essentially competitive structure and product-price performance of the soft drink bottling industry within the context of the territorial franchise system. The evidence on both of these counts strongly suggests that criticism of the franchise system as a significant departure from competitive market conditions is misplaced. The question remains, however, as to whether or not modification or elimination of the system as it now operates might bring about some significant strengthening of competitive forces for the benefit of consumers in the economy.

I am entirely convinced that elimination of the territorial franchise system in the soft drink industry would not result in any substantial benefit to consumers. It appears to me that summary elimination of the system as a result of court decisions or the action of administrative agencies would unquestionably lead to five significant developments:

1. Extensive vertical integration by the major-brand franchisors.
2. Backward integration by major chain stores.
3. Geographic market expansion by the largest and strongest established bottlers.
4. Disappearance of minor brands from the market.
5. Disappearance or substantial contraction of a large number of smaller, but currently viable and profitable, bottling firms throughout the country.

These expected developments are all, of course, strongly interrelated, and each feeds upon the others. However, let us consider each one briefly in turn.

Vertical integration by the major brand franchisors would seem almost inevitable, since they clearly have the resources to supply the product needs of the largest and most profitable customers served by any of their current franchisees. Whether the franchisors would choose to eliminate the franchisees entirely or simply permit them to survive, if possible, by serving the smaller and less profitable segment of the market is a secondary consideration. Undoubtedly, some bottlers would adapt and survive in an altered form, while some would simply disappear. In any event, the role of the franchisors in the bottling-canning and distribution phase of the industry would be substantially expanded, with a corresponding increase in the concentration of activity among very large economic units throughout the entire soft drink production and distribution system.

The position of chain stores in the production and distribution system for soft drinks would be substantially altered; and this alteration could take a number of different specific forms. Most obvious would be a backward integration into the bottling of franchised brands by the acquisition of bottling rights directly from the franchisors or the purchase of a small bottling franchise somewhere on the fringe of the chain store's market area. An alternative to franchise acquisition would, of course, be obtaining an extremely favorable sales contract from a weak bottler, to the advantage of the chain in terms of wider profit margins, but not necessarily to its customers in terms of lower prices. Finally, of course, if backward integration were prevented, the chains might respond to increased market power of the major brand franchisors and surviving large franchisees by placing greater emphasis on their own brand products, and even eliminating national brand items from their shelves altogether, as has been the pattern in fresh milk.

A third inevitable result of the elimination of territorial franchises would be horizontal geographic expansion of the largest bottlers, particularly their pursuit

of the largest and most profitable customers in market areas accessible from their existing locations. Again, the effect of this type of expansion would be either to greatly curtail the operations of surviving smaller bottlers or to eliminate them altogether. In either case, there is an additional tendency toward increasing concentration and greater market control by a smaller number of large units within the production and marketing system. (The notion that the returnable container territorial protection included in the FTC decision would in any way prevent this development is simply erroneous, as Professor Goldberg's statement points out.)

Finally, as a consequence of all of the above developments, one can anticipate with certainty the disappearance of minor brands and smaller firms. Indeed, it would appear that the only way for a small bottler to survive after the loss of major large accounts to his franchise supplier or neighboring large bottlers, or as a result of backward integration by major retailer-customers, would be for the firm to combine all conceivable major brand franchises into a single operation for production and distribution to small accounts. This result would also, of course, involve an increase in concentration since it would mean that the supply of surviving brands to small outlets would be entirely in the hands of a single bottler-distributor.

It is evident that each of these trends individually, and all of them taken together, point in the direction of increased concentration and declining product and price variety for soft drinks. These developments may also carry with them some implications for increasing costs, since larger territories inevitably increase transportation costs and also involve an extension of one-way packages, which are the most expensive forms of soft drink packaging. When these potential sources of cost increases are added to the possibilities of price increases due to increased concentration and bargaining power, there seems little reason to expect that competitive market forces would be strengthened, and certainly no reason to think that significantly lower final consumer prices would result. I cannot understand how anyone would view such a pattern of increased concentration and reduced variety, with no clear indication of lower prices, as a favorable development from the viewpoint of consumer welfare. Indeed, it seems bizarre that attempted enforcement of the antitrust laws would push an industry in this particular direction. Hence, it seems to me that the economic implications and legal validity of the specific types of franchise arrangements long utilized in the soft drink industry should be examined, if at all, on a case-by-case basis to determine the strength of competition in specific market areas, the net effects of existing franchise arrangements, and the likely impact of any feasible alternatives. This principle is precisely embodied in the piece of legislation before your Committee, and I am pleased to have this opportunity to endorse it as strongly as possible.

PREPARED STATEMENT OF OLIVER E. WILLLIAMSON

QUALIFICATIONS

I am a member of the faculty of the University of Pennsylvania, where I hold the title of Charles and William L. Day Professor of Economics and Social Science. My primary departmental affiliation is in the Economics Department. I hold secondary appointments in the Law School, the School of Public and Urban Policy, and in the Decision Sciences Department of the Wharton School. I hold an S.B. degree from MIT, an MBA from Stanford, and a Ph. D. in economics from Carnegie-Mellon University. My teaching and research have been mainly concerned with the theory of the firm and with market organization. I am the author of three books and approximately fifty articles. (A complete biographical statement is attached as Appendix A.)

I served as Special Economic Assistant to the Head of the Antitrust Division in 1967–68 and thereafter served as a consultant to the Antitrust Division of the U.S. Department of Justice. I am presently serving in the capacity of a consultant to the Federal Trade Commission. I appeared on a panel last fall before the National Commission for the Review of Antitrust Laws and Procedures in connection with its concern with persistent monopoly. I have been a consultant to various private firms and law firms. I am here today at the request of the National Soft Drink Association.

My expertise is limited to the evaluation of vertical market restrictions in general. Others with more extensive industry-specific background are better qualified to speak to the applications of the analysis to the soft drink industry than I. My remarks are based in large part on a paper that I presented at a Conference on Antitrust Law and Economics that was held at the University of Pennsylvania in November 1978. The paper, which is entitled "Assessing Vertical Market Restrictions: Antitrust Ramifications of the Transaction Cost Approach," appears in the April 1979 issue of the University of Pennsylvania Law Review.

My remarks are organized in three parts. First I examine the inhospitability tradition within antitrust, especially as this approach relates to the evaluation of vertical restrictions. I then turn to an alternate approach, the transaction cost approach, in which efficiency aspects are more prominently featured. While I argue that the inhospitability tradition relies on mistaken premises and that an efficiency presumption is a better guide to sound public policy, the efficiency presumption is subject to challenge in both dominant firm and collusive oligopoly industries. The third part of my remarks elaborates on these qualifications and relates them to S. 598.

THE INHOSPITABILITY TRADITION

The inhospitability approach to antitrust attributes anticompetitive purpose and effect to every novel or nonstandard business practice. Under this aproach there are only two standard, hence applicable, ways of organizing transactions. One of these, which is the "preferred" way, is to rely extensively on market exchange between successive stages of production and distribution. Each successive stage of economic activity is mediated by a contract between autonomous firms on each side of the transaction. A flow of goods and services from raw materials through intermediate product to distribution channels and into the hands of consumers occurs in this way. Autonomous contracting thus proliferates.

An alternative, but generally less acceptable way to organize economic activity, is by vertical integration. Transactions that might be mediated by markets are here mediated instead by administrative processes (internal organization). Although the inhospitability tradition recognizes that certain economies sometimes result from vertical integration, it is very implict about the nature of these economies. Market mediated exchange is thus favored.

Modes of organization that fall between fully autonomous contracting on the one hand and complete integration on the other are regarded with hostility. In particular, vertical market restrictions of all kinds—including territorial restrictions—are held to be motivated by anticompetitive purpose. The ultimate justification for this view is that markets will support all legitimate services that consumers demand. Any service that the market will support must, perforce, lack legitimacy. Dr. Comanor's views on vertical restraints are illustrative:[1]

"To the extent that services are demanded by consumers, a market will develop to supply them and a separate price will be charged. To the extent, moreover, that manufacturers have a legitimate interest in having them provided, they should be forced to bear the cost. In either case, no vertically imposed restrictions are required."

The government's arguments in *United States* v. *Arnold, Schwinn & Co.*[2] reflected such views. The Supreme Court's recent decision in *Continental T.V., Inc.* v. *GTE Sylvania Inc.*[3] effectively rejects such arguments.

THE TRANSACTION APPROACH

Reduced to its rudiments, the inhospitability tradition relies on an assumption of frictionlessness in the operation and organization of markets. Every legitimate economic activity can be organized and priced separately without incurring significant costs. The transaction cost approach, by contrast, recognizes that autonomous contracting can be a costly activity and that, except as special restraints are introduced, market modes of organization can malfunction and will sometimes break down altogether.

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[1] William S. Comanor, "Vertical Territorial and Customs Restrictions: White Motor and Its Aftermath," 81 Harvard Law Review 1419, 1427 (1958).
[2] 388 U.S. 365 (1967).
[3] 433 U.S. 36 (1977).

Two problems with autonomous contracting are essentially of two kinds. First, just as product variety and complexity are costly, so is contractual variety and complexity. Whether valued services can be delivered in the discriminating way contemplated by Dr. Comanor thus depends on the costliness of writing and negotiating comprehensive contracts. Secondly, even if comprehensive contracting were attempted, contracts are not self-enforcing. If there are incentives for the parties to cheat, policing costs must be incurred. In consideration of such difficulties, comprehensive contracting is sometimes supplanted by alternative means of organization. Vertical integration is largely explained as a means by which to economize on complex contracting costs. The same is true of intermediate forms of organization such as franchising whereby franchisors introduce marketing restraints on franchisees.

The transaction cost approach thus proceeds from very different premises than does the inhospitability tradition. Rather than assume that anticompetitive purposes lie behind and anticompetitive effects will accure to nonstandard business practices, it assumes instead that new modes of organization reflect an effort to economize on transaction costs. Organizing a transaction this way rather than that is thus presumed to have the purpose of promoting efficiency, and hence benefits society, rather than fostering monopoly.

The principal reason for maintaining an efficiency presumption is that this presumption better accords with reality. Not only are transaction costs real, but efforts to economize on them explain a good deal of economic activity within the enterprise system. Furthermore, monopoly hazards appear only if special structural preconditions are satisfied. The inhospitability tradition ran roughshod over transaction costs and made no effort to delimit the circumstances where monopoly hazards were serious. Maintaining an inhospitability attitude thus encouraged the enforcement agencies to behave in a counterfactual way and interpret innocent and beneficial developments in a suspect and even hostile manner.

Thus consider territorial restrictions. The inhospitability view is that territorial restrictions discourage intrabrand competition and thus must have antisocial consequences. The possibility that there might be economies is not even considered, and the possibility that interbrand competition is doing an effective job is held to be irrelevant. By contrast, the transaction cost approach (which intensifies a line of argument developed in earlier studies of these matters—by Professors Telser, Preston, Bork, and Posner, among others)[4] recognizes that such restraints may be essential to the viability of the franchise system and regards economical modes of distribution as a valued social outcome.[5]

Absent territorial restrictions, adjacent franchisees have the incentive to poach on (take a "free ride" upon) the promotional and service efforts of one another. Out of recognition of this, each lacks the incentive to develop his territory as fully as he otherwise would. On this account, manufacturers will be less attracted to the franchising mode or organization. Even though vertical integration weakens the profit incentives of distributors, the producer may integrate forward into distribution anyway—since the disincentives of poaching are thereby avoided.

It is no answer, moreover, to observe that manufacturers will frequently forego forward integration when vertical restraints are disallowed. The critical issue is whether valued promotional activities are reduced or misdirected as a result of the breakdown of territorial integrity. As this occurs, marginal franchisees will predictably fail. And those which survive will function less effectively.

Realization that marketing effectivenes can be contingent on vertical restraints is thus crucial to an accurate assessment of "nonstandard" modes for organizing markets. Once the relevant transaction cost features are recognized, it becomes clear that what others have characterized as arbitrary or even antisocial restrictions can and aften do serve a useful social purpose. Accordingly,

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[4] Lester Telser, "Abusive Trade Practices: An Economic Analysis." 30 Law and Contemporary Problems 488 (1965); Lee Preston, "Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards," 30 Law and Contemporary Problems, 506 (1965); Richard Posner, 'The Rule of Reason and the Economic Approach: Reflections on the *Sylvania* Decision," 45 University of Chicago Law Review, 1 (1977); Robert Bork, The Antitrust Paradox: A Policy at War With Itself (1978).

[5] By economical modes of distribution I have reference to both local processing as well as physical distribution stages of activity.

the choice between alternative modes or organization ought not to be artificially foreshortened to polar outcomes—either pure firm (vertical integration) or pure market (unrestrained autonomous contracting). To the contrary, mixed modes and their transaction cost properties need to be considered. In the degree to which (1) franchising is more viable when accompanied by vertical restraints and (2) such franchising offers the least cost mode of delivery, there are clear social benefits in permitting such restraints. Whether these benefits are offset by clear social costs, however, must also be considered. Thus, although an efficiency presumption reflects central tendencies, it is also subject to challenge. This brings us to the question of whether interbrand competition is effective.

INTERBRAND COMPETITION

The presumption that territorial restraints have the purpose of promoting more cost-effective marketing is subject to challenge in industries where interbrand competition is weak. Where this obtains, the possibility must be faced that vertical restraints have the purpose of regularizing distribution, thereby to promote more effective oligopolistic pricing.

Thus a crucial operating concern of a manufacturer's cartel is to devise signals whereby adherence to the cartel pricing policy can be inferred with confidence. The elimination of false moves or ambiguous actions which, if misinterpreted, would cause the cartel to unravel, is of special importance. Where distributors are owned or extensively controlled by manufacturers, retail price changes can normally be presumed to reflect manufacturers' intent. By contrast, the responsibility for pricing changes is less clear where distributors are fully autonomous agents. The possibility that territorial restraints serve other than efficiency purposes but promote pricing discipline must thus be faced in industries where interbrand competition is ineffective.

The qualification of S. 598 which stipulates that vertical restraints in the soft drink industry shall be lawful provided that "such product is in substantial and effective competition with other products of the same general class" is thus not only fitting but is an essential safeguard. Checks on effective interbrand competition need to be made and be met.

CURRICULUM VITAE—OLIVER E. WILLIAMSON

PLACE AND DATE OF BIRTH

Superior, Wisconsin; September 27, 1932.

MARITAL STATUS

Married to Dolores Celeni Williamson; 5 children.

EDUCATION

S.B., M.I.T., 1955. MBA, Stanford University, 1960. Ph.D., Carnegie-Mellon University (Economics), 1963.

EMPLOYMENT

Nonacademic

Project Engineer, U.S. Government, 1955–58.

Industrial Economist, Stanford Research Institute, Summer 1959.

Operations Analyst, Stanford Research Institute, Summer 1960.

Consultant to the RAND Corporation, 1964–66.

Special Economic Assistant to the Assistant Attorney General for Antitrust, U.S. Department of Justice, 1966–67.

Consultant to the U.S. Department of Justice, 1967–69.

Economic Consultant, Mayor's Advisory Task Force on CATV and Telecommunications (New York City), 1967–68.

Director, Media Networks, Inc. (600 Third Avenue, New York), 1973–77.

Member, Defense Science Board, U.S. Department of Defense, 1975–76.

Consultant, National Science Foundation, 1976–77.

Panel Member, Food Safety Regulation and Societal Impact, National Academy of Sciences, 1978–.

Consultant, Federal Trade Commission, 1978–.

University

University of California, Berkeley, Assistant Professor of Economics, 1963–65. University of Warwick (England), Visiting Professor, Spring Term, 1973. University of Pennsylvania: Associate Professor of Economics, 1965–68. Professor of Economics, 1968–. Chairperson, Department of Economics, 1971–72, 1976–77. Professor of Economics, Law and Public Policy, 1974–. Charles and William Day Professor of Economics and Social Science, 1977–. Director, Fels Center of Government, 1975–76. Director, Center for the Study of Organizational Innovation, 1976–.

PUBLICATIONS

Books

The Economics of Discretionary Behavior: Managerial Objectives in a Theory of the Firm, Prentice-Hall, Englewood Cliffs, N.J., 1964; reprinted by Markham Publishing Co., Chicago, Ill., 1967; reprinted by Eurospan Ltd., 1974; Chapter 4 is reprinted in *Readings in Industrial Economics; Theoretical Foundations* (C. K. Rowley, ed.) London, 1971.

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"Economies as an Antitrust Defense Revisited," *University of Pennsylvania Law Review*, April 1977, *125*, 699–736; reprinted in *Corporate Practice Commentator;* also reprinted in A. P. Jacquemin and H. W. Jong (eds.), *Welfare Aspects of Industrial Markets*, Leiden, The Netherlands, 1977, 237–271.

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Ward D. Bowman, "Patent and Antitrust Law," reviewed in *Yale Law Journal*, January 1974, *83*, 647–661.

Kenneth J. Arrow, "The Limits of Organization," reviewed in *Journal of Business*, January 1975, *48*, 452–54.

Peter O. Steiner, "Mergers: Motives, Effects, Policies," reviewed in *Journal of Economic Literature*, June 1976, *14*, 506–508.

Harold F. Williamson, ed., "Evolution of International Management Structures," reviewed in *The Business History Review*, Winter 1975, *49*, 111–12.

J. M. Montias, "The Structure of Economic Systems," reviewed in the *Bell Journal of Economics*, Autumn 1977, *8*, 620–623.

Robert H. Bork, "The Antitrust Paradox: A Policy at War with Itself," Reviewed in *University of Chicago Law Review*, 1979.

HONORS AND AWARDS

University Honors Fellowship, 1958–60, Sanford University.

Ford Foundation Fellowship, 1960–62, Carnegie Institute of Technology.

Alexander Henderson Award for Excellence in Economic Theory, 1962, Carnegie Institute of Technology.

Social Science Research Council Dissertation Fellowship, 1962–63, Carnegie Institute of Technology (declined).

Ford Foundation Dissertation Fellowship, 1962–63, Carnegie Institute of Technology.

1963 Award Winner, Ford Foundation Dissertation Competition.

Senior Fellow, Brookings Institution, 1967–71.

National Science Foundation Research Support, 1964–68, 1972–76.

Fellow, Econometrics Society, 1977–.
Fellow, Center for Advanced Study in the Behavioral Sciences, 1977–78.
Guggenheim Fellow, 1977–78.

EDITORIAL BOARDS

Administrative Science Quarterly, 1968–72.
Bobbs-Merrill Economics Reprint Series, 1969–.
Associate Editor, *Bell Journal of Economics and Management Science*, 1973–74, 1977–78.
Editor, Co-editor, *Bell Journal of Economics*, 1974–77, 1979–.
Journal of Economic Behavior and Organization, 1979–.

TEACHING EXPERIENCE

Carnegie Institute of Technology (as a graduate student) : Economic Principles. Behavioral Theory of the Firm (graduate seminar taught jointly with R. M. Cyert).

University of California, Berkeley (as Assistant Professor of Economics : Intermediate Economic Theory (Micro and Macro). Industrial Organization (both semesters of the undergraduate industrial organization sequence). The Economics of Public Services (graduate seminar).

University of Pennsylvania (Associate Professor, Professor) : Introductory Economics. Competition, Monopoly, and Public Policy. Industrial Organization (graduate course and graduate seminar). The Economics of Public Services (graduate seminar). Price and Distribution Theory (graduate course). Theories of Institutions (graduate course and seminar). Industrial Organization Workshop. Organizational Analysis (two semester graduate course). Organizations Workshop. Antitrust Economics (Law School).

RESPONSE TO SENATOR THURMOND'S WRITTEN QUESTION BY VICTOR P. GOLDBERG

Question. Are territorial franchise systems resulting in the preservation of large numbers of small and inefficient soft drink plants and operations?

Answer. As I suggested in my prepared statement, efficiency depends upon the context. Inefficiency should not be confused with incompetence. A well-managed firm designed to perform in a world of exclusive territories can be very capable in such a world, yet still be a high cost, inefficient competitor in a walls down world. Likewise, a firm that would do well in walls down competition might fail if exclusive territories were imposed.

In answering your question I think it is useful to pose a different one: why would the Coca-Cola Company want to use an inefficient (high cost) method of production and distribution if a better one were available? The answer, I believe, is clear: they would not. Their incentives are to find the best system available.

It is, as I have noted, probably true that if Coke were designing a territorial system from scratch today it would use different territorial boundaries than those in existence today. But that observation is simply a manifestation of a general truth in economics. Past investments determine the relative costs of current investment alternatives. Given the existence of the territories and the installed plant, Coke finds that immediate scrapping of existing plant (and business relationships built over time) will be too expensive. Indeed, it has the incentive to take these costs into account and phase the scrapping in a sensible way. The tremendous shrinkage in the number of bottlers in the last thirty years is evidence that the industry has been adjusting to changed circumstances. One cannot tell whether the rate of adjustment is "optimal," but the parties have appropriate incentives.

One further point is in order. Some of the syrup manufacturers are already active in bottling, with exclusive territories that created no problem. The syrup manufacturer wouldn't take advantage of the bottlers efforts in the market. But in a walls down world the syrup manufacturer becomes a competitor of the bottler creating numerous difficulties. These difficulties can be resolved, but the resolution is costly. (Complete vertical integration is one plausible form of resolution.) If it is true, as I believe it is, that the devices for coping with this problem will result in increased costs, then we must reckon these higher costs as one of the inefficiencies stemming from the remedy.

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In sum, I must repeat the basic theme of my prepared remarks: the effects of territorial restrictions on intrabrand competition will generally be desirable; we can usually count on the self-interest of the involved parties, and we should not expect that outsiders with a casual knowledge of the industry could improve upon their decision.

PREPARED STATEMENT OF VICTOR P. GOLDBERG

I am Professor of Economics at the University of California, Davis. I am currently on leave, spending the year as a Member of the Institute for Advanced Study in Princeton, New Jersey. I received my undergraduate degree in economics from Oberlin College and my M.A. and Ph. D degrees from Yale University. I began teaching at Davis in 1967. I spent the 1975–76 academic year as a Visiting Fellow at the Public Choice Center at Virginia Polytechnic Institute and State University; I have taught for one semester (Spring 1977) at the Law School of the University of California, Berkeley. I am the author of over thirty publications—articles, monographs, and book reviews—many of them in the area of industrial organization and law and economics. I have been teaching antitrust in the economics graduate program for ten years; in addition, in my visit to Berkeley I taught the Antitrust Law course. I appear here today at the request of the National Soft Drink Association.

I. INTRODUCTION

Professor Williamson's testimony has described the recent advances in our understanding of the economics of vertical restrictions. I will consider the specific issue of territorial exclusivity in soft drink bottling and the misunderstanding of the issue evidenced in the FTC's *Coca-Cola* decision.[1] Economic analysis typically focuses on behavior in impersonal markets and ignores other devices for organizing production and exchange. While this is only a matter of analytical convenience, there is a temptation (to which many economists and non-economists succumb) to treat the impersonal market as the ideal and the other devices as unfortunate interferences in the workings of the market mechanism. Over four decades ago, Ronald Coase[2] pointed out the absurdity of this position, noting that the business firm itself was an alternative to the market; many transactions are organized within the firm rather than across markets because, on net, the market mechanism is less efficient. Interference with impersonal market forces, whether in the form of complete vertical integration or integration by contract as in the bottling context, should not be viewed as an aberration. The standard analytic framework is simply not designed to illuminate such problems. We must, as Professor Williamson suggests, go to a richer analytical framework if we are to understand such things as exclusive territories.

There are two central messages of this approach. First, vertical restrictions have many more desirable features than have generally been recognized. Second, it is extremely difficult for an outsider to determine what the "best" contract would look like. As a general rule of thumb it would seem reasonable to presume that, in the absence of strong reasons to the contrary, the choice of contractual terms should be left to the immediate parties. I also want to develop a further point: Many of the grounds that have been advanced for opposing vertical restrictions reflect a concern for protecting franchisees from the threat of termination; oblique pursuit of this goal has resulted in much confusion in the case law. Proper consideration of this matter in the bottling context reinforces the point that, unless there are serious adverse effects on interbrand competition, public policy ought not to force this industry to undergo a painful and costly restructuring.

II. EFFICIENCY

In this section I want to first analyze the FTC's arguments rejecting Coca-Cola's justification of the exclusive territories. Then I will discuss the Commission's argument that the system's adjustment to changing circumstances has been inadequate.

A. FTC rejection of Coca-Cola's justification

Coca-Cola presented four justifications of their restriction on intrabrand competition: (1) it protects capital investment by bottlers; (2) it facilitates market

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[1] In the Matter of the Coca-Cola Company, et al., Docket No. 8855 (1978).
[2] Ronald Coase, "The Nature of the Firm," Economica, n.s. 4 (November 1937), 386–405.

penetration; (3) it encourages advertising and promotion at the local level; and (4) it facilitates quality control. The Commission dismissed them all. I shall consider these arguments in turn.

1. Capital Investment.—The Commission argued (pp. 28–29):

"The fact that the risks which attend a bottler's efforts to recover his investment would increase without territorial intrabrand monopoly protection is simply a corollary to the conclusion that as competition intensifies, business risks of capital recovery increase to the entrepreneur.

"Shielded by artificial trade barriers created by The Coca-Cola Co., bottlers may well feel secure in making investments which might seem unwise to them if their decisions were being fashioned by free market demands; but this is further evidence of the significant degree to which competition may be lessened by these restraints."

This argument embodies a fundamental misconception of how a reasonably competitive economy works. The bottler is contemplating making an investment in plant and equipment with few alternative uses. He will, as a matter of course, try to devise the contract to control the risks that the investment cannot be used for its intended purpose—bottling and distributing soft drinks. In an analogous situation the producer of a custom-made machine might be worried that the buyer will cancel his order before the machine is finished, leaving him with a useless piece of partially completed machinery. The seller can reduce this risk by using a number of devices—for example, by including a liquidated damages clause in the contract.

Protection of reliance is routine. The need (or demand) for protection is greatest where the difference between the investment's value in its intended use and its best alternative use is substantial. Since protecting reliance is not costless, we cannot be sure that the parties would choose to provide for it even where the demand were considerable. Nor can we confidently predict which devices would be employed. We can, however, say that investment in a bottling plant, trucks, and an inventory of bottles does give the bottler a considerable reliance interest to protect and that the exclusive territories do help in protecting this reliance.

2. Market Penetration.—Most of the soft drink bottlers utilize a route delivery system which is designed to get their product to a large number of retail outlets. About 60% of the sales are to food stores, with about a third of that total being sold to chain stores. A large number of small accounts, serviced by the same trucks that serve the food chain stores, account for a considerable share of soft drink sales. The bottlers employ a "level pricing policy" charging customers in their territory the same price irrespective of the costs of serving that customer.

The Commission argues that this arrangement entails subsidization of the high cost customers by the low cost ones (chain store customers).[3] This is quite probably true, but not of great importance. To some extent, sales of a single brand from different outlets in the same territory are not substitutes, but complements. That is, if a person has a bottle of Coke in a beauty parlor, that "paid sampling"[4] might stimulate the purchase of a carton in a food store. (The territorial exclusivity facilitates the bottler's recapture of the rewards from this form of promotion; I will elaborate on this point below.) Further, if the level of subsidization were signficant, then interbrand empetition from local brands, in-house brands, and brands selling primarily through chain stores (like Shasta) would skim off the cream.

The bottlers claim that if the exclusive territories were eliminated, chain stores would no longer utilize direct delivery to the stores. Rather, chains would have soft drinks delivered to their own warehouses from which they would then distribute to their own retail stores. The Commission accepted this scenario, but argued that such a shift would be efficient—exclusive territories prevent adjustment to a system yielding lower wholesale and, therefore, lower retail costs. This conclusion is almost certainly wrong.

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[3] The Commission presents another argument which I find extremely puzzling. "The record does not indicate whether the Coca-Cola Company consistently sells syrup unprofitably to some of its bottlers as its bottlers sell unprofitably to a large number of accounts presumably to create a demand for Coca-Cola; but it would not be second-guessing the bottlers' business judgments to observe that The Coca-Cola Company may be 'free riding' on the volume generated by its independent bottlers' give-aways and unprofitable sales." (p. 30). I find this quite mystifying. It does seem to imply that the monopolist is selling "too much" syrup; this is rather odd since the customary complaint in antitrust is that the producer is selling "too little."

[4] "Paid sampling" refers to the common industry practice of making soft drinks available in certain low volume, low profit accounts at the same prices as at large stores. Customers who try the soft drinks at these accounts may thereby become regular customers.

Let us assume what both sides accept to be true: the initial effect of "walls down" [5] competition would be price competition and lower prices for the large chain accounts.[6] This would mean that in many regions route delivery systems will lose a significant piece of their volume. The remaining volume will have to be spread over fewer sales. Cost per unit will, therefore, rise. Thus, the relative wholesale price of soft drinks sold through non-chain store outlets will rise relative to that in chain stores.

The story is not yet complete, but let us pause to examine the implications thus far. The change in relative prices will alter the mix of sales—a larger share of soft drinks will be sold through chain stores. We cannot be certain as to what will happen to the average price paid, nor to the quantity sold—even if we assume no loss in promotional effort. The lower chain store price could be more than offset by the higher prices elsewhere.

There will, however, be additional effects on promotional effort. I will discuss the matter in more detail below, but at this stage of the argument one simple point can be made. With the bottler no longer supplying the individual chain outlets, the intensive local selling effort will no longer be provided. The response to this situation is uncertain; the most plausible, I believe, is for the syrup manufacturers to substitute regional and national advertising for the local services formerly provided by the bottlers. The cost of this will be reflected in the price of syrup sold to bottlers and this in turn will have an upward pressure on wholesale prices in the industry. It is conceivable that the wholesale prices would rise to the point where the cost to chain stores returns to (or even exceeds) its initial level. This is not, I must emphasize, a prediction. It is simply a stark example of how misleading the initial observation of lower prices to chain warehouses can be when assessing the merits of the alternative distribution systems.

The Commission's remedy provided an exception for refillable bottles. The preceding discussion suggests the futility of this gesture. It is generally agreed that central warehousing is incompatible with returnable bottles. Without the chain volume, returnables will face a higher unit cost. While bottlers can alter their business to contain these costs by altering routes, consolidating territories, and spreading common costs over more brands, it is difficult to believe that returnables could survive in most markets. There is certainly no factual basis in the record of the case for the Commission's claim that such a system would be viable.

3. Advertising and Promotion.—Exclusive territories enable the bottlers to cope with the "free rider" problem. The bottler invests in promoting the brand's good will and, as in the case of investment in physical capital, desires some assurance that he will receive the returns from that investment. If other bottlers are free to capture the gains from the initial bottler's promotional activities, the rewards to such activity are drastically reduced. Each bottler has the incentive to free ride on the other's activities. Everyone wants to let George do it, but no one wants to be George. The result is that the local bottler's promotional efforts will be skewed towards those activities in which it is most able to capture the gains (for example, promoting the bottler's image rather than the brand's); activities in which it is virtually impossible to exclude free riders—like paid sampling—will disappear. An exclusive territories system enables the bottlers to engage in more local promotional activity and it also influences the relative attractiveness of alternative promotional techniques.

The Commission briefly recognizes the existence of the free rider problem. The Commission's discussion of local advertising is confusing and opaque. It appears that the Commission is concerned with determining when increased local promotion should be reckoned as a desirable feature of a vertical restriction. The Commission's answer seems to be that the justifications are few. Encouraging price advertising is acceptable; enhancing other forms of advertising is acceptable only for new or faltering firms.

These criteria reflect a skeptical attitude regarding the merits to society of extensive promotional activity. I confess that, to some degree, I share this skepticism. But it does not follow that society should therefore come down

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[5] "Walls down" refers to the state of competition which would exist if the territories were eliminated, i.e., walls down.

[6] Industry members argued that there was no evidence that the lower wholesale prices would be passed on to the customers in the form of lower retail prices. I do not find their arguments convincing; my point is quite different.

hard upon vertical restrictions that facilitate local promotional activity. It is not at all clear what the effect of abolishing territories will be on the overall level of promotional activity. The most likely industry response would be a shift to increased advertising by the syrup manufacturers at the national and regional level; cooperative advertising with certain retailers (especially the larger food chains) is also plausible. There is no reason to believe that there will be less money spent on advertising and other promotional activity. About all we can be certain of is that the industry perceives the existing mix of promotional activities as a more effective one than that which would exist in the absence of territories.

4. Quality Control.—The FTC concluded that local quality monitoring could be accomplished easily by requiring bottlers to place an identifing mark on their bottles and modified the remedy accordingly. If soft drink quality depended only on the manufacturing process this might be a reasonably effective device. However, quality depends on the distribution process as well. A properly manufactured beverage can deteriorate if the retailer allows it to sit too long on the shelf. Thus, even if the quality of the manufactured beverage remained unchanged after the abolition of exclusive territories, it is still plausible that the quality of the beverage at the point of consumption would decline. The local bottler has less incentive to control the quality by rapid rotation of stock and the costs to him of doing so are likely to rise. This is especially so for soft drinks sold to chain store warehouses since the bottler will no longer be responsible for rotating stock in the retail outlets. To be sure, the chain store will have some incentive to engage in this activity, but its motivation is less han that of a bottler with an exclusive territory.

The Commission's decision gives little indication of an appreciation of the nature of the problem of controlling quality at the distribution level. Indeed, most of their treatment of the issue consists of a discussion of how the FTC dealt with the issue in *Coors*.[7] But the appellate court upheld the FTC with great reluctance in the decision only because it felt bound by the *Schwinn per se* rule; had the rule of reason standard then been available, the decision would have been reversed.[8]

It is difficult for an outsider to determine how serious the quality control problem is. The record does suggest that quality deteriorates after a fairly short period of time, making this a potentially serious problem. There are good reasons to expect that if the FTC's decision is upheld the incentive structures of the parties would be altered in a way that would adversely influence quality. Further, there is no reason to believe that the FTC's alternative would be effective. Again, absent strong reasons to the contrary, it would seem reasonable to leave this issue to the parties involved.

B. Adjusting the bottling territories

The initial Coca-Cola territories are based on how far a horse and wagon could go in a day. The FTC argued that despite the tremendous changes in the transportation network, production, packaging, and marketing the territorial system "stands impervious to natural market evolution." (P 23). The facts, however, are quite different. The number of bottling plants in the United States has fallen from 6907 in 1949 to 4519 in 1960 and 2083 in 1978. Output per plant rose over 70 percent between 1960 and 1978. Territorial consolidations, agency relationships, and contract canning have all been used to facilitate adjustment.

It is quite probably true that if Coke were designing a territorial system from scratch today it would choose somewhat different territorial boundaries. But we must treat this observation carefully. It is equally true that if one were to build, say, a copper wire plant today he would use a somewhat different technology than a firm expanding a plant that had existed for some time. Past investments determine the relative cost of current investment alternatives. It will generally be cheaper to add on to an existing structure than to tear it down and build a brand new state-of-the-art plant. The firm must determine at what point it is in its financial interest to scrap an out-of-date plant. Coke is in precisely the same position regarding its territorial system. It has the appropriate incentives to take into account the costs and benefits of scrapping pieces of the existing territorial system. There is no reason to expect, and good reason to doubt, that public policymakers can weigh costs and benefits of changing territorial boundaries as well as the Coca-Cola Company.

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[7] *Adolph Coors Company* v. *FTC*, 497 F.2d 1178 (1974).
[8] At page 1187.

III. FRANCHISEE PROTECTION

The antitrust treatment of vertical restrictions has been concerned with protecting certain interests of franchisees, although it has not always been clear how those interests were to be identified. The primary concerns are, I would suggest, the unequal power of the franchisee after he enters into the relationship and the vulnerability of the franchisee's investments made in reliance on the continuation of the franchise relationship.[9] The courts have often discussed these issues under such rubrics as "business independence" and "freedom of opportunity", but this has been misleading. The freedom and independence are means to a further end, not a final goal. By treating them as if they were final goals and by answering certain questions—independence in what dimensions; whose freedom and opportunity—the courts have created a confusing pattern of decisions.

If we phrase the question correctly, it seems quite clear that in the bottling context the existing franchise arrangements provide ample protection on these franchisee interests. Coke and Pepsi both grant perpetual franchises; it is extremely difficult for these firms to terminate a bottler or to even make a credible threat of termination. The other syrup makers generally utilize shorter contracts (one to three years with annual renewals), but in practice their bottlers have been about as secure as the Coke and Pepsi bottlers. There is, in short, no ground for attacking the existing system on behalf of the franchisees. In fact, since the legal status of the contracts is unclear if so central a term as the territorial exclusive is voided, it is the remedy which increases the bottlers' vulnerability to the termination threat.

Moreover, the uncompensated dismantling of the exclusive territory system subjects a number of the bottlers to substantial reliance losses. The business they have built up is not well designed to compete in a "walls down" world. This is not an argument in favor of protecting inefficient firms. A firm that is designed to produce and market within an exclusive territory can be efficient for that purpose, yet be a high cost ineffective competitor if the territorial system were voided. Efficiency is contextual. (In biology, by analogy, polar bears are efficient in the Arctic, but not in Alabama). Those bottlers not well-situated to compete for chain store warehouse accounts are likely to suffer severe losses; their survival itself is problematic. To be sure, such losses are not uncommon in a capitalist economic system; we cannot protect everyone from the cold realities of the market place. But in the current context we should bear in mind that the source of these concentrated losses is the FTC ruling. Absent a strong showing that the decision will have desirable effects, it is hard to justify subjecting this subgroup of bottlers to significant losses.

It would seem, therefore, that the franchisee protection interests that have often been invoked in the antitrust decisions cut the other way in this instance. The FTC, not the franchisor, poses the threat. A proper consideration of this issue makes the FTC decision appear even less attractive.

IV. CONCLUDING REMARKS

The foregoing remarks establish that there is little reason to be concerned with intrabrand competition and that the FTC opinion, which focused almost exclusively on intrabrand effects, was misinformed.

My understanding is that the proposed legislation holds that the effects of territorial restrictions in bottler franchises on intrabrand competition should not be grounds for finding an agreement in violation of the antitrust laws; it does not shield the industry from attack on the grounds that interbrand competition is impaired. The legislation directs the attention of the enforcement agencies in the proper direction and is, I believe, a reasonable and modest addition to the antitrust laws.

Senator BAYH. The next and last witness here this morning is Professor Ernest Gellhorn, University of Washington School of Law, Bellevue, Wash.

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[9] This point is made clear in Frankfurter's discussion of his *Standard Stations* decision in his dissent in *FTC* v. *Motion Picture Advertising Service Co.*, 344 U.S. 392 (1953). Franchisee vulnerability has been a particularly important concern in the cases regarding oil companies and their dealers.

TESTIMONY OF ERNEST GELLHORN, UNIVERSITY OF WASHINGTON SCHOOL OF LAW, BELLEVUE, WASH.

Mr. GELLHORN. Thank you very much, Mr. Chairman. I am dean and professor of law at the University of Washington Law School. I testified before this committee 12 years ago on a similar subject regarding legislation seeking to reach an opposite conclusion from S. 598. I think my testimony is identical in both instances.

Twelve years ago there was a proposal before this subcommittee that there be a dealer good faith termination provision in the law which would prohibit a manufacturer from terminating a dealer, except on good faith. I suggested that upon analysis it was not a desirable piece of legislation, that the parties ought to be permitted within the law to reach their own contractual arrangements, to seek the best that they thought would serve their own interests, and as a consequence, those of consumers.

It seems to me we have the same question presented today. I will take the identical position, that it is undesirable for the law to intervene and to prevent the parties from reaching that accommodation which they believe will serve them the best.

In this instance, it would be to say to the Federal Trade Commission or the Department of Justice or the private plaintiffs that as long as there is competition in the marketplace, there is no reason to interfere and to intervene, to raise the price of contracting, to raise the price of dealing with each other. We should, instead, allow the parties to decide how they can best serve each consumer.

The focus of my remarks and of my prepared statement, which I will not repeat, is really what has happened in the legal area as to suggest the reason for this legislation.

We have had violent swings and fluctuations in the last 20 to 25 years in this area. It is for that reason that it looks as if legislation may now be a desirable and sensible route.

Prior to 1948, the general rule and understanding of the case law was that nonprice vertical restrictions would be permitted under the antitrust laws under what is called a rule of reason analysis. That is, they would be permitted where the benefits outweighed the possible detriments and any cost of competition. Each situation would be looked at carefully.

Then in 1944 in the *Bausch and Lomb* opinion, the Supreme Court declared that territorial restrictions, where they are an integral part of a program for resale price maintenance, are illegal per se. Following this decision the Justice Department, 4 years later, said, "We are going to change our policy and we are going to seek to make all territorial customer restrictions illegal per se, without regard to the impact on competition and without regard to any resale price elements." And it announced that policy.

It was not, however, until 15 years later that a case testing this Justice Department policy first reached the Supreme Court. In 1963, in *White Motor*, the lower court had ruled that territorial and customer restrictions were illegal per se. It did it on a case without a trial in what is called summary judgment.

The Supreme Court, however, reversed, saying: We don't know enough of the—and now I am quoting the court—"business stuff" from

which this arrangement derives for us to go ahead and say it is illegal automatically under the antitrust laws.

As a consequence, the Supreme Court returned the case to the district court for a trial to determine what are the benefits, what are the costs, and whether the practice should be permitted.

Immediately afterward, the case was misinterpreted frequently because three dissenters in the Supreme Court objected to the reversal saying that the per se rule as suggested by the Department of Justice should be adopted.

The law was, in other words, at that point unstable, because the Supreme Court said, "We ought to send the case back to the district court after a trial. Let us then examine the business stuff and determine what kind of a rule we ought to apply."

Before trial the case was settled. We therefore had no additional information in terms of the development of the law.

Following *White Motor*, there were two intermediate court opinions of that holding in essence that a rule of reason, close examination of the marketplace test, would be applied. Then, 4 years after the Supreme Court's *White Motor* decision when it said it didn't know enough, another case came before the Supreme Court. It is the *Arnold Schwinn* case involving territorial and customer restrictions on the sale of bicycles and similar items.

Here, without any real additional information, and going beyond the argument that the Government made, the Supreme Court announced for the first time a per se rule of illegality in connection with customer and territorial restrictions.

It did this not relying on any economic analysis but, rather, on a rule of property law over three centuries old, suggesting that it is inappropriate for the owner of property to put, to use the legal terminology, restraints on alienation.

The opinion by Mr. Justice Fortas subsequently underwent, in the next decade, enormous criticism. Virtually every scholar, be they a lawyer, an economist, a businessman, or whatever, suggested that this rule whose foundation was property law, developed for an entirely different reason, had no business in the economic marketplace.

I was one of those who wrote articles—in my case it happened to be part of a book—in connection with this topic.

Then in 1977, the Supreme Court was faced with the issue again. There had been in the interim many intermediate and district court cases, most of which sought to distinguish and apply a different rule than adopted by the Supreme Court in 1967 because, frankly, it didn't work. It didn't make much sense. There was enormous pressure to find a way around it.

However, instead of seeking to distinguish the *Schwinn* case, Mr. Justice Powell in *Continental TV* v. *GTE Sylvania* in an opinion joined by most of his colleagues, overturned the *Schwinn* decision and applied instead a rule of reason test. He ruled that if the evidence demonstrates that, in this case, a store location clause, or in other cases the territorial and customer restrictions, the costs to competition among competing independent firms outweighs the benefits, then it is barred by the antitrust laws. But if, on the other hand, the economic and business evidence suggests that the overriding effect is beneficial, then we should permit it. The court had swung 180 degrees around from

Schwinn, abandoned its per se rule, and adopted a rule of reason test for territorial and customer restrictions.

Despite that opinion——

Senator DOLE. Was that the *Sylvania* case?

Mr. GELLHORN. The *GTE Sylvania* case, yes, sir.

Despite that Supreme Court opinion, the FTC continued to prosecute its *Cola* cases which had been brought originally because of the Supreme Court's decision in *Schwinn*. The FTC's *Cola* opinions are really in two stages. First you have the administrative law judge deciding, after a careful examination of the evidence, with 195 independent findings in connection with Coca-Cola and an additional, I believe, 13 in connection with Pepsi-Cola, that the overwhelming impact of the territorial restraints in this particular industry were beneficial and that there was no reason to intervene.

Then the Federal Trade Commission, in a 2 to 1 decision reversed, claiming it was applying a rule of reason test, but focusing, I would suggest, only on the supposed costs to intrabrand competition.

To me, the Commission's decision attacks a strawman because it is conceded that territorial restraints and customer restrictions eliminate intrabrand competition. That is their very purpose. It wasn't, in other words, a very difficult case to make on that ground.

The defect, the problem I see with the Federal Trade Commission decision, which is currently before the court of appeals awaiting pronouncement, is that it did not examine, it did not consider, it did not properly weigh the benefits to competition among independent branded firms. That is, the Commission should, under the *GTE Sylvania* decision, first have evaluated the interbrand competition, which was undisputed in the record and relied upon by the administrative law judge.

Senator DOLE. If I could interrupt, the language referred to earlier in the legislation, does that take care of the defect you just referred to? I didn't mean to interrupt your train of thought.

Senator BAYH. "Such product is in substantial and effective competition with other products of the same general class?"

Senator DOLE. Right. Would that take care of the problem. And I haven't read my wife's opinion. Maybe I should do that. [Laughter.]

Would that take care of the problem you see with that opinion? Would that clause have any impact on that?

Mr. GELLHORN. Yes; I think it would. I think it would both satisfy the aims of the opinion set forth by the Federal Trade Commission in seeking to assure effective competition in the marketplace and yet overcome the particular application that concerns me in connection with that opinion. This would result because in this industry it would assure the opportunity of the parties, if they wish, to establish territorial and customer restrictions where effective competition exists.

I am likewise in somewhat of an uncomfortable position, Senator, because for a 3-month period I was on your wife's staff.

Senator DOLE. I know that. [Laughter.]

Mr. GELLHORN. I have great admiration and respect for her.

Senator DOLE. That is what I thought. I think Professor Williamson had mentioned that same point in his statement. I wanted to be sure we had agreement on that.

Mr. GELLHORN. It seems, in other words, to me that the legislation here serves two very desirable purposes. One, it would clarify the

law. That, in light of the history in this particular area of the law, vertical integration by contract, is desirable. We would not have to wait for an opinion by the court of appeals, which of course could be altered by the Supreme Court. If it affirms in this instance, my guess is the case might well go up and we may well see a different opinion by the Supreme Court if they choose to hear the matter.

Second, it would be limited to a very precise area and has the strong proviso that it would apply only where substantial and effective competition exists with other products of the same class.

An additional benefit from this legislation that I would point out is that it would simplify, shorten, and compress antitrust trials in this area. The reason for this is specific. The initial question before the court would be—Is there substantial and effective competition in this particular marketplace? If there is, that is the end of the case. The motion to dismiss would be granted. If there is not, then one ought to go ahead and look at what are the costs and what are the benefits from vertical restrictions.

This is consistent with the mandate given the National Commission for the Review of Antitrust Laws and Procedures by the President in 1977, and with their recommendations issued in early January of this year.

Finally, the other item I would note in connection with this legislation is that it provides no immunity to the use of territorial or customer restrictions if they are part of a scheme to engage in either collusive or exclusionary practices. In other words, this should not be able to be used as a cover for price-fixing, for horizontal market divisions, for customer boycotts or wholesaler boycotts. It is, in other words, an arrow aimed at a specific problem, not a buckshot.

Thank you very much.

Senator BAYH. Thank you for your testimony. It certainly is encouraging to those of us who have studied this problem to respond to constituent concerns that admittedly do not have the specific kind of expertise that you bring to this discussion to get your analysis, particularly of the lack of protection if we have any people out there trying to hide behind this bill and who are participating in the scheme to price-fix and monopolize. In your assessment this does not provide them protection.

Mr. GELLHORN. To some degree, in effect, my testimony would contradict the bottlers who suggest here they need the bill for their own protection. That may be true, though their protection is not my specific concern, other than on an individual, personal basis. I want them to be out there and continue if they can survive in the marketplace. If it is not in the self-interest of the manufacturer to set up exclusive territories, they may wither. Entry is not blocked in this industry. If somebody comes along with a better product, it is relatively simple to set up a plant to distribute it.

Sure, it costs money, but capital markets are not foreclosed. As long as entry is free, which I perceive to be generally the case here, then it seems to me there is absolutely no question to be concerned about the use of exclusive territories, customer locations, and any other kind of vertical restrictions, because these are devices by which firms can seek to become more efficient and serve the consumer better, in a variety of ways.

Senator BAYH. You had a chance down at the FTC to become personally familiar with the importance and impact of competition. Do you believe, what you know about the soft drink market now, the interbrand competition does provide substantial and effective competition in most instances?

Mr. GELLHORN. Without having read the record in the *Cola* cases, I am not in a position to put my own assessment on it.

What is interesting, it seems to me, however, is the four decision-makers involved—the administrative law judge and the three commissioners who participated in the final decision—all agree on one point, and that is that there is substantial interbrand competition in the industry. There is no dispute on that point. Those findings of fact by the administrative law judge were not disturbed, as I understand it.

The primary focus of the Commission's decision was on the impact of intrabrand competition. I don't dispute the effect seen by the Commission majority on intrabrand competition. My point would simply be that this restriction of firms competing with themselves is not significant. What counts is how do independent firms fight each other? Are they out working to lower the price, to increase service, to improve product quality, to make credit terms available, and all the other indicia of competition upon which we rely, with increased productivity and serving the consumer?

Senator BAYH. Thank you very much, Dean. I had some more questions to ask you, but you answered them in your opening remarks.

Senator Dole, do you have questions?

Senator DOLE. No; I think it is an excellent statement. I want to say, on a nonrelated matter, you mentioned I think in your early testimony about having testified here years ago on whether or not you could terminate the customer franchise or relationship.

We are getting some of that now in the energy area. There is a little bill floating around here that says we ought to have a dealer's day in court. That doesn't deal with the bottlers.

Mr. GELLHORN. It is the same issue. It seems to me I would urge that that kind of legislation, despite the pressure of the service stations or any other franchises and the human concerns involved, ought not to be corrected and responded to by interfering with the businessman's opportunity to make his own contracts.

I know the pressures must be enormous. But it is the same issue here. While the bottlers have an insight to offer and a human interest story to tell, and also some significant information on the industry, what is important about their testimony and what is significant, I believe, is their willingness to compete in the marketplace. They are not seeking legislation here which says, "We are entitled to our territories, regardless of how the marketplace operates." They are saying, "We want it only if there is substantial and effective competition."

Senator DOLE. Thank you.

Senator BAYH. I don't want to prolong this for you or for us, but I am going to have to dig out that testimony and relay it to those service station operators, because I have seen some major injustices performed there. We have had the man on the corner for 40, 50 years, with a $40,000, $50,000 investment in his business and all of a sudden he gets a 30-day notice, zapp, he is out; and there is a pumper station down the next block run by the multinationals.

Senator DOLE. Some of those guys are bigger than the bottlers. [Laughter.]

Mr. GELLHORN. Another day, another time I would like to discuss it.

Senator BAYH. Thank you very much. We appreciate your being here.

[The prepared statement of Mr. Gellhorn follows:]

PREPARED STATEMENT OF DEAN ERNEST GELLHORN

My name is Ernest Gellhorn and I am currently Dean and Professor of Law at the University of Washington Law School. My principal areas of teaching and scholarly experience have been in antitrust and administrative law. My participation in these hearings is being supported by The National Soft Drink Association. The views which I will express here, however, are not made on behalf of any group or organization and reflect my independent teaching and writing in antitrust.

I

The primary question raised by S. 598 is simply whether territorial distributino arrangements—specifically, the allocation of exclusive territories to franchised bottlers—should be allowed where substantial and effective competition exists among trademarked soft drink products. If, as I believe, the goal of antitrust is the maximization of consumer welfare through competition, then this proposed bill is consistent with the anttrust laws.

Where substantial and effective competition exists among soft drink products, franchised bottlers would be allowed by this legislation to retain their historic territories to bottle and sell soft drinks without fear of lawsuit by the government or private claimants. With the consumer protected by interbrand competition, this bill would assure that soft drink producers could seek the benefits of vertical integration by contract. These contract arrangements are generally designed to increase the efficiency of each firm's distribution system; in a competitive market these efficiency gains will result in lower product prices and thereby intensify competition among branded competitors. On the other hand, where markets lack strong and vigorous competition, this legislation would have no effect. That is, the usual rules of antitrust which measure such vertical arrangements under a rule of reason analysis would apply.

As will be described below, this result is consistent with the Supreme Court's recent decision in *Continental T.V. Inc.* v. *GTE Sylvania Inc.*, 433 U.S. 36 (1977). It would, in other words, codify existing legal rules. Yet, as illustrated by the Federal Trade Commission's opinions in *Coca-Cola*, Dkt. No. 8855 and *PepsiCo Inc.* Dkt. No. 8856 (FTC April 7, 1978), (the *Cola* cases) alternative interpretations are possible. Thus, without this legislation it may take years of litigation and numerous hearings and appeals to resolve the question. Adoption of S. 598 would establish the legal standard in a way likely to protect the consumer interest.

II

An understanding of the role which S. 598 would play in the antitrust laws requires brief analysis of these laws and the practices they prohibit. In serving the consumer interest, the antitrust laws seek to prevent individual firms, either acting alone or with each other, from restricting output and thereby raising price (or its equivalents) above competitive levels. Reduced to their primary elements, two practices are attacked by the antitrust laws: (1) collusion among competing sellers to raise price directly or indirectly; and (2) individual or group efforts to exclude other sellers from competing and thereby to gain a larger share of the market.

Under this framework, collusive practices have been banned by legal prohibitions of price fixing and market division. Each involves a horizontal agreement by competing firms where the effect on rivalry has seemed clear and little justification could be offered. Thus, per se rules have been applied to make such horizontal agreements illegal. However, where the horizontal arrangement does not fit within these categories—such as a trade association's public distribution of market statistics from its members, or a cooperative program of institutional advertising by all or some firms in an industry—the courts have applied a more lenient rule of reason test in order to determine whether some justification might

support the practice and whether it outweighs any adverse effects. When this latter rule of reason measure is applied, the courts usually examine the purpose of the arrangement, the market power of the participants and the effect of the arrangements on competition.

A similar approach has been followed in examining exclusionary practices by individual firms (monopolization or attempts to monopolize) or joint actions such as vertical tie-in agreements, horizontal group boycotts and similar arrangements. In situations where the exclusionary practice raises serious antitrust questions, those in or seeking a monopoly position are trading today's monopoly returns for a larger share of the market by making it unprofitable for others to compete with them. Here the law is in a state of flux as both per se and rule of reason tests are applied.

One reason for this lack of legal clarity, especially in regard to the rules governing territorial restrictions in vertical distribution arrangements, is that the courts and agencies have often tried to borrow antitrust concepts developed for collusive horizontal practices. However, they have applied these horizontal rules without careful consideration of their analytical foundations or whether they have any relevance for vertical agreements whose only possible harm could be exclusionary. On the other hand, many, perhaps alsmost all, vertical restraints are designed for another purpose. That is, rather than being aimed at restricting output, their likely goal is to increase firm efficiencies. For example, vertical sales restrictions required by firms without market power are generally conceded as having no possible effect on price or interfirm competition; yet the aim and result of horizontal sales restrictions are to restrict output and thereby to affect price. It is therefore not surprising that attempts to apply horizontal, per se, rules to their vertical counterparts have proved unsatisfactory and been unstable.

As will be explained below, this borrowing of horizontal case rules without qualification was first developed in the area of price fixing. Subsequently, it was extended to territorial allocations. In both areas the horizontal case rules are clear. Price fixing among competing firms has been condemned on a per se basis without regard to the reasonableness of the prices, any justification for the arrangement, or other supposed beneficial effects, since 1897. See *United States* v. *Trans-Missouri Freight Ass'n*, 166 U.S. 290 (1897); *United States* v. *Trenton Potteries Co.*, 273 U.S. 392 (1927); *United States* v. *Socony Vacuum Oil Co.*, 310 U.S. 150 (1940). Horizontal agreements to divide markets by allocating exclusive territories, assigning customer classes, or like arrangements similarly provide participants with an opportunity to restrict output and thereby to raise prices. Therefore, beginning in 1898 courts have condemned such territorial restrictions under increasingly rigid per se rules. See *United States* v. *Addyston Pipe & Steel Co.*, 85 Fed. 271 (6th Cir. 1898); *Timken Roller Bearing Co.* v. *United States*, 341 U.S. 593 (1951); *United States* v. *Sealy, Inc.*, 388 U.S. 350 (1967); *United States* v. *Topco Assoc., Inc.*, 405 U.S. 596 (1972). The application of these rules to similar vertical arrangements has long been criticized and with telling effect in recent years, at least in regard to vertical territorial restraints.

III

The development of the law regarding restrictions on the distribution of goods and services began with early efforts by manufacturers to set prices below which retailers could not subsequently resell their products. In the still leading case of *Dr. Miles Medical Co.* v. *John O. Park & Sons, Co.*, 220 U.S. 373 (1911), the Supreme Court ruled that a manufacturer who sells medicine to a wholesaler is not entitled to restrict its resale through interference with the purchaser's pricing decisions. It relied on ancient property law rules making restraints on resale invalid. Where the purpose of the arrangement is to destroy competition by fixing prices, the Court held, the restraint is "injurious to the public interest and void." In reaching this result, the Court equated vertical price fixing with horizontal cartel behavior. Since the latter was per se illegal, it followed that resale price maintenance was similarly prohibited.

The Court's assumption that a manufacturer's interest in eliminating price competition among its resellers is based on the same motives and consequences as those held by resellers in forming a cartel, however, was badly flawed. That is, unless forced to do so by his retailers, the manufacturer would seem to have no interest in assuring retailers a monopoly profit, especially since it would be done at his expense. As one leading antitrust critic has correctly observed, "a rule of per se illegality was thus created on an erroneous economic assumption." R. Bork, *The Antitrust Paradox* 33 (1978).

Perhaps recognizing the infirmity of its own rule, the Supreme Court shortly cut back its prohibition of vertical price fixing by creating an exception to the per se rule in *United States* v. *Colgate & Co.*, 250 U.S. 300 (1919). There the Court allowed a manufacturer to control resale prices by the simple expedient of announcing his intention not to sell to price-cutters and then unilaterally refusing to sell to any retailer who failed to comply. However, the exception, which was based on the absence of any agreement essential to a Sherman Act contract, combination, or conspiracy, quickly proved illusory. Subsequent cases established that the "fatal element of agreement" might be found in price discussions with retailers, in their assurance that they could comply with the condition, or in the reinstatement of errant dealers after a disciplinary waiting period.

The *Dr. Miles* approach to vertical price fixing—that it denied the retailer his "right" to resell his property—led to another exception where the retailer was the manufacturer's agent and, instead of taking title, received the products on consignment. Thus in *United States* v. *General Elec. Co.*, 272 U.S. 476 (1926), the Court held that where it is clear that the arrangement is legitimate and that the manufacturer both retains title and bears substantial risks of ownership, the antitrust laws do not prevent him from dictating the terms of sale, including retail prices. In this circumstance the Court held that vertical price fixing is not illegal.

Here too the exception proved unreliable. First, the legitimacy of consignment arrangements was attacked, the question being whether the retailers were in fact the manufacturer's agents. And then in *Simpson Oil* v. *Union Oil Co.*, 377 U.S. 13 (1964) the Court ruled that an oil company supplier had violated the antitrust laws by fixing the retail prices of its service station-consignees because the consignment arrangement was being used as a device to "coerce" nominal agents "who are in reality small struggling competitors seeking retail gas customers." Whether any form of consignment now provides safe passage for resale price agreements is uncertain. They were approved for nonprice restraints in *United States* v. *Arnold Schwinn & Co.*, 388 U.S. 365 (1967), where the consignment provided that "title, dominion and risk" remained with the manufacturer; and this part of the *Schwinn* decision was not overturned in *Sylvania* (discussed below).

The rigidity of the rule against all price fixing is further shown by the Court's restatement of the rule in *Albrecht* v. *Herald Co.*, 390 U.S. 145 (1968), when it held that a publisher's effort to fix maximum resale prices charged by independent newspaper carriers was illegal per se. The Court was unmoved by the fact that such price fixing seemingly protected the consumer's interest and was justified by the paper's independent interest in keeping prices down (to increase circulation and advertising revenues).

The continued strength of the per se rule against vertical price fixing was further revealed in 1977 in the *Sylvania* decision. Even though the Court there recognized that vertical restrictions serve different purposes from horizontal cartels, it expressly reaffirmed its earlier commitment to a per se rule against vertical price fixing, 433 U.S. at 51 n. 18. On the other hand, the Court did support a different rationale for its early ruling in *Dr. Miles* prohibiting resale price maintenance, namely that it reduces "price competition not only among sellers of the affected product, but quite as much between that product and competing brands." About all this suggests, however, is that the Court may ultimately back away from its rule against maximum price-fixing. Accord, Pitofsky, *The Sylvania Case: Antitrust Analysis of Non-Price Vertical Restrictions*, 78 Colum. L. Rev. 1, 16 n. 59 (1978).

With the opportunity for vertical price restrictions essentially proscribed especially after the "fair trade" law exception for the states was repealed in 1976, attention has focused on other distribution restrictions and in particular on manufacturer limitations on dealer territories and customers. Until the 1940's these arrangements were not challenged by the government and their lawfulness was upheld in several private actions. Then in 1948 the Department of Justice, relying on a Supreme Court opinion holding territorial restrictions illegal per se if they were an integral part of an agreement to fix prices (*United States* v. *Bausch & Lomb Optical Co.*, 321 U.S. 707, 721 (1944)), announced that it would henceforth treat vertical territorial and customer restraints foreclosing intrabrand competition on the same basis. For several years this position went unchallenged; consent agreements negotiated by the Department of Justice enforced this view, but no case supported its position. However, during the past

fifteen years the law has swung violently, from uncertainty to per se illegality and more recently to a flexible rule of reason approach, in three very different Supreme Court opinions.

Seemingly overturning the Justice Department's contention, the Court first reversed a summary judgment holding territorial and customer restrictions illegal per se. *White Motor Co.* v. *United States*, 372 U.S. 253 (1963). White Motor had sold its trucks to dealers who agreed to resell them to customers not otherwise reserved to the manufacturer and who had a place of business within the assigned territory. Because of the meager summary judgment record and the Court's admitted inexperience with franchise limitations, the Court concluded that it did not "know enough of the economic and business stuff out of which these arrangements emerge" to be certain whether they stifle or invigorate competition. It therefore remanded the case for a trial on the merits. The opinion was widely interpreted, however, as adopting a rule of reason approach to vertical limitations—especially since three dissenters called for a per se rule. In fact the Court had only held "that the legality of the territorial and customer limitations should be determined only after a trial." Following remand the case was settled, and the Court therefore did not have an opportunity to develop a rule on a full record.

It seemed, nevertheless, that a rule of reason approach would be applied as two Courts of Appeal subsequently upheld territorial restraints, and in each instance the court overturned a stringent Federal Trade Commission decision and applied a more flexible test. See *Sandura Co.* v. *FTC*, 339 F. 2d 847 (6th Cir. 1964) (territorial restraints used in rebuilding a dealer organization after its market position had deteriorated); *Snap-On Tools Corp.* v. *FTC*, 321 F. 2d 825 (7th Cir. 1963) (manufacturer was one of 80 firms in an intensely competitive industry with high dealer turnover). As indicated, each case presented appealing facts to support the territorial restrictions. And in light of subsequent developments, it is particularly noteworthy that neither *White Motor* nor the circuit court cases paid heed to the doctrinal distinctions developed in the vertical price fixing cases, namely, whether the provisions violated property law rights to resell property or whether title was retained by the manufacturer.

When the next case came before the Supreme Court four years after *White Motor*, the government retreated somewhat from its per se position and argued, in its brief, for a rule of presumptive illegality which would have required the defendant to justify any territorial restrictions. It thus came as a surprise to antitrust followers when, in *United States* v. *Arnold Schwinn & Co.*, 388 U.S. 365 (1967) the Supreme Court adopted a position even more restrictive than that put forward by the government. In condemning a nonprice vertical restriction, the Court ruled that "once the manufacturer has parted with title and risk... his effort thereafter to restrict territory or persons to whom the product may be transferred... is a per se violation of § 1 of the Sherman Act." Relying on the same rationale used a half-century earlier in *Dr. Miles* to condemn vertical price fixing, the Court said that such restrictions violate the "ancient rule against restraints on alienation." Thus the Court concluded that "under the Sherman Act it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it."

With this sweeping language the Court "threw into doubt the legality of every sort of post-sale vertical restriction on distributions other than exclusive dealing arrangements, regardless of the type of restriction or the market power of the supplier and its dealers." Pitofsky, supra at 6. Not surprisingly, this abrupt switch of direction drew a spate of criticism seldom matched in a decade of bitter debate about various antitrust rulings of the Supreme Court. See, e.g., Handler, *Twenty-Five Years of Antitrust*, 73 Colum. L. Rev. 415, 458–59 (1973) (*Schwinn* is "the most egregious error in all of antitrust."); A.B.A. Antitrust Section, *Monograph No. 2, Vertical Restrictions Limiting Intra-Brand Competition* 9 n. 24 (1977) 1 citing other criticisms).

Nor was all criticism mere hyperbole. As numerous scholars, both lawyers and economists, patiently explained, vertical territorial restrictions serve many useful ends, usually to increase distributional efficiencies and lower costs. While occasional theoretical possibilities may exist for the misuse of such restrictions, primarily to facilitate horizontal cartels by manufacturers or retailers, the risk seems insubstantial where substantial and effective interbrand competition exists. That is, where firms selling different products compete vigorously, efforts

by individual firms to achieve market efficiencies should be encouraged. The market will become even more competitive as a result, and in any case no individual firm's marketing strategy can have an adverse effect on competition in that circumstance. Moreover, since other avenues for vertical integration are open—especially by internal growth—barring integration by contract would be futile, except that it might force a manufacturer to select a less efficient distribution scheme (reducing competitive pressures) and in fact foreclosing opportunities for smaller retail firms.

As this analysis makes evident, whether vertical restrictions on distribution by customer and territory should be allowed is unrelated to whether the manufacturer retains title or to whether the dealer is his agent. Thus it seemed anomalous or worse to have the Supreme Court resolve a question of economic policy by resort to ancient (and unrelated) property law rules governing resale of personal property. The policy question is whether these restraints serve to make product distribution more efficient and interbrand rivalry more vigorous. To allow legal formalisms developed three centuries earlier for another purpose to dominate and decide antitrust law seemed absurd. With such a unstable base, it seemed only a question of time before the *Schwinn* per se rule would be ditsinguished and restricted.

Again, however, the law was changed abruptly and without warning by the Supreme Court. In the next case to reach its docket, shortly after the tenth anniversary of the Court's application of a per se rule to vertical territorial restrictions in *Schwinn*, the Court sharply reversed its direction, directly overruled Schwinn, and applied a rule of reason for every sort of nonprice vertically imposed dealer limitation. Although the case in fact involved dealer store location causes, the Court's opinion was not so limited and it appeared to suggest that a flexible rule of reason test—balancing the benefits (in particular business efficiency) against demonstrated costs—was to be applied in almost every circumstance where nonprice vertical restraints are under challenge. The critical factor in *Sylvania* was the Court's clear recognition that several significant efficiencies could be achieved by distribution restrictions. Among those cited by the Court are retailer investments, promotional activities, and quality controls. In reaching this result, the Court recognized the economic interests of competing suppliers and the value of allowing them almost untrammeled freedom in deciding which distribution system will serve their interests (and those of their customers). And it appeared to hold that the burden was on the government to show that the competitive "costs" overrode these possible gains.

That the Supreme Court announced a broad and flexible rule of reason test for nonprice vertical restrictions in *Sylvania* is indisputable. But as always seems to be the case with legal issues, or at least those involving antitrust, questions remained. The case, for example, involved location clauses which usually have only silght intrabrand effects—but the Court expressly (and carefully) chose not to limit its discussion so narrowly. In addition, the respondent accounted for less than five percent of the market and thus the clause could not have had a serious interbrand impact yet the Court appeared to place no reliance on *Sylvania's* size or market share as long as interbrand rivalry was present. Indeed, the Court specifically indicated that a supplier's market power would not justify reliance on a per se rule. 433 U.S. at 46 n. 12. On the other hand, in a final passage seemingly designed to assure a solid majority, the *Sylvania* Court carefully reserved the possibility that some vertical restrictions might justify per se prohibition in particular applications and that others might not survive a case examination of their competitive effects. Neither situation, however, was explained, although it seems difficult to imagine what circumstances the Court has in mind (if any).

This uncertainty was expanded and compounded by the Federal Trade Commission's recent decisions in the *Cola* cases, that the territorial restraints historically required of franchised bottlers are unreasonable and violate Section 5 of the Federal Trade Commission Act. There the Commission's law judge had approved the legality of territorial provisions in trademark licenses to bottle and sell Coca-Cola and Pepsi-Cola. After making over 200 detailed findings of fact, he determined that the effect of the restraint on intrabrand competition among bottlers of these brands was far outweighed by its benefiial effect on competition in the marketplace as a whole. He therefore concluded that on balance the challenged territorial restrictions promote competition.

Two and one-half years later, a two member majority of the FTC, over the dissent of the other Commissioner participating in the decision, ruled that the

territorial provisions were illegal because they eliminated intrabrand competition. In order to reach this result the majority first decided, as a matter of law, that the burden was on Coca-Cola and PepsiCo and their bottlers to demonstrate that the business justifications and the effect of the provisions to foster competition with other soft drinks outweighed any loss of rivalry among the bottlers. And this burden, the two person majority held, had not been met by the respondents. Even so, the majority recognized that the territorial provisions were justified when first adopted and all participating Commissioners found that the clauses did not involve horizontal collusion or other per se illegal conduct.

Whether the FTC's opinion in the *Cola* cases has improperly misconceived and misapplied the *Sylvania* standard for nonprice vertical restrictions such as the territorial provisions common in the soft drink industry—even under the limited judicial reiew standard applicable to administrative agency decisions—is now before the District of Columbia Court of Appeals and prediction of the legal outcome would be gratuitous. As a matter of antitrust policy, however, affirmance would seem a disturbing backward step and a retreat to the illogic of *Schwinn's* per se approach. For the essence of the Federal Trade Commission's two member position is that admittedly efficiency enhancing territorial provisions will not be saved if the intrabrand effect is not insignificant. The Commission's rule would place the burden on the respondent—a burden which few seem likely to satisfy—and in direct opposition to the provisions of the Administrative Procedure Act. See 5 U.S.C. § 556(d).

That this approach misunderstands the Supreme Court's purpose in *Sylvania*—which has been so highly praised by every commentator (of whatever persuasion)—seems clear. There, it will be recalled, the Court found that the consumer welfare is best served by promoting interfirm competition. And if that competition is substantial and effective, as was undisputed in the *Cola* cases, then internal efforts to achieve efficiency can only be procompetitive and beneficial to consumer interests. To prohibit such efforts to achieve vertical efficiencies runs the risk that competitive vigor will be diminished and consumer welfare decreased. It also places undue emphasis on the elimination of intrabrand rivalry, an automatic but usually insignificant casualty of every move toward vertical integration.

The Commission's decision in the *Cola* cases is also disturbing for the instability it has reintroduced to the rules governing nonprice vertical restrictions just one year after the Supreme Court sought to resettle matters in *Sylvania*. Instead of focusing its attention on the use of such restrictions where interbrand competition is limited and therefore more deserving of careful scrutiny, the Commission has sought to read the rule of reason standard to condemn restrictions which should be of no concern—when competition is substantial and effective.

IV

In reviewing the primary substantive provision of S. 598—Section 2's directive that territorial customer restrictions in trademark licenses for soft drink products are not unlawful under the antitrust laws if substantial and effective interbrand competition exists—three questions need to be addressed: (1) What is the meaning of S. 598? (2) What is the relationship of S. 598 to the Supreme Court's decision in *Sylvania?* and (3) What will be the likely effect of S. 598 if adopted?

The operative provision of S. 598 regarding the legality of nonprice vertical restrictions are clear. The bill is limited, first, to trademarked soft drink products where similar provisions have been relied upon for decades to support a large industry. Second, the proposed legislation only applies to territorial and customer restrictions. It does not involve other vertical restrictions such as price fixing or tie-ins which are usually subject to more stringent legal constraints. Rather it would govern in an area of well accepted territorial and customer restrictions whose purposes have been carefully considered and thoroughly explored, with the result that they are generally viewed as enhancing competition. Finally, and most importantly, S. 598 would protect such contract clauses from antitrust liability only where "substantial and effective competition" exists. That is to say, there must be vigorous competition among soft drink products before relationships between the syrup manufacturer (and trademark owner) and the bottler are protected by this legislation. The result of S. 598, then, is generally to limit the required inquiry, at least initially, to a determination of whether such

competition exists. If that finding can be made, the practice would be upheld. On the other hand, if this level of competitive activity cannot be found, the restrictions would be subject to the *Sylvania* tests.

A reading of S. 598 alongside the Supreme Court's decision in *Sylvania* reflects their similar purposes. Each is based on the understanding that competition is enhanced through interfirm rivalry and that it is this area of antitrust law enforcement that should be the primary concern. That is, consumer welfare is generally improved through competitive efforts by independent firms seeking to increase their position in the market. This rivalry may involve lower prices, improved quality, enhanced flavor, better service, increased information through advertising, and so forth, all designed to attract consumer support. In this connection, the competitive efforts of independent firms may be strengthened by lowering distribution costs, attracting effective dealers, retaining dealer loyalty and support, and focusing their efforts on developing increased customer purchases. These "efficiencies," the Supreme Court found in *Sylvania*, are aided by territorial and customer limitations. It therefore concluded that such nonprice restrictions should be tested under a rule of reason analysis. Where interbrand competition is strengthened as a consequence, the restrictions are lawful.

In this connection, both the law judge and all FTC Commissioners also agreed in the *Cola* cases that the territorial and customer clauses used in the soft drink industry were designed for similar purposes. Thus, a legislative determination in S. 598 that such nonprice vertical restrictions satisfy the antitrust laws if "substantial and effective competition" exists among soft drink products seems fully congruent with the general thrust and particular applications of the Court in *Sylvania*—and the findings of fact in the *Cola* cases. S. 598, in other words, would be a declaration by Congress that the rule of reason test restated in *Sylvania* is satisfied by a showing that the marketplace in which the firm uses a territorial or customer clause exhibits substantial and effective competition.

The effect of S. 598's passage is specific and clear. It would remove the confusion generated by the FTC's two member decision in the *Cola* cases and assure stability and continuity to the Supreme Court's ruling in *Sylvania* that nonprice vertical restraints are subject to a rule of reason analysis. In addition, S. 598 would build on the theory of *Sylvania* and specify that territorial and customer restrictions in the soft drink industry are lawful under the antitrust laws where "substantial and effective competition" exists. Recognizing that these restrictions are generally used for efficiency enhancing purposes, and supported by the FTC law judge's findings of fact that in the soft drink industry territorial and customer restrictions have been used to promote interfirm competition, the Congress would be making a determination that the rule of reason is fully satisfied by a finding that competition is vigorous and significant.

One further result of S. 598, consistent with the recommendations recently made by the President's National Commission for Review of Antitrust Laws and Procedures, is to shorten and simplify antitrust trials where the lawfulness of nonprice vertical restrictions on territories and customers in the soft drink industry is being questioned. This alone is an important objective. For example, the FTC's administrative trial in *Coca-Cola* lasted six weeks, heard from 43 witnesses, and developed a record of 4,000 pages of trial transcript, 14 stipulations encompassing 500 pages, and 1,300 exhibits in still more thousands of pages. The law judge's initial decision upholding the legality of territorial provisions in the trademark licenses to bottle and sell Coca-Cola required an added 91 pages.[1] And the Commission and courts are now supplementing this page log.

Under S. 598 the initial and, in most instances, deciding question would be whether substantial and effective competition exists. This issue is narrowly focused and confined, and would usually be answered after only a brief round of discovery and a short trial—or even without a hearing since the evidence could be submitted to the trial judge for decision upon expert submissions. Simplifying and expediting the resolution of antitrust cases by revision of substantive rules of law is an important national objective, a point that was reinforced by the President when he made this the first responsibility of the National Commission. See Executive Order 12022, § 2(a)(1) (December 1, 1977). Where policy and law make it clear that territorial and customer restrictions cannot have adverse effects—because vigorous competition exists in the market—no purpose is served by lengthy antitrust trials.

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[1] The contemporaneous PepsiCo case required an additional 278 pages of transcript and initial decision.

Nor is S. 598 written so broadly that it will confer protection on any collusive or exclusionary practices. That is, where territorial or other nonprice restrictions are being used for such pernicious purposes—and this can be demonstrated by other evidence—S. 598 provides no immunity. Price fixing by competing firms or market divisions by producers of competing soft drink products, for example, would continue to be fully subject to antitrust scrutiny and legal prohibition; and if used in conjunction with vertical territorial or customer restrictions, these actions would not be insulated in any way by S. 598. The purpose, aim and effect of S. 598 is solely to guarantee that distributors of trademarked soft drink products are free to select the most efficient means of distribution available and to assure consumers the benefits of substantial and effective competition.

[Whereupon, at 12:48 p.m., the subcommittee was recessed, to reconvene subject to the call of the Chair.]

SOFT DRINK INTERBRAND COMPETITION ACT

WEDNESDAY, SEPTEMBER 26, 1979

U.S. SENATE,
SUBCOMMITTEE ON ANTITRUST,
MONOPOLY AND BUSINESS RIGHTS
OF THE COMMITTEE ON THE JUDICIARY
Washington, D.C.

The committee met, pursuant to notice at 9:38 a.m. in room 5110, Dirksen Senate Office Building, Washington, D.C., Hon. Howard M. Metzenbaum (chairman of the subcommittee) presiding.

Present: Senators Metzenbaum, Bayh, Cochran, and Thurmond.

Staff present: Antitrust subcommittee: J. Michael Cooper, counsel; Marilyn Folksen, chief clerk; Steve Fingerhood, research assistant; Peter Chumbris, minority counsel; Joe Lanham, minority economist. Subcommittee on the Constitution: Kevin O. Faley, chief counsel and executive director; Linda Rogers-Kinsbury, chief clerk; Louise Milone, professional staff member. Joel Perwin and Hank Banta, counsels to Senator Kennedy; Arthur Briskman, counsel to Senator Heflin; Sam Kinser, counsel to Senator Leahy; Ralph Oman, counsel to Senator Mathias; Mark Grady, counsel to Senator Dole; Henry Ruempler, counsel to Senator Cochran.

OPENING STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO, AND CHAIRMAN, SUBCOMMITTEE ON ANTITRUST, MONOPOLY AND BUSINESS RIGHTS

Senator METZENBAUM [chairman]. Today the subcommittee meets to consider S. 598, the Soft Drink Interbrand Competition Act. This bill creates a broad antitrust exemption for the territorial restrictions that characterize the soft drink bottling industry. These territorial restrictions prevent a bottler from selling soft drinks to any customer outside of his assigned territory. They are agreements between private parties which eliminate competition between bottlers of the same soft drinks.

No one disputes that soft drinks are a major part of our diet. Some of us are members of the Pepsi generation, others are convinced that "Coke's the real thing," and still others prefer the Uncola or the new King Cola. Together we spent about $8 billion on soft drinks in supermarkets in 1978, and billions more at restaurants and ball games.

As chairman of this subcommittee and as a member of the President's National Commission for the Review of Antitrust Laws and Procedures, I view any exemption from the antitrust laws with extreme concern. The antitrust laws are the Nation's charter of economic free-

dom. They assure that free and open competition rules the Nation's marketplaces.

We are all familiar with the benefits that competition brings. Consumers receive the highest quality goods at the lowest possible prices. The Nation's resources are allocated in the most efficient manner. Businesses are spurred to innovate and to keep costs down. Because of these benefits, there is a strong presumption in our country in favor of unrestricted competition in the marketplace.

It is interesting to me that some of those who speak most strongly about the free enterprise system are here urging the Congress to enact this exemption from the antitrust laws which is certainly counterproductive as far as competition is concerned.

In 1935, Congress created an antitrust exemption for the trucking industry. In 1937, Congress created an antitrust exemption for the milk industry. And in 1945, Congress created an antitrust exemption for the insurance industry.

None of these exemptions has served the public interest.

With this in mind, the President's Antitrust Commission concluded that persons seeking an antitrust exemption must meet a heavy burden of proof. After "careful, factual inquiry" they must show "a convincing public policy rationale for abandoning competition." For an exemption from the antitrust laws to be appropriate, competition must be unworkable in a specific industry.

I have examined the many arguments that have been made to date both in favor and against granting an antitrust exemption to the soft drink industry. While arguments for the exemption seem to have some merit, I have not yet discovered a convincing public policy rationale in favor of it.

Even if we assume that all of the benefits of the industry attributed to its territorial restrictions do in fact exist, I am not certain that they outweigh the benefits likely to flow from unrestrained competition in the marketplace.

Another aspect of S. 598 troubles me. I am concerned that congressional action at this time might be particularly inappropriate. Prior to the Supreme Court's decision in the 1977 *Sylvania* case, territorial restrictions like those in the soft drink industry were per se unlawful under the *Schwinn* decision rendered in 1967. The soft drink industry then promoted legislation that would have required the courts to examine its territorial restrictions under the rule of reason approach.

The 1977 *Sylvania* decision overruled *Schwinn's* per se decision and adopted the rule of reason approach urged by the soft drink industry. The legislation originally requested by the soft drink industry was no longer necessary.

In 1978, the Federal Trade Commission applied this rule of reason test to the territorial restrictions in the soft drink industry, and found them unreasonable. Although the industry's appeal is awaiting decision, the industry now asks us to legislatively overrule the FTC decision without waiting for the appellate court of rule.

It is my understanding that the court of appeals decision should not be long forthcoming and so the real question presents itself whether or not this Congress ought to act when a matter is at this advanced stage in the courts.

Congress has always given the courts the responsibility to decide this reasonableness of particular restraints of trade. If Congress removes this responsibility from the courts for the soft drink industry, I fear that other industries may request similar exemptions from the antitrust laws for their own business practices. We may end up with antitrust laws which are made meaningless by a patchwork of special interest legislation.

For all these reasons, we must carefully examine the possible future impact of S. 598. We must be certain that an antitrust exemption for these territorial restrictions does not prevent whatever competition may still be possible among soft drink bottlers in the future.

On June 4, the subcommittee heard from several supporters of S. 598. Today we will hear from several witnesses who raise serious questions about this legislation. Their testimony will provide valuable assistance to the subcommittee in its consideration of this bill.

[A letter and statement from Mark Green, director of Public Citizen, to Senator Metzenbaum follows:]

PUBLIC CITIZEN,
Washington, D.C., September 26, 1979.

Hon. HOWARD M. METZENBAUM,
Chairman of the Antitrust, Monopoly, and Business Rights Subcommittee of the Judiciary Committee, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: Due to a number of pressing commitments, we regret that we are unable to appear at your Subcommittee hearings on S. 598, The "Soft Drink Interbrand Competition Act."

We would, however, like to submit the enclosed statement for the hearing record. We are strongly opposed to S. 598 and other proposals which provide certain industries or segments of industries with an exemption from the antitrust laws of the United States.

Thank you for the opportunity to present the views of Congress Watch on this important issue.

Sincerely,

MARK GREEN,
Director.
CAROLYN BRICKEY,
Staff Attorney.

S. 598. THE "SOFT DRINK INTERBRAND COMPETITION ACT"

In our view, S. 598, The "Soft Drink Interbrand Competition Act" establishes for the soft drink industry a blanket protection from the antitrust laws of the United States that is without justification. Legislation of this kind has been repeatedly introduced without success because the Congress has shown an increasingly stronger commitment to enforcement of antitrust laws, rather than a willingness to believe a special interest group claiming that "competition will ruin us." Other than for natural monopoly or other extraordinary situations, there should always be a strong congressional presumption in favor of competition and the antitrust laws that are premised on it.

Although an appeal is pending before the United States Court of Appeals for the District of Columbia of the Federal Trade Commission ruling that bottlers' territorial restraints are illegal, the proponents of this measure now wish to circumvent that process and reargue the facts of the case before the Congress. This intervention is sought in spite of the fact that the Commission used a rule of reason analysis in the case which allowed the bottlers to present all economic justifications for the use of territorial franchises to the Commission.

The proponents of S. 598 are offering a new standard of enforcement to replace the presumption that exemptions will not be granted unless clear and convincing evidence is produced that demonstrates that the application of antitrust laws is anticompetitive. The new standard would exempt the franchise arrangement if the soft drink product "is in substantial and effective competition with other products of the same general class." We believe that this proposed standard is ambiguous and unsubstantiated and could not realistically be

enforced by the Commission. Furthermore, even if the Commission could prove that a company violated this weaker standard, Section 3 of the bill exempts the violator from damages.

The soft drink industry argument rests upon two major tenets. The first is that intrabrand competition must be sacrificed in order to have interbrand competition because it is impossible to have both kinds. The second tenet is that without franchises the small bottlers will be forced out of business by the syrup companies and the large bottlers, resulting in higher prices for the consumer because of increased concentration and less competition.

While it is true that the major soft drink brands vigorously advertise in order to maintain or increase their respective shares of the soft drink market, the advertising done by syrup companies is directed toward image enhancement and consumer preference—not the kind of price advertising which promotes competition. The market shares of the big brands, Coke, Pepsi, 7-Up, are relatively constant. Price competition is left to the local markets.

It is axiomatic that if a supermarket in Town X compares the prices of the bottler who supplies it to those of the bottler who supplies neighboring Town Y and finds that the latter's prices are cheaper, the supermarket will switch to the cheaper bottler. Under the franchise system, that can't happen. Because there can be no competition between bottlers for Pepsi or Coke or any of the other brands that those companies own, a made-to-order price-fixing scheme exists. And that is the scheme that S. 598 is designed to maintain. Furthermore, since the retail operators are forced to buy from one bottler in each territory, there is no incentive for a Pepsi bottler to compete with a Coke bottler or any other name brand. Therefore, it is questionable that there is substantial interbrand competition, and it is obvious that there is no intrabrand competition.

The second major bottler argument is that small bottlers would be quickly driven out of business by large companies, principally operations owned by the syrup companies; the result would be fewer bottlers and higher prices. To accept this argument is to ignore at the outset a trend that has been continuing since World War II—the decline of the number of bottling plants in the United States. This decline has occurred in conjunction with the franchise system and shows no sign of stopping even if the system were continued. While bottling companies need not be as large as the Fortune 500 firms, a modest economy of scale must be maintained in order to compete efficiently in every industry.

The franchise system originated in the early part of this century, and the territories established often do not fit within urban population patterns and existing population routes. Therefore, it is likely that established small bottlers will be able to compete successfully in an open system which allows them to offer cheaper prices to areas that they can serve economically. To predict that large urban bottling companies will reach hundreds of miles to take over other territories is to ignore substantial transportation costs that have been inflated by recent oil price increases. Such a prediction further rests upon the large assumption that these same companies are in a position to double, triple, or quadruple their outputs overnight and prevent small companies from maintaining their present customers.

Not only do the proponents of S. 598 argue that small bottlers will be driven out of business without their exemptions, but they implicitly argue that the takeovers will be accomplished by undercutting their prices, a business practice that has been outlawed by the Robinson-Patman Act, The remedy for that unconscionable practice lies in the enforcement of laws that already exist and not in exempting companies from the antitrust laws.

We believe that the more likely result if the Commission ruling prevails is that those small bottling operations which are financially stable will increase their operations to the point where an economy of scale is reached, serve those customers it is economically efficient to serve, and compete with other companies to sell soft drinks at a better price to consumers. We do not advocate a subsidizing of any segment of an industry simply because it becomes difficult to compete in the open market. This view is consistent with the position we have taken on other issues, such as the Chrysler loan guarantee.

As we have indicated, this bill is not the way to deal with potential or conjectural illegal business practices by large bottlers. It is especially not the way, nor is this the forum, to deal with the fate of the returnable bottle. There are arguments to be made on both sides as to whether or not the end of the franchise system will mean the end of the returnable bottle. Although the Commission held that the franchise system is justified for the distribution of returnables (to

insure that each bottler can keep track of his own inventory), bottlers argue that a split delivery system will not work and the number of returnables will decline or disappear. They argue that supermarkets do not like to handle returnables, and that bottlers take the initiative to supply them to meet customer demand. The significantly lower prices of returnables, however, insures that the demand for returnables will at least remain constant, and there is no reason to believe that that demand will not be met.

If we as a society agree, however, that the returnable bottle serves an important function in use of resources and protection of the environment—and we believe that to be the case—Congress should enact a law banning the nonreturnable bottle and mandating the increased recycling of aluminum cans. Congress should not enact a special exemption for a special business group in order to protect the environment from a hazard that can be dealt with in a more appropriate and effective manner.

In conclusion, if this attempt is successful, it will be followed by a similar request from another industry which will be asking a question that is only fair, "Why am I not entitled to the same special treatment as the soft drink industry?" The answer to that question can only lead to a retrenchment of our commitment to a competitive market society.

Senator METZENBAUM. The author of the legislation is with us. He is also a very valued member of this subcommittee and a close personal friend of mine. Possibly Senator Bayh wants to say something at this point.

Senator Bayh?

Senator BAYH. Thank you, Mr. Chairman. I would ask unanimous consent that my full, comprehensive statement be placed in the record.

Senator METZENBAUM. No objection.

OPENING STATEMENT OF HON. BIRCH BAYH, A U.S. SENATOR FROM THE STATE OF INDIANA

Senator BAYH. The Soft Drink Interbrand Competition Act is designed to preserve a unique industry practice which has existed for 75 years—the manufacture, bottling and distribution of trademarked soft drinks by local companies.

While I anticipate we will hear much today and in future weeks about "economic efficiency" and about how such "efficiency" would be best served by the elimination of territorial franchises, these arguments have little meaning to the small businessman in Portland, Ind., who feels his business would be shut down in less than 6 months if such agreements did not exist, nor would such efficiency be a particular benefit to the families of the 83 employees of the plant who would be out of work and on the unemployment roles.

The most lucrative account for these small bottlers are the large chain store accounts. Without such accounts they would be left with the low volume, high service intensity "Mom and Pop" store and vending machines, their fear is, that without territorial restrictions, large bottlers in neighboring areas would raid their chain store accounts by offering to sell to them in high volumes for warehousing. These smaller bottling businesses would then be worth little more than the price of their machinery.

It is easy for us to talk about efficiency and about broad economic theory sitting here in this hearing room. However, those words mean much more than philosophical musings to a man who inherited his bottling business from his father and hopes to pass it on to his children. It could mean the end of his business and his way of life.

We have heard that the elimination of territorial restrictions would be beneficial to the consumer. The reason most often cited is an alleged decrease in the price of a soda. Yet even an official of the FTC states that calculating the alleged benefits is impossible. Moreover, others have contended that the long range effect of the FTC ruling might be an increase in pricing.

We have heard that current territorial agreements have and will continue to lead to concentration in the industry. Claims are made that the number of soft drink bottling plants around the country have been reduced by as much as 50 percent in the last 20 years. Yet, no one can or will deny that what is meant by economic efficiency in the soft drink industry is simply a further and faster concentration or vertical integration of this industry.

We have heard that there is no intrabrand competition with exclusive territorial franchises. We agree that it must be the case under such agreements. Yet no one has been able to explain how, with further concentration, with the possibility of the sirup companies owning all of their brands' bottling plants, how there will be intraband competition.

In fact, as I have examined this problem, it has become more and more apparent to me that absent these territorial agreements and in the presence of substantial vertical integration there will not only be an absence of any intrabrand competition, but there may be substantially less interbrand competition. I defy anyone to explain how that will be of benefit to the consumer. If Coca-Cola owns all of its bottling plants and Seven-Up and Pepsi-Cola owns all of their bottling plants and the other companies do the same, Pepsico is surely not going to set up a situation, nor are any of the other sirup companies going to set up a situation, in which they are in competition with themselves.

I have been given information which leads me to believe that, should territorial franchises not be permitted in the soft drink industry, the State of Indiana's soft drink business could be divided between Dayton Coke and Chicago Coke. That would mean the end of approximately 50 businesses in Indiana and unemployment for the people who work in those businesses. We are told that economic theory is such that those people would find other work in another industry. That could be. However, I doubt they would find that a comfort.

In the absence of compelling evidence that the consumer would save substantially through the vitiation of the present agreements between bottlers and syrup companies and in the presence of significant evidence that an entire industry would suffer through a potentially devastating reorganization, I decided to offer this legislation for the consideration of my colleagues. Over 75 of those colleagues have agreed that the evidence is on the side of the bottlers and have joined me in this effort.

The American small businessman deserves some consideration. He is the bulwark of our American economic system and we here in Washington must not impose upon such businessmen unworkable regulations based on economic philosophy and theory but without concern for their very pressing economic realities.

Mr. Chairman, as you know, I have great respect for you personally, politically, and professionally and consider it a privilege to serve with

you and particularly to have a chance to serve with you on this committee.

I find it difficult to reconcile how you and I grew up with the same facts and came up with different conclusions. I guess that is what makes the world a more interesting place in which to live.

I think it is important to try to distinguish some of the characteristics of the soft drink industry compared with some of those which you addressed in your very proper opening remarks. It is difficult for me to see how when you are very familiar with the way soft drink bottlers operate, at least in my State and in the States of most of our colleagues that are supporting this, you can compare this kind of industry with the trucking industry, with the rail industry, even with the electronics industry. To be sure there are a few of what are referred to in a piece in this morning's Washington Post as "Big Boys" in the soda pop bottling industry. They are there. But I find it almost inconceivabe that when very conscientious, careful, studious individuals who are concerned about the "Big Boys" look at this legislation, some of them for some reason ignore what is going to happen to the large bottlers if this legislation doesn't pass.

If this legislation doesn't pass, the "Big Boys" that we are all afraid of are going to control the whole industry. They are going to move out there, they are going to buy up these little franchises for the price of equipment and, in my judgment, we are going to have less competition instead of more competition. That is what concerns me. The "Big Boys" that I am concerned about are some 49 bottlers in Indiana and about three-fourths of them require less than 100 people to run their business. Hardly what I call "Big Boys." What happens if they go under, which will very likely be the case? I believe that then the so-called "Big Boys" will move in and buy up that operation and be in a much stronger position to monopolize it and to fix prices—they will undoubtedly cut down on the number of machines which now service thousands of people. That service will go right out the window with the small dealers who are able to provide that service now but who will not be around to provide it if this legislation does not pass.

I think it is important for us to understand that the reason I got involved with this legislation is that the bottling industry has operated successfully as presently organized for 75 years. I will be "darned" if I, as a legislator, am going to sit here and not have some voice in determining the interpretation of a rule established by an agency when that agency, not responsible to the people in this country, makes a determination that will reverse 75 years of successful operation and restructure a well-run industry.

It is rather remarkable to me that some can reach an opposite conclusion. One of the distinctions that exists between the soft drink industry and other industries that have been used by opponents of this bill as examples of similar industries and which, as a matter of concern, the Chairman and I find ourselves shoulder to shoulder in most instances, is that there is already significant interbrand competition out there in the soft drink market. In my opinion it is not a question of whether or not there needs to be more intrabrand competition, whether you buy this fellow's Coke or that fellow's Coke,

or this fellow's Pepsi or that fellow's Pepsi, the real competition in the soft drink industry is whether you want to get Pepsi or Coke, or some of the other competing brands and nobody can deny that there is tremendous competition of that kind out there. Mr. Chairman, you have already gotten too much from me, I'm sorry. You would have been better off, we all would, I think, if I had just read my statement. [Laughter].

Senator METZENBAUM. I would like to point out to my very good friend, Birch, who, incidentally, has seniority over me on this very committee, that, in the 1950's, with the restrictions, there were 7,000 bottling companies and in 1978, there were 1,900 companies and it is reliably being predicted at the moment that by 1985 there will only be 200 bottling companies and I am not sure, but part of the implicit aspect of strong support of this legislation by the smaller bottlers isn't a concern on their part—and a rightful concern and I don't fault them for this—that with the territorial restrictions, they will be able to sell out for a better price. My guess is that they will continue to be selling out. That, in and of itself, is of major concern. I am not sure that this legislation keeps that—it doesn't keep it from happening. The real question is can the bottler in Mansfield, Ohio, compete with the bottler in Ashland, Ohio or whatever the case may be? I think that is a basic question and I guess we will hear from the FTC today and we will hear from the Department of Justice as well as some others who are knowledgeable in this area.

Before doing so, I am very pleased to have with us today, sitting with us today, Senator Cochran. Do you care to make any statement?

OPENING STATEMENT OF HON. THAD COCHRAN, A U.S. SENATOR FROM THE STATE OF MAINE

Senator COCHRAN. Thank you, Mr. Chairman, for permitting me to join you this morning.

Senator METZENBAUM. Happy to have you.

Senator COCHRAN. I want to thank the subcommittee for your holding these hearings. I think it is very important to the subcommittee, as well as the full Committee on the Judiciary to try to get to the bottom of this very thorny issue. I am a cosponsor along with the distinguished Senator from Indiana of this legislation and have a very keen interest in it.

I am convinced, as he is as he so well stated that without this legislation, we are going to see a deterioration in the opportunity for competition within this important industry. Nonetheless, I am willing to give a fair hearing to those who have a contrary view and as I understand it, that is the purpose of this hearing today.

Thank you again, Mr. Chairman for permitting me to be here. I am supposed to be in another place right now so I may not be here that long but I wanted you to know that I appreciate your having these hearings.

Senator METZENBAUM. We are happy to have you with us at any time. Our first witness today is William B. Comanor, Director of the Bureau of Economics of the Federal Trade Commission.

Mr. Comanor, do you have a prepared statement?

Mr. COMANOR. I have a prepared statement with attachments.

Senator METZENBAUM. Are you in a position to include your entire statement in the record? You can either read the entire statement or, if it is rather lengthy, you can orally deliver your remarks and we will put the entire statement in the record.

TESTIMONY OF WILLIAM S. COMANOR, DIRECTOR, BUREAU OF ECONOMICS OF THE FEDERAL TRADE COMMISSION

Mr. COMANOR. Thank you, Mr. Chairman. Actually, my statement is only seven or eight pages and the rest of it is attachments; perhaps, I might just summarize my statement.

With me is Keith Anderson, Bureau of Economics, FTC.

Let me say that I am delighted to return to the subcommittee to talk about this issue. This has been a reoccurring task for me. I testified on very similar matters both in 1972 and in 1976; I believe 1972 was before this same subcommittee. Copies of the earlier statements are attached for your information.

My interest in this topic is long standing now. Over 10 years ago I wrote an article on territorial and vertical restrictions which was published in the Harvard Law Review. That article is also attached to my statement. I will spare you complete repetition of these statements and the article.

The fact that this issue reappeared with some regularity, suggests that to some persons this matter is rather important. This fact tells us little about appropriate public policies. What it may mean is the increased profits associated with these restrictions may mean increased efficiency, but at the same time, there may be an increase of monopoly power. The issue which I talk with you about today is the prospective effects of the vertical restraints in this industry on both efficiency and monopoly power.

There is no doubt that increased monopoly power may indeed result from direct restraints on competition from alternative suppliers. Intrabrand competition is certainly directly suppressed. In addition, the protected positions reserved for distributors may encourage the provision of dealer services which enhances product differentiation, and I believe, will have a direct effect on competition at the manufacturers' stage. There are certainly circumstances, however, where the imposition of vertical restraints may have few incompetitive effects. For example, if the structure of the market at the manufacturing stage were highly competitive, then one could not say that these restraints would restrict competition.

I think a crucial issue in this matter is the degree of competition which exists at the manufacturer stage, between Coke and Pepsi, and that issue I will return to later on in my statement.

On June 4 of this year, this committee heard testimony of various supporters of this legislation and included in that testimony was that of three economists. Perhaps it would be useful for me to examine their positions and point out the differences which exist between them and the position that I take.

I have argued that the imposition of vertical restraints leads to higher costs to consumers. It is interesting that Professor Goldberg who testified on behalf of the National Softdrink Association admitted,

and I quote "the initial effect of 'walls down' competition would be price competition and lower prices for the large chain accounts."

Senator METZENBAUM. Would you repeat that, please.

Mr. COMANOR. Professor Goldberg said "the initial effect of 'walls down' competition would be price competition and lower prices for the large chain accounts."

Senator BAYH. Mr. Chairman, would the witness then go on and read the rest of Professor Goldberg's assessment and what would happen. You said initial.

Mr. COMANOR. Oh, that's right, that's in my next paragraph.

Senator BAYH. I am only bringing this up because you have done a great job in your statement of taking bits and pieces of the testimony of others without presenting a fair assessment of the point they are trying to make.

Mr. COMANOR. Well, I do, indeed, come to their conclusions, but I want to try to point out why I come to different conclusions.

Senator BAYH. I don't want to get argumentative, obviously you come to a different conclusion but I do want to suggest that they come to different conclusions than one might gather from your testimony and I don't think it's fair.

Mr. COMANOR. You are right, Senator, but of course.

Senator BAYH. Excuse me for interrupting, but this business of taking part of the sentence, I mean, we all have that done to us on occasion, I am used to it, but I hate to see some academic treated in the same way as we are.

Mr. COMANOR. Mr. Goldberg, indeed, said that this initial effect would be countered. If you examine the statement, and I would be perfectly happy to read the entire statement, his argument says that prices would rise from sale of the smaller outlets even though they fell on sales to the larger chains. I think that is the essence of this position.

Yet, it seems to me that this argument that prices would rise on sales to smaller outlets requires an assumption which is implicit, but not explicit in his statement, that distribution costs for these smaller outlets would rise. Personally, I cannot see any reason why this should be so. The costs of distribution for the smaller stores may just as likely be unchanged because the same activities would enter in.

More important is that the elimination of territorial restraints permits new channels of distribution to develop if they are more efficient, with accompanying benefits to consumers. The imposition of these restrains impedes the development of new methods of distribution and serves inevitably to raise prices overall.

Let me say that, while these restraints may have made sense in the past with an old technology, we have a growing changing economy and the problem with restraints of this sort is that they lock us into existing kinds of distribution where new kinds may, indeed, be more efficient and more effective.

Further testimony was provided by Professor Williamson of the University of Pennsylvania, who refers directly to my earlier article where I suggested that any additional services provided free or below cost to consumers through the imposition of vertical restraints would be supplied separately if there was sufficient consumer demand for them.

Professor Williamson objects. He argues that "whether valued services can be delivered in the way contemplated by Dr. Comanor * * * depends on the costliness of writing and negotiating comprehensive contracts." I think Professor Williamson's essential position is that these services, these ancillary services, distribution and advertising, may be reduced in supply because of the difficulty of contracting to provide them separately.

These services—and I think you have to look at the precise services he is referring to—these services include frequent delivery. But more important is substantial advertising and promotional efforts which characterize the marketing in this industry. I agree with him that these services are valued by consumers, but even so, consumers do not value them regardless of price. That's the important issue. The issue at hand is whether the optimal quantity of these services would not be provided if they were supplied separately.

I think a more important passage in Professor Williamson's testimony, a passage I would like to call your attention to, is the following statement:

> The presumption that territorial restraints have the purpose of promoting more cost-effective marketing is subject to challenge in industries in which interbrand competition is weak. Where this pertains, the possibility must be faced that vertical restraints have the purpose of promoting more effective ologopolistic pricing.

He emphasizes this. This is the testimony given earlier—that the presumption these restraints promote efficiency must be called into question where "intrabrand competition is ineffective." Let me say that I agree and concur with Professor Williamson's statement. I think, as Senator Bayh said earlier, that much depends on scope of competition in the soft drink industry.

Let me turn to that issue now. It seems to be of primary concern in both Senator Bayh's statement and in Professor Williamson's statement.

I have three tables which I would like to call to your attention. Although there are more than 50 firms that manufactured soft drink concentrates in 1977, the 5 major firms had, as you can see from table 1, a combined market share of 77 percent. This picture is not a picture of a highly competitive industry, but rather, an industry which is characterized by substantial ologopoly where control is in the hands of a small number of firms.

Let's look at these issues in terms of concentration ratios the share of total output of the largest four or eight firms. This is the traditional measure of market power. Indeed, this committee publishes such statistics on a nationwide basis for a large selection of industries.

Relevant concentration ratios at the manufacturers stage are given in table 2. I think that most economists that look at the statistics in tables 1 and 2 would agree that there is a substantial amount of monopoly power. I am struck by the fact that the third economist who testified on behalf of the National Soft Drink Association, Professor Preston, indeed, wrote a book which concentrated on the importance of concentration as a source of monopoly power. No doubt, if he were here today, I could ask him whether these concentration measures indicate competition and monopoly. I think he would agree with me.

Perhaps, an even more important index is the level of profitability, earned not in a single year, but over a long period of time. I would

like to call your attention to the statistics given in table 3. The average rate of return for these five firms was 21.6 percent, after taxes, in 1977 which should be compared to the average rate of all manufacturing firms of this country in the same year, which was 14.2 percent. So, these dominant firms earned substantially higher rates of return than was earned by other firms.

Still, the picture persists if we look at the longer 15-year period. The average rate of return, after taxes, on stockholders equity exceeded 21 percent, which is compared to an average return for all manufacturing of 12 percent—not quite double, but substantially greater than the average manufacturer.

What we observe, therefore, is an industry where high levels of market concentration coexist with rates of return that substantially exceed the average for all manufacturing. There appears to be considerable monopoly power in this industry. These data hardly suggest that this industry corresponds to the textbook version of perfect competition.

Even though Coke competes with Pepsi, these firms are both dominant firms and we all know that there are industries in which smaller firms coexist and compete with each other but for which the degree of monopoly power in the industry is still considerable.

We cannot rely on intrabrand competition as a solution for all competitive problems in this kind of industry. In such circumstances, using the test suggested by Professor Williamson, vertical restraints may, indeed, be used to achieve anticompetitive results.

Let me make one final point. For the most part, these restraints result from perpetual contracts entered into some years ago between the syrup manufacturers and their bottlers. Whatever the benefits which we may have accrued originally from these restraints, it seems apparent that the major beneficiaries currently are the bottling companies. Competition faced by these companies is limited as a direct result of these restraints.

Special exemptions to the antitrust laws of the sort contained in this proposed legislation limit our efforts to achieve a more competitive economy. As such, I oppose its enactment.

Senator METZENBAUM. Thank you, Dr. Comanor.

S. 598 generally makes territorial restrictions lawful in the soft drink industry, provided the soft drink is in substantial and effective competition with other products of the same general class. Do you believe this proviso is strong enough to protect the consumers from monopoly pricing in the soft drink industry?

Mr. COMANOR. The crucial issue is the structure of the market at the manufacturing stage. With the tables that I had indicate that competition in this industry is not vigorous; otherwise, we would not expect to see substantial rates of return over a long period of time of this magnitude and I think once you carry out this test today, in my judgment, we can't rely on competition at the manufacturer stage to deal with this issue. I think these tests should be carried out today and I don't know that we need to rely on some point in the future.

Senator METZENBAUM. Is there any language that could be included in this legislation in the event the committee saw fit to pass it that would provide that kind of protection that you think would be desirable?

Mr. COMANOR. Let me say that I am not an attorney and, therefore, providing this language is not my job. I presume that one could devise language that would emphasize the fact that in markets characterized by a substantial degree of concentration, especially high level of concentration, these restraints would not be permitted. I cannot give you specific language.

Senator METZENBAUM. The subcommittee would be pleased to have you obtain from those who do provide legal counsel to the FTC whether you have any specific suggestions that would necessarily not make you favor the legislation, but might improve its quality.

Mr. COMANOR. I would be delighted to discuss this with them.

Senator METZENBAUM. Dr. Comanor. Do you believe there is a real danger that Coke and Pepsi will use their own bottling operations and their superior resources to drive the independent bottlers out of business if territorial restrictions are eliminated?

Mr. COMANOR. No; I do not. In a real sense, these firms serve the industry—including Coke and Pepsi—that's how the bottling firms were created in the first place. I see no reason why the benefits of entering the bottling stage would be such that either Coke or Pepsi would move in that direction.

Senator METZENBAUM. Has the soft drink bottling industry become more concentrated in recent years? I guess from your table, that it has. That is quite obvious.

Mr. COMANOR. These tables refer to the manufacturer level. However, it is true, that in any territory each of the soft drink firms has just one bottler. For example, in Santa Barbara, Calif., there would be one Coke bottler and one Pepsi bottler. Then the market, at the local stage, would typically mirror the situation at the national stage, though there may be difference across different locations. These figures, however, refer to concentration levels at the manufacturer level, not at the bottler level.

Senator METZENBAUM. In simple direct terms, what would be the likely consequences for consumers if territorial restrictions remain in effect?

Mr. COMANOR. I think territorial restrictions lead to higher prices for consumers. They prevent the development of new methods of distribution which may result in having one bottler shipping into a larger territory. These new methods may be more efficient, and if they are more efficient, one would expect these efficiency gains to be translated into the lower cost for consumers. I am afraid that these restraints keep us tied to a system of distribution which may have been effective and efficient some years ago but not necessarily today.

Senator METZENBAUM. The argument is made that the small bottler will be driven out of business because the large bottler will ship into the territory. In view of the very substantial transportation costs for the bottling industry, whether they are returnables or nonreturnables, do you think that this is a logical argument since the cost of production, as I see it, does not vary that much between the larger bottler and an efficiently operated smaller bottler?

Mr. COMANOR. If a large bottler and a small bottler are equally efficient as you suggested, then there is certainly no damage from the large bottler; indeed, there is a disadvantage because of the transportation costs which he must bear. So, in fact, if efficiency considerations

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are as you suggested, I can see no prospect that smaller bottlers would be forced out. It depends on relative efficiency levels. There may, of course, be some small bottlers who are less efficient and these firms may be driven out but that would be a benefit to consumers. That of course is the basic underlying purpose of this.

Senator METZENBAUM. Supporters of S. 598 also argue that warehouse delivery of Coke, Pepsi, and other soft drinks will mean the end of the returnable soft drink bottle. Can you respond to that argument?

Mr. COMANOR. I have heard that argument but I don't truly understand why returnables should be eliminated if there is warehouse delivery. As I understand it, there is no logic behind it.

Senator METZENBAUM. I won't attempt to make the argument.

You correctly pointed out that consumers do not value services such as frequent delivery, advertising, and promotional efforts regardless of price. Price is a very major consideration for the consumer. Are you suggesting that consumers may be paying for services and advertising that they would gladly do without if the cost were deducted from the cost of their soft drinks?

Mr. COMANOR. Yes; I think that is precisely the point that I wanted to make. It may be true that these restraints are needed to increase the volume of some services such as advertising promotion. I certainly accept the validity of the point. But at the same time, the issue is not what is best for the manufacturer or what is best for consumers. There is no reason to believe that the volume of these services which consumers are paying for implicitly through the higher price of restraints is the volume that they would buy if they were sold separately. My argument would be that while consumers may value the services, they should be asked to evaluate them independently.

Senator METZENBAUM. You point out that the sirup companies have had an average after-tax return in excess of 21 percent over the past 15 years. That is 75 percent higher than the average for all manufacturing companies. How do you believe this rate of return would have been affected if the sirup companies had eliminated these territorial restrictions?

Mr. COMANOR. I think this rate of return would have declined somewhat, although we don't have any good statistical evidence to tell you how much. I think the sirup manufacturers benefit from these restraints but I know no way of telling the quantitative value.

Senator METZENBAUM. You stated in your testimony that the major beneficiaries of these territorial restrictions are the bottling companies. How did you reach that conclusion?

Mr. COMANOR. Because these restraints limit competition among bottlers. A bottler in one area does not have to compete with another bottler of the same soft drink. Where these restraints break down, and there are cases in which the restraints break down, we see directly that the outside bottler will be selling at the lower price and the local bottler will be forced to meet this lower price and competition will take place. There is no doubt that the main beneficiaries of these restraints are bottlers who are protected from this intrabrand competition.

Senator METZENBUM. Much has been made of the fact that some of the restrictions were created 75 years ago. Is it possible that restric-

tions which originally enhanced competition could, at this point in time, retard competition?

Mr. COMANOR. Yes, indeed. In a competitive market, restraints may be procompetitive, proefficiency and that may have been the picture of the soft drink industry 75 years ago. To be quite honest, I have not done a study of the nature of the industry that long ago. However, today, the industry is characterized by ologopoly and high returns. There is no reason why this industry requires these restraints.

Senator METZENBAUM. Senator Thurmond.

Senator THURMOND. Thank you, Mr. Chairman. I am glad to have you with us, Mr. Comanor.

I was just wondering why it is that your position, that is, the position of the FTC, in proposed legislation, such as S. 600—you are familiar with this——

Mr. COMANOR. Yes.

Senator THURMOND [continuing]. Is that "bigness is bad," while this bill, S. 598, your position appears to be just the opposite.

Mr. COMANOR. Let me say that my position on this bill is a long-standing one. I have been with the Commission for only 1 year now. However, I have been involved in the argument over this topic over 10 years, so that the position I am taking today is the position that I took, as professor of economics at the University of California, well before I came to the Federal Trade Commission. It is my position, as much as it is the Commission's position. The Commission has certainly taken the position you described on S. 600. That bill deals with very large firms, dominant firms—it has to do with mergers where increases in size are associated with very special types of firms. I think that, logically, one could separate a position on that type of legislation from a position here, where our policy is predominantly one promoting competition. This may mean some exceptions from the merger policies suggested by S. 600. I think this is essentially different.

Senator THURMOND. S. 600 is more or less to keep companies from becoming bigger, isn't it?

Mr. COMANOR. That's right.

Senator THURMOND. Now, S. 598 is the opposite, isn't it?

Mr. COMANOR. I don't think so. I think the object here is not to help big firms or small firms. It really is to promote competition which benefits consumers. The consumer interests are served best, in my judgment, by—better competition and if the large firms and small firms are equally efficient, then it will not be that large firms will gain at the expense of small firms or small firms will gain at the expense of large firms. The object is to benefit consumers through more effective competition.

Senator THURMOND. I notice that you state that "special exemptions in the antitrust laws of those contained in this proposed legislation limit our efforts to achieve a more competitive economy." I believe you made that statement. But in reality, would it not be more accurate to say that without this proposed legislation the very large companies would be allowed special exemption by having no territorial provisions?

Mr. COMANOR. I don't believe that would be the case, sir, because certainly you have some bottlers, some large bottlers which would exist

in this industry and you wouldn't expect to see these large bottlers not face competition from small bottlers or other larger bottlers, especially if new forms of distribution arise, new means of transportation—you would not be locked into a preexisting system of distibution. I would not see the condition as large versus small firms. In every instance that I know, where these restraints have broken down, consumers have benefited from the lower prices typically through large chain retailers, but these lower prices have been passed on to these consumers. I think that should be our main course.

Senator THURMOND. I don't think you answered the question I propounded, or are you aviding it?

Mr. COMANOR. Perhaps you could repeat it, and if I didn't answer it, I will try again.

Senator THURMOND. Well, you stated, and I think you agreed you stated, that special exemptions to the antitrust laws of the sort contained in this proposed legislation limit our efforts to achieve a more competitive economy. But in reality, would it not be more accurate to say that without this proposed legislation the very large companies would be allowed special exemption by having no territorial provisions?

Mr. COMANOR. I don't understand that. Why would the large bottlers be granted a special exemption? Do you mean the large manufacturers who enter into the bottling business?

Senator THURMOND. Well, you don't allot territory anywhere and if a big bottler came in and competed with a little bottler and cut prices, you would put the little bottler out of business, wouldn't you.

Mr. COMANOR. That would only be possible if this big bottler were more efficient than the little bottler. As Senator Metzenbaum indicated, there is no indication that this is the case.

Senator THURMOND. Now, in answer to a question from the chairman, I believe that you indicated that large bottlers would not invade the territory of a small bottler.

Mr. COMANOR. No, I didn't say that, sir.

Senator THURMOND. Well, in our hearings in the early 1970's Senators from a number of States testified that large bottlers from large cities would invade the territory of a small bottler which resulted in the congressional bills in 1972 and since then.

Mr. COMANOR. Yes, sir, it certainly may be the case that some large bottlers may be more efficient than some small bottlers and that one would expect and, indeed, hope and desire that these more efficient firms either large or small would expand themselves, lower prices, and have a beneficial effect on the consumers. It may very well be that less efficient firms will leave the business, that would be true of less efficient small firms or less efficient large firms. The gain from competition, the reward of efficient firms, large or small, would be at the expense of these firms.

Senator THURMOND. You know, it's a little difficult to believe that there is not a problem here, yet over 70 Senators introduced the bill to correct something. Over 70 Senators—how do you reconcile that? You only have 100 Senators in the Senate and that is over two-thirds of them and if they introduce a bill they feel is needed to correct the problem, then there must be some merit in that feeling, along that line, don't you think?

Mr. COMANOR. Let me say, sir, that I don't understand the workings of the U.S. Senate and I can say very little as to why that is. You have moved beyond my area of knowledge.

Senator THURMOND. Now you see, you have got people on here, not just one group like liberals or conservatives, or northerners or southerners, you have Senator Bayh here from Indiana—nobody could accuse him of being a conservative, I don't think. [Laughter.]

Senator METZENBAUM. A very reactionary fellow.

Senator THURMOND. And you have Senator Helms from North Carolina—I don't think anybody could accuse him of being a liberal. [Laughter.]

And you have Senator Eagleton from Missouri, in the middle of the country; you have Senator Chiles from Florida and then you have people from North Dakota, South Dakota and Georgia and Montana, Kansas; you have them from all over, and Senator Mathias from Maryland, I believe is a cosponsor here, too.

Now, these people wouldn't join on this bill, so many of them, unless they thought there was a problem.

Senator METZENBAUM. Is it possible, Mr. Comanor, that the consumer's lobby isn't quite as effective as the soft drink lobby? Do you think that is possible?

Mr. COMANOR. I defer my judgment.

Senator METZENBAUM. I want to point out to my friend from South Carolina that he should not overlook the House; they have 310 cosponsors over there according to last count.

Senator THURMOND. I am not surprised, that is about the ratio over here—about three-fourths of them. That shows the sentiment of the people back home because I think that if they listen to any lobby that isn't in line with the thinking of that constituent, I think they will get in trouble.

Well, I just wanted to call that to your attention because what you are saying in your position is completely out of line with the thinking of about three-fourths of the Senate. Now, you might be right sometimes, in minority in that case. You could be right, but I do not think so.

Senator METZENBAUM. Mr. Comanor, don't feel too bad; I think the Gulf of Tonkin resolution passed unanimously and I am not sure that was right in that respect.

Senator Bayh?

Senator BAYH. I don't want to get semantical here, but I would like a clarification. In your statement, you continue to refer to bottlers. Now, could you tell us, on table 3 where we talk about the rates of return of the leading soft drink concentrate manufacturers, is it concentrate manufacturers, or is it the return of bottlers which you refer to in your oral testimony?

Mr. COMANOR. The rate of return refers to concentrate manufacturer, as does table 1. I see no reason why these would—I should have used the word "concentrate manufacturer" in table 1 and throughout the statement, when I was talking about competition at the manufacturers stage, I was referring to the soft drink concentrate manufacturers.

Senator BAYH. Here again, I think you need to clarify, if we are talking about the rate of return of major corporations headquartered in Atlanta and the rate of return of the bottler who is in Crawfords-

ville or Terre Haute or Portland. Do you have any studies on the profitability of actual bottling plants?

Mr. COMANOR. No, sir, not of profitability of firms at the bottling stage of production. These numbers were preliminary, simply because of the test suggested by Professor Williamson, who testified earlier. Professor Williamson indicated that the appropriate test is the degree of competition at the manufacturers' stage. And, therefore, what I did was to gather evidence of the degree of competition at the soft drink concentrate or sirup manufacturing stage. His argument asks whether interbrand competition is effective. To look at that issue, one would look at competition among the soft drink concentrate manufacturers. One could look at bottlers, I suspect, but I do not know what they are. This rate might apply to some bottlers. There might be others with a larger return, some bottlers with a smaller return.

Senator BAYH. Did the FTC when they made this decision, did they have a chance to study the profitability of the bottling part of the soft drink industry?

Mr. COMANOR. I really didn't get into that. That position was taken down to our commission—I have not looked through the entire record. To answer that question I could in writing if you want, sir.

Senator BAYH. You wrote a law journal article 10 years ago at Harvard, did it contain any data in it about the profitability or efficiency of the people who actually bottle the soft drinks.

Mr. COMANOR. That article does not refer to soft drinks, individually. It refers to basic principles about vertical restraints throughout the economy. It is not a statistical piece. I would suspect that there would be some evidence in the record of the FTC case, but I do not know and can only answer that question, I——

Senator BAYH. Mr. Comanor, you are the Director of the Bureau of Economics, you are one of the foremost scholars and writers in this period in this area and you are here in opposition to a bill that is designed to maintain a kind of contractual relationship in geographical areas between major companies and bottlers and you can't tell us that there has positively been any study of the economic health of the bottler. Does that not strike you as strange?

Mr. COMANOR. Let me try to answer that question in the following way. It may very well be that small bottlers are efficient——

Senator BAYH. We are not talking about small bottlers, do you have any information about large bottlers?

Mr. COMANOR. Maybe large bottlers, some large bottlers are efficient. These firms, I would expect to see, earn very low profits. However, the fact that they earn low profits perhaps even throughout the industry would indicate nothing to my viewpoint as to whether or not these restraints promote monopoly power. It would seem to me that the appropriate test was the test suggested by Professor Williamson who testified on behalf of the National Soft Drink Manufacturers. Therefore, I do not think that you could understand the economic implications of these restraints by simply looking at the health, the profitability of some bottlers and others. I think the right test is the test that he suggested which is the one I focused on.

Senator BAYH. I don't see how you can sit in Washington or someplace else and examine theories of basic underlying concepts and not

understand how these concepts impact on the people that are in the industry.

The only way you can tell whether there is going to be more or less competition, whether the large firms are going to go and buy up the small firms, whether firms are going to go bankrupt and this kind of thing is to know what the health of the local bottler or the bottling industry itself is.

Mr. COMANOR. Suppose you found that some large bottlers had moved into smaller territories and that they would buy out the smaller bottlers, the question is what would that tell you? Suppose you found it, what would it mean? It might very well mean that new modes of distribution had arisen in which it became more efficient through the territory being larger than previously. That is precisely what an efficient economy would show.

Senator BAYH. And you don't feel there has been any efficiencies in the bottling business? What happened? Why do we go from 7,600 to 1,900 in a relatively short period of time?

Mr. COMANOR. I think that is an indication that the appropriate scale of production is growing larger. The trouble with the restraints is that it locks us in to an old pattern of distribution; it impedes bottlers that may be more efficient from expanding their territories at the admitted expense of others but in the interests of promoting the welfare of consumers. We have moved some in this direction but these restraints limit the extent of this movement.

Senator BAYH. We have seen the competition or whatever it is, apparently there is not much competition out there by your definition, but something has caused three-fourths of the bottlers to leave the industry. It would seem to me that there must be forces out there, efficiency and this kind of thing that have resulted in the kind of integration that you want to see. You mentioned that the bottling industry is not a textbook version of competition. Could you tell me an industry that is?

Mr. COMANOR. You certainly find that the more competitive activity in the sale of most agricultural products which comes close to the textbook version of competition in this.

Senator BAYH. How many major grain firms are there today?

Mr. COMANOR. I am not prepared to answer that.

Senator BAYH. Probably five or six. They operate on a multinational level and it is the darndest cartoon we have got going. Let's not get started with this—the Federal Trade Commission ought to look at grain handling and the way those major grain firms jack up the market, rip off the farmer and then make a fat profit.

Now, Mr. Chairman, that is probably not relevant to our record but——[Laughter.]

I wish that Director of the Bureau of Economics of the Federal Trade Commission would know a little more about how the grain industry as a whole really operates.

Mr. COMANOR. Sorry, I thought it was on the producer level, not the intermediate stages, but perhaps we should look into it. The point is that there are industries which are more or less competitive.

Senator BAYH. You are not suggesting that we are going to compare a million farmers as a textbook version of industry with any other American industry.

Mr. COMANOR. Let me go further—certainly it is true that if the average rate of return for all manufacturers were 12 or 14 percent we know that there are many, not most, whose profitability lies in that range and it is striking that this industry is one of the handful in which the profitability is substantially higher than the average of all manufacturers.

Senator BAYH. Sirup manufacturers?

Mr. COMANOR. That is what I am talking about.

Senator BAYH. That is what you are talking about?

Mr. COMANOR. That is correct, sir.

Senator BAYH. The thing that concerns me about this, Mr. Chairman, is that the concentration of study has been on the concentrate manufacturers with no efforts to try to determine what this legislation or what the change of policy brought by the Federal Trade Commission decision is going to do to the way this concentrate is distributed.

Senator METZENBAUM. Perhaps there would be some value in this subcommittee setting up other hearings to allow the bottlers to tell us what their degree of profitability is. I am certain that they, in their organized effort, have had some figures and facts on that. The Chair would certainly be interested in learning that kind of information.

Senator BAYH. Mr. Chairman, with all respect, we have already had that testimony in the first day's hearings, but, apparently, the people down at FTC haven't heard it.

Mr. Comanor, I am sure you are very sincere and you feel very strongly about this but I don't know how you can look just at theory without seeing how that theory is going to be implemented.

You know we had the administrative law judge who found substantial interbrand competition. The FTC overruled that. You have Professor Williamson who is stressing interbrand competition and that is my concern about this.

Mr. COMANOR. If one was concerned with examining interbrand competition, one would look at competition among the major producers, sirup manufacturers, and that is precisely what I have done. If it is true that there is one bottler in any given territory for each of the sirup manufacturers, then one would expect approximately that the relevant market shares would be the same within each location, as they are for the country as a whole. There are some differences, and this would represent the average of concentration levels in a given territory.

Senator BAYH. What is going to happen—let me get that straight—to a small bottler or a medium sized bottler when they get into intrabrand competition, which you have emphasized you believe would lead to greater efficiency and benefit the consumer, as far as the chainstores are concerned when you have a large bottler making large quantities of their product available to warehouses. What is going to happen to the smaller and medium sized bottlers in this country then?

Mr. COMANOR. If these firms are equally efficient as the larger bottlers, they should be able to compete for warehouse sales with the larger bottlers and we expect to see prices decline from the higher prices which are currently set. If, however, these firms are less efficient than the larger manufacturers, then they would be at a disadvantage. In any respect, it is the more efficient firms which remain in the business and the consumers will benefit if the smaller bottlers are more

efficient. If they are equally efficient they will be able to match the lower prices set by the outside larger bottlers and consumers will benefit. The effect is the price levels which the chains will pay for soft drinks which we would then expect to see and have seen in some cases, the lower prices will mean lower prices to the consumers.

Senator BAYH. What about the sales that don't go into the warehouse?

Mr. COMANOR. That is an issue that I did address in my testimony—it seems to me that these sales would continue at current prices. There is no reason to believe that the smaller bottlers who sell directly to the smaller outlets——

Senator BAYH. You have profitability in syrup companies.

Mr. COMANOR. That's right, sir.

Senator BAYH. Syrup companies basically make the same profits on the syrup whether it is sold by a large bottler from Dayton, Ohio coming into Portland, Ind. as they would by the Portland bottler.

Mr. COMANOR. Yes, sir.

Senator BAYH. If you have a bottler in Dayton, I am making this a specific example because there is some of that now under the franchise situation where a Dayton bottler does cover part of Indiana, but take Chicago, maybe Indianapolis, where they can ship long distances in truckload volume and will do that without territories because they make a profit. Why should they continue to service small volume accounts. In essence, would not those outlets cease to be served?

Mr. COMANOR. That's not true sir, because the smaller bottlers may stay in business simply to service them.

Senator BAYH. That's where your logic breaks down. Talk to some bottlers. Most of the volume of the small bottlers goes into the chain store too and the only way a bottler can afford to service the marginally profitable accounts is because he is sustained by the profit of the volume of chain stores.

Mr. COMANOR. Note the implication that you just said. You said that sales to chain stores subsidize sales to smaller outlets. The smaller bottler makes profits on one area and uses these profits to subsidize sales to smaller stores. That is an inefficiency because that means that the price charged to consumers does not reflect the true cost of distribution. If the costs of distributing the soft drink is lower to chains than to smaller stores that should be reflected in the prices the consumer pays for the convenience of going to the smaller store, they can buy that convenience.

Now think what would happen if the subsidization did not exist. The price that the smaller bottler would have to charge to these stores, to the smaller stores, would rise because they couldn't subsidize and these higher prices would be passed on to consumers. Consumers would then have the choice of buying soft drinks at the larger chains at the lower price, or, perhaps, nearer to their homes at a higher price. But that difference in distribution costs surely should, in fact, be related to relative prices. The problem with the current system is that you have this form of internal subsidization which creates an inefficient vehicle of distribution. You don't distribute enough to chains. I guess that is the implication of this form of subsidization.

Senator BAYH. Well, I must say I have never written a treatise and sure don't know nearly as much about the basic underlying philoso-

phies that you do and I salute you for the knowledge you have. I have talked to small bottlers and seen the way they operate; I have talked to retailers and they are mutually concerned that instead of the way you characterize it, that the service will just be terminated or become so expensive that it will, in effect, be terminated. Now you are talking and your whole premise is based on consumer interest and I salute you for that. Why are there exemptions under the FTC decision for returnable bottles?

Mr. COMANOR. Let me try to answer that in the following way.

Senator BAYH. Was it related to the concern for the consumer of the soft drink?

Mr. COMANOR. I am not certain. I think the answer to that is—that exemption for returnables.

Senator BAYH. Have you read what the FTC says the reason was?

Mr. COMANOR. Yes, sir.

Senator BAYH. What does the FTC say?

Mr. COMANOR. The FTC says that, and I have it right here, that bottle recapture would be unpredictable and economically burdensome. It would be more costly to return bottles.

The important thing to note there is that soft drinks in returnables compete with soft drinks in nonreturnables. Therefore, it would be difficult, indeed, for these restraints, these limitations that restrain competition in one segment of the market, to give rise to monopoly power since the consumer would readily switch from returnables to nonreturnables if prices of returnables were higher. Therefore, one can say that this exception does not burden consumers because of the ease of switching, the readiness of switching between returnables and nonreturnables.

Can I get back to a statement which you made earlier? You said that many small bottlers need chain accounts in order to serve the smaller outlets. And, that if the large chains in an area shift suppliers the cost of servicing these small stores would go up and, perhaps, be prohibitive. That may, indeed, be true. But suppose it were true, that would mean that consumers would buy the soft drinks to a greater extent than currently from the large chains. But if the large chains can sell these soft drinks and distribute them more economically and sell them at a lower price, isn't that really in the interests of the consumers? Even if what the bottlers say is true?

Senator BAYH. That depends on whether you want to get in your car and drive to the supermarket or whether you want to walk to the corner grocery store; it depends on whether you want to take your own Dr. Pepper with you or whether you want to have the convenience of using the machine. That is what it all depends on.

Mr. COMANOR. The cost differential is reflected in price. If consumers really want to buy the convenience that you suggest, and I think they do, then they will pay the higher prices to the corner stores and they will buy this convenience. But we should not subsidize this convenience which has been what we do now, through this internal subsidization. At least I believe.

Senator BAYH. We have made concessions where we feel that service to the consumer is affected as well as price. I must say that I am very concerned about what the impact on consumers is going to be. We

have seen efficiencies in the bottling industry. We have seen the numbers of plants cut by three-fourths. I assume there will be additional mergers and buy outs, and this trend will at least continue partially. But I want to talk about competition—competition is what you are really looking for which, frankly, I think, we both regard with equal importance, Mr. Chairman I have already gone on longer than I intended to, but I think we have ignored the decision that the housewife makes when she determines what she is going to take home. I mean to say that she does not only have a choice between these five syrup companies in the kind of beverage she is going to serve. Why one has a coke instead of a glass of milk or a cup of ice tea or a cup of coffee, I don't know. We did a survey in our State and there are over 300 different kinds of beverages out there that the housewife looks at when she makes that kind of decision.

So we are really talking about limited competition through much more sophisticated economic theory and I must say as I look at what I think will happen here, and the reason I am supporting this legislation, and here again I guess my judgment is what it is because I have talked to the people that actually bottle soft drinks and I am not that familiar with the big boy that sells syrup. I am at odds with the sophisticated economic thinkers. When the smaller bottler goes out of business, you are going to have the syrup companies owning more and more of the bottling plants so that you will have vertical integration perhaps paralleling the oil industry and I think we are going to have less competition and competition is what serves the consumer. I think we are going to find the consumer in a less advantageous position rather than a more advantageous position. I know that you disagree with that judgment in the scholarly manner in which you have approached the committee.

Senator METZENBAUM. Dr. Comanor, at this point I am going to put into the record a letter I received from Mr. Thomas M. North, who describes himself as the "Pop Man," 4546 Dixie Highway, Drayton Plains, Mich., because it relates directly to your testimony. He writes, and I am excerpting it, not reading the entire letter:

> Four or five years ago I was first shown how powerful our American beverage industry is. At that time, I arranged to purchase all of my Coca-Cola from a bottler outside of my Coca-Cola franchise area. This bottler even sold me an old semi-tractor trailer and fork lift to facilitate shipment of this soda because I was responsible for the transportation of this product to my retail store. At this time, I was retailing for wholesale. After a short period of time, my local bottler found out where I was getting my Coca-Cola, and I found my prices were steadily being raised to where I could no longer afford to purchase my supply of Coca-Cola from anyone but my local bottler. At this time I contemplated an antitrust suit of my own but found there was no way I could afford this action. The result of this was that my customers were forced to pay more for their Coca-Cola. It goes on.
>
> At about this same time, because I had a truck, I decided to try to buy some of my other beverages from other suppliers. I was successful in finding a bottler of Squirt north of my area that decided to sell to me. Again, at a reduced price which made it worthwhile for me to afford transporting and still sell below the existing wholesale price in my area. Again my customers benefited. But only for a short period. As soon as my local bottler found out about it, I was told flatly that I could no longer buy Squirt from any bottler other than the one that served my area.
>
> Today, if I call a bottler out of my area and ask for the price of an item, I am given many different excuses. I have been told such things as you can't bring your truck into our warehouse to flat refusals to sell to me.

He continues writing about his problem with Hires Rootbeer and then he says, and I think this is the key paragraph:

The beverage industry is also telling us that they compete between the different brands. I cannot follow this when in my area, the wholesale price of all products are exactly the same and if one increases his price, all of the others will follow with the exact price increase within a couple of weeks.

Then he concludes. The entire letter will be included in the record, but I think it certainly relates to the question of the impact upon the consumer and the whole question of interbrand competition.

[The letter referred to by Senator Metzenbaum follows:]

SEPTEMBER 17, 1979.

Senator HOWARD METZENBAUM,
Chairman, Senate Judiciary Subcommittee on Antitrust and Monopoly,
Washington, D.C.

DEAR SENATOR METZENBAUM: I am the owner of a small retail pop store with annual sales of less than $400,000.00. Ninety-nine percent of my sales are beverage, and I am very interested in the "soft drink interbrand competition act" you are now studying.

Four or five years ago I was first shown how powerful our American beverage industry is. At that time I arranged to purchase all of my Coca-Cola from a bottler outside of my Coca-Cola franchise area. This bottler even sold me an old semi-tractor trailer and fork lift to facilitate shipment of this soda; because I was responsible for the transportation of this product to my retail store. At this time I was retailing Coca-Cola at a price less than my local bottler was selling it for wholesale. After a short period of time my local bottler found out where I was getting my Coca-Cola, and I found my prices were steadily being raised to where I could no longer afford to purchase my supply of Coca-Cola from anyone but my local bottler. At this time I contemplated an anti-trust suit of my own but found there was no way I could afford this action. The result of this was that my customers were forced to pay more for their Coca-Cola.

At about this same time, because I had a truck I decided to try to buy some of my other beverages from other suppliers. I was successful in finding a bottler of Squirt north of my area that decided to sell to me. Again at a reduced price which made it worthwhile for me to afford transporting and still sell below the existing wholesale price in my area. Again my costumers benefited, but only for a short period. As soon as my local bottler found out about it, I was told flatly that I could no longer buy Squirt from any bottler other than the one that served my area.

Today, if I call a bottler out of my area and ask for the price on an item, I am given many different excuses. I have been told such things as "you can't bring your truck into our warehouse" to flat refusals to sell to me.

This past summer my wholesaler of Hire's rootbeer decided to discontinue Hire's because he was also selling another rootbeer and sales of Hire's was slow. This meant that there was no wholesaler of Hire's in my area. Within a month after the discontinuance, a bottler outside of my area came to me and offered Hire's (delivered to my store) at a price $2.38 less than what I had been paying from my local wholesaler.

The beverage industry is now telling us that this could not be the case with the refillable returnable bottle, but I want to point out that in all of the above cases I was buying just that bottle.

The beverage industry is also telling us that they compete between the different brands, I cannot follow this when in my area the wholesale price of all products are exactly the same, and if one increases his price, all of the others will follow with the exact price increase within a couple weeks.

If you can support this act, then I think it is only proper for you to pass a law which makes all consumers within a 10 mile radius of my retail store purchase all of their beverage needs from me.

The beverage industry wrote this act to over-ride many years of federal trade commission labor, and my experiences should demonstrate to you that there is not enough competition in this industry and S-598 should be defeated.

Sincerely,

THOMAS M. NORTH,
The Pop Man,
4546 Dixie Highway, Drayton Plains, Mich.

Senator BAYH. Mr. Chairman, with respect to that letter, I would hope that we would also note that in the pop that this gentleman was buying, the soft drinks that the gentleman was buying from one market, he was picking up in his own truck and bringing it back to his store and whereas in the other market they were providing on-the-spot service, which is normally higher.

Second, I think if anyone looks at the price index in Port Huron and in Detroit, you will find that everything, not just pop, is selling higher in Detroit than in Port Huron because it is a higher priced market. So I don't want to make a Supreme Court case out of this but I think if we are going to pick one example, then we need to examine it carefully.

Senator METZENBAUM. I don't think the difference in the areas is that great—Mr. North also talks about the distributor in his area discontinuing selling Hires and outsiders coming in and offering him Hires at $2.30 a case less, delivered to his store, so it wasn't a question of his picking it up.

Dr. Comanor, do you have any comment that you care to make on that?

Mr. COMANOR. I think that is the type of prohibiting of preventing of retailers and wholesalers of this type that is indicative of the fact that these restraints lock us into old manners of competition, old manners of distribution and that this is a new approach and in my judgment, this is indicative of the fact that these restraints, indeed, are innovative of distribution.

It is true that in any innovative effort, someone gets hurt. This is the nature of a dynamic, competitive economy. In other words, these restraints lock us into the old ways of doing things and impede often the new approaches.

Senator METZENBAUM. Senator Cochran?

Senator COCHRAN. Thank you, Mr. Chairman. I was curious if you were aware of a letter that was sent around to some if not all Members of the House and Senate back in February by the Federal Trade Commission, a cover letter signed by Bill Baer enclosing a so-called "Fact Sheet", purporting to describe the Federal Trade Commission's decision which is the subject of legislation in that we are concerned with here today.

Mr. COMANOR. No, I haven't seen that letter.

Senator COCHRAN. Well, I wonder if you could have answers to a few questions that I would like to ask about that letter which you could submit for the record.

Mr. COMANOR. Yes, I could.

Senator COCHRAN. Specifically, I am wondering whether or not it is a common practice by the Federal Trade Commission to attempt to influence votes or action by Congress through letter-writing campaigns or other efforts directed to Members of Congress on legislative issues pending before the Congress? I would like to know whether or not Government funds were used in compiling the letter and sending it around. I would also like to know whether all Members of Congress received this letter dated February 12, 1979.

If not, why were some omitted and some included in the letterwriting? I would also like to know who authorized the mailing of the letter by the Federal Trade Commission.

It would be interesting to the committee to know how many times in the last 5 years the Federal Trade Commission has sent out similar letters on other issues to Members of Congress. I suppose, finally, I would like to know whether this mailing was requested by any Member of Congress.

My one comment is that I feel from reading this "Fact Sheet" that it is not a very valid presentation, if there was an effort to present facts, concerning the territorial restraints decision. It appears to be an argument in support of the Commission's decision which, of course, at this time and at that time has been appealed and was the subject of a decision by a Federal court.

Also, in attempting to describe the facts surrounding the issue, there is not reference at all to legislation that has been introduced attempting to change the decision or affect the decision of the Federal Trade Commission.

Senator METZENBAUM. May I ask, Senator, if you have a copy of that letter?

Senator COCHRAN. I do, indeed.

Senator METZENBAUM. And is there a covering letter with it?

Senator COCHRAN. Yes, there is.

Senator METZENBAUM. Would it be agreeable with you if we include the covering letter as well as the letter in the record?

Senator COCHRAN. I would like to have it made a part of the record, Mr. Chairman, thank you very much.

Senator METZENBAUM. Without objection, it is so ordered.

Senator COCHRAN. It seems to me that it is your argument that the economic consequences of the Federal Trade Commission decision would be lower prices for the consumer. However, I can't help but remember when we had hearings in June of this year the testimony that was delivered at the hearings by Charles Moak from Indianola, Miss., who owns and operates the smallest bottling company in our State. He discussed the competition that exists in his area of the State, the constant promotions and discounts that have to be offered in order to obtain a share of that market and to stay alive economically and he brought with him an ad that was run in a local paper advertising Dr. Pepper, 8 quarts for 99 cents. I wonder whether or not in your argument that consumers are hurt by high prices caused by a lack of competition foisted off on the American people by the franchise arrangement is supported by those facts. Now that price is not unusual, according to his testimony before our committee in June.

Mr. COMANOR. I am not familiar with the incident which you describe. But certainly it is true that the more competition that exists both among bottlers of the same brands and different brands will result in a greater frequency of this type of price cutting. This is not to say that price cutting does not go on entirely. However, in the absence of these restraints, one would see more frequent examples of the price cutting like this.

Senator COCHRAN. Well, I think you are shadow boxing with the issue. When you wrote your article back in 1969 or thereabouts, the price of Coca-Cola in one market that was referred to by a witness in those hearings was selling for less than 1 cent per ounce and this price was 22 percent less than the product was selling for in 1923. It is curi-

ous to me that we are engaged in an effort to benefit consumers by helping reduce prices and changing the franchise system when it is this system history bears out that has permitted products to be sold to consumers at reduced prices as time has gone on.

Referring again to Mr. Moak's testimony, which included a recitation of the cost to consumers in his area of soft drinks, he concludes that he knows of no product in the market where competition has resulted in such a bargain for the consumers there.

I would just like to conclude, Mr. Chairman, by making an observation about a comment in your opening remarks.

While I have a high regard for the distinguished Senator from Ohio, I wonder whether or not the Government ought to be sensitive to the fact that many of these franchise owners have purchased that as a property right and as a property as one would purchase a piece of real estate. Many have to finance that purchase over a long period of time. When the Government changes the rules and says that franchise doesn't exist as a property right, I think that is a legitimate matter for the Congress to consider, when it is engaged in an effort to protect the interests of the citizens of this country. I don't think it should be ignored and I don't think it should be one of the reasons why the system ought to be changed.

Senator METZENBAUM. Thank you, Senator Cochran. Dr. Comanor, I do want to point out to my friend from Mississippi that those who purchase franchises should have been aware of and alerted to the problems because in 1967, the Supreme Court held that territorial restrictions were per se illegal. At a later date, there was a subsequent decision that provided some opening. But I think it is important that we get you away from the witness table, Dr. Comanor, because I have four other witnesses and one of whom came from New York and I want to be able to conclude this hearing by 12. I am very grateful to you for being with us this morning.

[The factsheet from the Federal Trade Commission with covering letter submitted by Senator Cochran and Mr. Comanor's prepared statement with attachments follow:]

FEDERAL TRADE COMMISSION,
Washington, D.C., February 12, 1979.

HON. THAD COCHRAN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR COCHRAN: I understand that some of your constituents have expressed interest in the Commission's recent decisions involving territorial restrictions imposed by certain soft drink bottlers. Those decisions, involving Coca Cola Company and PepsiCo, Inc., currently are on appeal in the United States Circuit Court for the District of Columbia. The orders will not become final until after the court renders its decisions on those appeals.

Enclosed is a fact sheet, prepared by the FTC staff, that outlines the Commission's recent decisions and provides some background to our involvement in this area. I hope this information will assist you and your staff in responding to questions and concerns that your constituents have raised. Should you have further questions on these issues, please feel free to contact me (523-3620) or Kevin Cronin (523-3779), of my staff.

Cordially,

WILLIAM J. BAER,
Acting Assistant General Counsel
for Legislation and Congressional Relations.

Enclosure.

FTC DECISIONS CONCERNING TERRITORIAL RESTRAINTS ON BOTTLERS OF COKE AND PEPSI

In April, 1978, the Federal Trade Commission issued final orders and opinions in two companion cases, the *Coca-Cola Company*, Docket No. 8855, and *PepsiCo, Inc.*, Docket No. 8856. In the opinions, the Commission held that for the most part the territorial restraints imposed by Coke and Pepsi on their bottlers were anti-competitive and in violation of Section 5 of the Federal Trade Commission Act. The Commission's decisions, which are not final until they are reviewed, are now before the Court of Appeals for the District of Columbia. Until the judicial review process is completed the Commission's orders have no effect.

BACKGROUND—THE SOFT DRINK COMPANIES AND THEIR BOTTLERS

The Coca-Cola Company (Coke) and PepsiCo, Inc. (Pepsi) market most of their soft drink products by selling soft drink syrups and concentrates (syrup) to independent bottlers. The bottlers usually add carbonated water to the syrup and package the soft drinks for delivery and sale at the wholesale level.

The relationship between Coke or Pepsi and most of their individual bottlers is a contractual one. Under the terms of the contracts, Coke's bottlers receive a license to sell Coca-Cola (and Coke's other soft drinks, *e.g.*, Tab) ; Pepsi's bottlers receive a license to sell Pepsi (and Pepsi's other soft drinks, *e.g.*, Teem). Also under the terms of the contract, the soft drink companies and their bottlers agree to territorial restraints. In other words, the bottlers agree not to operate their business outside specified boundaries. These exclusive territorial restraints prompted the Commission to issue complaints.

THE PROBLEM WITH TERRITORIAL RESTRAINTS

Territorial restraints have economic consequences akin to those of resale price maintenance. In the case of resale price maintenance, manufacturers or producers are able to fix the prices at which their products are sold. The result is that consumers usually end up paying higher prices for the finished product. The same is true with territorial restraints.

When producers and distributors agree among themselves that only one distributor will operate in a given geographic area, the agreement effectively eliminates competition among distributors of the product. Producers and distributors are free to charge retailers higher prices so long as consumers differentiate the product from the others. In other words, because of lack of competition among distributors, producers can charge higher prices, and in the end, consumers pay more.

COMMISSION PROCEEDINGS

An Administrative Law Judge (ALJ) first heard the complaint against Coke and ruled that an inquiry into the reasonableness of the territorial restraints was required. During the inquiry, an extensive record was compiled consisting of some 4,000 pages of testimony and more than 4,000 pages of exhibits. Meanwhile, because of the similarity of issues, the parties in the proceeding against Pepsi agreed to let the determination of the reasonableness of Pepsi's territorial restraints rest on the record in the Coke proceeding along with some additional testimony. At trial, representatives of local bottlers were allowed to intervene as parties with full rights to present evidence and arguments and to cross-examine witnesses.

In October, 1975, the ALJ issued simultaneous decisions concluding that neither Coke nor Pepsi violated the law by imposing territorial restraints on their bottlers. This initial decision was vacated by the Commission which heard oral arguments on two separate occasions and then issued its own rulings on April 7, 1978. The Commission decision came on a 2–1 vote with Commissioner Clanton dissenting. Chairman Pertschuk and Commissioner Pitofsky did not participate.

THE COMMISSION'S OPINION

(*a*) The Commission found that Coke and Pepsi and the parties who joined them *did not justify* the territorial restraints on bottlers in the case of soft drinks packaged in nonrefillable containers such as cans and non-returnable

bottles (non-returnables). The Commission concluded that these territorial restraits were unlawfully anticompetitive chiefly for the following reasons:

the territorial restraints prevented the bottlers of Coke from competing among themselves; likewise, they prevented the bottlers of Pepsi from competing among themselves (intrabrand competition);

the territorial restraints prevented the bottlers from expanding beyond their agreed-upon territories thus eliminating potential competition;

the territorial restraints indirectly lessened competition in delivery services of the soft drinks; and

the territorial restraints deprived consumers of the benefits of open intrabrand competition.

(*b*) The Commission also found that Coke and Pepsi did justify the territorial restraints on bottlers in the case of soft drinks packaged in refillable, returnable bottles (returnables). The Commission concluded that territorial restraints in the case of returnables were not in violation of the law because the restraints are necessary for the bottlers to identify their own bottles for return to the bottling facilities in order to be refilled.

WHAT HAPPENS NEXT

The Commission's rulings are final agency decisions in these adversary litigation matters but the orders are not final until reviewed and sustained on appeal. The Commission's decisions have been appealed by Coke, Pepsi, the bottlers and bottlers' associations. They are now pending in a consolidated proceeding before the United States Court of Appeals for the District of Columbia.

PREPARED STATEMENT OF WILLIAM S. COMANOR[1]

I am delighted to return to this Subcommittee to discuss the competitive effects of vertical restrictions in the Soft Drink Industry. This has been a recurring task for me. Earlier, I testified on this topic before this Subcommittee on August 10, 1972, and before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary on July 1, 1976. Copies of both earlier statements are attached.

My interest in this topic is long-standing. Over ten years ago now, I published an article in the Harvard Law Review entitled "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath" which discusses generally the competitive implications of these restrictions. A copy of this article is also attached.

This issue has reappeared with some regularity, which probably suggests that these restrictions are important to some firms. Unfortunately, the mere fact that these restraints improve the fortunes of private firms implies little about the appropriate scope for public policy. The profitability of individual firms may be improved either by increased efficiency or greater monopoly power. Our task, therefore, is to determine which alternative applies in particular circumstances.

Increased monopoly power may result from direct restraints on competition from alternative suppliers. Intra-brand competition is suppressed which may have direct effects on prices charged in the marketplace. In addition, the protected positions reserved for individual distributors may encourage the provision of dealer services which enhances product differentiation. In my earlier article and testimony, I suggested that manufacturers may benefit substantially from such actions by their distributors at the expense of final consumers.

To be sure, there may be circumstances in which the imposition of vertical restraints has few anti-competitive effects. For example, when the structure of the market at the manufacturing stage, which in soft drinks corresponds to syrup and concentrate producers, is perfectly competitive, restraints raise few antitrust problems. The degree of inter-brand competition is then sufficiently great so that the elimination of intra-brand competition makes little difference. A crucial issue posed by this bill, therefore, is whether the market structure of soft drink concentrates is sufficiently competitive.

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[1] The views expressed are the author's own and do not necessarily represent those of the Federal Trade Commission nor of any individual commissioner.

On June 4 of this year, earlier hearings were held on this topic. Among the witnesses heard at that time were three economists proposed by the National Soft Drink Association. Perhaps, it would be useful to examine their testimony closely so that the differences between our positions can be clearly posed.

I have argued that the imposition of vertical restraints leads to higher costs to consumers. On this point, Professor Goldberg, who testified earlier, admits that "the initial effect of 'walls down' competition would be price competition and lower prices for the large chain accounts." He does not dispute the inescapable conclusion that eliminating these restraints would lead bottlers to compete, leading to lower prices for at least the largest customers.

He suggests, however, that prices would rise on sales to smaller outlets. But his argument requires that distribution costs must rise on these sales. This result is hardly necessary and indeed it is equally likely that distribution costs on such sales will remain unchanged. More important, the elimination of territorial restraints permits new channels of distribution to develop if they are more efficient, with accompanying benefits to consumers. The imposition of these restraints impedes the development of new methods of distribution and serves inevitably to raise prices overall.

Further testimony was provided by Professor Williamson, of the University of Pennsylvania, who refers directly to my earlier article. I suggest there that any additional services provided free or below cost to consumers through the imposition of vertical restraints would be supplied separately if there was sufficient consumer demand for them.

Professor Williamson objects. He argues that "whether valued services can be delivered in the . . . way contemplated by Dr. Comanor . . . depends on the costliness of writing and negotiating comprehensive contracts." In effect, he suggests that these ancillary services may not be provided because of the cost and difficulty of contracting for them separately.

The services referred to include frequent delivery, but more important, the substantial advertising and promotional efforts which characterize marketing in this industry. I agree that these services are valued by consumers, but even so, consumers do not value them regardless of price. The issue at hand is whether the optimal quantity of these services would not be provided if they were supplied separately.

Williamson's position is that consumers require more of these services than would be provided in an unrestrained market because of possible savings in transaction costs achieved through a system of vertical restraints. What is required is that the cost of alternate contracts between syrup manufacturers and bottlers exceeds the increased prices charged to consumers under the joint supply arrangement. While this may be so, no evidence is provided that individual outlets could not readily be charged directly for distribution services nor that consumers are better off when advertising and promotional efforts are undertaken by individual bottlers rather than by the syrup manufacturer. Evidence in support of these propositions is required but has not been provided. At this point, all we have is a theoretical possibility.

Let me draw your attention to a more important passage in Professor Williamson's testimony. He writes: "The presumption that territorial restraints have the purpose of promoting more cost-effective marketing is subject to challenge in industries in which inter-brand competition is weak. Where this pertains, the possibility must be faced that vertical restraints have the purpose of . . . promote(ing) more effective ologopolistic pricing." In effect, he admits that these restrictions may have anti-competitive effects "where inter-brand competition is ineffective."

I fully concur with this position. Whether there are any efficiency effects achieved through these restraints is called into question by the prospect that they may also serve to promote monopolistic results. As Professor Williamson admits, much depends on the scope of competition in the soft drink industry.

Although various indices of monopoly power could be examined, the most frequently used measures are concentration ratios—the share of total output or employment accounted for by the largest firms in an industry—and the level of profitability earned by the leading firms over a substantial period of time. Indeed, the importance of both factors has been emphasized by Professor Preston, who also testified in support of this legislation. Professor Preston and a col-

league have published a volume entitled "Concentration and Price-Cost Margins in Manufacturing Industries" which emphasizes the importance of both factors.

Although there are more than 50 firms that manufactured soft drink concentrates in 1977, the five major firms had a combined market share of 77 percent. The market shares of these firms from 1966 through 1977 are given in Table 1.

Relevant concentration ratios are given in Table 2. By traditional standards, these concentration levels are relatively high and suggest considerable monopoly power. Moreover, concentration has increased somewhat in recent years.

A more important index is the level of profitability. Data on profit rates for the largest five firms is given in Table 3. The average rate of return for these five firms was 21.6 percent in 1977 which can be compared to the average rate for all manufacturing firms of 14.2 percent. Indeed, over the past 15 years these firms have earned an average rate of return after taxes on stockholders equity exceeding 21 percent, compared to an average return for All Manufacturing of 12.0 percent.

What we observe, therefore, is an industry where high levels of market concentration coexist with substantial rates of return that substantially exceed the average for All Manufacturing. There appears to be substantial monopoly power in this industry. These data hardly suggest that this industry corresponds to the textbook version of perfect competition.

While the facts presented do not indicate that this monopoly power necessarily rests on the vertical restraints which limit intra-brand competition in soft drinks, they do indicate that we cannot rely on inter-brand competition as the solution for all competitive ills. With this underlying structure, the qualifications suggested by Professor Williamson are fully applicable. In such circumstances, vertical restraints may indeed be used to achieve anticompetitive results.

Let me make one final point. For the most part, these restraints result from perpetual contracts entered into some years ago between the syrup manufacturers and their bottlers. Whatever the benefits which may have accrued originally from these restraints, it seems apparent that the major beneficiaries currently are the bottling companies. Competition faced by these companies is limited as a direct result of these restraints. In such circumstances, the higher prices which result cannot be justified as serving the interests of consumers.

Unless there are major reasons to the contrary, we should not deviate from our traditional policy of eliminating private impediments to competition. Special exemptions to the antitrust laws of the sort contained in this proposed legislation limit our efforts to achieve a more competitive economy. As such, I oppose its enactment.

TABLE 1.—MARKET SHARES IN PHYSICAL UNITS OF LEADING SOFT DRINK PRODUCERS, 1966–77

[Percent of market for soft drinks]

	Coca-Cola Co.	Pepsi Co.	Seven-Up Co.	Royal Crown Cola Co.	Dr. Pepper	Top 5
1966	33.4	20.4	6.9	6.9	2.4	70.1
1967	33.5	20.0	6.5	6.7	2.6	69.3
1968	34.2	20.4	6.8	6.7	2.8	70.9
1969	34.3	19.9	7.2	6.3	3.1	70.8
1970	34.7	19.8	7.2	6.0	3.8	71.5
1971	34.0	20.4	7.1	6.1	3.9	71.5
1972	34.3	20.4	7.2	6.1	4.6	72.6
1973	34.6	20.4	7.4	6.0	5.0	73.4
1974	34.7	20.7	7.6	5.4	5.2	73.6
1975	35.3	21.1	7.6	5.4	5.5	74.9
1976	36.1	22.1	7.5	5.3	5.8	76.8
1977	36.6	22.3	7.2	5.0	6.3	77.4

Source: Estimates by John C. Maxwell, Jr., "Maxwell Consumer Service Reports," Maxwell Division of Wheat, First Securities, Inc., Richmond, Va., quoted in Standard & Poors Industry Surveys, "Beverages—Basic Analysis," Sept. 8, 1977, p. B65. Maxwell obtains its data from interviews with industry executives and these data are not perfectly reliable. However, they are broadly consistent with Bureau of the Census data. Also see Maxwell estimates in "Beverage Industry," Apr. 2, 1976, Apr. 15, 1977, and Apr. 21, 1978.

TABLE 2.—SOFT DRINK CONCENTRATE CONCENTRATION RATIOS OVER TIME

	Percentage of sales accounted for by—			
	4 largest companies	8 largest companies	20 largest companies	50 largest companies
1935	47.0	54.0	NA	NA
1947	50.0	58.0	68.0	NA
1954	53.0	63.0	75.0	NA
1958	55.0	67.0	78.0	87
1963	62.0	70.0	78.0	86
1966	63.0	71.0	NA	NA
1967	67.0	75.0	82.0	90
1970	61.0	69.0	NA	NA
1972	66.0	74.0	82.0	89
1975 [1]	69.2	83.5	91.0	NA
1977 [1]	72.4	86.5	95.1	NA

[1] Denotes estimates from "Beverage Industry," Apr. 21, 1978.

Notes: SDC and soft drink syrups cannot be directly compared because manufacturers of soft drink syrups add sugar whereas manufacturers of SDC permit their bottlers to add sugar. Since soft drink syrup sales are significantly affected by the cost of sugar, such concentration measures would overestimate the market shares of manufacturers of soft drink syrups relative to SDC. The Census of Manufacturers, therefore, has used a more comparable basis for estimating concentration ratios, namely, soft drink sales of equivalent eight ounce servings. Concentration ratios for 1975 and 1977 are not strictly comparable to the earlier estimates because estimates based on "Beverage Industry" reflect physical volume whereas estimates based on the Census data reflect dollar value of shipments.

Source: U.S. Department of Commerce, "1972 Census of Manufacturers," Concentration Ratios in Manufacturing, SIC No. 2087 (flavoring, extracts, and syrups), p. SR-9.

TABLE 3.—RATES OF RETURN [1] OF LEADING SOFT DRINK CONCENTRATE MANUFACTURERS

[In percent]

Year	Coca-Cola	Pepsi Co	Royal Crown	Seven-Up	Dr Pepper
1963	17.3	18.6	25.5	NA	16.4
1964	19.3	18.9	30.0	NA	18.8
1965	20.1	19.5	30.1	NA	20.9
1966	22.1	16.5	29.0	17.9	24.2
1967	22.5	18.1	23.0	21.3	24.2
1968	22.2	17.6	21.4	23.9	24.3
1969	22.3	14.0	[2] 7.8	26.0	24.0
1970	22.5	16.9	21.0	23.9	25.9
1971	22.8	16.4	21.1	23.6	26.8
1972	22.8	16.3	20.3	22.2	26.0
1973	22.7	16.0	18.6	21.4	25.5
1974	19.2	15.7	12.0	21.9	22.7
1975	19.5	16.7	17.3	23.0	24.0
1976	21.0	18.1	19.6	24.4	27.0
1977	20.9	19.3	18.6	22.7	26.5
1963–77	21.1	17.3	21.0	22.7	23.8

[1] Net income after taxes as a percent of stockholders' equity.
[2] Includes $1,704,025 of nonrecurring losses, due to the Food and Drug Administration ban on cyclamates.

Source: Annual reports, various years.

Testimony of William S. Comanor, Associate Professor of Economics, Graduate School of Business, Stanford University Before the Subcommittee on Antitrust and Monopoly, U.S. Senate, August 10, 1972

The Competitive Effects of Vertical Restrictions

Introduction

An antitrust appraisal of vertical territorial and customer restrictions rests fundamentally on the question of what are the basic objectives of government policy. Whose interests is antitrust designed to protect? This question is important because, in many circumstances, a conflict exists between the interests of producers and consumers in our society. Too often, however, this conflict of interest is overlooked or ignored. It is argued that we should search for government policies which benefit all Americans.

While this approach may be sufficient in some policy areas, it is not sufficient in all. It is necessary to accept the fact that real differences of interest exist between groups in our society. Actions taken to assist one group may be at the expense of others, while failures to take action have similar consequences. Government measures frequently have an important effect on distributions of income and wealth in our society and these effects must be recognized when judgment are made.

In the realm of antitrust policy, the interests of producers and consumers converge with respect to costs. Both groups have an interest in seeing that goods are produced at the minimum possible costs. However, the interests of producers and consumers diverge in significant respects with regard to prices.

High prices lead to high profits which serve the interests of producers in a number of ways. High profits lead to high returns to the owners of the firm. High profits lead to high salaries and high expense accounts for the managers of the firm. High profits lead also to high wages paid to workers fortunate enough to work for particular firms. At the same time, however, high profits, which are due to high prices, also lead to increased costs of living for consumers generally. Low prices, on the other hand, benefit the broad class of consumers and lead to low living costs for all members of society.

The point at issue in the case of vertical restrictions, as in many areas of antitrust, is that of monopoly prices. The most important effect of high monopoly prices is on the distribution of income between producers and consumers. The objective of promoting competition is associated with that of protecting consumers by restraining firms from setting high prices and realizing high monopoly returns.

Vertical restrictions as a business practice

Vertical restrictions represent a business practice which can be examined in terms of its prospective effect on average prices. The important quetsion here is whether vertical territorial or customer restrictions are likely to assist in the attainment of monopoly power in an industry and contribute to the setting of high prices.

One point about which there is little disagreement is that vertical restrictions are designed specifically to eliminate intra-brand competition, which is the competition between dealers or bottlers who sell the same branded product. Territories are specified precisely to prevent the dealers or bottlers of a single manufacturer from competing with others of the same company. In some circumstances, particular classes of customers are specified. In either case, the purpose is to divide the market into segments within which each dealer or bottler has little or no competition in terms of the same branded product. These restrictions often lead to the creation of monopoly positions for dealers insofar as they concern particular brands.

This effect of vertical restrictions on intra-brand competition is clearly evident. However, it is often argued that the presence of interbrand competition is sufficient to keep prices at low, competitive levels. There is competition among branded products and therefore the loss of interbrand competition has little bearing on the final prices charged to consumers. This position is an important one and it raises some serious issues.

First, it suggests that inter-brand competition is strong and effective, and that little more is to be gained from promoting intra-brand competition. While this suggestion may be true in some instances, it may not be so in others. Indeed, various factors indicate that the extent of inter-brand competition is likely to be limited in markets characterized by vertical restraints. A second but related matter is that vertical restrictions appear to have an important effect on inter-brand as well as on intrabrand competition.

My primary concern is the second issue. It is to examine the prospective effect of vertical restraints on the degree of competition among different branded products in the market place.

The importance of product differentiation

The strength of competition in an industry depends on factors in addition to the number of firms and their relative sizes. It is not sufficient to look only at the number of firms to determine the degree of monopoly power. One of the most important of these additional considerations is the extent to which con-

sumers are willing to substitute among the products of competing firms. When the products of different firms are highly substitutable, consumers are unwilling to pay more for one product than for another, and individual firms cannot set prices which are higher than those of competing firms without suffering a substantial lose in demand. Where substitutability is low, on the other hand, demand does not decline significantly even if prices are raised above those charged by their rivals. In the later circumstances, consumers are sufficiently attracted, for one reason or another, to the products of individual firms so that they continue to purchase them even when their prices are higher than those of competing products.

An important implication of this form of consumer behavior is that a considerable incentive exists for firms to differentiate their products from those of their rivals. Much is to be gained from influencing consumer behavior in such a way that consumers will not switch from specific brands of a product even when higher prices are charged. Where consumer substitutability among competing products is low, products are said to be differentiated, and in these circumstances, firms are insulated to some extent from the effects of price competition.

Product differentiation is founded on both real and fancied differences among products. It depends on the basic nature of the product as well as on the business policies pursued by the firm. Both advertising and distribution arrangements may have an important influence on the degree of product differentiation.

While product differentiation generally leads to higher prices than would be set in the absence of differentiation, this certainly does not suggest that every instance of differentiation is socially undesirable. Strong consumer preferences for specific products, and the resulting low consumer substitutability often results from real differences among products and from the peculiar skills or attributes of a particular firm. In these instances, the price effects of product differentiation may be offset by the social gains associated with product variety. However, where product differentiation requires the imposition of vertical restraints, our conclusion is different. The need for these restraints suggests, that there is insufficient consumer demand for the attributes of differentiation in a free and unrestricted market. Higher prices result but there are no offsetting factors.

The importance of dealer markups

Manufacturers have a clear incentive to adopt policies which maximize the degree of product differentiation. Indeed this is an important means of achieving the high prices and high profits to which all firms aspire. Where products are highly differentiated, and substitutability is low, consumers behave as though they are tied to the products of individual firms. In this situation, manufacturers can charge relatively high prices without fear of losing customers. Since losing customers is the major constraint imposed by a market system on price increases, we should not be surprised if prices are relatively higher where differentiation is effective.

Whether carried out through integrated facilities or through independent dealers or bottlers, distribution outlets frequently contribute to the achievement of effective product differentiation. The degree of consumer substitutability, or product differentiation, can often be altered significantly by the commercial policies pursued by a manufacturer's dealers. For this reason, it can be observed that manufacturer-dealer relationships are often founded on factors which create and foster product differentiation.

Where product differentiation is promoted by conditions of sale at the dealer level—fancier showrooms or additional dealer services, for example—higher gross markups may be associated with a greater volume of sales. That this effect is likely to be important can be noted from the interest shown by manufacturers that their products are sold in attractive surroundings and not in what one executive has called "clapboard shacks." Conditions of sale are important to the manufacturer, and this concern follows from his desire to achieve effective product differentiation. In these circumstances, manufacturers and dealers together benefit from reduced consumer substitutability which leads directly to higher prices being charged for particular branded products.

Because the manufacturer and dealer both benefit—at the expense of the consumer—from the higher dealer markups which are required for product differentiation, a clear motive exists for restricting competition among the dealers or bottlers associated with a single firm. The manufacturer cannot bear the costs of differentiation and assure an adequate markup simply by lowering his

price to the dealers, for price competition among dealers would drive markups down to their previous levels. Conditions which protect dealer markups and insure that they are used to create conditions which enhance differentiation become necessary. Furthermore, effective practices are likely to require the active support of the dealer. It may therefore be necessary for the manufacturer to protect higher markups in order to provide his dealers with a share of the prospective gains, as well as to with the resources required for effective differentiation.

The role of territorial and customer restrictions becomes evident. By fragmenting the market among his dealers, with respect to territory or class of customers to be served, the manufacturer protects dealers markups from the eroding effects of intra-brand competition. Dealers are no longer subject to the competition of others who sell the same branded product. In this manner, the effects on competition are similar to those obtained by a horizontal price fixing arrangement. Moreover, vertical restrictions have economic results which are similar to those fashioned more directly through price fixing via resale price maintenance to insure high margins in the distribution sector of the economy.

To the extent that vertical restrictions are permitted, and adopted by the leading firms at the manufacturing stage of an industry, the structure of retail submarkets resembles the national market in manufacturing. When the market structure at manufacturing is oligopolistic, local oligopolies are created at the distribution stage. In the end, vertical restrictions not only eliminate intra-brand competition, but also through their effect on product differentiation, serve to restrict price competition among the products of rival firms. On both accounts, the presence of vertical restrictions leads to higher prices paid by consumers for branded products.

Despite the prospect that vertical territorial and customer restrictions have substantial anticompetitive consequences, the extent of appropriate antitrust actions against them depends also on whether there are any competitive justifications. For this reason, it is necessary to examine some proported justifications.

Encouraging dealer investment

It is sometimes argued that vertical restrictions may be necessary to induce prospective dealers to invest capital in buildings and other fixed equipment. In the absence of these restrictions, the argument proceeds, the required flow of funds would not be forthcoming because prospective dealers would fear that strong competition from other dealers would drive margins down and make the investment unprofitable.

Throughout the economy, however, restrictions on competition are not needed to induce capital investment. Real investment in economic activities is generally forthcoming whenever the prospective rate of return exceeds the cost of additional capital. So long as the return in an industry is sufficiently high, entrepreneurs recognize that profits can be earned by the investment of funds, which are obtained either from internal sources or from the capital markets. As demand expands in some markets and contracts in others, the return on investment varies accordingly. High returns serve as a signal for the required capital investment even without restrictive agreements. Investment proceeds so long as returns are sufficiently high, but will halt when the additional capital invested in a particular industry drives the profit rate down to the competitive level. Through this process, capital funds are allocated among the various sectors of the economy.

When further investment in distribution facilities is needed by consumers, the normal functioning of a market creates temporarily higher markups and increased distributor profits. These increased profits serve as a signal for new investment. If, however, costs are too high or consumer demands too low, so that distributor profits are not sufficiently high to induce increased investment in distribution, it is likely that society will be better served by greater investment in other areas.

The conclusion to be drawn from this discussion is that it is wrong to assume that more dealer investment is always preferable to less. Society may well benefit more from increased investment in other sectors of the economy rather than in distribution facilities. Indeed the need to enforce vertical restrictions to achieve the profit levels required for this investment suggests that a free market would not support the volume of dealer investment desired by the manufacturer. Consumer demand for the services provided may simply be insufficient.

Provision of dealer services

When manufacturers assert that vertical restrictions are needed to insure "adequate" dealer services, they may be correct on their own terms. The word "adequate" may simply describe services which are adequate to insure effective product differentiation. It is quite possible that vertical restrictions may be needed for markups which are sufficiently large for dealers to provide credit terms, other dealer services, or advertising—all of which may lead to effective product differentiation.

Vertical restrictions encourage dealers to provide customer services jointly with the manufacturer's product at a single price. While some of these services may be necessary and useful, the need for vertical restraints to insure their provision indicates only that an insufficient demand for them exists in an unrestricted market. This practice leads to an effective tying arrangement between services and product, which generally results in the provision of more dealer services than would be obtained if consumers were free to purchase them separately from the manufactured product. This arrangement, moreover, is likely to lead to a joint price for the product and service which is higher than the sum of the two prices which would be set were the commodities priced and sold separately.

A system of joint supply contributes to the achievement of effective product differentiation and increased monopoly power at both the manufacturing and distribution stages of production. It leads both to higher manufacturers prices and higher dealer markups. Furthermore, it should be evident that the objective of maintaining an effective tying arrangement cannot serve to justify the imposition of vertical restraints.

Market coverage

Another justification offered in defense of vertical restrictions is that they lead to increased sales of the manufacturer's products through wider coverage of geographic markets. Since distribution costs to large, nearby customers are frequently lower than costs to smaller and more distant customers, the manufacturer benefits if a single price is charged to all, and the dealer's savings from sales to one group is used to cover the higher costs of sales to the other. While this type of distribution arrangement may lead to wider market coverage than could be achieved by overlapping and competing distributorships, it must be supported by some form of market restriction. Otherwise, dealer competition for sales to low-cost customer will destroy the single price regime and eliminate the high markups which are used, in effect, to subsidize sales to high cost customers. What is taking place here is the use of vertical restrictions for the purpose of subsidizing some consumers at the expense of others.

Even if significant cost differences among customers exist, there is little economic justification for a set of commercial practices which insures that all customers are charged the same price. There is little economic justification for cross-subsidization among classes of consumers. Where sales to specific customers are attractive because they reflect lower costs of distribution, the prices charged to these customers should be lower, and competition among distributors would lead to lower prices. Where costs of distribution are high, on the other hand, we should expect to find higher prices. At those prices, dealers will compete for sales. In either case, markets are well covered, although possibly not to the same extent.

While market processes, unencumbered by vertical restrictions, will generally have the effect of destroying a single price regime, and leading to different prices charged for customers with different costs of distribution, this is not an undesired result. Indeed, it is well known that competitive markets lead to higher prices where costs are higher, which has a desired effect on the allocation of society's resources.

It should be stressed that there is no reason to believe that vertical restrictions leads to a better allocation of resources. If a substantial number of customers desired greater market coverage, there would be an expansion of demand for the services of distribution facilities and a corresponding increase in demand for products which are distributed widely. This will give firms with relatively limited market coverage an incentive to increase the number of their distribution outlets. If sufficient demand exists for their products, firms will achieve the high retail margin needed to make more intensive distribution possible. This is precisely the process through which the market serves to allocate resources to

distribution facilities in a socially desirable manner. And it is here also that restrictions on competition, through the imposition of vertical restraints, are likely to hinder the achievements of desired objectives.

Some conclusions for antitrust policy

When the relevant market at the manufacturing stage is already an oligopoly, we can expect to find a measure of monopoly power present even when vertical restrictions are totally absent. However, it should be stressed that product differentiation is a further dimension of market structure which may be as significant to the achievement of monopoly power as is the degree of market concentration. Moreover, while they comprise only one facet of product differentiation, dealer facilities and services may play an important role. Indeed, the achievement of competitive levels of prices and profits at the manufacturing stage may be significantly frustrated by product differentiation stemming from practices at the dealer stage.

In the distribution sector, vertical restraints lead directly to higher markups than would otherwise exist. Although these markups may result in higher distributor profits, they are also likely to be associated with inflated dealer costs. Fancier showrooms or more elaborate facilities are constructed, and more dealer services are provided than would be demanded by consumers in unrestricted markets. This conclusion follows from the need for vertical restraints to assure these showrooms or services.

The major line of defense for vertical territorial and customer restrictions lies in the prospect that inter-brand competition might be fostered through the suppression of intrabrand competition. However, vertical restraints may lead instead to increased levels of product differentiation and therefore to the achievement of increased monopoly power. As a result, vertical restraints are likely to impede the growth of price competition and the movement of prices towards costs.

While some measure of product differentiation may be desirable, even though price competition is lessened, the attainment of differentiation is certainly not a valid reason for rejecting the normal presumption of antitrust policy in favor of maximum competitive behavior on the part of independent firms. This is especially so since traditional antitrust objectives, in terms of protecting the interests of consumers, are more likely to be secured through the promotion of price competition.

A concern with protecting the interests of consumers leads to the view that vertical territorial and customer restrictions should be prohibited under the antitrust laws. Even in the case of a small manufacturing firm facing a giant rival in an oligopolistic market, these restrictions are undesirable. We are concerned here with competition as a process for achieving social objectives and not merely with the number of competitors in the market. Moreover, there is not much to be gained from bolstering a small and perhaps inefficient rival when this can be accomplished only by market restrictions which sacrifice primary objectives. Even in these circumstances, vertical restraints should not be permitted.

This analysis leads to the conclusion that vertical customer and territorial restrictions should not be exempted from the antitrust laws. Furthermore, it seems evident that the qualifications included in S. 3587 are fully insufficient to meet the needs of customers. The fact that there is more than one trademarked product in a market does not indicate that the degree of inter-brand competition is likely to be sufficient to keep prices at low competitive levels. In the first place, these qualifications are consistent with the presence of high degree of market concentration, and it is a well-known fact in economics that high levels of monopoly power are often achieved in markets where there are two or three or a small number of rival firms. Second, there is the fact that product differentiation is an equally important determinant of the degree of competition. Where product differentiation is significant, due perhaps to real differences among products, individual consumers have strong preferences for the products of a sinble manufacturer. In these circumstances, the only prospects for competition is intra-brand competition, and it is this competition which is specifically proscribed by the presence of vertical restraints.

Furthermore, there is considerable likelihood that the presence of vertical restraints contributes to the degree of product differentiation. This result has the direct effect of reducing the degree of competition at the manufacturing stage. Rather than leading to increased competition at the manufacturing stage, the tolerance of vertical restraints has the opposite effect: vertical restrictions lead

instead to reduced competition. Moreover, vertical restraints have the direct effect of restricting competition among dealers of the same manufacturer. On both accounts, consumers are likely to pay higher prices.

A policy designed to protect the interests of consumers by promoting the maximum degree of competition should prohibit vertical territorial and customer restrictions. As such, the passage of S. 3587 would be a significant step backwards in the creation and enforcement of an effective antitrust policy in the United States.

TESTIMONY OF PROF. WILLIAM S. COMANOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT SANTA BARBARA, BEFORE THE SUBCOMMITTEE ON MONOPOLIES AND COMMERCIAL LAW, JULY 1, 1976

Mr. COMANOR. My name is William Comanor, and I am professor of economics at the University of California, Santa Barbara. My bachelor's degree is from Haverford College in Pennsylvania, and my Ph.D. in economics is from Harvard University. I have been teaching and doing research for a number of years now in the field of industrial organization, which, as you know, concerns the structure of markets and competition, and monopoly and the effect of antitrust on these markets.

I have written over 25 professional papers in this area, as well as a book on the economics of advertising, and I am also on the editorial board of the Antitrust Bulletin, as well as various other professional journals in economics.

What I have here today is a short statement as well as two more lengthy attachments, and I would like to quickly go through my short statement and leave the more lengthy attachments for your record, if you will.

Let me emphasize, however, that these other attachments contain most of my analysis of the effects of vertical restrictions.

I will try to go briefly through the shorter statement.

My concern with the question of vertical territorial and customer restrictions originated during the fall of 1965 while I was serving as Special Economic Assistant to the Assistant Attorney General for Antitrust in the U.S. Deparment of Justice.

The Assistant Attorney General at the time was Donald F. Turner, and he asked that I examine the economic consequences of vertical restrictions. This analysis was carried out both during my tenure at the Department of Justice and subsequently when I returned to university teaching. The fruits of this research were subsequently published in the May 1968 issue of the Harvard Law Review in an article entitled "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath." A copy of this article is attached.

In the course of this study, I found various circumstances under which the imposition of vertical restrictions was likely to have substantial anticompetitive consequences. These prospects arose from the fact that the high dealer margins, protected by the imposition of these restrictions, frequently led to higher expenditures on factors designed to promote product differentiation and contributed thereby to a lessening of competition. Because of more protected market positions, dealers or bottlers are likely to spend more, for example, on point-of-purchase advertising or promotion, which should affect the state of competition at the manufacturing stage of production. My analysis suggested not that these results always occurred but simply that they might be expected to arise in a number of cases.

In the case of the soft drinks, bottler practices may be particularly important for their effect to produce differentiation, and this can be attributed to a number of factors.

First, a substantial amount of advertising is carried on by bottlers which may have an impact on product differentiation.

Second, promotions and other selling efforts are typically carried on by bottlers. Various efforts are made at the point of sale, which also may affect the state of competition among the sirup manufacturers.

Three, services provided to retail outlets may influence the amount of shelf space given to a product, which thereby affects the state of competition.

All of these factors will affect sales for individual products by which we must mean sales at given prices. And it's thereby the same thing to say that these factors affect the prices at which various soft drinks can be sold to the public.

Of course, the sirup manufacturers are vitally concerned with the bottlers' efforts of these types. All of them affect the state of product differentiation in the industry, the prices which can be charged, the prices at which products can be sold, and the state of interbrand competition.

The point I want to make is that practices carried on at the bottler level may influence the degree and type and extent of competition among the various brands of soft drink, and so, although the vertical restrictions are designed in the first part to affect intrabrand competition, they may, indeed, have a substantial impact on interbrand competition as well.

The second part of the analysis which I carried out, and which was published in my Harvard Law Review article, examined various justifications which have been offered for these restrictions.

While many of these justifications have superficial appeal, I found that none of them represented a sufficient reason to depart from the principle that the allocation of resources is best served by the operation of free and unencumbered markets. While the imposition of these restrictions might well affect the allocation of resources, there was no indication that they would lead to a more efficient allocation. As such, the justifications could be rejected.

Because of this analysis, I have continued to stand in opposition to proposed legislation such as the legislation at issue here, which attempts to provide exemptions from antitrust laws as they refer to vertical restraints, and as you may know, I testified against such legislation a few years back before the Senate subcommittee that was reviewing this.

An excellent example of the justifications offered for vertical restraints is contained in the testimony of Prof. Lee E. Preston on behalf of the National Soft Drink Association as published on page 369 of the 1974 hearings on similar proposed legislation before a subcommittee of the House Committee on Interstate and Foreign Commerce.

Professor Preston argues that the elimination of vertical restrictions "cannot do other than decrease the variety—in available brands—since the effect will be to eliminate at least some of the minor brands and certainly to eliminate some of the sources of supply."

I do not know whether Professor Preston is correct in his supposition, and indeed whether any set of industry experts can fully predict the effect of unencumbered distribution channels.

Whether right or wrong, however, the question for public policy remains. This I would like to emphasize. This question is specifically not whether product variety will increase or decline, but rather whether such variety as exists is in accordance with consumer preferences. Since product variety typically requires higher costs, the relevant question for public policy is not how to maximize the degree of variety but rather how to obtain that much product variety which consumers are willing to pay for, which consumers desire sufficiently that they are willing to pay the necessary costs.

I submit that this result is best served and obtained in an unencumbered marketplace, and the answer to this question is best left to the working of a free market.

The operation of free markets in this economy requires the active enforcement of the antitrust laws. These laws represent, in a real sense, an economic constitution, and exceptions are warranted only in extreme circumstances. There is no question, to my mind, but that such circumstances are not present here.

I thereby strongly support the position that proposed legislation such as H.R. 6684 not be approved. It can only represent a step backward in the maintenance of a free and competitive economy.

[The prepared statement of Prof. William S. Comanor and attachment follow:]

STATEMENT OF WILLIAM S. COMANOR, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, SANTA BARBARA

The Competitive Effects of Vertical Restrictions

INTRODUCTION

An antitrust appraisal of vertical territorial and customer restrictions rests fundamentally on the question of what are the basic objectives of government policy. Whose interests is antitrust designed to protect? This question is im-

portant because, in many circumstances, a conflict exists between the interests of producers and consumers in our society. Too often, however, this conflict of interest is overlooked or ignored. It is argued that we should search for government policies which benefit all Americans.

While this approach may be sufficient in some policy areas, it is not sufficient in all. It is necessary to accept the fact that real differences of interest exist between groups in our society. Actions taken to assist one group may be at the expense of others, while failures to take action have similar consequences. Government measures frequently have an important effect on distributions of income and wealth in our society and these effects must be recognized when judgments are made. In the realm of antitrust policy, the interests of producers and consumers converge with respect to costs. Both groups have an interest in seeing that goods are produced at the minimum possible costs. However, the interests of producers and consumers diverge in significant respect with regard to prices.

High prices lead to high profits which serve the interests of producers in a number of ways. High profits lead to high returns to the owners of the firm. High profits lead to high salaries and high expense accounts for the managers of the firm. High profits lead also to high wages paid to workers fortunate enough to work for particular firms. At the same time, however, high profits, which are due to high prices, also lead to increased costs of living for consumers generally. Low prices, on the other hand, benefit the broad class of consumers and lead to lower living costs for all members of society.

The point at issue in the case of vertical restrictions, as in many areas of antitrust, is that of monopoly prices. The most important effect of high monopoly prices is on the distribution of income between producers and consumers. The objective of promoting competition is associated with that of protecting consumers by restraining firms from setting high prices and realizing high monopoly returns.

VERTICAL RESTRICTIONS AS A BUSINESS PRACTICE

Vertical restrictions represent a business practice which can be examined in terms of its prospective effect on average prices. The important question here is whether vertical territorial or customer restrictions are likely to assist in the attainment of monopoly power in an industry and contribute to the setting of high prices.

One point about which there is little disagreement is that vertical restrictions are designed specifically to eliminate intra-brand competition, which is the competition between dealers or bottlers who sell the same branded product. Territories are specified precisely to prevent the dealers or bottlers of a single manufacturer from competing with others of the same company. In some circumstances, particular classes of customers are specified. In either case, the purpose is to divide the market into segments within which each dealer or bottler has little or no competition in terms of the same branded product. These restrictions often lead to the creation of monopoly positions for dealers insofar as they concern particular brands.

This effect of vertical restrictions on intra-brand competition is clearly evident. However, it is often argued that the presence of interbrand competition is sufficient to keep prices at low, competitive levels. There is competition among branded products and therefore the loss of interbrand competition has little bearing on the final prices charged to consumers. This position is an important one and it raises some serious issues.

First, it suggests that inter-brand competition is strong and effective, and that little more is to be gained from promoting intra-brand competition. While this suggestion may be true in some instances, it may not be so in others. Indeed, various factors indicate that the extent of inter-brand competition is likely to be limited in markets characterized by vertical restraints. A second but related matter is that vertical restrictions appear to have an important effect on inter-brand as well as on intrabrand competition.

My primary concern is the second issue. It is to examine the prospective effect of vertical restraints on the degree of competition among different branded products in the market place.

THE IMPORTANCE OF PRODUCT DIFFERENTIATION

The strength of competition in an industry depends on factors in addition to the number of firms and their relative sizes. It is not sufficient to look only at the number of firms to determine the degree of monopoly power. One of the most im-

portant of these additional considerations is the extent to which consumers are willing to substitute among the products of competing firms. When the products of different firms are highly substitutable, consumers are unwilling to pay more for one product than for another, and individual firms cannot set prices which are higher than those of competing firms without suffering a substantial loss in demand. Where substitutability is low, on the other hand, demand does not decline significantly even if prices are raised above those charged by their rivals. In the latter circumstances, consumers are sufficiently attracted, for one reason or another, to the products of individual firms so that they continue to purchase them even when their prices are higher than those of competing products.

An important implication of this form of consumer behavior is that a considerable incentive exists for firms to differentiate their products from those of their rivals. Much is to be gained from influencing consumer behavior in such a way that consumers will not switch from specific brands of a product even when higher prices are charged. Where consumer substitutability among competiting products is low, products are said to be differentiated, and in these circumstances, firms are insulated to some extent from the effects of price competition.

Product differentiation is founded on both real and fancied differences among products. It depends on the basic nature of the product as well as on the business policies pursued by the firm. Both advertising and distribution arrangements may have an important influence on the degree of product differentiation.

While product differentiation generally leads to higher prices than would be set in the absence of differentiation, this certainly does not suggest that every instance of differentiation is socially undesirable. Strong consumer preferences for specific products, and the resulting low consumer substitutability often results from real differences among products and from the peculiar skills or attributes of a particular firm. In these instances, the price effects of product differentiation may be offset by the social gains associated with product variety. However, where product differentiation requires the imposition of vertical restraints, our conclusion is different. The need for these restraints suggests that there is insufficient consumer demand for the attributes of differentiation in a free and unrestricted market. Higher prices result but there are no offsetting factors.

THE IMPORTANCE OF DEALER MARKUPS

Manufacturers have a clear incentive to adopt policies which maximize the degree of product differentiation. Indeed this is an important means of achieving the high prices and high profits to which all firms aspire. Where products are highly differentiated, and substitutability is low, consumers behave as though they are tied to the products of individual firms. In this situation, manufacturers can charge relatively high prices without fear of losing customers. Since losing customers is the major constraint imposed by a market system on price increases, we should not be surprised if prices are relatively higher where differentiation is effective.

Whether carried out through integrated facilities or through independent dealers or bottlers, distribution outlets frequently contribute to the achievement of effective product differentiation. The degree of consumer substitutability, or product differentiation, can often be altered significantly by the commercial policies pursued by a manufacturer's dealers. For this reason, it can be observed that manufacturer-dealer relationships are often founded on factors which create and foster product differentiation.

Where product differentiation is promoted by conditions of sale at the dealer level—fancier showrooms or additional dealer services, for example higher gross markups may be associated with a greater volume of sales. That this effect is likely to be important can be noted from the interest shown by manufacturers that their products are sold in attractive surroundings and not in what one executive has called "clapboard shacks." Conditions of sale are important to the manufacturer, and this concern follows from his desire to achieve effective product differentiation. In these circumstances, manufacturers and dealers together benefit from reduced consumer substitutability which leads directly to higher prices being charged for particular branded products.

Because the manufacturer and dealer both benefit—at the expense of the consumer—from the higher dealer markups which are required for product differentiation, a clear motive exists for restricting competition among the dealers or bottlers associated with a single firm. The manufacturer cannot bear the costs of differentiation and assure an adequate markup simply by lowering his

price to the dealers, for price competition among dealers would drive markups down to their previous levels. Conditions which protect dealer markups and insure that they are used to create conditions which enhance differentiation become necessary. Furthermore, effective practices are likely to require the active support of the dealer. It may therefore be necessary for the manufacturer to protect higher markups in order to provide his dealers with a share of the prospective gains, as well as to with the resources required for effective differentiation.

The role of territorial and customer restrictions becomes evident. By fragmenting the market among his dealers, with respect to territory or class of customers to be served, the manufacturer protects dealers markups from the eroding effects of intra-brand competition. Dealers are no longer subject to the competition of others who sell the same branded product. In this manner, the effects on competition are similar to those obtained by a horizontal price fixing arrangement. Moreover, vertical restrictions have economic results which are similar to those fashioned more directly through price fixing via resale price maintenance to insure high margins in the distribution sector of the economy.

To the extent that vertical restrictions are permitted, and adopted by the leading firms at the manufacturing stage of an industry, the structure of retail submarkets resembles the national market in manufacturing. When the market structure at manufacturing is oligopolistic, local oligopolies are created at the distribution stage. In the end, vertical restrictions not only eliminate intra-brand competition, but also through their effect on product differentiation, serve to restrict price competition among the products of rival firms. On both accounts, the presence of vertical restrictions leads to higher prices paid by consumers for branded products.

Despite the prospect that vertical territorial and customer restrictions have substantial anticompetitive consequences, the extent of appropriate antitrust actions against them depends also on whether there are any competitive justifications. For this reason, it is necessary to examine some proported justifications.

ENCOURAGING DEALER INVESTMENT

It is sometimes argued that vertical restrictions may be necessary to induce prospective dealers to invest capital in buildings and other fixed equipment. In the absence of these restrictions, the argument proceeds, the required flow of funds would not be forthcoming because prospective dealers would fear that strong competition from other dealers would drive margins down and make the investment unprofitable.

Throughout the economy, however, restrictions on competition are not needed to induce capital investment. Real investment in economic activities is generally forthcoming whenever the prospective rate of return exceeds the cost of additional capital. So long as the return in an industry is sufficently high, entrepreneurs recognize that profits can be earned by the investment of funds, which are obtained either from internal sources or from the capital markets. As demand expands in some markets and contracts in others, the return on investment varies accordingly. High returns serve as a signal for the required capital investment even without restrictive agreements. Investment proceeds so long as returns are sufficiently high, but will halt when the additional capital invested in a particular industry drives the profit rate down to the competitive level. Through this process, capital funds are allocated among the various sectors of the economy.

When further investment in distribution facilities is needed by consumers, the normal functioning of a market creates temporarily higher markups and increased distributor profits. These increased profits serve as a signal for new investment. If, however, cost are too high or consumer demand too low, so that distributor profits are not sufficiently high to induce increased investment in distribution, it is likely that society will be better served by greater investment in other areas.

The conclusion to be drawn from this discussion is that it is wrong to assume that more dealer investment is always preferable to less. Society may well benefit more from increased investment in other sectors of the economy rather than in distribution facilities. Indeed the need to enforce vertical restrictions to achieve the profit levels required for this investment suggests that a free market would not support the volume of dealer investment desired by the manufacturer. Consumer demand for the services provided may simply be insufficient.

PROVISION OF DEALER SERVICES

When manufacturers assert that vertical restrictions are needed to insure "adequate" dealer services, they may be correct on their own terms. The word "adequate" may simply describe services which are adequate to insure effective product differentiation. It is quite possible that vertical restrictions may be needed for markups which are sufficiently large for dealers to provide credit terms, other dealer services, or advertising—all of which may lead to effective product differentiation.

Vertical restrictions encourage dealers to provide customer services jointly with the manufacturer's product at a single price. While some of these services may be necessary and useful, the need for vertical restraints to insure their provision indicates only that an insufficient demand for them exists in an unrestricted market. This practice leads to an effective tying arrangement between services and product. which generally results in the provision of more leader services than would be obtained if consumers were free to purchase them separately from the manufactured product. This arrangement, moreover, is likely to lead to a joint price for the product and service which is higher than the sum of the two prices which would be set were the commodities priced and sold separately.

A system of joint supply contributes to the achievement of effective product differentiation and increased monopoly power at both the manufacturing and distribution stages of production. It leads both to higher manufacturers prices and higher dealer markups. Furthermore, it should be evident that the objective of maintaining an effective tying arrangement cannot serve to justify the imposition of vertical restraints.

MARKET COVERAGE

Another justification offered in defense of vertical restrictions is that they lead to increased sales of the manufacturer's products through wider coverage of geographic markets. Since distribution costs to large, nearby customers are frequently lower than costs to smaller and more distant customers, the manufacturer benefits if a single price is charged to all, and the dealer's savings from sales to one group is used to cover the higher costs of sales to the other. While this type of distribution arrangement may lead to wider market coverage than could be achieved by overlapping and competing distributorships, it must be supported by some form of market restriction. Otherwise, dealer competition for sales to low-cost customer will destroy the single price regime and eliminate the high markups which are used, in effect, to subsidize sales to high-cost customers. What is taking place here is the use of vertical restrictions for the purpose of subsidizing some consumers at the expense of others.

Even if significant cost differences among customers exist, there is little economic justification for a set of commercial practices which insures that all customers are charged the same price. There is little economic justification for cross-tabilization among classes of consumers. Where sales to specific customers are attractive because they reflect lower costs of distribution, the prices charged to these customers should be lower, and competition among distributors would lead to lower prices. Where costs of distribution are high, on the other hand, we should expect to find higher prices. At those prices, dealers will compete for sales. In either case, markets are well covered, although possibly not to the same extent.

While market processes, unencumbered by vertical restrictions, will generally have the effect of destroying a single price regime, and leading to different prices charged for customers with different costs of distribution, this is not an undesired result. Indeed, it is well known that competitive markets lead to higher prices where costs are higher. which has a desired effect on the allocation of society's resources.

It should be stressed that there is no reason to believe that vertical restrictions leads to a better allocation of resources. If a substantial number of customers desired greater market coverage, there would be an expansion of demand for the services of distribution facilities and a corresponding increase in demand for products which are distributed widely. This will give firms with relatively limited market coverage an incentive to increase the number of their distribution outlets. If sufficient demand exists for their products, firms will achieve the high retail margin needed to make more intensive distribution possible. This is precisely

the process through which the market serves to allocate resources to distribution facilities in a socially desirable manner. And it is here also that restrictions on competition, through the imposition of vertical restraints, are likely to hinder the achievements of desired objectives.

SOME CONCLUSIONS FOR ANTITRUST POLICY

When the relevant market at the manufacturing stage is already an oligopoly, we can expect to find a measure of monopoly power present even when vertical restrictions are totally absent, However, it should be stressed that product differentiation is a further dimension of market structure which may be as significant to the achievement of monopoly power as is the degree of market concentration. Moreover, while they comprise only one facet of product differentiation, dealer facilities and services may play an important role. Indeed, the achievement of competitive levels of prices and profits at the manufacturing stage may be significantly frustrated by product differentiation stemming from practices at the dealer stage.

In the distribution sector, vertical restraints lead directly to higher markups than would otherwise exist. Although these markups may result in higher distributor profits, they are also likely to be associated with inflated dealer costs. Fancier showrooms or more elaborate facilities are constructed, and more dealer services are provided than would be demanded by consumers in unrestricted markets. This conclusion follows from the need for vertical restraints to assure these showrooms or services.

The major line of defense for vertical territorial and customer restrictions lies in the prospect that inter-brand competition might be fostered through the suppression of intrabrand competition. However, vertical restraints may lead instead to increased levels of product differentiation and therefore to the achievement of increased monopoly power. As a result, vertical restraints are likely to impede the growth of price competition and the movement of price towards costs.

While some measure of product differentiation may be desirable, even though price competition is lessened, the attainment of differentiation is certainly not a valid reason for rejecting the normal presumption of antitrust policy in favor of maximum competitive behavior on the part of independent firms. This is especially so since traditional antitrust objectives, in terms of protecting the interests of consumers, are more likely to be secured through the promotion of price competition.

A concern with protecting the interests of consumers leads to the view that vertical territorial and customer restrictions should be prohibited under the antitrust laws. Even in the case of a small manufacturing firm facing a giant rival in an oligopolistic market, these restrictions are undesirable. We are concerned here with competition as a process for achieving social objectives and not merely with the number of competitors in the market. Moreover, there is not much to be gained from bolstering a small and perhaps inefficient rival when this can be accomplished only by market restrictions which sacrifice primary objectives. Even in these circumstances, vertical restraints should not be permitted.

This analysis leads to the conclusion that vertical customer and territorial restrictions should not be exempted from the antitrust laws. The fact that there is more than one trademarked product in a market does not indicate that the degree of inter-brand competition is likely to be sufficient to keep prices at low competitive levels. In the first place, these qualifications are consistent with the presence of high degrees of market concentration, and it is a well-known fact in economics that high levels of monopoly power are often achieved in markets where there are two or three or a small number of rival firms. Second, there is the fact that production differentiation is an equally important determinant of the degree of competition. Where product differentiation is significant, due perhaps to real differences among products, individual consumers have strong preferences for the products of a single manufacturer. In these circumstances, the only prospects for competition is intra-brand competition, and it is this competition which is specifically proscribed by the presence of vertical restraints.

Furthermore, there is considerable likelihood that the presence of vertical restraints contributes to the degree of product differentiation. This result has the direct effect of reducing the degree of competition at the manufacturing stage. Rather than leading to increased competition at the manufacturing stage, the tolerance of vertical restraints has the opposite effect: vertical restrictions lead

instead to reduced competition. Moreover, vertical restraints have the direct effect of restricting competition among dealers of the same manufacturer. On both accounts, consumers are likely to pay higher prices.

A policy designed to protect the interests of consumers by promoting the maximum degree of competition should prohibit vertical territorial and customer restrictions.

[From the Harvard Law Review, 1968]

VERTICAL TERRITORIAL AND CUSTOMER RESTRICTIONS: WHITE MOTOR AND ITS AFTERMATH

(By William S. Comanor)*

Contractual arrangements between a manufacturer and his dealers, limiting the customers to whom and the territory within which the dealers may sell, have been attacked persistently under the antitrust laws during the last decade. A recent decision of the Supreme Court has held such vertical restraints to be per se violations of section I of the Sherman Act, but that holding was limited to those manufacturer-dealer relationships where the product is actually sold to the dealers. Professor Comanor urges that this is a meaningless distinction, and that all customer and territorial restrictions should be per se violations of the Act, with possible exceptions for those imposed by new manufacturers or by old manufacturers selling new products. In addition to the evident, intended elimination of intrabrand competition, these restrictions make possible product differentiation and its concomitant—obstruction of interbrand price competition. He finds the arguments offered in justification unpersuasive and dismisses the danger that per se condemnation of these agreements will result in the integration of manufacturer and distributor.

I. INTRODUCTION

Judicial development of the law of antitrust has traced a circular pattern. Although section I of the Sherman Act proscribes "*Every* contract, combination . . . or conspiracy, in restraint of trade or commerce among the several States,"[1] the Supreme Court in *Standard Oil Co.* v. *United States*[2] early announced the "rule of reason," which limits section I prohibitions to agreements which are in unreasonable restraint of trade. Yet, when the courts are instructed to examine the competitive impact of an agreement to determine its reasonableness, antitrust litigation becomes prolonged, complex, and unwieldy. To reduce this complexity,[3] the courts since *Standard Oil* have adopted and increasingly applied the doctrine of "per se illegality": defendants have violated section I if they are parties to an agreement categorized as a per se violation, without inquiry into its reasonableness Hence, with respect to certain restraints, the courts have come full circle—section I is applied literally.

The per se concept, however, should be considered a refinement rather than a departure from the rule of reason. Attachment of the per se label to a type of agreement expresses the judgment that the adverse competitive effects of the arrangement outweigh its purported justifications,[4] or, at least, that the benefits accuring from the restriction can be achieved by a less restrictive alternative. The role played by this doctrine is summarized in *Northern Pacific Railway* v. *United States*:[5]

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[1] 15 U.S.C. § 1 (1964) (emphasis added).

[2] 221 U.S. 1 (1911).

[3] For a discussion of the desirability of reducing the size and complexity of antitrust cases see Bok, *Section 7 of the Clayton Act and the Merging of Law and Economics*, 74 Harv. L. Rev. 226, 271 n. 180 (1960).

[4] With respect to price-fixing agreements, it was thus decided that "[w]hatever economic justification particular price-fixing agreements may be thought to have, the law does not permit an inquiry into their reasonableness. They are all banned because of their actual or potential threat to the central nervous system of the economy." *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 224 n. 59 (1940) (Douglas, J).

[5] 356 U.S. 1, 5 (1958) (Black, J.).

> [T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without elaborate inquiry as to the precise harm they have caused or the business excuse for their use. This principle of *per se* unreasonableness not only makes the type of restraints which are proscribed by the Sherman Act more certain to the benefit of everyone concerned, but it also avoids the necessity for an incredibly complicated and prolonged economic investigation into the entire history of the industry involved, as well as related industries, in an effort to determine at large whether a particular restraint has been unreasonable—an inquiry so often wholly fruitless when undertaken.

The Court has held that price-fixing agreements, both horizontal [6] and vertical [7] are per se violations of the antitrust laws. Similarly, the Court has found that horizontal agreements allocating territories within which competitors may operate are "tantamount to agreements not to compete, and hence inevitably violative of the Sherman Act. . . ." [8] More recently, agreements vertical in character, between a manufacturer and his dealers, which allocate territories among latter and limit the class of customers to whom they may sell, have come under attack.[9] This article examines the economic role played by vertical territorial and customer restrictions. It explores their competitive consequences, considers various justifications offered in their defense, and, finally, discusses appropriate standards for antitrust policy.

II. RECENT CASES: A TREND TOWARD PER SE ILLEGALITY

Manufacturing firms in many lines of commerce reach their final consumers through the intermediary of independent franchised dealers. The association between supplier and dealer is frequently marked by agreements restricting the dealer's territory and customers. In the first case involving such restrictions to reach the Supreme Court, *White Motor Co.* v. *United States*,[10] the Court was unwilling to affirm the lower court's summary judgment which had found that the territorial [11] and customer [12] restrictions, contained in the manufacturer-dealer contracts were per se violations of section 1:

> We do not know enough of the economic and business stuff out of which these arrangements emerge to be certain. . . . We need to know more than we do about the actual impact of these arrangements on competition to decide whether they have such a "pernicious effect on competition and lack . . . any redeeming virtue" . . . and therefore should be classified as *per se* violations of the Sherman Act.

The inquiry in *White Motor* did not progress beyond this stage, however, since the case on remand was concluded by consent decree.

In a more recent case, *United States v. Arnold, Schwinn & Co.*,[13] the Court held that both territorial and customer restrictions are per se violations of the Sherman Act, but it refused to extend this condemnation to agency or consignment arrangements where the seller retains "all indicia of ownership, including title, dominion, and risk." This distinction between vertical restraints involving

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[6] *Kiefer-Stewart Co.* v. *Joseph E. Seagram & Sons*, 340 U.S. 211 (1951). A "horizontal" agreement is one among firms, usually competitors, at the same stage of production. Thus, agreements among manufacturers, among wholesalers, or among retailers are horizontal.

[7] *United States* v. *Parke, Davis & Co.*, 362 U.S. 29 (1960); *see Dr. Miles Medical Co.* v. *John D. Park & Sons*, 220 373 (1911). "Vertical" agreements are those among firms or individuals at succesive stages of production, such as manufacturer and wholesaler, or wholesaler and retailer. The Miller-Tydings Act of 1937 amended section 1 to exempt from its operation vertical agreements fixing resale prices when such agreements are lawful in the state of resale. 15 U.S.C. § 1 (1964) (proviso).

[8] *White Motor Co.* v. *United States*, 372 U.S. 253, 267 (1963) (Brennan, J., concurring).

[9] *United States* v. *Arnold Schwinn & Co.*, 388 U.S. 365 (1967); *White Motor Co.* v. *United States*, 372 U.S. 253, (1963).

[10] 372 U.S. 253, 263 (1963).

[11] A typical territorial restriction clause was contained in the original *White Motor* agreements. It read:

> Distributor is hereby granted the exclusive right . . . to sell during the life of this agreement in the territory described below . . . Distributor agrees to develop the aforementioned territory to the satisfaction of the Company, . . . and not to sell such trucks except to individuals, firms, or corporations having a place of business and/or purchasing headquarters in said territory, 372 U.S. at 255–56.

[12] A typical customer restriction clause read: "Distributor further agrees not to sell nor to authorize his dealers to sell such trucks to any Federal or State government or any department or political subdivision thereof . . . ." 372 U.S. at 256.

[13] 388 U.S. 365 (1967).

sales and those which are part of consignment arrangements is difficult to justify in terms of the underlying consequences of the restraints. While it is clear that some exceptions are required for agency relationships which are internal to the organization of the firm, since "otherwise a department store manager could not tell his sales girls what prices they could charge or from which counters they could sell: they would have to compete with each other," [14] there is little reason for moving beyond this point. Even when formal ownership is retained by the manufacturer, these restraints have the same effect on dealer behavior as they do when ownership is relinquished, and it is this behavior which has a major impact on the degree of competition. Restrictions of this character, moreover, are not a necessary part of agency-type distribution arrangements. Unlike fully integrated operations where a single organization exists and where outside interference may imply weaker chains of command, distribution by agent is founded on contractual relationship among independent firms, which may readily be altered without necessarily leading to weaker forms of organization and the attending inefficiencies.

III. VERTICAL TERRITORIAL AND CUSTOMER RESTRAINTS: ANTICOMPETITIVE EFFECTS

The most obvious undesirable effect of customer and territorial restrictions is the elimination of intrabrand competition. Both types of restriction prevent dealers [15] in a manufacturer's product from competing with one another for the same customers; the dealers, in most cases, are given a monopoly in the manufacturer's product, in either territories or customers. Although this impact alone might appear sufficiently serious to warrant per se condemnation of these arrangements, it is argued in justification that the very restriction of intrabrand competition has the beneficial effect of stimulating and improving interbrand competition. It is crucial, therefore, to examine the likely effects of these restraints on interbrand competition.

A. Product differentiation—One cause of market power—

The degree of competition in an industry—or its antithesis, the level of market power—depends on factors in addition to the number and relative sizes of firms in an industry. One to the more important of these further considerations is the extent to which consumers are willing to substitute among the products of competing firms. When the products of different firms are highly substitutable, consumers by definition are unwilling to pay more for one product than for another, and individual firms cannot set prices which are higher than those of competing products without suffering a substantial loss in demand. When substitutability is low, on the other hand, demand will not decline significantly even if prices are raised above those charged by rival firms. There is considerable incentive, therefore, for firms to differentiate their products from those of their rivals precisely for the purpose of promoting low consumer substitutability, thereby insulating themselves from the effects of price competition.[16]

Product differentiation is founded on both real and fancied differencies among products, and depends on the basic nature of the product as well as on business policies such as advertising. The degree of differentiation, moreover, varies among classes of customers, being generally greater in final markets where buyers are individual consumers than in industrial markets where buyers are other firms.[17] Regardless of its underlying determinant, however, product dif-

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[14] *The Supreme Court, 1966 Term,* 81 Harv. L. Rev. 69, 236 (1967).

[15] This article assumes for simplicity a two-tier distribution process consisting of a manufacturer and his retailers (dealers).

[16] Not all differences among competing products indicate product differentiation. Various commodities, such as wheat and coal, are produced and sold in a number of standardized grades, and frequently different firms produce different grades of output. In addition, price differences are normally found among the various grades, and these tend generally to reflect differences in production costs. Where differentiation is low or absent, firms can readily switch their production from one grade or product to another, depending on relative profit margins. Since increased output normally leads to lower prices, and reduced output leads to higher prices, this form of transferability of production tends to equalize margins among the products produced by rival firms. On this account, product differences alone signify little concerning the effect of competition on market prices. In this result, however, a significant factor is the ability of firms to switch production between the various grades of output and to initiate their rivals sufficiently well that consumers have few preferences between products of competing firms which will withstand significant differences in price.

[17] J. Bain, Barriers to New Competition 114–43 (1956).

ferentiation has the effect of restricting the degree of price competition and contributing to the achievement of market power.[18]

In many market situations, product differentiation is fairly low among the products of existing firms, but it is often quite high with respect to products offered by new entrants. Where this is the case, an important entry barrier exists and established firms as a group are free to raise their prices to noncompetitive levels without danger of enticing new firms into the industry. In this manner, the degree of competition may be severely lessened.

While product differentiation generally leads to higher prices and monopoly returns, this does not imply that every instance of differentiation is socially undesirable, much less that it should always be condemned under the antitrust laws. The mere departure from the purely competitive model does not alone signify that condemnation is appropriate. Low consumer substitutability often results from real differences among products and from the peculiar skills or attributes of particular firms. In these instances, the price effects of product differentiation are often offset by the social gains resulting from the existence of product variety.[19] Even if sufficient market power were achieved to warrant a charge of monopolization under section 2 of the Sherman Act, a defense of "superior skill, foresight, and industry" [20] might well prevail.

On the other hand, when product differentiation is achieved not by "superior skill, foresight, and industry," but rather by imposing customer and territorial restrictions—agreements which expressly restrict the behavior of independent firms—the offending firm becomes subject to antitrust attack. As argued below, there are no offsetting factors to justify these restrictions, and therefore, since they are likely to promote product differentiation and contribute to the achievement of market power, they are clear violations of section 1 of the Sherman Act.

B. Dealer markups and product differentiation

Manufacturers have a clear incentive to adopt policies which maximize the degree of product differentiation. Where products are highly differentiated and substitutability is low, consumers behave as though they were tied to the products of specific firms. In this situation, manufacturers can charge higher prices without fear of losing customers. Whether carried out through integrated facilities or through independent dealers, distribution outlets may contribute to the achievement of effective product differentiation. The degree of consumer substitutability can be altered significantly by the commercial policies pursued by a manufacturer's dealers. For this reason, manufacturer-dealer relationships are founded generally on factors which create and foster product differentiation.

It is often argued that agreements which establish exclusive territories are less offensive when they are vertical (between a manufacturer and his dealers) than when they are horizontal (among the dealers themselves) because the manufacturer's interests are best served when his dealers' gross markups [21] are maintained at low levels, which is a desirable competitive result, whereas the interests of conspiring dealers are best served when their markups are at high levels, which provides monopoly returns. This argument is founded on the premise, unassailable when the manufacturing industry is a single-firm monopoly, that higher markups reduce total retail sales, and that the manufacturer aims, of course, to maximize the quantity of output sold after his own selling price has been set. In the more common case, however, there are a number of firms in the industry and the manufacturer will benefit from dealer markups which exceed competitive levels when the resulting revenues are used by the dealer to create consumer preferences for the manufacturer's products. In oligopolistic markets, where the leading firms account for a substantial share of total output, rivalry generally assumes a nonprice character. In contrast to price changes which can be readily followed, it is likely to be more difficult for competitors to duplicate "product changes" or new selling and distribution arrangements, and these represent various dimensions of product differentiation. Active rivalry thereby serves as a further incentive for the firm to achieve effective differentia-

[18] An empirical analysis of the relationship between profit rates and advertising, which serves as both a source and a symptom of product differentiation, suggests that differentiation is one of the major factors responsible for high degrees of monopoly power. Comanor & Wilson, *Advertising Market Structure and Performance*, 49 Rev. of Econ. & Statistics 422 (1967).

[19] Chamberlain, *Product Heterogeneity and Public Policy*, in Readings in Industrial Organization and Public Policy 236–43 (R. Heflebower & G. Stocking eds. 1958).

[20] *United States* v. *Aluminum Co. of America*, 148 F.2d 416, 430 (2d Cir. 1945).

[21] "Gross markup" is the difference between manufacturer's and retailer's prices.

tion. Business policies which promote differentiation are often a form of interfirm rivalry at the same time that they serve to limit the development of price competition.

To the extent that product differentiation is fostered by conditions of sale at the dealer level—fancier showrooms or additional dealer services, for example—higher gross markups may be associated with a greater volume of sales. Moreover, what is important to the firm is not the number of units sold but revenues, and it seems probable that higher manufacturing prices will be charged once the product has been effectively differentiated through dealer practices. While there may be some divergence of interests between manufacturer and dealer with regard to the size of dealer markups, there is also a considerable community of interest in terms of practices which promote effective product differentiation. We can note, for example, the apparent concern of manufacturers that their products be sold in attractive surroundings and not in what one executive has called "clapboard shacks." [22] Manufacturer and dealer can both benefit; the higher markups which are required and which result may be a small cost for the manufacturer to bear relative to the prospective gains.[23]

C. Restricting intrabrand competition to protect dealer markups

Because the manufacturer and the dealer are both likely to benefit—at the consumer's expense—from the higher dealer markups required for product differentiation, a motive for restricting competition among a firm's dealers is clearly present. The manufacturer cannot bear these costs and assure an adequate markup simply by lowering his price to his dealers, for price competition among his dealers would drive their markups down to the previous levels. Conditions which protect dealer markups and ensure that they will be used to differentiate the product become necessary. Furthermore, effective practices are likely to require the active support of the dealer. For this reason, it may be necessary for the manufacturer to protect higher markups to provide his dealers with a share in the prospective gains as well as to provide the resources required for effective differentiation.

The role of territorial and customer restrictions thus becomes evident. By fragmenting the market among his dealers, with respect to territory or class of customers to be served, the manufacturer protects his dealers' markups from the eroding effects of intrabrand competition. In this respect vertical restrictions have economic results similar to those fashioned more directly through price fixing via resale price maintenance.

Some customer restrictions directly facilitate the achievement of product differentiation. The attempts of dealers to differentiate the product will be more effective if the product is available only through authorized dealers. Sales by discount houses or other outlets where price is the major condition of sale are hardly likely to promote buyer concern for the peculiar attributes of the products of a particular manufacturer. And this is what we mean by product differentiation. Moreover, these outlets typically sell at lower retail prices than do authorized dealers, which further undermines existing price structures. Manufacturer efforts, therefore, to prevent dealer sales to other than final consumers may be an important component in a program designed to promote differentiation at the distribution stage.

To the extent that these practices are held permissible and adopted by leading firms at the manufacturing stage, the structure of retail submarkets will resemble the national market in manufacturing. Where the market structure is oligopolistic, local oligopolies will be created at the distribution stage. In the end, vertical restrictions not only will eliminate intrabrand competition but also, through their effect on product differentiation, will serve to restrict price competition among the products of different firms.[24]

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[22] Note, *Restricted Channels of Distribution Under the Sherman Act,* 75 Harv. L. Rev. 795, 806 (1962).

[23] Although higher gross markups will reduce the total output sold by the industry and also the total joint profits secured by member firms, this may simply represent the divergence of oligopolistic from monopolistic results. Rivalry in terms of "product" may lead to greater levels of differentiation and lower levels of profits, and this is what we should expect.

[24] This view contrasts sharply with the position taken by Professor Bork. In a recent article he denies this possibility and states bluntly that the "ability of all truly vertical restraints to enhance the efficiency of the integration has been demonstrated by the argument that they can serve no other function." Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division,* 75 Yale L.J. 373, 404 (1966). These restraints serve also to promote product differentiation and contribute thereby to the achievement of market power.

IV. PURPORTED JUSTIFICATIONS FOR VERTICAL RESTRAINTS

Despite the fact that vertical customer and territorial restrictions have substantial anticompetitive consequences, the extent of appropriate antitrust action against these restraints depends also upon whether any competitive justifications for them exist. If not, per se condemnation may be merited; if so, the courts may be forced to examine economic conditions in particular cases to assess the reasonableness of the restrictions.

A. Encouraging dealer investment

It is sometimes urged that vertical restrictions may be necessary to induce prospective dealers to invest capital in buildings and other fixed equipment. In the absence of these restrictions, the argument proceeds, the required flow of funds would not be forthcoming because prospective dealers would fear that strong competition—from other dealerships, existing or potential, or from the manufacturer directly—would drive prices down and make the investment unprofitable. But economic theory suggests that investment in economic activities will be forthcoming whenever the prospective rate of return exceeds the cost of additional capital. So long as the return in an industry is high, entrepeneurs will recognize that profits can be earned by the investment of funds, which are obtained either from internal sources or from capital markets. As demand expands in some markets and contracts in others, the return on investment varies accordingly. And high returns signal for the required level of capital investment even without restrictive agreements. Investment will proceed so long as returns are sufficiently high, but will halt when the additional capital invested in the particular industry drives the profit rate down to the competitive level. Through this process capital funds are allocated among the various sectors of the economy.

The cost of capital, however, includes a premium for risk and uncertainty. Thus, the investment justification for territorial and customer restrictions may be founded on the proposition that, by insulating dealers from the risks of competition, these restraints limit uncertainty and hence reduce capital cost for investment in distribution facilities. While this argument is appealing, we should recognize that a measure of uncertainty is a normal component of the investment process, and it is one which competition generally increases: indeed, "the greatest of monopoly profits is the quiet life." While it is true that an antitrust policy designed to promote competition may increase the cost of capital, that increase may be a small price to pay to avoid the harms associated with a lessening of competition. If it is desirable to increase the rate of capital investment in a particular industry, alternative public programs can be instituted which do not limit the degree of competition and abandon the policies of the antitrust laws.

Given the policy judgment that competition best serves the community's needs, there is no basis for treating dealers differently than manufacturers. At the manufacturing level, we do not consider lower risks of investment a valid justification for horizontal market restrictions. Furthermore, since there are few reasons for believing that the degree of risk or uncertainty is greater in distribution than in other areas, there is little indication that special treatment is required. Even more important, if the risks of investment in distribution are lowered through vertical restraints, the market process through which capital funds are allocated will be distorted in favor of distribution. The market system is designed to allocate funds among sectors of the economy, and it is necessary to recognize that an efficient allocation of resources is not always served by further capital investment in any single industry. Although these restrictions might provide firms with the capital required to achieve more easily and more fully the patterns of investment which they desire, these patterns are likely to diverge extensively from those which are socially optimal. The funds diverted by these agreements can probably be used more productively in other areas.

When further investment in distribution facilities is demanded by consumers, the normal functioning of the market will create higher markups and distributor profits—either through lower manufacturer prices or higher final prices. If, however, production costs are too high or consumer demands too low to result in distributor profits sufficiently high to induce capital movement into distribution, society is probably better served by increased investment in other areas.

B. Provision of dealer services

When manufacturers assert that vertical restrictions are required to ensure "adequate" dealer services, they may well be correct on their own terms. The word "adequate" may simply describe services which are adequate to ensure effective product differentiation. It is quite possible that vertical restrictions are necessary to provide dealers with markups—or prospective markups—which are large enough to encourage them to provide credit terms, other dealer services, or advertising—factors which may lead to product differentiation.

While some of these services may be necessary and useful, the need for vertical restraints to ensure their provision indicates only an insufficient demand for them in an unrestricted market. Vertical restrictions, which encourage dealers to provide customer services jointly with the manufacturer's product at a single price, are thus likely to result in the provision of more of these services than would be the case if consumers were free to purchase them separately from the manufactured products. This arrangement is likely also to lead to a joint price which is higher than the sum of the two prices which would be set were the commodities priced separately. A system of joint supply leads to the achievement of product differentiation, increased market power at both the manufacturing and distribution levels, and thereby to both higher manufacturers' prices and higher dealer markups.

Furthermore, a joint supply arrangement means that consumers are compelled to purchase the entire package; the purchase of dealer services is tied to the purchase of the manufactured product. To the extent that the amounts consumed differ from those which would be chosen in separate markets, resources are misallocated at the distribution stage even if dealer markups are only high enough to cover incremental costs. This result seems especially apparent in the case of advertising, for consumers might purchase very little indeed of this "service" were it provided separately. In short, a system of joint products not only fails as a justification for contractual restrictions on competitive behavior, but also is likely to lead directly to a further misallocation of society's resources.

C. Market Coverage

Another justification offered in defense of vertical restrictions is that they lead to increased sales of the manufacturer's products through wider coverage of geographic markets. Since the distribution costs of sales to large nearby customers are frequently lower than those made to smaller and more distant consumers, the manufacturer will benefit if a single price is charged to all customers and the dealer's savings from sales to one group are used to cover the higher costs of sales to the other. While this type of distribution arrangement may indeed lead to wider market coverage than could be achieved by overlapping and competing distributorships, it must be supported by some form of market restriction if dealer competition for sales to low-cost customers is not to destroy the single-price regime and eliminate the high mark-ups which are used, in effect, to subsidize sales to high-cost customers. But even if significant differences among customers do exist, there is little economic justification for a set of commercial practices which ensures that all customers are charged the same price. Where sales to specific customers are attractive because they reflect lower costs of distribution, the prices charged to these customers should be lower, and competition among distributors would lead to lower prices. Where costs of distribution are high, however, we should expect to find higher prices; at these prices dealers will generally be willing to compete for sales. When dealers do not attempt to sell in an area, however, the conclusion to be drawn may simply be that total product and distribution costs exceed the price the consumer is willing to pay, and that therefore the required distribution outlays should not be made.

Even if a single-price regime is not maintained, it is argued, restrictions imposed on competition among dealers are still necessary to support dealer markups at the levels required to serve high-cost markets. In the absence of vertical restrictions, competitive price reductions may limit the extent of market coverage since it may no longer be profitable to provide selling and distribution services to high-cost customers.[25]

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[25] This position is developed in Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Standards*, 30 LAW & CONTEMP. PROB. 506, 515 (1965).

The shortcomings of the market coverage justification for vertical restrictions are similar to those inherent in the promotion-of-investment argument. While market coverage and customer contact may indeed be enhanced by certain types of restrictions, these are gains which are not free to society but which involve a cost. What is important is not whether these restrictions enhance market coverage or customer contact, for this they may well do, but rather whether restrictions of this character are likely to improve the competitive processes through which resources are allocated to these activities. While society generally approves of improved market coverage, it also generally deplores higher dealer markups and higher costs of distribution. Whether the additional gains are worth the additional costs is, of course, the essence of the problem of resource allocation—a problem whose solution we normally leave to the market place.[26]

There is little reason to believe that vertical restrictions would result in a better allocation of resources. If a substantial number of customers desire greater market coverage, there will be an expansion of demand for the services of distribution facilities and a corresponding increase in the demand for products which are distributed widely. This will give firms with relatively limited market coverage an incentive to increase the number of their distribution outlets. If sufficient demand exists for their products, firms will attain the high retail margins which are necessary to make more intensive distribution possible. This is precisely the process through which the market serves to allocate resources in a socially desirable manner, and it is here also that restrictions on competition are likely to hinder the achievement of this objective.

D. The "Free Ride" Problem

An attempt has also been made to justify vertical restrictions as necessary to ensure that dealers will concentrate their efforts on making sales within their assigned territories rather than attempting to invade the territories of others. It is argued that in the absence of market restrictions, distributors will not undertake costly selling activities but will hope to rely on the efforts of others and to obtain, in effect, a "free ride." [27] They will not provide customer services, such as advertising or repair facilities, within their own market areas as extensively as they would with imposed market boundaries because others will realize the benefits of their efforts. This argument recognizes that facilities such as showrooms will influence sales for only a particular dealer and therefore will be provided regardless of the existence of market restraints, but it also emphasizes that restraints lead dealers to supply a greater volume of services.

As far as it goes, this argument may well be correct. Vertical restrictions may be needed to provide an incentive for dealers to supply certain kinds of services. At the same time, however, it ignores the question whether the increased supply of these services, free of charge, by dealers rather than by the manufacturer, is sufficient to serve as a valid justification for market restraints which are otherwise suspect under the antitrust laws.

Where the impact of these efforts on sales is widely diffused, vertical restrictions probably have little effect in encouraging dealers efforts; in this situation these activities are generally carried out by the manufacturer himself. In other situations, however, the absence of vertical restrictions may force the manufacturer either to finance selling efforts and customer services which his dealers could perform, or to accept what he regards as an insufficient dealer effort to promote the product and to provide free consumer services. But since "free" services imply only that a single price is charged for both product and service, and since, as noted above, a system of joint supply leads generally to enhanced product differentiation and increased monopoly power, the existence of a "free ride" cannot justify vertical restrictions. To the extent that services are demanded by consumers, a market will develop to supply them and a separate price will be charged. To the extent, moreover, that manufacturers have a legitimate interest in having them provided, they should be forced to bear the cost. In either case, no vertically imposed restrictions are required.

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[26] It appears that this question has been specifically excluded from Professor Preston's analysis of this problem. He writes that "[w]hether the establishment of additional distributorships results in an over-commitment of resources to distributive activity in the economy . . . [is a question] we do not investigate here." Id at 517.

[27] In this context, Professor Bork writes: "The member of a group has a special problem, however. It may find that it is unable to recapture all of its expenditures in local sales effort because a neighboring member of the group undersells it. The interloper gets all the advantages of the first firm's expenditures wtihout paying for them. It thus gets a free ride . . . ." Bork, *supra* note 24, at 435.

E. The problem of price discrimination

It may also be argued that market restrictions among dealers are necessary to allow manufacturers to discriminate in price among customers; it is urged that only by charging lower prices to certain classes of customers can interbrand competition for these customers exist. When a firm sells in a number of distinguishable final markets through its dealers, discrimination is made possible by limiting each dealer to a single market through the imposition of customer or territorial restraints. Were the same dealer to sell in a number of final markets, the manufacturer would lose control over the distribution of sales among final markets, and thereby over the mechanism through which discrimination is achieved.

Thus, the economic concept of price discrimination is based on the ability of a firm to fragment its markets and, despite similar costs, sell the same product at different prices. Higher profits can be earned than even those obtainable by a single-price monopolist if the firm can set a relatively high price for consumers willing to pay it and a relatively low price for those who would not buy if they had to pay the higher price.[28] Effective price discrimination requires: (1) that buyers cannot move among markets or buy in one market and resell in another, and (2) that firms have sufficient market power to control substantially the prices of their products.

A common form of price discrimination is found where, as in *White Motor*, a manufacturer uses restraints on his dealers to reserve large customers for himself. It may be that the responsiveness of these buyers to changes in price is greater than that of the more normal class of customers, and that higher profits are earned when they are charged a lower price while a higher price is charged to others. But if the optimal price to large buyers were less than that paid for the product by the dealers, customer restrictions would not be necessary to achieve this form of discrimination; the manufacturer would need only to charge a lower price than his dealers could set. A recent study, however, found that "a significant number, although by no means a majority, of manufacturers interviewed reported that their price to distributors is normally lower than that given large outside customers." [29] In these situations, the manufacturer will often impose customer restrictions on his dealers to reserve these customers for himself and to eliminate any prospect that his dealers will undercut him. Although distribution costs on sales to large customers are often lower than those to other consumers, these restraints may still be necessary in some cases to ensure that optimal discriminatory prices are established.

Price discrimination fails as a justification for vertical restraints on a number of counts. Although discrimination may well lead to lower, more competitive prices for some customers, at the same time higher, less competitive prices are charged to others. While output will generally be greater in one market, it will generally be smaller in another, and the net result will depend on demand conditions in the individual markets. Regardless of the new change in total output, however, discrimination will foster different price-cost margins as between customers in different markets and thereby will tend to distort the allocation of resources. Furthermore, the increased revenues from discrimination result from the existence of monopoly power and exploitation of an entrenched market position. While such restrictions benefit the manufacturer, there are no corresponding gains to society which outweigh their anticompetitive effects, and private gains clearly do not serve to justify restraints.

V. INTEGRATION OR VERTICAL RESTRICTIONS

Because the preceding analysis suggests that vertical territorial and customer restrictions have serious anticompetitive consequences and little economic justification, stringent antitrust enforcement seems appropriate. At the same time, it is important to examine the implications of prohibiting these restraints. The primary consideration is that because section I is applicable only to agreements among firms,[30] prohibiting these arrangements may encourage the integration of

[28] High prices are set where the elasticity of demand is low and low prices where the elasticity of demand is high.

[29] Note, *supra* note 22, at 818.

[30] Some check on integration might be achieved, however, through § 7 of the Clayton Act, 15 U.S.C. § 18 (1964), if the firm sought to integrate via merger, or by § 2 of the Sherman Act, 15 U.S.C. § 2 (1964), if the integrated firm had monopoly power or if the facts supported an allegation of an attempt to monopolize.

manufacturing and distribution facilities to achieve the same objectives sought in imposing these restrictions. Two inquiries are critical. First, if vertical restraints are condemned, will there be a marked increase in vertical integration? Second, are there grounds for dealing differently with vertical restraints than with vertical integration?

In response to the first inquiry, there are a number of reasons why firms might find it inefficient to operate their own distribution outlets. One article has listed three characteristics of distribution which make these operations unattractive to manufactures.[31] First, distribution tends to be a low-profit activity, and suppliers would prefer to obtain the desired degree of control without tying up the necessary funds. Second, distribution frequently involves the purchase and sale of many products and the optimal product mix of distributors may differ substantially from the optimal mix of the manufacturer. Finally, distribution is normally associated with local managerial problems and with a high personal service component so that integration may lead to higher cost operations than would exist among independent distributors. In sum, because substantial diseconomies of integration may exist, it cannot be assumed that vertical integration is always a viable alternative to distribution through independent dealers.[32] And if integration does not result, condemnation of contractual restraints may lead to more vigorous competition.

Even if integration does result in some instances because of the prohibition of vertical restraints, there are still valid reasons for antitrust action which is limited to contractual restrictions. In some circumstances, economies in distribution result from fully integrated facilities, and these economies may outweigh the competitive loss resulting from integration. With contractual relationships, however, not only are comparable efficiencies less likely, but, even more important, franchise arrangements to achieve possible efficiencies can be maintained in the absence of restrictive provisions.

VI. SOME CONCLUSIONS FOR ANTITRUST POLICY

When the relevant market at the manufacturing stage is already an oligopoly, we can expect to find a measure of market power present even when vertical restrictions are totally absent. However, it should be stressed that product differentiation is a dimension of market structure which may be as significant to the achievement of monopoly power as is market concentration. And, while they comprise only one facet of product differentiation, dealer services and facilities may play an important role. Indeed, the achievement of competitive levels of prices and profits at the manufacturing stage may be significantly frustrated by product differentiation stemming from practices at the dealer stage.

In the distribution sector, vertical restraints will lead directly to higher markups than would otherwise exist. Although these markups may result in higher distributor profits, they will generally be associated with inflated dealer costs. Fancier showrooms or facilities are constructed and more dealer services are provided than would be demanded by consumers in unrestricted markets. To the extent, moreover, that increased market coverage is achieved through vertical restraints, which permit high markups to be set but which confine dealers to relatively small territories, excess distribution capacity will result in higher unit costs. In either event, market restrictions lead directly to an inefficient use of society's resources at the distribution stage.

The major line of defense for vertical territorial and customer restrictions lies, of course, in the prospect that interbrand competition might be fostered through the suppression of intrabrand competition. This may indeed be true when rivalry is founded on advertising, dealer services, or other factors which enhance the degree of product differentiation. In these areas, market restrictions

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[31] Preston, *supra* note 25, at 512.

[32] In the petroleum industry, for example, a recent study found that the franchise system is a far more efficient method of distribution than direct ownership. Salaried managers are subject generally to limitations on the hours a week they can work and also are more prone to the organizational efforts of labor unions. An independent dealer, on the other hand, is not subject to these limitations. A station which is open from 8:00 a.m. until 6:00 p.m., six or even seven days a week is expensive to operate if employees stop work at the end of 40 or 48 hours. The average workweek for independent dealers tends to approach 70 hours. It is not surprising, therefore, that operating costs of stations owned by the major oil companies are estimated to be about one cent per gallon of gasoline greater than for leased stations. Miller, *Exclusive Dealing in the Petroleum Industry: The Refiner-Lessee Dealer Relationship,* 3 Yale Econ. Essay 223, 232 (1963).

might well promote greater rivalry. But, while these restrictions might stimulate improvement in the "product" offered by the dealer, they are likely at the same time to impede tthe growth of price competition and the movement of prices toward costs. While some measure of product differentiation may be desirable, even though price competition is lessened, the attainment of differentiation is not a valid reason for rejecting the normal presumption of antitrust policy in favor of maximum competitive behavior on the part of independent firms. This is especially so since traditional antitrust objectives, which are normally stated in terms of achieving an efficient allocation of resources, are more likely to be secured through the promotion of price competition. And it is in this direction that policy judgments should be made.

A concern with this policy goal would lead to the view that territorial and customer restrictions should be declared per se violations of the antitrust laws. Even in the case of a small manufacturing firm facing a giant rival in an oligopolistic market, these restrictions are undesirable. We are concerned with competition as a process for achieving certain social objectives—not merely with the number of competitors in the market—and it is not clear that much is to be gained from bolstering a small and perhaps inefficient rival when this can be accomplished only by market restrictions which sacrifice primary objectives.

There may, however, be two possible exceptions to this per se condemnation: the entry of new firms and the introduction of new products. These activities have considerable social value, which is likely to be underestimated by the market. Because prospective private gains from the entry of a new firm or the introduction of a new product may understate potential social gains, the free market is likely to lead to less investment for those purposes than is socially desirable.[33] And in the case of new products, the highest degree of competition may not always promote the fastest rate of innovation. For these reasons, some form of restraint on competition may be necessary to encourage the development of the distribution facilities which are needed to market successfully a new product or to promote successfully the entry of a new firm. We should recognize, however, that even in the absence of restrictions the original dealers will gain an advantage which will last until more dealerships are created, and probably for some time thereafter. And during this period greater than normal returns will be earned. In determining whether a "new firm" or "new product" defense should be allowed, therefore, the relevant inquiry is whether the gains from a "head start" enjoyed by the original dealers are likely to be sufficiently great to obtain the dealers needed for the introduction of new products or the entry of new firms. Of course, if vertical restrictions are permitted in these exceptional circumstances, the difficult problem remains of determining how long the restrictive agreements should be allowed to continue.[34] Too long a period would encourage excessive product differentiation and permit monopoly returns which exceed those required for these social purposes.

Allowing an exception on grounds of new firms or new products is not inconsistent with a per se rule. The per se doctrine itself may simply mean that a certain type of agreement is a prima facie violation of section I which can be rebutted only by proof of one of a limited number of justifications. In other words, the effect may, and perhaps should, be merely to shift to the defendant the burden of establishing the presence of a judicially recognized justification. Nevertheless, such a per se rule still has the extremely important advantage of limiting the issues decided in an antitrust suit, for the question of reasonableness would not be reached unless the defendant can establish an acceptable justification and demonstrate that no less restrictive alternative exists for achieving the justified result.

Senator METZENBAUM. I want to welcome our next witness. One of them also came from Cincinnati and is probably more important to me. [Laughter].

Mr. Favretto, Deputy Assistant Attorney General of the Antitrust Division of the Department of Justice.

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[33] The entry of new firms into a market is often a pro-competitive factor, while the introduction of new products represents a major dimension of technical advance. Both may represent external economies to the extent that their benefits reach beyond those realized by the individual firm, and therefore some limitation might appropriately be placed on the market mechanism.

[34] *See United States* v. *Jerrold Electronics Corp.*, 187 F. Supp. 545, 556-58 (E.D. Pa. 1960), *aff'd mem.*, 365 U.S. 567 (1961).

Mr. Favretto, we are going to put your entire statement in the record and ask you if you can summarize your position very, very briefly.

TESTIMONY OF RICHARD J. FAVRETTO, DEPUTY ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE

Mr. FAVRETTO. I am sensitive to your needs, in light of the Chairman's schedule, I will attempt to do that. If there are any questions after my summarization, or questions that result from reading of my statement by members of the subcommittee, I would be more than happy to answer them.

I think that my remarks, even in summary, will have a slightly different emphasis than Dr. Comanor's. Basically, they will be keyed to the general philosophical approach to this area and are in tune with the view the chairman expressed earlier this morning.

We are not unsympathetic to the concerns raised by Senator Bayh and Senator Cochran and other sponsors of the legislation. We just feel that these very basic issues are susceptible to consideration under the laws as they presently exist.

Essentially, we feel that the passage of this legislation would be, first, inconsistent with the steps Congress has taken in recent years to strengthen antitrust enforcement.

Second, it would result in an unfortunate precedent which will encourage other industries to seek similar specialized exemptions and specialized treatment under the antitrust laws. It is generally a bad idea as a matter of policy, we feel, to proceed industry by industry carving out exemptions from the antitrust laws.

Third, we believe that the legislation will unnecessarily impinge on the fundamental national policy of free competition.

The rule of reason, as it presently applies to these kinds of practices, is more than adequate to deal fully with the concerns expressed by proponents of the legislation, as well as by opponents by the legislation. The rule of reason is the ultimate rule of antitrust flexibility designed to adapt to the changing needs of a changing economy, to deal with the concerns that have been expressed and with whether or not the particular system is procompetitive or anticompetitive.

The test in S. 598 which my statement indicates is somewhat ambiguous and most likely difficult to apply, would, I believe, cut against the flexibility that I always found attractive in the antitrust laws, particularly with the rule of reason, and would establish a test which in the future may not be justified by the market structure or by the practices in the industry. I believe this is a bad idea, particularly when we have an existing rule of law that can deal with the problems that have been focused upon by members of the subcommittee.

Ultimately, I think that legislation of the kind apparently reflected in the bill under consideration would be untimely. There is no question about the tradition or right of this body to legislate and to change the rules of law that it feels are undesirable; however, I think the process should ultimately spin out to its conclusion before judgments

are made about the desirability or undesirability of a particular rule of law.

The matter of particular concern now is that the FTC proceeding is currently under review by the Court of Appeals, and I believe prudence would counsel us to await the decision of the Court of Appeals and, indeed, any ultimate review by the Supreme Court that might occur. That would tend to narrow and focus the debate and perhaps assist in the drafting of any legislation if this body still feels that legislation is required after that opinion is rendered.

It is important to note that this case would represent the first major test by the Supreme Court involving the rule of reason as it applies to these kinds of restraints after the *Sylvania* case. I think that is very important because only 2 years ago the Supreme Court ruled in *Sylvania;* I think this represents the first major test of the scope of the decision.

After resolution of the Court proceedings, if there is dissatisfaction with the way the rule is framed by the Court—with the way it was applied by either the Court or the FTC—I think that may be addressed at that time.

Myself, I am confident that the rule of reason, as it has been explained by the Supreme Court in *Sylvania* and in the case in the following year of the *National Society of Professional Engineers*, will more than adequately deal with the concerns raised.

The issue is proof, not just theoretical concern, but proof of the actual impact on competition and to balance the competitive results from either the continuation of these restraints or their prohibition.

Senator METZENBAUM. Mr. Favretto, do you believe there is anything unique about the soft drink industry which would justify an exemption from the antitrust laws?

Mr. FAVRETTO. We are not aware of one, Your Honor.

Senator METZENBAUM. I am not "Your Honor" but——

Mr. FAVRETTO. Mr. Chairman, I don't pretend to be an expert on all phases of the soft drink industry, but I am not aware of any particular aspect that would require an exemption. Moreover, as I indicated in my summarization, I think any peculiar characteristics of the industry are discernible and treatable under the rule of reason as the law presently evaluates it.

Senator METZENBAUM. I might say to members of the subcommittee, I am going to try to restrict myself to about 3 to 4 minutes of questions so that we can get through all of these witnesses. I ask members of the subcommittee to do likewise.

Mr. Favretto, S. 598 grants an antitrust exemption if the soft drink product is in substantial and effective competition with other products of the same general class. I understand that you believe that the substantial and effective competition test is too loose to give consumers much protection. Is the same general class test just as loose?

Mr. FAVRETTO. Mr. Chairman, the same general class phrase is also undefined in the legislation, and I for one cannot be sure what it would be meant to apply to—whether it would be all alcoholic beverages or carbonated beverages or soft drinks. I think that is one of the technical problems with the legislation and is the same kind of problem that we find with the substantial and effective concept.

Senator METZENBAUM. I want to ask you as I asked Dr. Comanor, if you have any suggestions as to the language of this legislation, should this subcommittee decide to enact it. We would very much appreciate your advising us as promptly as possible in writing.

Mr. FAVRETTO. I think, Mr. Chairman, I am prepared to reflect upon your request, but I think the sum and substance of our position is that no legislation is necessary, that we have a rule of law that is ultimately more flexible than this legislation would ever be and would take into consideration more factors than this legislation would presently indicate should be taken into consideration. So I believe that the response is that we don't feel there would be any need.

Senator METZENBAUM. You can't make a bad bill into a good bill by amending.

Mr. FAVRETTO. I believe that is correct, and the emphasis of my testimony is on general principles and philosophical position.

Senator METZENBAUM. Supporters of S. 598 argue that if the restrictions are eliminated, supermarket chains will demand warehouse delivery and as a result, returnable bottles will disappear. Is there a response to that argument?

Mr. FAVRETTO. I think there are two aspects to that. I would like to address first the warehouse delivery issue, which is something that Dr. Comanor testified a little bit about. That is an efficiency question, and I think the market generally ought to be open to new modes in efficiency. If warehouse delivery will result in lower prices to consumers, I think that is kind of a desirable objective.

In terms of the environmental impact, I don't think that there is anything in the present bill under consideration that would require bottlers to use returnable bottles. I think that if Congress wants to legislate in the environmental area, it ought to do so directly and require returnable bottles. Carving out this exemption in a backward manner I don't think would generally be a good idea, even to achieve environmental objectives.

Senator METZENBAUM. S. 598 would deprive persons injured by these restrictions prior to its enactment of their right to recover. Is this fair in view of the risk that the bottling industry willingly assumed by maintaining the restrictions despite *Schwinn* and earlier cases?

Mr. FAVRETTO. I think that our conclusion is that it is an unwarranted provision in the bill by any test. The industry is a sophisticated one that is represented generally through its trade association and also at the lower levels by sophisticated counsel. The rule since 1968 was known to the industry generally—I think *Schwinn* was a landmark decision and certainly put everyone on notice. In any event, the statute of limitations limits recoveries to 4 years, and furthermore, any damage action would be required to be sustained only if the restraints were proved to be unreasonable in impact and only during the period of unreasonability.

Senator METZENBAUM. Senator Bayh, while you were out, I have indicated that we were going to try to limit our questions to 3 or 4 minutes because I would like to be able to finish by 12 and I would like to hear others, if we can.

Senator BAYH. Well, why don't we obtain answers in writing to the questions that I have. I wouldn't object to that. It is a difficult question

and I think it is important that we complete the hearings and I appreciate the courtesy of the chairman. It is a complicated kind of thing and some of us are particularly concerned about the consumer and are anxious to be able to pursue these questions in a comprehensive way and I don't see how we can do justice to that in 3 minutes, with all due respect.

Senator METZENBAUM. We have a problem and I am certain that you would not like to continue the hearings if it is not necessary and I am trying to accommodate that aspect.

Senator BAYH. I appreciate that.

Mr. FAVRETTO. Senator, I am more than willing.

Senator BAYH. Well, I have some questions that I will submit to you.

Mr. FAVRETTO. Fine.

Senator METZENBAUM. Thank you very much.

Mr. FAVRETTO. Thank you.

[Questions submitted by Senators Thurmond, Bayh, and Cochran, and Mr. Favretto's prepared statement follow:]

QUESTIONS SUBMITTED BY SENATOR THURMOND FOR MR. FAVRETTO

Question. Your statement regarding the extent that you would allow the courts to interpret the current law vis-a-vis the proposed bill, S. 598, appears inconsistent. Why are you not willing for the courts to use its same interpretive powers within the meaning of S. 598, just as now allowed under current law?

Answer. Under current law, the courts apply the rule of reason to vertical territorial restrictions, determining whether, on balance, the particular arrangement unreasonably restrains competition. This requires them to weigh the beneficial effects of any enhancement of competition resulting from the territorial restriction against the drawbacks of impaired intrabrand competition. In this process, the courts consider not only the current level of interbrand competition, but also such factors as the market power of the firms involved, the extent to which the arrangement limits intrabrand competition, the extent to which the arrangement achieves its claimed benefits and facilitates interbrand competition, and the availability of less restrictive alternatives that could meet the parties' legitimate needs. This wide-ranging inquiry is necessary to ensure that both the positive and negative effects of a territorial restriction are fully taken into account.

S. 598 would preclude the courts from determining whether, under all of the circumstances, a vertical territorial restriction in the soft drink industry is unreasonable. It would legalize automatically any such arrangement if there is "substantial and effective" interbrand competition without regard to other relevant facts. If Congress believes that soft drink bottlers and manufacturers should be afforded such a special exemption from the antitrust laws for territorial arrangements that do not meet the rule of reason standard (an exemption that we believe is unwarranted), it should at least tailor it narrowly and precisely. The antitrust laws embody our fundamental national policy of reliance on free and unrestrained competition, and any immunity should be no broader than absolutely necessary to address the particular problem that Congress seeks to correct. We do not believe that the standard of legality set forth in S. 598 meets this requirement. Not only is the meaning of the phrase "substantial and effective competition" unclear, but the meaning of the terms "same general class" and "soft drink" are likewise ambiguous. Thus, there is a substantial risk that courts, uncertain of the scope of the special immunity, will interpret it more broadly than Congress intended.

We emphasize that we are not suggesting that any changes in S. 598 could eliminate our objections to the bill. We object not only to its ambiguous language but also to its prematurity in light of the ongoing FTC litigation and to its attempt to carve out an antitrust immunity which is unnecessary and unjustified by any special characteristics of the soft drink industry. In addition, we can conceive of no justification for the virtual elimination of damage liability even for defendants who cannot meet the modified standard of liability of S. 598.

Question. By denying the territorial provisions of S. 598, are you not, in fact, saying that we should have a few very large suppliers, rather than a larger number of more competitive large, small, and medium-size suppliers?

Answer. Whether a prohibition on the use of exclusive territories would result in substantially increased concentration in the soft drink industry is an issue that was litigated in the FTC proceedings. The FTC concluded that there was no convincing evidence that such a prohibition would significantly accelerate or affect the trend to concentration that the industry has experienced in the last several years, in spite of the prevalence of exclusive territories. Because the case is still in litigation, it would be inappropriate for the Department of Justice to comment on the merits of the FTC's findings.

It is important to note, though, that the effect of exclusive territories on the level of the concentration was considered in that case, under current law. This illustrates the basic point that the rule of reason takes this concern, like many concerns raised by proponents of S. 598, into account. If the elimination of exclusive territories would result in greater concentration, and if that increase in concentration would impair competition more seriously than exclusive territories do, the exclusive territorial arrangement would be found reasonable under the rule of reason analysis mandated by current law. We continue to believe that the rule of reason is comprehensive and flexible enough to take fully into account all the factors relevant to an assessment of the competitive effects of exclusive territories. Therefore, no change in the legal standard governing such arrangements is necessary.

Question. Our consideration of the proposed bill, S. 598, is directed toward reviewing both the potential benefits and the potential dangers of such legislation. Would this be the case in the long-run, when the smaller companies are eliminated and only a few large companies are left to supply the national market?

Answer. In formulating its position, the Department of Justice too has tried to consider both the potential benefits and the potential dangers of enacting S. 598. Our conclusion is that the dangers are substantially greater than the benefits.

Your question is premised on a number of assumptions: (1) that the court of appeals (and possibly the Supreme Court) uphold the FTC's decision; (2) that only a few very large companies will be left to supply the national market; and (3) that this concentration would be caused by the elimination of exclusive territories and not by some other factor (like those that have caused the apparently substantial increase in concentration over the past few years in spite of the use of exclusive territorial arrangements). If all of these assumptions are accurate (a question on which we cannot comment in view of the ongoing litigation), it would indeed be fair to ask whether consumers would suffer more from increased concentration resulting from the elimination of exclusive territories or from the lack of intrabrand competition resulting from their retention.

Existing law, however, takes these concerns fully into account. The rule of reason allows consideration of the effect of exclusive territories on trends toward vertical integration and horizontal concentration and of the effect those trends may have on the vigor of competition. Enactment of S. 598 would offer no advantage over current law.

QUESTION SUBMITTED BY SENATOR BAYH FOR MR. FAVRETTO

Question. With regard to your tetsimony concerning the lack of uniqueness about the soft drink industry, please identify any other industries in the United States which have more than one thousand manufacturing licensees.

Answer. There are a number of industries in the United States characterized by large numbers of licensees and franchisees whose vertical nonprice restraints are tested under the rule of reason to determine whether, on balance, they are procompetitive or anticompetitive. For example, the fast food industry, the automobile sales and repair industries, the hotel and motel industry, and various consumer goods and services industries frequently rely extensively on licensees and franchisees to achieve adequate market penetration and customer service.

We recognize that licensees and franchisees in these industries are not engaged in the strict sense in manufacturing, but that distinction is not necessarily critical. The magnitude of the capital investment required of a licensee or franchisee, the degree of vertical integration, the extent of competition from independent dealers, and other relevant factors will normally differ from indus-

try to industry. The characteristics of the soft drink industry obviously are not identical to those of other industries which have many licensees and franchisees. But the key question is not whether the soft drink industry is different in any relevant respect but rather whether its differences are so great or unusual that the current legal standard cannot adequately take them into account. We believe that the rule of reason analysis is sufficiently flexible and adaptable to allow for these differences. We are aware of no special characteristic of the soft drink industry, related to the manufacturing aspects of the bottlers' operations or otherwise, that would not receive appropriate consideration under current law. Congress should therefore not give the soft drink industry any special exemption from the antitrust standard applied to vertical territorial restrictions in other industries.

QUESTION SUBMITTED BY SENATOR COCHRAN FOR MR. FAVRETTO

Question. In your speech on May 12, 1978, in Dallas on the subject of vertical restraints, you discussed the Supreme Court's decision in *Sylvania* which identified ways in which vertical restrictions may promote interbrand competition, namely: (1) by helping the manufacturer achieve certain efficiencies in the distribution of its product; (2) by inducing retailers (or distributors) to make new investment or new entry; (3) by inducing retailers (or distributors) to engage in promotional activity. Do you know any facts which would refute the specific findings of the FTC's administrative law judge that all of these benefits have been achieved because of the existence of bottler territories:

(1) Finding No. 29 states that territorial restrictions encouraged greater development of marketing and distribution, thereby achieving maximum market penetration,

(2) Findings No. 159 and 160 show how territorial license agreements helped Dr. Pepper enter the market, and

(3) The conclusion on page 87 of the decision states that because bottlers can focus on their own territories they are encouraged in their efforts for price promotions . . .

Aren't these the precise benefits you referred to, and, if so, shouldn't you support this bill?

Answer. It would be inappropriate for the Department of Justice to comment on the merits of a Federal Trade Commission case that is still in litigation. We do note that the Commission is not bound in its cases to accept the findings of fact of the administrative law judge (ALJ), and indeed, the Commission has the authority and obligation to make its own independent review of the record. Its decision not to accept the overall conclusions of the ALJ (although not necessarily each of the specific findings mentioned in your question) is now being reviewed by the United States Court of Appeals for the District of Columbia Circuit in order to determine whether it is supported by substantial evidence.

Even assuming, for purposes of argument only, that the findings you cite are correct, it does not necessarily follow that the exclusive territorial agreements are reasonable and desirable. In order to determine whether an agreement is, on balance, procompetitive or anticompetitive, it is necessary to consider the costs of the arrangement as well as its benefits. It is also important to consider whether less restrictive alternatives are available that would produce the same benefits. Only if the benefits of the restriction exceed its costs should it be deemed reasonable and legal. Thus, we cannot say that a restriction is reasonable on the basis of four findings concerning claimed benefits (even assuming the correctness of the findings) without weighing those benefits against the costs of the restriction and the available alternatives.

Moreover, the rule of reason standard mandated by current law allows for full consideration of each of the factors to which your question points; there is no need to change the law in this respect. By contrast, none of those factors would be considered under the standard of S. 598, which focuses exclusively on the current level of interbrand competition. This is one of the reasons for the Department of Justice's opposition to this standard, which would prevent consideration of other factors which, as your question recognizes, should be taken into account. The rule of reason is a better approach than the narrow standard of S. 598 because the rule of reason allows the court to look at the whole picture in evaluating the reasonableness of a vertical territorial restraint.

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PREPARED STATEMENT OF RICHARD J. FAVRETTO

Mr. Chairman and Members of the Subcommittee: I appreciate the opportunity to appear before you today to present the views of the Department of Justice on S. 598, the "Soft Drink Interbrand Competition Act." This legislation is one in a series of bills designed to confer a special antitrust exemption on exclusive territorial agreements between soft drink manufacturers and bottlers.

The Department of Justice has consistently opposed this type of special interest legislation over the years, and we continue to believe that it is both unnecessary and undesirable. This bill, and similar bills now pending, unnecessarily impinge on our fundamental national policy of reliance on free and open competition. This legislation would also create an unfortunate precedent by encouraging every industry to seek specialized exemptions from the antitrust laws. And it is fundamentally inconsistent with the steps Congress has taken in recent years to strengthen the antitrust laws and their enforcement.

It may be helpful to begin by placing this legislation in context. Over the years, a series of bills has been introduced to establish a special standard for territorial agreements in the soft drink industry.[1] The first such bills were introduced after the Federal Trade Commission issued a complaint alleging that exclusive territory licensing agreements maintained by major soft drink manufacturers and their bottlers violated Section 5 of the FTC Act. The bottlers originally argued that legislation was necessary to allow them a fair opportunity to present all the economic evidence in favor of such agreements. As it turned out, though, the Supreme Court subsequently decided that vertical nonprice restraints generally are to be evaluated under the rule of reason, a flexible standard which permits consideration of all of the circumstances.[2] And throughout the litigation, the defendants have had a full hearing on the claimed economic justifications. Even though the soft drink industry has gotten all that it originally sought, it has continued to press for special legislation.

Moreover, these legislative efforts are now continuing despite the fact that it is not yet clear what the final outcome of the normal administrative and judicial process will be. The FTC has rendered its decision but the case is now on petition for review before the District of Columbia Circuit, which will give further consideration to the bottlers' arguments in the course of determining whether the FTC's decision was supported by substantial evidence.[3] Legislative action at this time, while that factual record is still under review, would, we believe, be at the least premature.

I would now like to discuss the two principal features of S. 598. The first relates to the standard by which exclusive territorial arrangements in the soft drink industry are judged. The bill would provide that territorial agreements between soft drink manufacturers and bottlers are legal under the antitrust laws provided that the products covered by the agreements are in "substantial and effective competition with other products of the same general class." The second important feature of S. 598 is that it would virtually eliminate damage liability for the illegal use of exclusive territory agreements. I will discuss each of these provisions in turn.

S. 958 would substitute for the current standard of liability the "substantial and effective competition" standard that I just described. To decide whether this change is a useful, beneficial one, it is necessary to ask two questions: first, what, if anything, is wrong with the current legal standard? and, second, how, if at all, does this bill improve that standard?

As I have noted, the legal standard by which vertical exclusive territory agreements in the soft drink industry are judged under current law is the rule of reason.[4] Under the flexible rule of reason, courts take into account all of the circumstances in order to determine whether, on balance, the exclusive territories enhance or impair competition. The defendant is afforded a full opportunity to present economic justifications.

For this sensible and comprehensive rule of reason approach, S. 598 would substitute a narrow approach which focuses exclusively on interbrand competi-

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[1] *See* S. 978 (93d Cong., 1st Sess.); H.R. 16916 (93d Cong., 2d Sess.); H.R. 6684 (94th Cong., 1st Sess.); S. 3421 (94th Cong., 1st Sess.); S. 1483 (95th Cong., 1st Sess.); S. 598 (96th Cong., 1st Sess.); H.R. 1224 (96th Cong., 1st Sess.); H.R. 1611 (96th Cong., 1st Sess.).

[2] *Continental T.V., Inc.* v. *GTE Sylvania, Inc.* 433 U.S. 36 (1977).

[3] The Coca-Cola Co., 91 F.T.C. 517 (1978), *appeal docketed,* No. 78–1364 (D.C. Cir. April 24, 1978).

[4] *Continental T.V., Inc.* v. *GTE Sylvania, Inc., supra.*

tion. Under S. 598, if interbrand competition is "substantial and effective," the agreement on exclusive territories is automatically legal. How does this test compare with the rule of reason? The rule of reason does not limit antitrust analysis to this single factor involving the current strength of interbrand competition. Rather, it takes into account not only interbrand competition, but also other factors relevant to the overall competitive effects of the particular arrangements at issue.

The rule of reason does not ignore or downplay the significance of interbrand competition. To the contrary, the courts place great weight under existing law on the vigor of interbrand competition, which the Supreme Court in the *Sylvania* case called "the primary concern of antitrust law." And the FTC carefully considered the vigor of interbrand competition in its decision concerning vertical restraints in the soft drink industry.[5] In short, current law accords interbrand competition all the weight it deserves; there is no need to change the law in this respect. The effect of this legislation will simply be to preclude consideration of other factors that may be equally important.

The narrow focus of the "substantial and effective competition" standard of S. 598 is not its only defect. The meaning of that standard is unclear. How robust and vigorous must interbrand competition be before it becomes "substantial and effective" within the meaning of S. 598? The bill does not answer this question, and to work out its meaning through litigation could take years and divert the courts and the FTC from their other important responsibilities. I would note that our experience with a similar standard in the Miller Tydings and McGuire Acts was not encouraging.[6] Those statutes legalized resale price maintenance sanctioned by state law where commodities were in "free and open" competition with commodities of the same general class. The courts interpreted that standard very broadly, so that it offered consumers little protection.[7]

We cannot afford to water down the protection that the rule of reason provides to the consumer. The dangers of a weakened standard become clear when one considers the arguments generally suggested in favor of territorial restraints on competition. The heat of those arguments usually is that bottlers need the additional profits that they could earn if they were sheltered from intrabrand competition. These additional revenues, the bottlers assure us, would be well spent and would benefit the consumer because the bottlers would be able to make greater capital investments and to provide supperior products and service. But what guarantee do consumers have that the bottlers would use their artificially inflated revenues for these purposes? If, for example, those capital investments are profitable, they would normally be undertaken under a system of free competition. Indeed, the spur of competition from other bottlers of the same brand may be necessary to give bottlers the incentives to perform efficiently and to innovate in such areas of competition as service and packaging.

By pointing out these dangers from exclusive territories, I do not mean to imply that vertical territorial arrangements always decrease overall competition. To the contrary, as the Supreme Court has recognized, such restraints may sometimes enhance competition. For example, they may help small but aggressive businesses enter a market and compete effectively. My only point is that we cannot afford to neglect the potential benefits. Under the rule of reason, the positive as well as negative effects of exclusive territories are fully taken into account. If these agreements foster interbrand competition more than they hinder intrabrand competition, they are legal as the law now stands. We see no reason to change the law to legalize agreements that cannot meet that standard.

I also want to note that this bill would legalize the most extreme form of territorial restraint, which completely precludes a bottler from making sales outside the assigned area. In many situations, a more limited restraint may be sufficient to achieve any positive results claimed for territorial agreements. For example, so-called "area of primary responsibility" clauses permit each distributor to make sales outside his area of primary responsibility provided that he covers his assigned territory effectively. S. 598 gives bottlers and manufacturers

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[5] The Coca-Cola Co., *supra*, 91, F.T.C. at 634–644.

[6] The "fair trade" statutes weer repealed by the Consumer Pricing Act of 1975. Pub. L. 94–145, 89 Stat. 810.

[7] *See Bowen* v. *New York News, Inc.*, 366 F. Supp. 651, 661–662 (S.D.N.Y. 1973), *aff'd on this ground, rev'd on other grounds*, 552 F.2d 1242, 1249 (2d Cir. 1975), *cert. denied*, 425 U.S. 936 (1976). The standard was criticized for its vagueness. Herman, "Free and Open Competition," 9 Stan. L. Rev. 323, 327–332 (1957).

a license to deprive consumers completely of the benefits of intrabrand competition even when less restrictive alternatives may be sufficient. Existing law, in contrast, considers whether exclusive territories are reasonably necessary to achieve legitimate business goals in light of the available marketing alternatives. This, we believe, is the better approach.

The Department of Justice recognizes that many proponents of S. 598 see this bill as a way to encourage the use of returnable bottles and thereby to conserve energy and protect the environment. Certainly these energy and environmental goals are important. The question is whether the enactment of S. 598 represents an efficient solution. S. 598 contains no provision which requires, or even encourages, bottlers to use returnable bottles. It offers them immunity from the antitrust laws even if they make no effort to market returnable bottles. If the soft drink industry should make a special effort to market returnable bottles as a means to save energy and keep the environment clean, and if the industry will not make that effort without special federal legislation, that special legislation should deal directly with the problem. Giving soft drink manufacturers and bottlers an unrestricted license to eliminate intrabrand competition in the hope that some of them may voluntarily choose to offer more returnable bottles is not an efficient solution to energy or environmental problems.

Let me sum up these comments on the standard of legality that would be established by S. 598. Private plaintiffs, the FTC, and the Department of Justice already bear the burden of proving that the particular territorial restraint is unreasonable. That burden is a significant one because the rule of reason involves a broad-ranging, comprehensive inquiry into all the factors affecting the antitrust consequences of vertical territorial restrictions. S. 598 could make that burden even heavier by creating a new and vague standard for illegality. The proposed standard could unfairly tip the scales in favor of the soft drink industry, and consumers would pay the price. There has been no showing that existing law is unfair or deficient. Congress should reject this proposed new standard just as it rejected similar proposals in previous sessions.

S. 598 would also change the law concerning damages. Under Section 3 of the bill, a soft drink manufacturer or bottler could participate in an illegal territorial restraint on competition until a court ordered it to stop without fear of damage liability. The victims would have no right to compensation unless the defendants ignored a court order. There is simply no justification for this provision.

It is important to understand what this provision means. It means that the victim of such an anticompetitive restraint could not recover any damages, much less treble damages, no matter how serious the injury suffered. And he would be denied compensation even if the illegal agreement that which caused the injury was used for the worst of motives—to raise prices and restrain competition—and even if the defendants faced no interbrand competition at all, much less "substantial and effective" interbrand competition. S. 598 would theoretically permit such victims to recover for any injury inflicted after a court ruled that the agreement was illegal, but the practical effect of this provision could be virtual immunity from damage liability even for clearly anticompetitive and unjustified territorial restrictions in this industry.

This drastic restriction on damage liability for vertical restrictions illegal even under the modified standard of legality of S. 598 would leave victims uncompensated and wrong-doers undeterred. Without the incentive of damages, the victims of these conspiracies would not sue. S. 598 would cripple in this industry enforcement of the antitrust laws, which Congress has made a vital supplement to enforcement by the Justice Department and the FTC.

Proponents of this provision claim that it would be unfair to subject members of the soft drink industry to damage liability because some cases suggest that certain types of territorial agreements in the industry are legal.[8] That argument just is not persuasive. A victim of illegal practices should not be denied compensation simply because another plaintiff once lost a similar antitrust case involving related issues in the same industry. The soft drink industry is a sophisticated industry with sophisticated legal advice. Its members realize that both the legal standards applicable to vertical restraints and the economic conditions which determine their effect on competition have changed since those old cases were decided, just as they have for every other industry. Holding compa-

[8] For example, proponents often point to *Coca-Cola Bottling Co.* v. *Coca-Cola Co.*, 269 F. 796, 813–814 (D. Del. 1920).

nies in the soft drink industry responsible for the consequences of their actions creates no special surprise or unfairness that justifies singling them out for any damage immunity not afforded other industries.

In conclusion, I want to mention some of the broader issues raised by this bill. The antitrust laws embody Congress' commitment to competition as the best means to assure that consumers can buy the best possible products at the lowest possible price.[9] In recent years, Congress has taken important steps to strengthen these laws and to narrow immunities from them. Through unhappy experience we have learned that broad exemptions enacted in response to short-term economic conditions or to the pleas of special interests often persist long after they have served any useful purpose.

For these reasons, it is vital that Congress take a long, hard look at the claims made by proponents of antitrust exemptions and immunities. It should be up to the proponents to support their claims with solid evidence that some unusual characteristic of an industry requires special antitrust standards. Because the traditional rule of reason standard is designed to be flexible enough to accommodate a range of industrial structures and practices, the burden must rest on proponents of immunities to justify those special immunities by clear and convincing factual evidence. As the National Commission to Review Antitrust Laws and Procedures recently concluded, unrestrained competition, not specific immunities, generally offers the surest guarantee of consumer welfare.[10]

When the arguments advanced by the soft drink industry are tested under this approach, they must be found wanting. No need for the passage of these bills has been demonstrated. Moreover, modifying the already extremely flexible law on exclusive territories for the benefit of this industry would only encourage other industries to demand equal treatment. S. 598 represents an unjustified effort by special interests to remove themselves from the application of antitrust rules under which firms in other industries prosper. The Department of Justice, therefore, recommends that this legislation not be enacted.

Senator METZENBAUM. J. F. Koons, I would like to call you up.

Mr. Koons, there is probably nobody in the country who has done much more on this subject or indicated greater concern about it than have you. I know you have commissioned some studies and we know you have great interest in the subject and we are happy to welcome you here at the table today. Having said that, I will, at the same time have to say to you, I know you have a rather lengthy statement, if you can shorten it—the entire statement will be included in the record. I would be grateful to you if you could make your presentation in 5 to 8 minutes.

Mr. KOONS. I will do my best. I have spent about 2 years on this presentation and I didn't know how short it would be, but I will proceed.

TESTIMONY OF J. F. KOONS, JR., PRESIDENT, CENTRAL INVESTMENT CORP.

Mr. KOONS. First of all, I want to thank you and give you the best wishes of all the Pepsi-Cola bottlers in the State of Ohio.

My name is Bud Koons and I am president of the Ohio State Pepsi-Cola Bottlers Association. My family owns two franchises in Ohio and two in Florida. At the far left is my son, Jeff, vice president of our Florida operations and Richard Caudill, president of our Florida operations, and on my right Emanuel Goldman, of Sanford C. Bernstein & Co., Inc. Mr. Goldman is a security analyst and was voted the

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[9] *See, e.g. National Society of Profesional Engineers* v. *United States*, 435 U.S. 679, 695 (1978), *Northern Pacific Ry* v. *United States*, 356 U.S. 1, 4–5, (1958).

[10] Report of the National Commission for the Review of Antitrust Laws and Procedures 177-189 (1979).

last 2 years as one of the top soft drink and beverage analysts in the United States.

I am going to skip through this as you recommend, Senator, and I would be happy to come back for further questioning or whatever.

Senator BAYH. Our chairman is proceeding because of the time frame and every word that you have in your statement will be in the record for us to study carefully and anyone who wants to study it from the outside will have a chance to do so, so I don't want you to think that——

Mr. KOONS. I know that. We are proud of our Senator in Ohio and I know that you are going to be fair and reasonable and I am happy to be here and I appreciate it.

Senator METZENBAUM. Happy to have you here.

Mr. KOONS. First of all, I appreciate what you said earlier, Senator Bayh, and that is separating the soft drink industry—that is paramount in this issue. That was paramount in the issue and apparently wasn't recognized by the FTC until you brought it before the Federal Trade Commission representative testifying today. Even in his presentation, he did not designate between the independent bottlers and the syrup companies.

Gentlemen, who are the winners in the Federal Trade Commission decision? Winner No. 1—the three large syrup manufacturers, Coca-Cola, Pepsi-Cola and 7-Up. 7-Up was acquired 1 month after the Federal Trade Commission by Philip Morris.

Winner No. 2—Can manufacturers.

Winner No. 3—Glass manufacturers.

Three of the largest oligopolies in the United States.

The losers are:

Loser No. 1. The independent bottlers. Currently there are about 1,833 independent bottlers who are competing vigorously in interbrand competition unmatched by any other item sold through food stores. In 1977, Senator, in a study that we bought from Majers Co., they analyzed the soft drink industry and found out the cost per ounce. In 1977 on a returnable package and emphasized a returnable package was 0.0079. That package in 1939, when Pepsi-Cola Co. came out of bankruptcy, Coca-Cola sold for a nickel—that was 0.0077 per ounce which was 2.6-percent increase on per-ounce cost by the bottling industry—by the bottlers compared to the increase of 34.4 percent in the CPI, and yet we are said to be noncompetitive. The bottling industry is competitive.

Loser No. 2. The Consumer. In a highly concentrated industry, vigorous price competition is lacking and with the added loss of lower prices from refillable containers, the consumer will be forced to pay from 50 percent to 100 percent more per ounce.

There was a discussion of concentration. The concentration of the syrup manufacturers, the Pepsi-Cola Co. owns its own franchises serving 25 percent of the population in the United States. Along the eastern seaboard, in which Philadelphia, Boston, New York, Newark, make up about 10 percent, 10.5 percent of the ACV of the United States, the refillable bottle package, sir, is practically nonexistent. These franchises are owned by Pepsico. Yet, in the rest of the United States, over half the products sold to the food stores by Pepsi-Cola

and Coca-Cola independent bottlers in the United States, last year, was in the returnable bottle.

Seventy-two percent of all the feature price ads in the United States was for the returnable bottle. In Ohio, it was 85 percent last year, its 90 percent this year—the returnable bottle feature price advertising.

Now what is the FTC saving? Consumers groups say there has to be a savings. The Federal Trade Commission originally estimated savings to consumers would be $250 million per year. Then down to $50 million. At trial, they refused to discuss any savings. There are no savings. Our industry is the most competitive industry serving food stores in the United States.

Loser No. 3. Now, there is something that has not been brought up before and that is the energy loss. The Franklin Associates study that we commissioned indicated that we would have 36 percent additional energy use annually to produce the billions of additional nonrefillable containers required to replace 40 percent of all soft drink sales currently sold in returnable containers. Half the food store business of soft drinks sold annually is in refillable containers.

We had a report, if I can find it. The interesting thing about that report, is that the balance-of-trade deficit from that alone would be over $300 million.

Now, I think the independent bottlers are the losers. The syrup manufacturers are the winners. The Federal Trade Commission, in its statement, encouraged the syrup manufacturers to compete with their franchisees. There is no way in the world that a franchisee can buy syrup from The Coca-Cola Co. or The Pepsi-Cola Co. and compete against them. It is impossible.

The Federal Trade Commission ruled that the nonrefillable containers could flow without any restraint whatsoever.

Senator METZENBAUM. Mr. Koons, what percentage of the total cost to the consumers is involved in the cost of syrup?

Mr. KOONS. I don't know that. But I will find out.

Senator METZENBAUM. The economist, can you give me the answer?

Mr. GOLDMAN. The concentrate part of it I think is under 10 percent.

Senator METZENBAUM. The concentrate—how much?

Mr. GOLDMAN. On the order of 8 or 9 percent. It will vary by manufacturer because concentrates prices themselves vary and the economics of one bottler to another varies so the selling price will vary. But in general, it is on the order of 8 percent, 9 percent. That is the concentrate cost to the bottler as a percentage of the bottler's selling price to the retailer.

Senator METZENBAUM. And what I don't understand is why the bottler cannot in any way compete with the parent company, since the parent company only has control over about an 8-percent factor in the final selling price.

Mr. KOONS. There is a lot more than just the cost of the syrup—there is the warehouse delivery, there is advertising, there are discounts that they would provide. I read about a theory that you had, Senator Metzenbaum, in the coffee industry where you pointed out that certain coffee manufacturers picked on one market discounted and all of a sudden they got the market and then they raised the price. That is a national strategy by a national company.

In the soft drink industry, where the independent bottlers, and there are 1,833 of them, there is no national strategy on cutting price. It is all local price advertising and there is a difference and that is why the independent bottlers should be maintained. If the franchise system is eliminated and the franchisor proceeds as recommended by the Federal Trade Commission to go over this country in nonrefillable containers, then the independent bottlers will be wiped out. There will be no way he can compete.

Senator METZENBAUM. You say that the independent bottler will be wiped out and yet in your report to your stockholders you say that the company will be in a very favorable competitive position to meet the challenges that would be forthcoming if an unfavorable FTC ruling is made. That doesn't sound as if you would be wiped out, you seem to be saying to your stockholders that we will be all right, we will be able to battle from that position.

Mr. KOONS. I don't have that, I don't carry balance sheets around with me, but I think, was there something prior to that?

Senator METZENBAUM. Well, there is no question that you made it clear—I don't mean to view this as a matter of considerable concern. The company has done everything possible to put itself in a position to cope with the negative effects of an adverse decision if it results, but then you go on to say that we will be in a favorable competitive position to meet the challenges. I am only making that comment, not because I am saying that it still means that you ought not to be for the bill, but I am making it in the context that you had indicated that we will be "wiped out". I am just questioning that.

Mr. KOONS. I think the facts, Senator, once explained to you, once we separate the independent bottlers from the syrup manufacturers, are so overwhelming that I believe that, I hope, that you will see our way and I believe that you will.

Senator METZENBAUM. You are the only bottler we have today. Has the bottling industry been a reasonably profitable industry?

Mr. KOONS. Yes, sir. I think so. We make a profit on all packages. As I say, I don't have my statement here, but I think that we run around 5½ percent on sales, something like that.

Senator METZENBAUM. And it shows a profit of about 20 percent on equity, approximately, which is certainly respectable and nothing to be——

Mr. KOONS. Nothing to be ashamed about, that's right.

Senator METZENBAUM. And you operate the company well, there is no doubt about that.

Mr. KOONS. Yes, we have competition that is so strong, and Mr. Goldman is an analyst and he could answer this question, perhaps, better if it were directed to him or whatever, but we have strong competition in certain areas where the Miami Coca-Cola is about 10 times as big as we are.

Nevertheless, I would like to proceed on a statement that Mr. Goldman made about the elimination of the returnable bottles.

Senator METZENBAUM. Could you wind up in 2 minutes, do you think. Let me be very frank with you. The chairman is not a supporter of this legislation. There are members of the subcommittee, certainly its author, who are very anxious to complete the hearings on

this matter so that the subcommittee may bring it to a head. We have brought down a lady from New York who is an expert witness and we have someone here from the Consumer's Union, they have a right to be heard and we have 20 minutes left to go in this hearing.

Senator BAYH. Mr. Koons, you have spent a lot of time and money really studying this and I think from your remarks, with respect to your testimony, is a sufficient contribution. The chairman has been very thoughtful and he says that he is inclined to be on the other side of this, despite the fact that he has always wanted to listen to this particularly. We are always glad to listen to you but——

Mr. KOONS. Can we summarize that the returnable bottles will disappear and then we will conclude and thank you very much.

Senator BAYH. Any elaborating remarks that you want can be put in our record just as if you gave it here so we have it.

Mr. KOONS. We've got it here in a nutshell.

Senator METZENBAUM. Your name.

Mr. GOLDMAN. Emanuel Goldman from Sanford C. Bernstein & Co., Inc.

Senator METZENBAUM. And where are you from?

Mr. GOLDMAN. Sanford C. Bernstein & Co. is a New York City brokerage house and I am the beverage analyst with them.

At the heart of our argument in terms of refillable bottles is them disappearing if the FTC were to implement it—is the fact that very simply and understandably that supermarkets don't want to handle returnable containers. They don't get milk cartons back, they don't get orange juice bottles back, they don't get soft drink bottles. They would prefer not to handle refillable soft drink containers. The only reason that they do, the main reason that they do is that they want to have a Coke or Pepsi, there is only one Coke bottler that they can deal with. The bottler has a leverage. He has a certain amount of shelf space, and depending on consumer preference in a particular area, that bottler will stock the shelves with one-way bottles, cans, and in some parts of the country, the preponderance would be in returnable bottles. The cost to the consumer is far less with returnables than nonreturnables.

With the implementation of the FTC order the leverage totally shifts away from the bottler to the supermarket and the supermarket can then choose whichever bottler he wants for that particular type of soft drink package, cans, plastic or whatever that is most convenient for him and, certainly, from convenience standpoint, it is much easier to have a nonreturnable—there is no checking in, no loading up the backroom, no potential health problem in the stacking of the bottles. It is clearly understandable why the supermarket doesn't want returnables and with the implementation of the FTC order, there is little question in my mind that the refillable bottle will disappear with a tremendous amount of indications that the one-way bottle average has a 50 percent cost per ounce higher than the returnable bottle. The can is twice as expensive as the returnable.

In addition, there are other very substantial ramifications to the ecology, to the use of oil. We estimated that $300 million initial effect on the balance of trade— a negative effect, due to the disappearance of the returnable bottle which we think would take no more than 4 years.

Senator METZENBAUM. Mr. Goldman, or Mr. Koons, if Congress grants this antitrust exemption for territorial restrictions, that really provides no assurance whatsoever, does it, that you will continue to supply returnable bottles?

Mr. KOONS. What you say is correct.

Mr. GOLDMAN. In some parts of the country, there is a definite preference for returnables. In some cases Ohio, you say is a 90 percent——

Senator METZENBAUM. But isn't the argument somewhat extraneous to the validity to this piece of legislation?

Mr. KOONS. This legislation has been pending for sometime and in 1978 there were more returnables sold to foodstores in the United States than there was in 1976. People on the east coast don't recall that there is such a thing as a returnable. It is the most popular package there is. It is how the independent bottler has deep market penetration and can compete against the store brand flavor on a per ounce basis—is the returnable bottle. That is why it is the most popular package with the independent bottler.

If that was eliminated, the cost to the consumer, Senator, if we stack it all up, is $1.45 billion more each year in the foodstore cost to the consumer.

Senator METZENBAUM. If the consumers demand it, the bottlers will make it available and if they don't, they won't; is that right?

Mr. KOONS. It is like a three legged stool. (1) is the consumer, (2) is the retailer, and (3) the bottler, who in the soft drink industry is the manufacturer and the distributor. If one of those three legs of the milking stool falls the whole stool falls down. We can say that the Pepsi-Cola Co. does not want to put out returnable bottles, that would be unfair because we are not sure—they do not have returnable bottles on the east coast but it very well may be that the consumer doesn't want it on the east coast. It could be the retailer doesn't want to handle returnable bottles on the east coast.

If the franchise system falls, the leverage that the independent bottler has over the retailer or the chain store would fall. When that leverage disappears, so would the leverage of the independent bottler to promote the returnable package.

Senator METZENBAUM. Do you think that we ought to have Pepsi-Cola and Coca-Cola and supermarkets appear before this committee and address themselves to the various issues you are talking about?

Mr. KOONS. This is the first time I have ever been before a committee in my life, Senator, and I don't know what comes before you; if you feel that is proper to get the story, fine. But I know that in certain areas, Pepsi-Cola does promote the returnable bottles.

On the east coast, there is an disinclination on somebody's part not to provide the choice to the consumer of the returnable bottles, and I am sure that the Pepsi-Cola Co. can speak well for itself. I feel that I am fighting a lot of giants when we are talking about Pepsi-Cola, Coca-Cola, steel compaines, glass companies, but I mean everything I said and I think we can back it up.

The consumer, if they want returnable bottles, they can yell loud enough. I am sure that when the Senator from Massachusetts, who is the senior member of the Senate Judiciary Committee comes to Cleveland to buy a bottle of Pepsi or Coke and he is paying about half as

much per ounce as he is paying in Boston, he is going to say what the heck is wrong with Boston.

There are two things that I would like to read.

Mr. KOONS, Jr. I want to make a point. There is a study out on BCDL by the OTA. It is about a $3 million study with five reports on mandatory deposit legislation—this is in the summary:

> If upheld by the Court and not modified by Congress, the recent decision by the Federal Trade Commission which outlaws territorial franchise restrictions for trademarked softdrinks in nonreturnable containers, could lead to rapid concentration of that industry.

I think that is an anticompetitive effect.

Mr. KOONS. My son was quicker—that is what I was looking for. Good for him.

Mr. KOONS, Jr. [reading].

> The outcome would be an industry, with only a few firms having a few large plants, as well as the rapid disappearance of the refillable bottle.

Mr. KOONS. I will conclude with this statement, Senator, this is from Stephen Breyer, who was then professor of law, Harvard Law School, now chief counsel, Senate Judiciary Committee. He wrote this following the oral argument on the appeal from the Federal Trade Commission and I will have to say this, that part of these facts that Mr. Breyer got came from my son, Jeff, and Dick Caudill when they visited him at Harvard. He says this:

> There apparently was no consideration of whether or not the returnable bottles would survive under the "split relief" that the commission ordered.

You can tag that one up, Senator. [Laughter.]

We put a tag on that rascal and I think when the chief counsel for the Senate Judiciary Committee makes a statement like that, I think it is worthwhile to the subcommittee to look into it and we thank you very much and we would be happy to come back again.

Senator METZENBAUM. He was just hired by the Judiciary Committee—we may have to fire him as rapidly as he was hired. [Laughter.]

Thank you very much.

Senator Cochran, I didn't ask you—Mr. Koons, there may be some questions that members of the committee will submit to you and I am sure you will be glad to answer them.

Mr. KOONS. I would love to.

Senator METZENBAUM. I have no doubt about that. [Laughter.]

[Mr. Koon's summary of his remarks, prepared statement, and the statement of Emanuel Goldman follows:]

SUMMARY

Mr. Chairman and Members of the Committee: I want to thank you for this opportunity to appear before you today. We are aware that other independent bottlers have appeared before you and we are pleased to join them in support of S. 598 and we are grateful to the 79 Senators who have sponsored this bill.

My name is Bud Koons and I am President of Central Investment Corporation of Cincinnati, Ohio. It is a publicly held corporation with approximately 65 percent of the stock owned by members of my family. We own two Pepsi-Cola franchises in Ohio and two in Florida. I am also President of the Ohio Pepsi-Cola Bottlers Association, membership of which includes all Pepsi-Cola franchises in Ohio; all independently owned and operated. With me today is Richard Caudill, President of our Florida operations, my son Jeff, Vice President of our

Florida operations and Emanuel Goldman of Sanford C. Bernstein and Co., Inc., a security analyst specializing in the soft drink and brewing industries.

We are here today to summarize and perhaps expand upon through dialogue the results of the 2 to 1 decision of the FTC reversing the findings of its own Administrative Law Judge in the Coca-Cola and Pepsi-Cola cases The ALJ had dismissed the complaint and found that exclusive territorial rights in the nearby century-old franchise system not only do not restrain competition but actually are procompetitive.

Our prepared statement, which we have submitted, will give you details of this summary.

In fact, the effect of the FTC ruling will be the exact opposite of what the FTC intended. The decision will eliminate the Independent Bottler and the returnable bottle from the market place. The winner will be three of the largest oligopolies in the USA:

1. 3 large Syrup Manufacturers: Coca-Cola Company, Pepsi-Cola Company, and Seven-Up (acquired by Philip Morris who also owns Miller Beer only one month after the decision).

2. Can Manufacturers—only 5 control the vast majority of the business.

3. Glass Manufacturers—only 5 control 70 to 80 percent of glass sales to the soft drink industry.

The losers would be:

1. The Independent Bottler.—currently about 1833 Independent Bottlers are competing vigorously in interbrand competition unmatched by any other item sold through food stores. If FTC is affirmed, the Independent Bottlers will be quickly disposed of by the 3 huge Soft Drink Syrup Manufacturers, leaving in its wake the demise of the refillable bottle and the vigorous interbrand competition in the marketplace.

2. The Consumer.—In a highly concentrated industry, vigorous price competition is lacking and, with the added loss of lower prices from refillable containers, the consumer will be forced to pay from 50 percent to 100 percent more (depending on the nonrefillable container used) that is currently paid for carbonated soft drinks in refillable containers on a cost per ounce basis.[1]

3. The Environmentalist.—Concentration in the soft drink industry of necessity dictates the loss of the refillable container as has already occurred in the beer industry with the resultant increase of over 32 billion additional nonrefillable containers per day being added to the solid waste stream, according to Franklin Associates, Ltd.

4. Every American Through Energy Loss.—Franklin Associates, Ltd. study and other studies indicate that the 36 percent additional energy use necessary to produce the billions of additional nonrefillable containers required to replace about 40 percent of all soft drinks sold annually in refillable containers is staggering to an energy-deficient society as ours. Sadly enough, there is absolutely no sound reasoning in making such a situation occur.

THE EFFECT OF THE FTC DECISION ON CONCENTRATION [2]

If the FTC order is allowed to become effective, there will be a rapid movement to concentration within the industry by the major syrup manufacturers. Pepsi-Cola Co. owns and operates its own bottling plants in franchises covering about 25 percent of the population of the U.S.A. The Coca-Cola Company does likewise for about 14 percent of the population.

The huge conglomerate syrup manufacturers will feel compelled to expand their company-owned operations so as to expand both market share and the dual profits realized, first, from the syrup they sell to their independent bottlers and, secondly, from the sale of the finished products manufactured by their company-owned franchised plants. The syrup manufacturer can reap all the profit available by raising the price of the syrup, both to its own bottling subsidiaries as well as its independent franchises. This classic "price squeeze" is well described by Dr. Jesse Markham, former chief economist of the Federal Trade Commission, at pages 13 and 14 of our statement. They are well positioned to do this now vis-a-vis Lee Way Motor Freight and Pepsi-Cola.

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[1] The FTC originally estimated that savings to consumers from elimination of exclusive territories would be $1 billion "or more." Later the estimate was reduced to $250 million and then to $50 million. At trial, complaint counsel made no attempt to prove that there would be savings to consumers in any specific amount.

[2] OTA conclusion p. 19.

THE EFFECT OF THE FTC DECISION ON THE RETURNABLE BOTTLE [3]

Why will the returnable bottle disappear bringing with its demise the disastrous results upon the economy, the environment and energy?

An excellent analogy is provided by the brewing industry proving the correlation which exists between concentration and the decline of the returnable bottle.

The history of the brewing industry since World War II demonstrates this positive relationship between concentration and the decline of the returnable bottle. In 1945, there were 457 breweries, almost all local and regional firms. Eighty-five percent of beer sold was in the returnable bottle. By 1977, the number of breweries had declined to 47 (Exhibit 3), and the use of returnable bottles was down to 12 percent (Exhibit 4). In 1947, the five largest breweries controlled only 20 percent of the market, but, by 1977, the top five had a 70 percent market share (Exhibit 5). Miller and Anheuser-Busch serve the entire country mostly with cans and non-returnable bottles shipped long distances, from a few strategically located plant sites (Exhibits 6 and 7). At present there are 1833 independent soft drink bottlers. However, PepsiCo and Coca-Cola, and now Seven-Up (recently acquired by Philip Morris, which also owns Miller Beer) are now positioned under the FTC decision to do the same thing in the soft drink industry which the large brewers have done in the beer industry. (I.e.) Lee Way Motor Freight.

We emphasize the question is not whether the returnable bottle will disappear if the FTC decision becomes effective, but how quickly it will occur. We commissioned Mr. Emanuel Goldman to analyze the question. His statement is offered for the record, and we also attach as Exhibit 8 to our statement his affidavit in the Florida litigation commenced by our company against the FTC. It is estimated that there are presently 4 billion in use, with an annual replenishment rate of new returnable bottles of one billion. Each time a returnable bottle permanently disappears from the "float," it must be replaced by 20 cans or nonreturnable bottles. Mr. Goldman concludes that, if the returnable market share declines at a rate of five percentage points a year, by 1982 we will have added 32 billion additional nonreturnable containers to our solid waste stream. In the event of a ten percentage point annual decline, the number of one-way bottles and cans would be 63.8 billion.

What will be the effect of this shocking increase in nonreturnables? We commissioned Franklin Associates, Ltd., consultants in resource and environmental policy and planning, to find the answer. A copy of their final report, dated February 14, 1979, accompanies our statement and is offered for the record. The Franklin report describes in detail the methodology employed and quantifies in appropriate units of measure the adverse impact on the environment (including the depletion of natural resources) and energy sources associated with replacement of the returnable bottle with the other commonly used nonreturnable package forms. The popular equivalency expressions of these impacts or losses are described as follows:

Total energy

Equivalent to the electrical energy consumed by a city of 100,000 in 34 to 69 years, plus

Natural gas

Equivalent to the natural gas requirements for heating 100,000 midwestern homes for 2.4 to 4.9 years, plus

Petroleum

Equivalent to imports of 65 to 129 million gallons of gasoline, plus

Coal

If placed in a coal train, the train would stretch 331 to 686 miles, or a maximum distance extending from Washington, D.C., to Chicago, plus

Air pollution

Equivalent to 1.2 to 2.4 years of emissions from 1,000 Mw coal-fired powerplant, plus

Water pollution

Equivalent to 3.2 to 8.9 years of emissions from a 1,000 Mw coal-fired powerplant, plus

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[3] Stephen Breyer statement p. 20.

Solid waste

Trash can volume: Equivalent to 30 to 87 fillings of the Orange Bowl in Miami, Florida; or landfill volume: Equivalent to 12 to 30 completely filled medium-sized city landfills, plus

Water consumption

Equivalent to 2.8 to 5.3 years of domestic water use in the City of Washington, D.C., plus

Raw materials

Bauxite: Equivalent to 7 to 15 percent of bauxite imports in 1976.

Iron ore: Equivalent to 2 ot 5 percent of iron ore imports in 1976.

Glass sand: Equivalent to the sand in a beach 100 feet wide and 2 feet deep stretching 6.1 to 12.5 miles long.

There is also the effect on the economy—particularly as it relates to the consumer of the product—of the disappearance of the returnable bottle.

The carbonated soft drink beverage industry generates $15 billion in annual sales. It is twice the size of the beer industry. Soft drinks are the number one dollar volume sales item in food stores, constituting 4.1 cents of every sales dollar. Based on 1978 food store sales of $164 billion, $6.724 billion was spent on soft drinks of which 41.5 percent were refillable containers. If refillables are eliminated, the minimum cost to the consumer based on Majers survey data, will be an additional 52 percent or an increase of $1.45 billion every year for carbonated soft drinks.

We submit the evidence in this matter is overwhelming to the effect that vertical territorial restraints in soft drink franchise agreements are procompetitive and in the public interest, if for no other reason than that they permit the continued high level usage of the returnable glass bottle with all its subtle but important benefits to our economy, environment and energy conservation goals. Our lawyers tell us the FTC decision is wrong simply as an interpretation of existing statutory and case law. But even if the decision arguably were somehow sustainable as an interpretation of existing law, it should be reversed because of its many external, adverse ramifications, conflicting with the policy objectives of the Council on Wage & Price Stability, the Environmental Protection Agency and the Department of Energy—to name a few agencies whose mission will become more difficult of fulfillment if the decision becomes effective. Perhaps the adverse consequences of that decision might be worth suffering if offset by any benefits to consumers in the form of lower prices for soft drinks. However, there is simply no evidence of any such savings occurring, and, in fact, as we have shown, if the returnable bottle disappears from the marketplace, the consumers will on average pay higher prices for soft drinks.

It has been suggested recently that legislation be enacted conferring power on the President to veto the action of one agency which conflicts with and frustrates the policy objectives of other agencies. We express no opinion on the wisdom of such a proposal, but the matter before you points up its potential merit. But, in any event, since the Executive does not now have such a power, we must appeal to the Congress to enact legislation protecting the economy, the environment and our scarce energy resources from the ill effects bound to follow the implementation of the FTC decision in the soft drink cases.

PREPARED STATEMENT OF J. F. KOONS, JR.

Mr. Chairman and Members of the Committee: You have my great appreciation for this opportunity to appear before you to support the imperative need for legislation to override the decision of the Federal Trade Commission invalidating exclusive territorial rights in the soft drink beverage industry, assuming that result is not sooner achieved by judicial action.

The company of which I am president, Central Investment Corporation, has its headquarters in Cincinnati, Ohio. It is a publicly held corporation with approximately 65% of the stock owned by members of my family. The company owns two Pepsi-Cola franchises covering nine northern Ohio counties around Mansfield and Canton, and two in Florida—Palm Beach and Ft. Lauderdale. I am also president of the Ohio Pepsi-Cola Bottlers Association, the membership of which includes all Pepsi-Cola franchises in Ohio, all of which are independently owned. With me today is Richard Caudill, President of our Florida operations; my son, Jeff Koons, Vice President of our Florida operations, and Emanuel

Goldman of Sanford C. Bernstein and Co., Inc., a security analyst specializing in the soft drink and brewing industries.

When I became president of the company, we were exclusively brewers of beer under the trademark "Burger Beer." The increasing concentration of economic power in the brewing industry subsequent to World War II led to our decision to leave the beer and enter the soft drink business. Observing that concentration develop in an industry that did not have territorial rights, provided me with firsthand experience relevant to my testimony today.

We are aware that other independent bottlers have appeared before you, and we are pleased to join them in support of legislative relief from the FTC decision. We are also grateful to the approximately 80 members of the Senate who have sponsored S. 598. If we could not contribute something more to the debate on this legislation, we would not have requested this opportunity to testify. The fact is, however, that we have made a substantial personal effort to demonstrate that, if the FTC decision is not reversed by judicial or legislative action, it will have an immediate and serious adverse impact on essential national energy, environmental and economic goals. Moreover, the FTC order confiscates without compensation the most valuable property right of any independent bottler—the grant of his exclusive territorial rights which was paid for by him or a predecessor in title. It will lead to the destruction of hundreds of independent bottlers and a reduction in interbrand competition, without increasing intrabrand competition, and without benefits of any kind to the consumer.[1]

The thrust of our case is that, if the FTC decision becomes effective, the near total disappearance of the returnable, reusable glass bottle will soon occur, directly resulting in the adverse effects just mentioned. We have commissioned a study by Franklin Associates, Ltd., consultants on resource and environmental policy and planning, a summary of which we offer for the record, and to which we shall later refer. That study establishes the enormity of the environmental energy loss consequences that will follow the disappearance of the returnable bottle in the carbonated soft drink beverage industry. When we became aware of how seriously the FTC decision would affect the environment, we filed suit against the Commission in the U.S. District Court in Florida,[2] seeking to enjoin the enforcement thereof on the grounds that the orders entered constituted "major federal actions significantly affecting the quality of the human environment" and that the FTC had failed to file an environmental impact statement as required by the National Environmental Policy Act. A motion for preliminary injunction, which has been briefed and argued, is presently held under advisement by the trial judge awaiting the outcome of the direct appeal from the decision pending in the Court of Appeals for the District of Columbia.

BACKGROUND

Let me briefly describe how the structure of the soft drink industry has developed. Starting with Coca-Cola near the turn of the century, hundreds of independent bottlers have acquired exclusive trademark licenses to manufacture, distribute and sell the trademarked products within a specified territory. These territories are usually rather small in area, consisting of a municipality and its suburbs, or, in rural areas of the country, a number of counties may comprise a territory. The bottlers, by contract, must purchase all of their syrup or concentrate needs from their franchisor—Coke, Pepsi, Seven-Up, etc.—national concerns which own the formula and the trademark. The bottlers then complete the manufacturing processing of the products in their own plants. The bottler franchisee must maintain a large capital investment in plant, package inventory and production lines, and a fleet of trucks to distribute the product. The soft drink franchisee is a manufacturer of the product sold in addition to his role as a distributor. The franchise owned is perpetual and may be bought and sold at current market values, and transferred in accordance with the owner's wishes at death.

The soft drink industry structure described has permitted the development of vigorous competition among the many popular brands, to the benefit of all con-

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[1] The FTC originally estimated that savings to consumers from elimination of exclusive territories would be one billion dollars "or more." Later the estimate was reduced to $250 million and then to $50 million. At trial, complaint counsel made no attempt to prove that there would be savings to consumers in any specific amount.

[2] *Pepsi-Cola Bottling Co. of Ft. Lauderdale-Palm Beach, Inc.* v. *FTC.* CA–79–8060, U.S.D.C., S.D. of Florida.

sumers. There is intensive price advertising competition among brands seeking to increase their market shares. The effectiveness of competition within the industry is proven by the fact that by 1977 the price per ounce of Coke in the 16 ounce returnable bottle had increased less than three per cent over the 1939 cost of the product, despite a rise in the Consumer Price Index during those years of 344 percent. Nevertheless, in 1971, the FTC filed a complaint against the syrup manufacturers, alleging that the exclusive territorial provisions in the franchise agreements were unlawful because they prevented intrabrand competition among the bottlers. After many delays and a lengthy six-week trial, the Administrative Law Judge, in a 91-page Initial Decision containing 195 detailed findings of fact, upheld the legality of the territorial provisions and dismissed the complaint. Undertaking an extensive rule-of-reason analysis, the ALJ concluded that the effect of the restraint on intrabrand competition is outweighed by its effect on competition in the marketplace as a whole—interbrand competition—and that on balance the challenged territorial restrictions promote competition.

Indeed, the territorial system has helped to promote competition by making it much easier and less expensive for new brands to enter the market. With a ready-made system of local manufacturers and distributors in place, promoters of new brands can "piggy-back" by contracting with existing bottlers, instead of having to invest in a complete distribution system of their own.

Unfortunately, the wise and sensible ruling of the ALJ was rejected by the FTC in a 2–1 decision. The case is now on appeal to the U.S. Court of Appeals for the District of Columbia.

To give you some idea of the weakness of the complaint counsel's case before the Administrative Law Judge, we quote the following from one of the briefs filed in the Court of Appeals:

Complaint counsel could not and did not make the type of showing promised by his predecessor: he did not establish the existence of submarkets; could not prove the existence of product differentiation; made no showing of undue concentration either within the "corridor" or nationwide; could not establish that barriers to entry into the soft drink industry were high; did not show that advertising and promotion were inordinate or useless to the consumer; could not call a single chain store representative or other purchaser to testify to any problems in purchasing soft drinks; eschewed the attempt to demonstrate cost savings or other benefits to the consumer; and in six weeks of trial devoted largely to bottler testimony, could not produce a single witness to say that he felt restrained or disadvantaged in his business because of territorial restrictions. Brief of Pepsi-Cola Bottlers Association *et al.*, p. 13.

To our knowledge, this statement remains unchallenged.[3]

COMPETITION AND PRICE ADVERTISING

Since presumably the FTC action and decision was based on the belief you could improve competition and reduce price to the consumer by eliminating territorial restraints, we shall briefly give a layman's views on the subject. Based

[3] That the FTC's staff found difficulty in developing a consistent theory on which to try the case is apparent from the following remarks of Raymond Hays, Esq., new complaint counsel who entered the case in May 1973. In asking approval at a prehearing conference to abandon his predecessor's approach on the ground proof for it could not be found, he stated.

"Perhaps I might say, just by way of background, that all of the Government counsel at this table who are charged with carrying these cases forward are new on the cases. As of May of this year, none of us had any knowledge of any aspect of any of these cases, officially or unofficially.

"Our first duty was to find out about the cases, what were they all about, what was the background, the procedure and what was the evidence. I did that. We did that to the best of our ability and as quickly as possible.

"I say, with a great deal of sadness and with a great deal of humility, that I reached the judgment that I just could not live with the positions that had been taken by Government counsel that preceded us. I don't like to say that. I think the Government should be held to strict accountability where it is possible to do so without prejudicing the public interest.

"But, in analyzing the theory of the case—which was, in part, a per se theory and, in part, a partial rule-of-reason case to be put on in Los Angeles, Minneapolis, Chicago, and Washington—in looking at the backup material to the designated witnesses, I could not discern any continuity in factual development that would support the charges.

"So, with that in mind, I wish to formally move you here today to allow us, among other things, to amend the previous trial briefs and designations of witnesses and designations of documents. When I say 'amend,' I mean, for all intents and purposes, it is a substitution, practically a whole new list of witnesses." (Tr. of Nov. 29, 1973 Prehearing Conference in FTC Dockets 8853, *et al.*, at 3–4.)

upon our knowledge of the FTC proceeding, there was ample evidence to justify the findings of the Administrative Law Judge that competition is intense and increasing in our industry. We quote from the summary of the ALJ's findings appearing in the brief of the Pepsi-Cola Bottlers Association (omitting citations to the record) :

(1) There exists price sensitivity between Coke and other carbonated soft drink brands;

(2) The relative success of the different brands varies according to competitive conditions such as competitors' discounting and promotional activities;

(3) Intense interbrand competition is carried out both in terms of list prices and by means of continuous promotions and discounting;

(4) The interbrand market is characterized by an enormous number of different brands available to the consumer;

(5) The interbrand market is characterized by an enormous variety of package types and sizes, including the economical returnable packages which can compete directly in price on a per-ounce basis with the cheapest form of carbonated drink and even with the prices of Coke and Pepsi of decades ago;

(6) Interbrand competitors must engage in intense marketing activity in order to gain acceptance in the market and prevent subsequent loss of sales to competitors. They must fight for shelf space; and vie with one another in performing in-store and point-of-sale services, in servicing numerous points of sale, in offering free or low-cost special events services, and in placing and servicing vending machines;

(7) Entry of new competitors, both new brands and new product types, into the soft drink market has been frequent and effective and has been made easier by the territorial system of local bottlers;

(8) Bottler profits are reasonable.

The two-member FTC majority that decided the case apparently chose to ignore these findings and as one commentator observed: "The Commission relied primarily upon logic, and only secondarily upon empirical data, to support its conclusions that [the territorial] restrictions had significant anticompetitive effects."[4] From what both our lawyers and our common sense tell us, there is little logic in the Commission's approach, only the dogged determination of two members to reject any kind of vertical restraints in the process of manufacturing and distributing soft drinks.

In an effort on our part to determine the status of competition in the carbonated soft drink beverage industry, we engaged the services of Majers Corporation of Omaha, Nebraska, an independent marketing research firm which monitors newspaper retail food store advertising in the top 106 United States markets. Majers found that out of 45 leading categories (excluding meat and fresh produce) in food stores measured over a period of years carbonated soft drinks ranked second in feature price ad activity and first in dollar volume. (Exhibits 1 an 2)

How competitive is the soft drink industry? So highly competitive that the featured ad price per ounce of Coca-Cola and Pepsi-Cola in the 16-oz. returnable bottle for the 12 months ending November 1977 rested only 2.6 percent higher than the price of Coca-Cola in the only bottle available in 1939. The unadorned facts found by the Administrative Law Judge and now confirmed by the Majers data, establish that the independent franchised soft drink bottler system is highly competitive and that the consumer is receiving the benefit of intense price competition.

THE EFFECT OF THE FTC DECISION ON THE RETURNABLE BOTTLE

Soft drinks are sold in either returnable or non-returnable (NR) packages. By definition, returnables are packages which, following use, are collected by the bottler, washed and reused. Returnables are bottles made of glass which are heavier and more durable than non-returnable bottles. Nonreturnables, packages used only once, consist of cans made from various materials and bottles of lighter glass and thinner construction than returnables. There are also some nonreturnable plastic bottles.

[4] *The Federal Trade Commission and the Soft Drink Cases:* Stepheen Breyer, Consultant; Martin Romm; The First Boston Corp.; New York, July 1978. In fairness to Mr. Breyer, we observe he is not entirely critical of the commission's methodology in this respect.

Despite the fact that the returnable bottle is the most expensive container for the bottler to purchase, the product can be sold therein to the consumer at the lowest cost per ounce. This reflects the simple fact that the returnable bottle is used on an average of 20 times and the package cost amortized over so many sales. Present approximate costs per container to the bottler of three major package forms are returnable glass (16 oz.) 16.7 cents; (10 oz.) NR glass 7.8 cents; and (12 oz.) cans 8.66 cents.

The returnable bottle continues to enjoy a high level of usage in the market. Approximately 58 percent of all soft drinks are sold in food stores. Figures for 1978 show that 41 percent are in returnables, with the percentages considerably higher for Coke (51.7 percent) and Pepsi (49 percent).

Virtually everyone with knowledge of the soft drink industry agrees that, if the FTC order is allowed to become effective, there will be a rapid movement to concentration within the industry, resulting in the major markets falling under control of the syrup manufacturers. Pepsi-Cola Co., a subsidiary of the conglomerate Pepsi Co., Inc., which manufactures the Pepsi concentrate, and from whom all independent bottlers must, by contract, purchase all of their Pepsi concentrate, also owns and operates its own bottling plants in franchises covering about 25 percent of the population of the United States. Coca-Cola Company USA does likewise in franchises covering about 14 percent of the population. These Pepsi-Cola Company-owned franchises include Boston, New York, Newark and almost all of New Jersey, Philadelphia, Detroit, Pittsburgh, Dallas, Houston, Los Angeles, Phoenix, Las Vegas and Orlando/Daytona. The Coca-Cola Company-owned franchises include Boston, Chicago, San Francisco, Columbus, Toledo, Baltimore and Bellvue (Seattle). The FTC decision now permits, and indeed seems to require, the syrup manufacturers to compete with their independent bottler franchisees anywhere in the country.

Why will the FTC decision lead to concentration in the industry and with that concentration the demise of the returnable bottle? The reasons are manifold and, in our opinion, relatively obvious. We shall briefly examine a few of the more important ones.

Perhaps the most powerful economic force in accelerating concentration would be the incentive of the large syrup manufacturers to exploit a greatly enhanced opportunity to increase their market share, thereby increasing dual profits. The syrup companies already realize a significant degree of dual profit, first from the syrup they sell to their independent bottlers and, secondly, from the sale of the finished products manufactured by their company-owned franchised plants. Without territorial restrictions the syrup companies will find the temptation irresistible to expand their company-owned bottling operations and thereby claim a greater share of market and overall profits generated by the sale of soft drinks to the public.[5] Such expansion will be facilitated by the ease whereby the syrup manufacturer can reap all the profit available by raising the price of the syrup, both to its own bottling subsidiaries as well as its independent franchisees. This classic "price squeeze" has been described by Dr. Jesse W. Markham, Professor of Economics at Princeton University and former chief economist of the Federal Trade Commission, in testimony before the House Small Business Committee:

> The vertically integrated firm can use the market power it has in the preceding stage to attain approximately the market share it desires in the subsequent stage by manipulating the prices at which it supplies itself and its customers with which it competes. When it wishes to expand its share of the market at the subsequent stage it simply raises the price at which it supplies both itself and its competitors, but holds the price line at the later stage. Competitors cannot pass on the price increase without driving customers to the integrated firm. The integrated firm, which by strict accounting may be incurring losses at the later stage, is making gains to offset them on its operations at the earlier stage. On its total operations it may be making a satisfactory rate of return. The unintegrated competitors, having no previous stage operations to draw on, simply operate at losses that may eventually drive them out of the business altogether. This strategy is known in the economic literature as the "price squeeze". . . . Hearings on the Im-

[5] The point was made in one of the appeal court briefs that: "Ironically, it could be argued that the Commission orders . . . would require such expansion, in that they prohibit The Coca-Cola Company and PepsiCo from 'continuing' or 'maintaining' any 'understanding' or 'agreement'—even with their subsidiary bottlers—to limit territories." Brief of Intervenors, Coca-Cola Bottling Company of Los Angeles, et al., p. 8.

pact Upon Small Business of Dual Distribution and Related Vertical Integration Before the Subcomm. No. 4 of the House Select Comm. on Small Business, 88th Cong., 1st Sess., vol. 1 at 50 (1963).

We have been told that "price squeeze" conduct of the kind described is unfair competition and probably unlawful, and that independent bottlers injured thereby could sue to prevent it or to recover damages if harmed thereby. However, if artfully employed it would be difficult to apprehend, at least before it was too late to prevent a devastating loss of market share by the affected independents. Moreover, resort to litigation against Coke or Pepsi by an independent bottler is about as attractive as it is for a small computer firm to sue IBM.

Another important factor leading inexorably to concentration in the industry and the disappearance of the returnable bottle is the aversion of the supermarkets to store door delivery and the stocking of returnable bottles. There are a number of reasons why supermarkets do not like returnables. They take up more shelf space, and the process of receiving and redeeming returnables in checkout lanes and storing empties until pickup by the bottler is viewed as an unrewarding nuisance. More important, perhaps, is the fact that supermarkets prefer central warehouse delivery of all inventory so that they can control the flow of merchandise into the retail outlets. One central warehouse may serve all stores in a chain within a radius of 100 to 300 miles located in many different municipalities and counties and several states, and, in the soft drink industry, many different franchise territories. If a large supermarket chain had its preference, it would almost always be to deal with one supply source for each of the soft drinks it opted to stock in its retail stores and to receive delivery at a central warehouse serving many retail outlets. This is, of course, virtually impossible under the present exclusive territory system which imposes on each bottler the obligation to limit the sales of the product within the confines of his territory. This is a principal reason for store door delivery.

Exclusive territorial rights and store door delivery are concomitants which make possible the continued high level use of returnable bottles in our industry. Even the FTC recognized that exclusive territories were necessary for returnables, because of the need for a bottler to control his glass "float" within a discrete area when it limited its order invalidating vertical restrictions to nonreturnable packages However, what the Commission failed to recognize is that no independent bottler can continue profitably to use returnables after his supermarket accounts are no longer required to accept store door delivery and have ceased doing business with him in favor of a large supplier (and, most logically, the bottler's own franchisor) shipping cans and non-returnable bottles over long distances to a central warehouse.

The economic and marketing characteristics of our industry are such that a substantial level of returnable bottle sales can be achieved and maintained profitably only in conjunction with a mix of non-returnable package sales. Let's confront reality as consumers. Non-returnables, particularly cans, have various convenience features. They are easier to store, taking up less space in the refrigerator or in the kitchen closet. When used, they can be thrown away and need not be brought back to the store. They are obviously more convenient than bottles on a picnic or camping trip. The returnable bottle can overcome these advantages only through strong promotion utilizing feature price advertising. Earlier in our statement, we noted the result of the Majers study finding carbonated soft drink beverages ranking second in newspaper price promotion ads of 45 leading food store products. Almost three-fourths of these ads feature an attractive price for the returnable bottle. The survey found that, in 1977, the consumer was paying $0.0079 per ounce of Pepsi in the 16-oz. returnable bottle in contrast with a price of $0.0156 for Pepsi in the 12-oz can, or 97 percent more. But this price advantage is made possible only if the bottler can exercise the leverage his exclusive territorial rights give him with the supermarkets in his territory to cause the latter to stock and promote the returnable bottle. The use of the returnable bottle is both capital and labor intensive, considerably more so than non-returnables. The returnable bottles can be sold at a lower price than the competing packaging forms only if volume and velocity are high. When volume and velocity decline through loss of supermarket accounts, the cost to the consumer will rapidly rise. When the price advantage to the consumer disappears so too will the returnable bottle disappear.

Another cause for concern for the returnable bottle posed by concentration in the industry as the result of the FTC decision is that the movement to concen-

tration will most surely be led by the large syrup manufacturers and their wholly-owned bottling subsidiaries, which already control many major markets. At least in the case of PepsiCo, there appears a strong disinclination to use the returnable bottle. Report data by Majers from the year 1977 on Pepsi advertising activity in the north eastern sector of the country—namely, New York-Newark, Philadelphia and Boston markets exclusively controlled by Pepsi-Cola Company-owned franchise subsidiaries—reveal no price ads in the economical 16-oz. returnable bottle.

If one needs further evidence of how availability of non-returnable packaging and lack of territorial restraint combine to result in market concentration, we can look at the beer industry.

The history of the brewing industry since World War II demonstrates the positive relationship between concentration and the decline of the returnable bottle. In 1945, there were 457 breweries, almost all local and regional firms. Eighty-five per cent of beer sold was in the returnable bottle. By 1977, the number of breweries had declined to 47 (Exhibit 3), and the use of returnable bottles was down to 12 percent (Exhibit 4). In 1947, the five largest breweries controlled only 20 percent of the market, but, by 1977, the top five had a 70 percent market share (Exhibit 5). Miller and Anheuser-Busch serve the entire country mostly with cans and non-returnable bottles shipped long distances, from a few strategically located plant sites. (Exhibits 6 and 7). At present there are 1833 independent soft drink bottlers. However, PepsiCo and Coca-Cola, and now Seven-Up (recently acquired by Philip Morris, which also owns Miller Beer) are now positioned under the FTC decision to do the same thing in the soft drink industry which the large brewers have done in the beer industry.

If the FTC decision becomes effective, the ease by which our franchiser, Pepsico, can vertically integrate its soft drink operations, beyond its present substantial status, is enhanced because of Pepsico's recent acquisition of a large motor carrier, Lee Way Motor Freight. Lee Way's resources include 5,000 tractor trailer trucks, 85 terminals and service to more than 3,000 cities and towns. For example, look at the State of Ohio where every Pepsi franchise is independently owned. PepsiCo, through its trucking subsidiary, now owns eleven terminals located throughout the State, including every major population center, and also owns the Pepsi bottling franchises in Detroit and Pittsburgh. Without territorial restraints, PepsiCo can easily serve every chain store center warehouse in Ohio in its own trucks with non-returnable cans from its Detroit or Pittsburgh plants, or, if it desires, from one or more new facilities it could build and operate within the State. How, we ask, is the independent bottler to survive under these circumstances, bearing in mind that our sole supplier of syrup will then be our major competitor.

An exhaustive study entitled "Materials and Energy from Municipal Waste," recently released by the Office of Technology Assessment, Congress of the United States, contains the following comments in support of our views (p. 236) :

> If upheld by the courts and not amended by the Congress, the recent FTC decision, which outlaws territorial franchise restrictions for trademarked soft drinks in nonreturnable containers, could lead to rapid concentration of that industry. The outcome would be an industry with only a few large plants, as well as the rapid disappearance of the refillable bottle for soft drinks.

Another commentator, Stephen Breyer, Professor of Law, Harvard Law School, and now Chief Counsel, Senate Judiciary Committee, wrote following the oral argument on the appeal from the FTC Decision :

> The companies' strongest argument is that the Commission, in permitting territorial restrictions for returnable bottles, has acted inconsistently and without adequately examining the evidence. The companies claim that the very fact that the Commission allows territorial restrictions for returnable bottles shows that the Commission accepts the "returnable bottle" justification as procompetitive and desirable. The Commission wishes to encourage their use, yet the companies claim that unless territorial restriction for all bottles are allowed, the bottlers will be unable to use returnables. Although both the hearing examiner and the Commission considered evidence related to returnable bottles, there apparently was no consideration of whether or not returnable bottles could survive under the split relief that the Commission ordered. Update on the Soft Drink Cases, Stephen Breyer, Consultant Martin Romm, The First Boston Corporation, December 1978.

In our opinion, the question is not whether the returnable bottle will disappear if the FTC decision becomes effective, but how quickly this will occur. We

commissioned Mr. Emanuel Goldman of Sanford C. Bernstein & Co., Inc., New York City, a recognized expert securities analyst specializing in the brewing and soft drink industries, to analyze the question. Mr. Goldman is with me here today and available to answer any questions you may wish to direct to him. We are attaching to this statement his affidavit filed in the litigation commenced by our Florida subsidiary against the FTC (Exhibit 8).

Mr. Goldman finds "that elimination of territorial exclusivity for cans and non-refillable bottles will result in a decline of at least 5 percentage points a year and perhaps as high as 10 percentage points per year in the share of market accounted for by returnable containers. This would result in the elimination of the returnable bottle as a viable form of package in the soft drink industry within four to eight years." He attributes the disappearance of the returnable after territorial rights are no longer enforceable. He estimates the present bottle bottle primarily to the loss of supermarket accounts by the independent bottlers "float" at approximately four billion bottles with an annual replenishment rate of new returnable bottles at one billion. If there is a 50-percent reduction in rate of replenishment, total exhaustion of the "float" will occur in the eight years; with no replenishment, the "float" will be consumed in less than four years. Mr. Goldman concludes, "If the returnable market share declines at a rate of 5 percentage points per year, we will, by 1982, have added 32.0 billion additional nonreturnable containers to our solid waste stream. In the event of a 10 percentage point decline, the number of additional one-way bottles and cans would be 638 billion."

EFFECTS ON THE ECONOMY, ECOLOGY AND ENERGY CONSERVATION

Our statement from this point forward proceeds on the assumption that the returnable bottle will disappear if the FTC decision is implemented. The effect of that occurrence on the economy, our environment and energy conservation goals is truly shocking.

THE ECONOMY

The carbonated soft drink beverage industry generates $15 billion in annual sales. It is twice the size of the beer industry. Soft drinks are the number one dollar volume sales item in food stores, constituting 4.1 cents of every sales dollar. Based on 1978 food store sales of $164 billion, $6.724 billion was spent on soft drinks of which 41.5 percent were refillable containers. If refillables are eliminated, the minimum cost to the consumer based on Majers survey data, will be an additional 52 percent or an increase of $1.45 billion every year for carbonated soft drinks.

INTERACTION OF BCDL AND THE FTC DECISION

It has been suggested that even without territorial restraints a high level usage of the returnable bottle can be maintained through the enactment of Beverage Conainer Deposit Legislation (BCDL). Regardless of the merits of BCDL, and whether it will ever achieve widespread enactment, it will not for long prevent the demise of the returnable bottle if territorial restrictions are eliminated.

The OTA, in its previously cited report to Congress, considered the interaction of Beverage Container Deposit Legislation and the FTC decision. Greater use of the refillable container is a stated objective of BCDL and supported by OTA. The report suggests that BCDL could help slow any trend to regional bottling stimulated by the FTC decision. "BCDL would undercut the economic advantages of centralized bottling, which is limited to nonreturnable containers. (The heavier weight of refillables and the need to back haul empties discourages their centralized bottling.) Thus, BCDL might slow any trend toward elimination of local bottlers," p. 234.

It becomes readily apparent that the OTA recognizes the potential for the two disastrous results of the FTC decision we have discussed (concentration and the demise of the returnable bottle), and attempts to project BCDL, not as a solution to the problem, but only as a temporary barrier to an ultimate negative result. The report states, "Since BCDL would decrease the economic advantages of centralized brewing, bottling and wholesaling, the current trend toward a small number of large firms in beer and soft drink production might be slowed. By making the refillable bottle more attractive economically, BCDL could help preserve smaller, local bottlers. Legislation now under consideration to preserve the territorial franchise system could help maintain the refillable bottle's current market share," p. 17. We are pleased, parenthetically, that an arm of Congress

recognizes the extremely negative implications of removing territorial restrictions in the soft drink industry.

Granted, as the OTA predicts, BCDL might slow the trend to regional bottling stimulated by the FTC decision. However, without exclusive franchise boundaries in the soft drink industry, concentration will still occur and the refillable bottle will disappear. This is what the experience in Oregon indicates.

THE OREGON STORY

We decided to find out what has occurred in Oregon—the only mature BCDL state. After the enactment of BCDL in Oregon, the brewing industry sales market share was still well in the hands of the two "local" breweries—Blitz-Weinhard and Olympia, and at the end of 1974, 96 percent of all sales in Oregon were in refillable containers. At the end of 1978, or 4 years later, concentration by national companies had occurred (Miller Brewing was No. 1 in sales) and refillable container sales had declined by 48.1 percent down to 49.8 percent (Exhibit 9). Miller, the No. 1 selling beer, sold no refillables. By June 1979, further concentration occurred after Blitz-Weinhard had sold out to Pabst, and 4 of the top 5 in sales shares were national companies, with a combined 63 percent market share. By June 1979, the refillable sales share had fallen to 36 percent of sales in the brewing industry. (Exhibit 10.)

On the other hand, in the soft drink industry, with exclusive franchise territories and the absence of concentration, refillable bottle sales were still at 80 percent of food store sales at the end of 1978. This proves that exclusive franchise territories inhibit concentration and keeps viable the refillable container, and that without territorial restrictions, BCDL will not save the returnable bottle.

IMPACT ON ENVIRONMENT AND ENERGY CONSERVATION GOALS

Franklin Associates, Ltd., consultants in resource and environmental policy and planning, were commissioned by our company to study the energy and environmental impacts associated with the demise of the returnable bottle. A copy of their final report, dated February 14, 1979, accompanies this statement as a part hereof.

In conducting the study, Franklin relied on the scenarios regarding the disappearance of the returnable bottle developed by Emanuel Goldman. Franklin examined the impacts associated with soft drink delivery in the various container types, including all manufacturing operations beginning with raw material extraction, proceeding through processing, manufacturing, use, and final disposal of the container and secondary packaging, and including filling and transportation. This systems analysis is structured to determine all inputs and outputs at each stage of the container's "life cycle." Then, these data condense into several basic impact categories. These categories serve as the basis for determining the overall effect on environmental quality. They are listed below:

Total Energy Consumption.
Energy Source Summary.
Raw Materials Consumption.
Air Pollutant Emissions.
Water Pollutant Discharges.
Industrial Solid Waste.
Postconsumer Solid Waste.
Process Water Requirements.

The Franklin report describes in detail the methodology employed and quantifies in appropriate units of measure the adverse impact on the environment (including depletion of natural resources) and energy sources associated with replacement of the returnable bottle with the other commonly used nonreturnable package forms. The popular equivalency expressions of these impacts or losses are described as follows:

Total energy

Equivalent to the electrical energy consumed by a city of 100,000 in 34 to 69 years, plus

Natural gas

Equivalent to the natural gas requirements for heating 100,000 midwestern homes for 2.4 to 4.9 years, plus

Petroleum

Equivalent to imports of 65 to 129 million gallons of gasoline, plus

Coal

If placed in a coal train, the train would stretch 331 to 686 miles, or a maximum distance extending from Washington, D.C. to Chicago, plus

Air pollution

Equivalent to 1.2 to 2.4 years of emissions from 1,000 Mw coal-fired powerplant, plus

Water pollution

Equivalent to 3.2 to 8.9 years of emissions from a 1,000 Mw coal-fired powerplant, plus

Solid waste

Trash can volume: Equivalent to 30 to 87 fillings of the Orange Bowl in Miami, Florida; or, landfill volume: Equivalent to 12 to 30 completely filled medium-sized city landfills, plus

Water consumption

Equivalent to 2.8 to 5.3 years of domestic water use in the City of Washington, D.C., plus

Raw materials

Bauxite: Equivalent to 7 to 15 percent of bauxite imports in 1976.

Iron ore: Equivalent to 2 to 5 percent of iron ore imports in 1976.

Glass sand: Equivalent to the sand in a beach 100 feet wide and 2 feet deep stretching 6.1 to 12.5 miles long.

S. 598 AND SIMILAR LEGISLATION

We stated earlier our gratitude to the many members of the Senate who have co-sponsored S. 598. We are equally appreciative of the many members who have co-sponsored the identical bill in the House, H.R. 3567. We wish to call attention also to H.R. 3573, introduced by Rep. Luken and Rep. Mica, which has the same purpose as S. 598 and H.R. 3567—to overturn the FTC decision and permit the continued use of exclusive territories in the soft drink industry. Both versions of the legislation seek a common objective—the preservation of competition and the avoidance of concentration in the soft drink industry and the maintenance of a manufacturing and distribution system in the industry that permits a continued high level use of the returnable bottle. The Luken-Mica bill differs only to the extent that it emphasizes the need for the legislation to protect the environment, to avoid unnecessary energy consumption, and to make the product available in the lowest cost package form. It also represents an unambiguous legislative declaration that nothing in the Federal Trade Commission Act or other antitrust laws shall render invalid exclusive territorial agreements in the soft drink industry, unless it is found that within a territory there is an absence of generally available competing products, and further found that the elimination of the territorial rights will not adversely affect the quality of the environment, increase energy consumption, inflate the cost of soft drink products, or lead to concentration of economic power in the industry.

Some opponents of the legislation have described it as an "antitrust exemption" for the soft drink industry. This is both untrue and unfair since all the bills do is permit the continued use of the present franchise contracts, which, in essentially the same form, have been in effect for more than 75 years. The legislation would not, for example, permit such pernicious forms of anticompetitive behavior as collusion among interbrand competitors to fix prices or to eliminate the returnable bottle.

CONCLUSION

We submit the evidence in this matter is overwhelming to the effect that vertical territorial restraints in soft drink franchise agreements are pro-competitive and in the public interest. In fact, there is not an iota of reliable and credible evidence that they operate to the detriment of consumers, or that their elimination would lower the price of the product a penny. All evidence is to the contrary—that without these restraints the returnable bottle will disappear with resulting overall higher prices to the consumer and very serious adverse impacts on our environment and energy conservation goals.

We urge the Congress promptly to enact legislation that will avoid the many evils most certain to follow the implementation of the FTC decision in the soft drink cases.

MAJERS CROSS CATEGORY

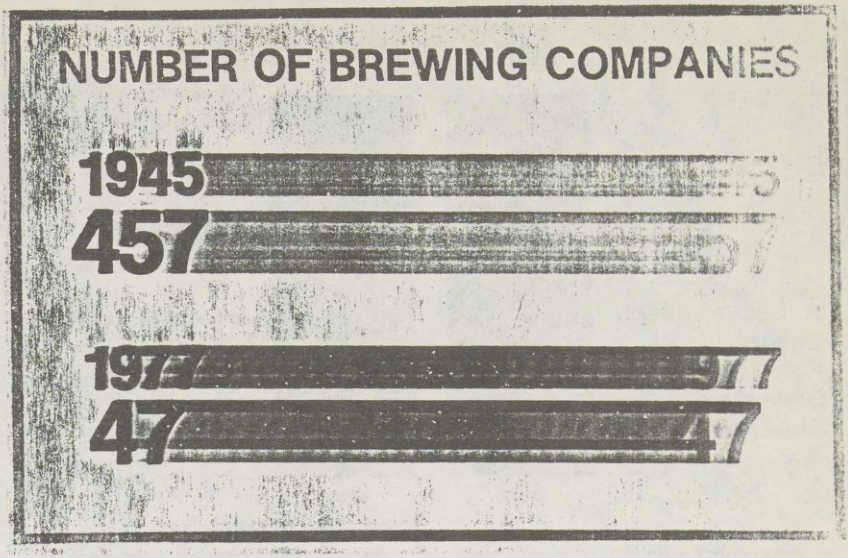
20 MARKET ACTIVITY
YEAR TO DATE
DECEMBER 17, 1977

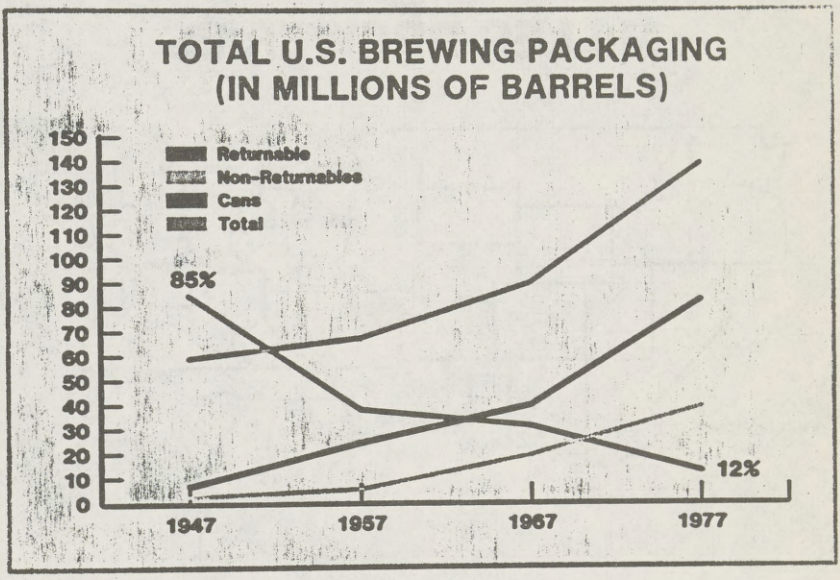
CATEGORY BY RANK	TOTAL ADS		% CHANGE	AVG. ADS PER ACOUNT		% ADS A/B/C
	1977	1976		1977	1976	
1. PROC. & NATL. CHEESE	27813	NA	—	11	—	12/26/62
2. CARB. SOFT DRINK	14243	13070	+9%	6	5	40/31/29
3. MARGARINE	11143	12535	−11%	4	5	26/28/45
4. REG. & COMB. FZ. VEG.	10905	15067	−28%	4	6	21/29/50
5. HEAVY DUTY DETERG.	10739	10417	+3%	4	4	39/34/27
6. DEODORANT	7369	7177	+3%	3	3	23/48/29
7. SHAMPOO	7232	6977	+4%	3	3	27/42/31
8. REGULAR COFFEE	7160	9415	−24%	3	4	43/16/41
9. PICKLES & RELISH	6681	6582	+2%	3	3	15/28/57
10. FRUIT DRINKS	6466	7095	−9%	3	3	25/30/45
11. FROZEN JUICE CONC.	6365	9026	−29%	3	3	26/29/45
12. POURABLE DRSNG.	6222	6580	−5%	3	3	16/27/57
13. LIGHT DUTY DETERG.	5908	5815	+2%	2	2	34/36/29
14. COLD CEREAL	5579	NA	—	2	—	37/18/44
15. CANNED CORN	5422	5516	−2%	2	2	44/28/27
16. PAPER TOWELS	5088	4797	+6%	2	2	38/30/32
17. BAR SOAP	5054	NA	—	2	—	21/36/42
18. ANALGESICS	5005	4936	+1%	2	2	24/48/28
19. BATHROOM TISSUE	4909	4614	+6%	2	2	40/28/33
20. FLOUR	4617	NA	—	2	—	46/19/35

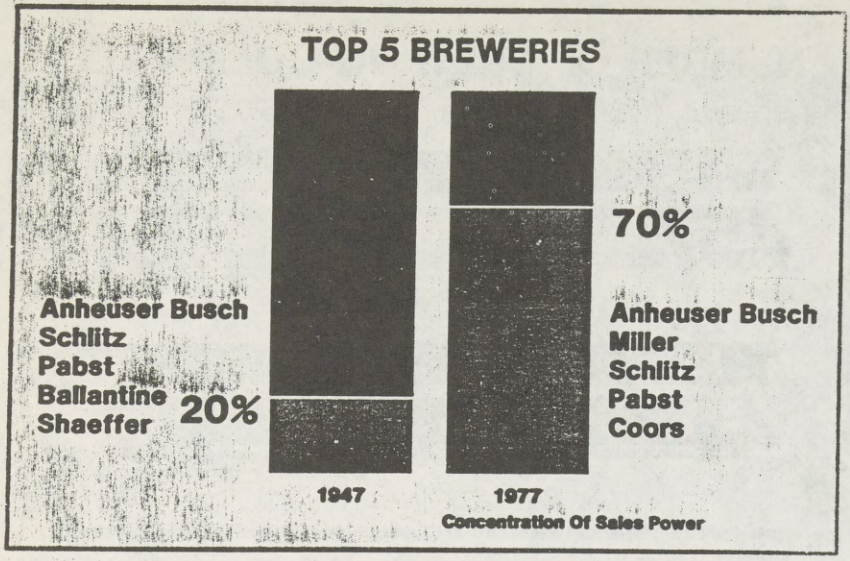
MAJERS CROSS CATEGORY

20 MARKET ACTIVITY
YEAR TO DATE
MARCH 11, 1978

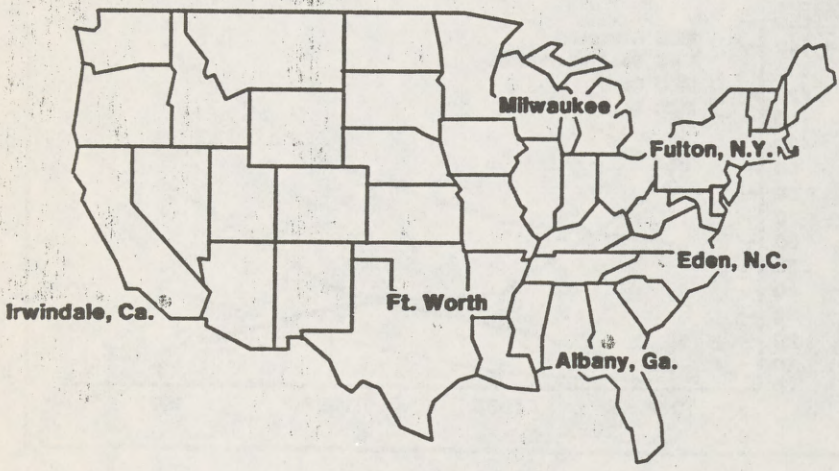
CATEGORY BY RANK	TOTAL ADS 1978	AVG. ADS PER ACCOUNT 1978	% ADS A/B/C	$ VOLUME RANK
1. PROC. & NATL. CHEESE	6790	12	12/28/60	2
2. CARB. SOFT DR.	3243	6	38/35/27	1
3. MARGARINE	2584	5	25/33/42	8
4. REG. & COMB. FZ. VEG.	2500	4	25/32/43	7
5. HVY. DUTY DETERG.	2351	4	40/35/24	6
6. REGULAR COFFEE	2207	4	46/19/35	4
7. DEODORANT	1472	3	21/51/28	25
8. SHAMPOO	1426	2	24/43/33	31
9. ANALGESICS	1395	2	24/46/30	38
10. CANNED CORN	1319	2	47/30/22	27
11. PICKLES & RELISH	1318	2	16/28/56	19
12. LT. DUTY DETERG.	1299	2	34/40/25	20
13. POURABLE DRSNG.	1247	2	14/31/55	29
14. FROZ. JUICE CONC.	1241	2	26/30/44	5
15. BATHROOM TISSUE	1144	2	41/32/27	12
16. PAPER TOWEL	1141	2	41/31/28	15
17. FRUIT DRINKS	1097	2	29/30/42	18
18. INSTANT COFFEE	1025	2	26/27/47	11
19. CANNED TUNA	1014	2	48/27/26	10
20. CATSUP	1010	2	41/34/26	32


NUMBER OF BREWING COMPANIES
1945
457
1977
47


TOTAL U.S. BREWING PACKAGING
(IN MILLIONS OF BARRELS)
150
140
130
120
110
100
90
80
70
60
50
40
30
20
10
0
Returnable
Non-Returnables
Cans
Total
85%
12%
1947
1957
1967
1977



MILLER BREWERIES



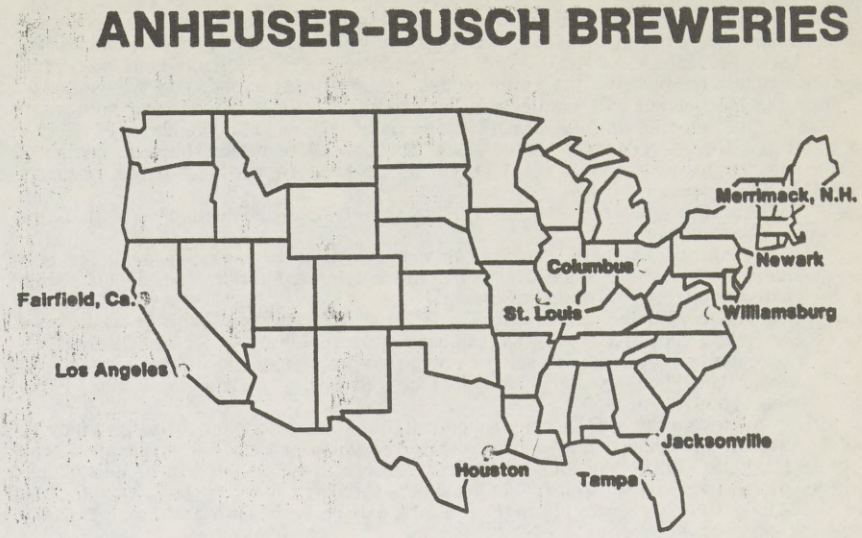


EXHIBIT 8

STATE OF NEW YORK, COUNTY OF NEW YORK, SS.:

AFFIDAVIT

Now comes Emanuel Goldman, who being first duly sworn, for his affidavit states as follows:

1. That he is a Securities Analyst specializing in the soft drink and brewing industries, employed by Sanford C. Bernstein & Co., Inc., in New York City.

2. That in his capacity as a Securities Analyst, he keeps track of factors, including marketing trends, cost considerations, industry growth and packaging trends that are likely to affect the future performance of particular soft drink companies and the soft drink industry as a whole. That he utilizes in the process statistical data, including that provided by U.S. Government agencies and soft drink industry trade association sources, and that he conducts interviews with corporate executives in individual soft drink companies.

3. His opinion concerning future industry performance is utilized by major financial institutions in connection with investments in the soft drink industry. He has published numerous reports on the industry, that include statistical data on particular companies within the industry. For the last four years running, he has been named one of the top three securities analysts covering the beverage industry in a nationwide poll of financial institutions.

4. He is familiar with the orders of the Federal Trade Commission in the *Coca-Cola* and *PepsiCo* cases (Docket Nos. 8855 and 8856, respectively) and has examined portions of the records, including the Commission's Opinion.

5. At the request of the Plaintiff in this case, he undertook a study to determine the probable effect of enforcement of the FTC's Orders on the nationwide soft drink "package mix" between returnable bottles, on the one hand, and metal cans and nonrefillable bottles on the other. In performing this study, he undertook an analysis of industry statistics and a series of interviews with soft drink syrup manufacturers and bottlers.

6. On the basis of this study, it is his opinion that the elimination of exclusive territorial franchises in the soft drink industry for cans and nonrefillable bottles will cause a significant decline in the percentage of soft drinks sold in returnable bottles. He believes that elimination of territorial exclusivity for cans and nonrefillable bottles will result in a decline of at least 5 percentage points per year and perhaps as high as 10 percentage points per year in the share of market accounted for by returnable containers. This would result in the elimination of the returnable bottle as a viable form of package in the soft drink industry within 4 to 8 years.

7. Elimination of exclusive territories will lead to a decline in returnable market share because:

(a) small, exclusive territories are required to make returnables economically feasible, since otherwise the bottler cannot be assured of recapturing enough of his glass; and

(b) supermarket chain stores will have the market leverage to indulge their long-standing strong aversion to returnables by ordering all their requirements from distant sources, whereas now they are under pressure to accept the "package mix" of the local, exclusively franchised bottler for each brand.

Thus not even the FTC's proviso permitting continued territorial exclusivity for returnables alone can save the returnable bottle, since it will not affect the supermarket's ability to order its entire requirements in the form of nonreturnable bottles and cans shipped from outside the territory.

8. The decline of returnable market share will be between 5 and 10 percentage points per year, because:

(a) approximately 50 percent of all returnable sales are currently made through supermarket outlets;

(b) bottlers will be strongly discouraged from reinvesting in that portion of the returnable bottle "float" (the total number of bottles in the possession of bottlers, retailers, and consumers) which previously serviced their supermarket accounts;

(c) the size of the "float" nationwide is approximately 4 billion bottles, or roughly 4 times the number purchased annually by bottlers to replenish the level of the "float";

(d) thus a 50 percent reduction in the rate of replenishment will lead to exhaustion of the "float" in 8 years, or a 5 percentage point annual decline;

(e) as the "float" contracts, the returnable bottle will become increasingly unattractive economically to bottlers and consumers which will reinforce the other disincentives to reinvestment in returnable bottles and possibly lead to a complete cessation of reinvestment;

(f) with no replenishment, the "float" will be consumed in less than 4 years.

9. A decline in returnable market share leads to a much more significant increase in the number of cans and nonreturnable bottles used by the industry. This is because each returnable bottle is used on the average of 20 times. Thus, each time a returnable bottle is eliminated from the stream of commerce, 20 additional comparably-sized, nonreturnable containers are required to deliver the same quantity of soft drinks.

10. If the returnable market share declines at a rate of 5 percentage points per year, we will, by 1982, have solid waste stream. In the event of a 10 percentage point decline, the number of additional one-way bottles and cans would be 63.8 billion.

Further affiant sayeth not

EMANUEL GOLDMAN,

Sworn to before me and subscribed in my presence this 21 day of February, 1979.

_____, _____,

Notary Public.

RESULT OF OREGON BEVERAGE DEPOSIT LAW
REFILLABLES

Year	Franchise Carbonated Soft Drink	Non-Franchise Beer
1971	56.8%	
1972	62.1%	36%
1973	89.7%	
1974	89.3%	96%
1975	90.3%	
1976	85.5%	83%
1977	81.4%	70%
1978	80.0%	49.8%
	(-10%)	(-48.1%)

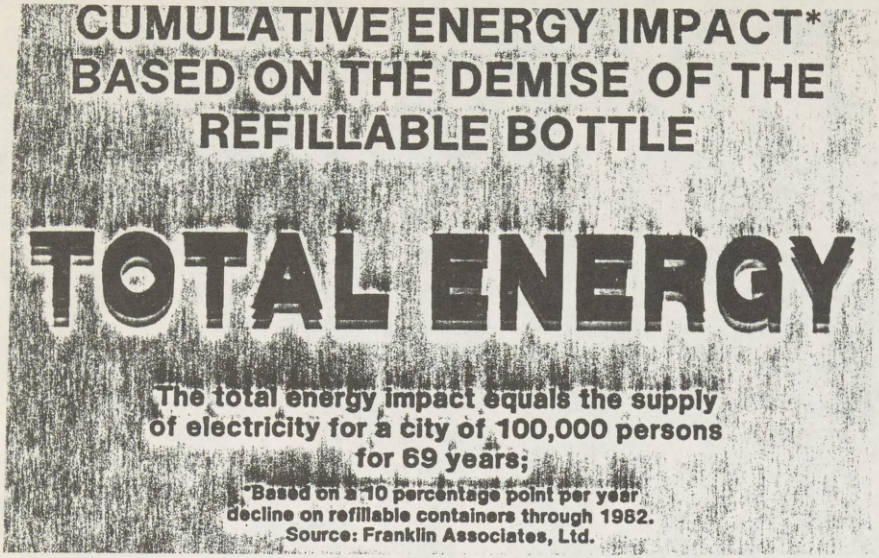
Source
Carbonated Soft Drink
Nielsen 80% of Oregon Market
Portland, Vancouver

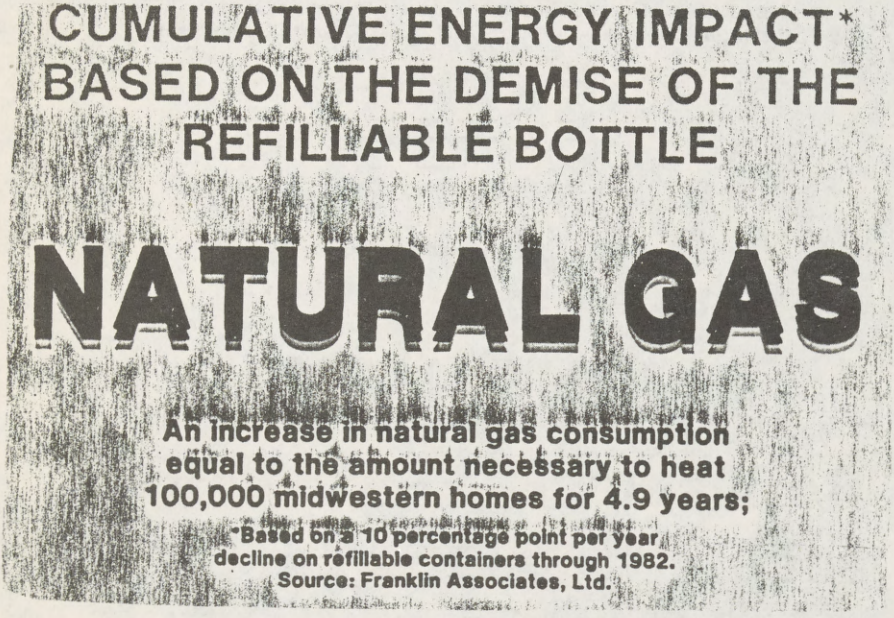
Source
Beer
Oregon Liquor
Control Commission

SALES
Beer - Non Franchise
Oregon

JUNE 1979

Refillables	-	36%
NR's	-	34.7%
Cans	-	29%


CUMULATIVE ENERGY IMPACT*
BASED ON THE DEMISE OF THE
REFILLABLE BOTTLE
TOTAL ENERGY
The total energy impact equals the supply
of electricity for a city of 100,000 persons
for 69 years;
*Based on a 10 percentage point per year
decline on refillable containers through 1982.
Source: Franklin Associates, Ltd.


CUMULATIVE ENERGY IMPACT*
BASED ON THE DEMISE OF THE
REFILLABLE BOTTLE
NATURAL GAS
An increase in natural gas consumption
equal to the amount necessary to heat
100,000 midwestern homes for 4.9 years;
*Based on a 10 percentage point per year
decline on refillable containers through 1982.
Source: Franklin Associates, Ltd.

CUMULATIVE ENERGY IMPACT* BASED ON THE DEMISE OF THE REFILLABLE BOTTLE

PETROLEUM

An increase in petroleum consumption equal to the amount of fuel requirements for 100,000 passenger cars (based on 14 miles per gallon and 12,000 miles per year, per car);

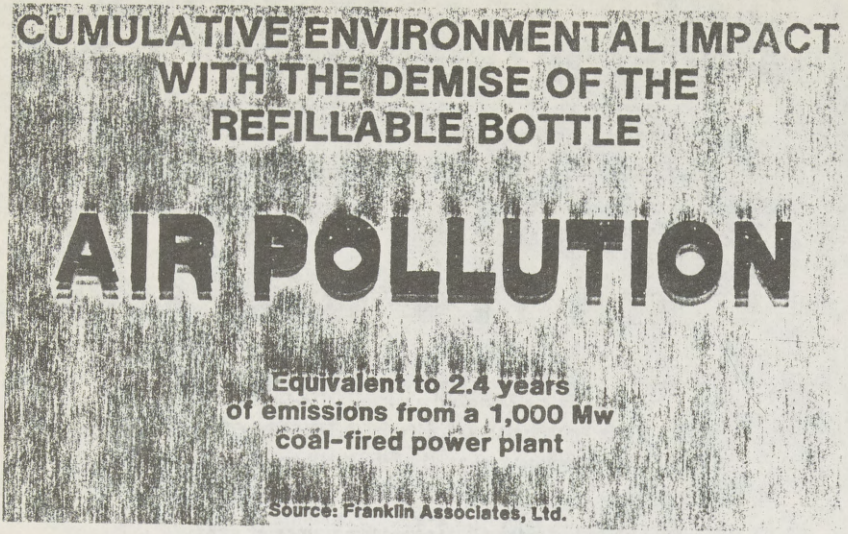
*Based on a 10 percentage point per year decline on refillable containers through 1982.
Source: Franklin Associates, Ltd.

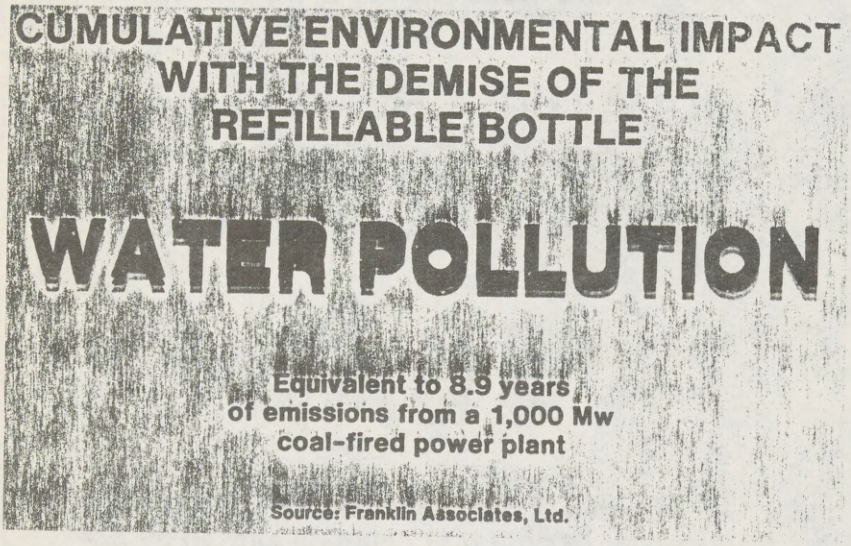
CUMULATIVE ENERGY IMPACT* BASED ON THE DEMISE OF THE REFILLABLE BOTTLE

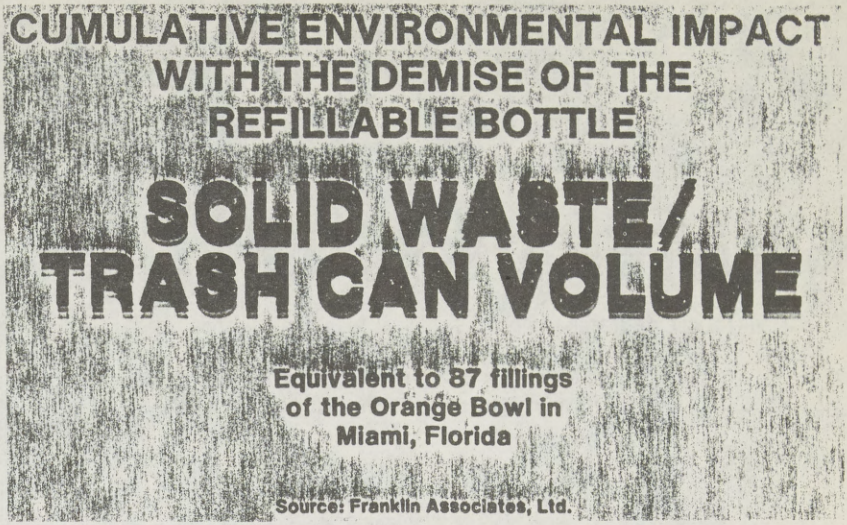
COAL

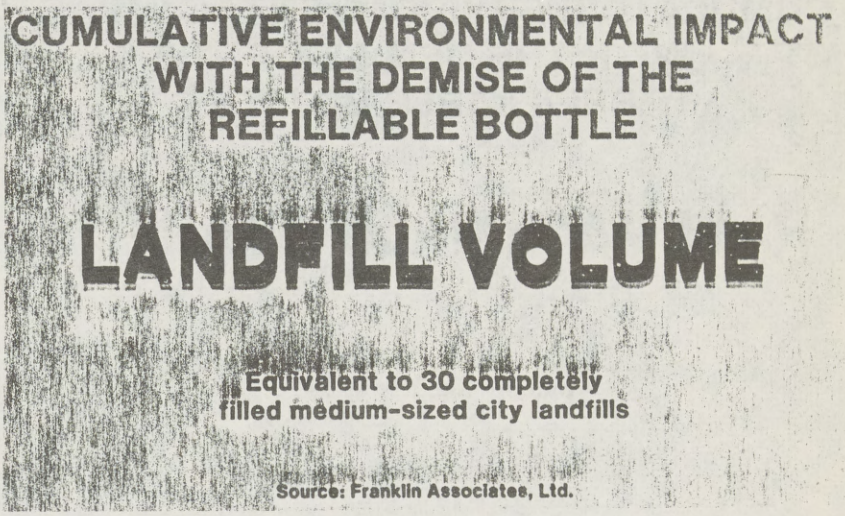
An increase in coal consumption equal to the amount of coal that could be carried by a train 686 miles long.

*Based on a 10 percentage point per year decline on refillable containers through 1982.
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
AIR POLLUTION
Equivalent to 2.4 years
of emissions from a 1,000 Mw
coal-fired power plant
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
WATER POLLUTION
Equivalent to 8.9 years
of emissions from a 1,000 Mw
coal-fired power plant
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
SOLID WASTE/
TRASH CAN VOLUME
Equivalent to 87 fillings
of the Orange Bowl in
Miami, Florida
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
LANDFILL VOLUME
Equivalent to 30 completely
filled medium-sized city landfills
Source: Franklin Associates, Ltd.

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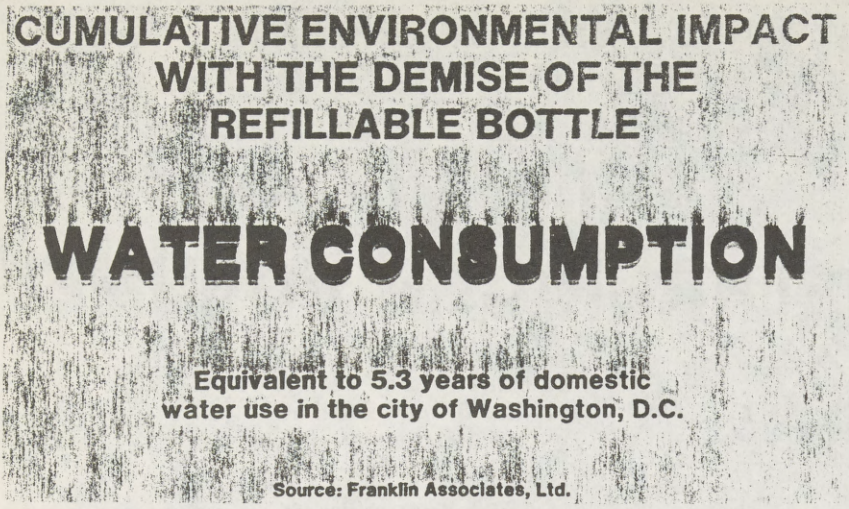
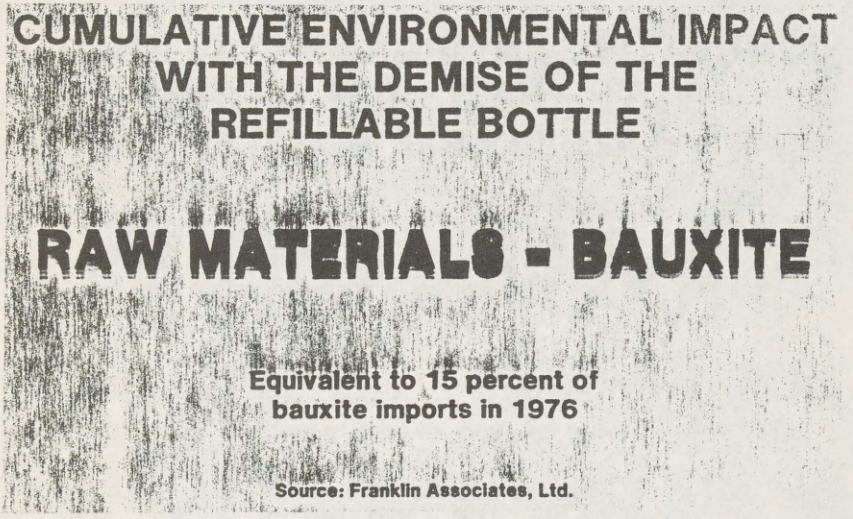
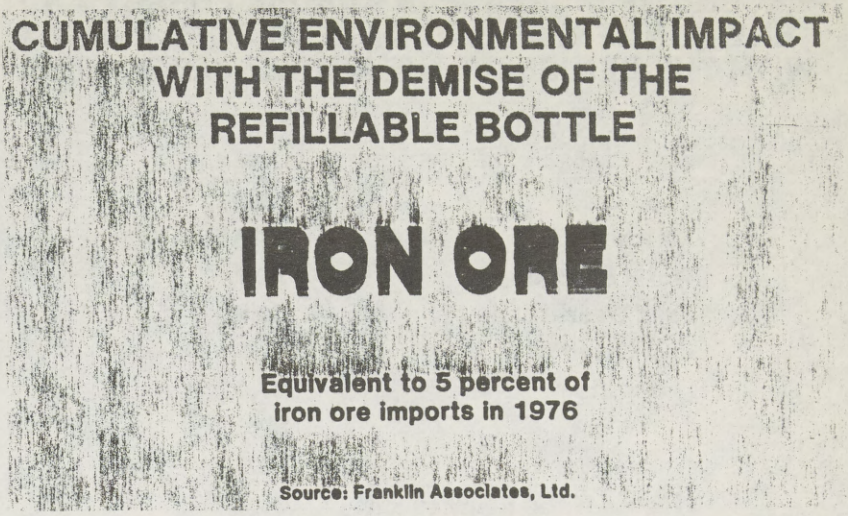
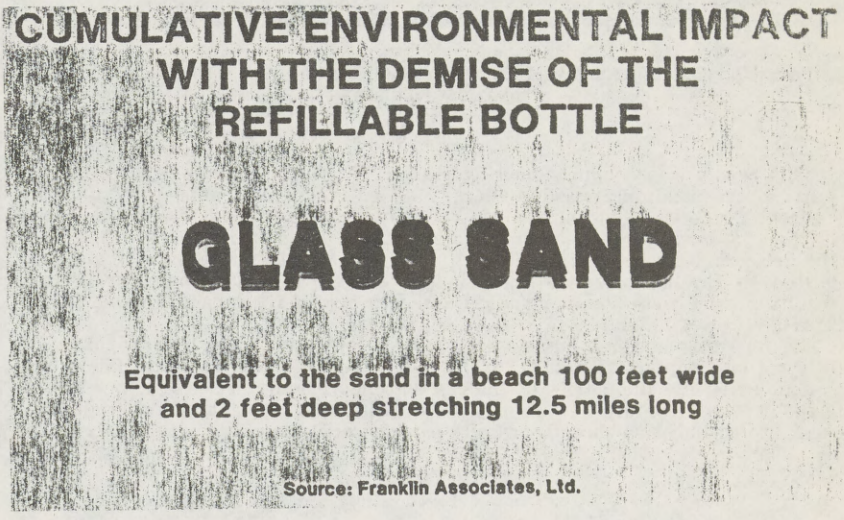
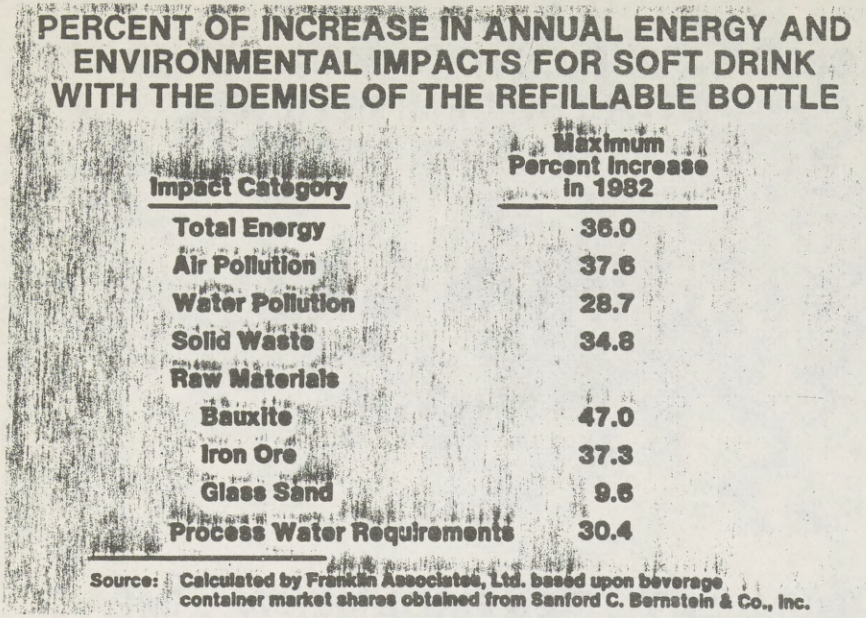

CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
WATER CONSUMPTION
Equivalent to 5.3 years of domestic
water use in the city of Washington, D.C.
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
RAW MATERIALS - BAUXITE
Equivalent to 15 percent of
bauxite imports in 1976
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
IRON ORE
Equivalent to 5 percent of
iron ore imports in 1976
Source: Franklin Associates, Ltd.


CUMULATIVE ENVIRONMENTAL IMPACT
WITH THE DEMISE OF THE
REFILLABLE BOTTLE
GLASS SAND
Equivalent to the sand in a beach 100 feet wide
and 2 feet deep stretching 12.5 miles long
Source: Franklin Associates, Ltd.



PERCENT OF INCREASE IN ANNUAL ENERGY AND ENVIRONMENTAL IMPACTS FOR SOFT DRINK WITH THE DEMISE OF THE REFILLABLE BOTTLE

Impact Category	Maximum Percent Increase in 1982
Total Energy	36.0
Air Pollution	37.6
Water Pollution	28.7
Solid Waste	34.8
Raw Materials	
Bauxite	47.0
Iron Ore	37.3
Glass Sand	9.6
Process Water Requirements	30.4

Source: Calculated by Franklin Associates, Ltd. based upon beverage container market shares obtained from Sanford C. Bernstein & Co., Inc.

ENERGY AND ENVIRONMENTAL IMPACTS ASSOCIATED WITH A FEDERAL TRADE COMMISSION DECISION

PREFACE

This report was commissioned by Richard G. Gay, attorney at law, for the purpose of examining possible energy and environmental impacts of a recent Federal Trade Commission decision concerning the soft drink franchise system in the U.S. Possible changes in container shares for soft drinks resulting from the decision were determined by Sanford C. Bernstein and Company and submitted to Franklin Associates, Ltd. The energy and environmental impacts resulting from these possible changes in container shares were evaluated in this report.

The report is in three basic sections. Chapter I is a brief overall summary, followed by Chapters II and III which describe details of the methodology and present extensive summaries of the calculations. Finally, a set of appendices is included which contain details of the calculations. Sufficient details and references are included so that the results can be verified by interested individuals.

CHAPTER I

SUMMARY

OVERVIEW

This study was performed to determine the energy and environmental impacts associated with possible effects of a change in soft drink container market shares that may follow from a recent FTC decision on franchises. A detailed set of scenarios projecting the effect of the FTC decision on soft drink container shares was provided by Sanford C. Bernstein & Co., Inc. Four market share scenarios were used in this analysis—one representing baseline conditions (no change in refillables) and three representing varying declines in refillable market shares. The decline scenarios correspond to annual decreases in refillable con-

tainer market shares equal to 5, 7, and 10 percentage points of the total market annually. The scenarios are projected over the period 1978 to 1982.

The energy and environmental impacts associated with the projected container mix under each scenario were calculated using unit energy requirements for each container system. The resultant impacts for each scenario were directly compared with the baseline impacts to ascertain the effects of the scenarios on energy and resource requirements and overall environmental quality.

RESEARCH METHODOLOGY

The procedure used to determine the energy and environmental impacts associated with the FTC decision scenarios consisted of several levels of calculations. They are listed and briefly described below.

(*1*) *Container Market Share Modifications.*—The market share scenarios obtained from Sanford C. Bernstein & Co., Inc., made three container distinctions: nonrefillable ("one-way") bottles, metal cans, and refillable bottles. Franklin Associates, Ltd. further differentiated cans and nonrefillable bottles into three container types each. The seven container distinctions used to determine overall resource and environmental impacts are as follows:

Aluminum cans.
2-piece bimetal cans (a style of steel can with an aluminum lid).
3-piece bimetal can (another type of steel can with an aluminum lid).
Nonrefillable glass bottles.
Plastic-coated glass bottles.
Refillable glass bottles.
PET (plastic) bottles.

Figure I–1 is a simplified illustration of the effects of the scenarios on container market shares through 1982. All containers are categorized into two container classifications on that figure (refillables and one-ways). The scenarios depict a decline in refillable bottle share, and corresponding growth in the use of one-ways. The extent of the shift from refillables to one-ways is different for each scenario, with the refillables ranging from a 0 to 20 percent share by 1982 and a corresponding 80 to 100 percent share by the one-ways. This compares to a projected baseline of 40 percent market share for refillables and 60 percent share for one-ways without the FTC decision.

(*2*) *Determination of Container System Impacts*—To account for the resource and environmental impacts of each soft drink container alternative, a systems approach was used. The impacts associated with soft drink delivery in each of the container types described with raw materials extraction, proceeding through processing, manufacturing, use, and final disposal of the container and secondary packaging, and including filling and transportation. This systems analysis is structured to determine all inputs and outputs at each stage of the container's "life cycle." Then, these data condense into several basic impact categories. These categories serve as the basis for determining the overall effect on environmental quality. They are listed below:

Total Energy Consumption.
Energy Source Summary.
Raw Materials Consumption.
Air Pollutant Emissions.
Water Pollutant Discharges.
Industrial Solid Waste.
Postconsumer Solid Waste.
Process Water Requirements.

The impacts associated with the delivery of 1,000 gallons of soft drink have been quantified for each impact category.

(*3*) *Resource and Environmental Impact Projections*—The resource and environmental impacts associated with each container type are not constant because they depend on several variable factors. Under competitive circumstances there would be changes even under a "status quo" situation. Franklin Associates projected impacts through 1982 based upon expected "status quo" changes in recycling rates, container innovation which result in improved container manufacturing efficiencies. These projections are based primarily upon current industrial trends and expectations.

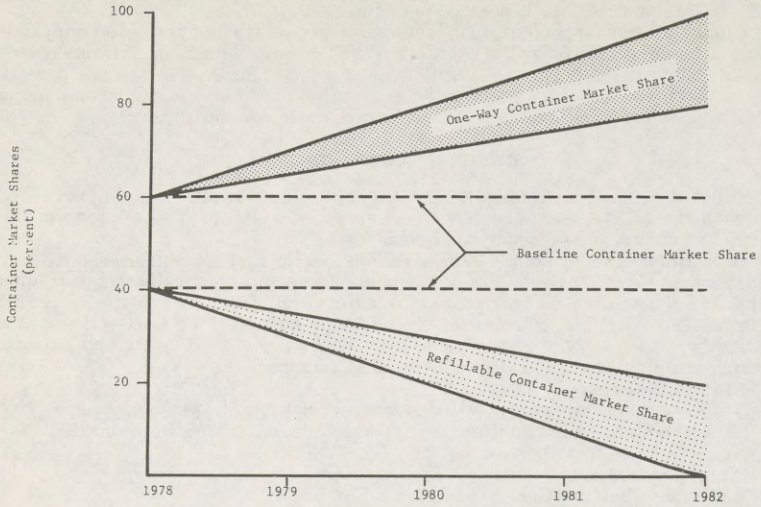


Figure I-1. The effects of the FTC decision scenarios on refillable soft drink container market share.

STUDY RESULTS

The interpretation of results of a study of this type is usually complicated by the fact that several impact categories have been investigated and impacts will increase in some categories and decrease in others. If a given situation produces adverse effects in some impact categories and favorable effects in others, the analysis of results is quite difficult because relative impact judgments must be incorporated into the analysis. On the other hand, when all impact categories are adversely affected one can safely assume the prospective conditions lead to negative overall impacts. The scenarios in this study which project a decline in refillables equal to 5 to 10 percent of the soft drink market share result in an adverse effect for each impact category. Therefore an overall negative impact is readily apparent.

The energy and environmental impacts associated with the scenarios are presented in a summarized form in the following sections. For a more complete presentation as well as a more thorough discussion of the results, see Chapter III of this report.

Energy Impacts

A summary of the energy impacts associated with the three scenarios is presented in Table I–1. Energy impacts are quantified cumulatively through 1982 for total energy as well as for natural gas, petroleum, and coal. The difficulty in comprehending such large numbers led to the development of equivalent expressions of each impact quantity. These equivalencies are also included in Table I–1. Inspection of these data show the three scenarios causing a significant impact in terms of energy consumption. The consumption of each energy source is increased by the accelerated shift to one-way containers, particularly for coal, which is a major electrical energy fuel used extensively in can manufacture. Also, increasing significantly is natural gas, a primary fuel in the manufacture of glass bottles.

The basic reason for these energy increases is that new one-way containers must be manufactured for each filling, while refillable bottles are simply washed and reused. Thus, the refillable bottles require less energy per fluid ounce of soft drink consumed. Figure I–2 graphically displays the effect of the three scenarios on total energy consumption for the entire soft drink packaging cycle. Note that energy use is expected to increase by 17 to 36 percent under the conditions of the scenarios which were predicted on the FTC decision.

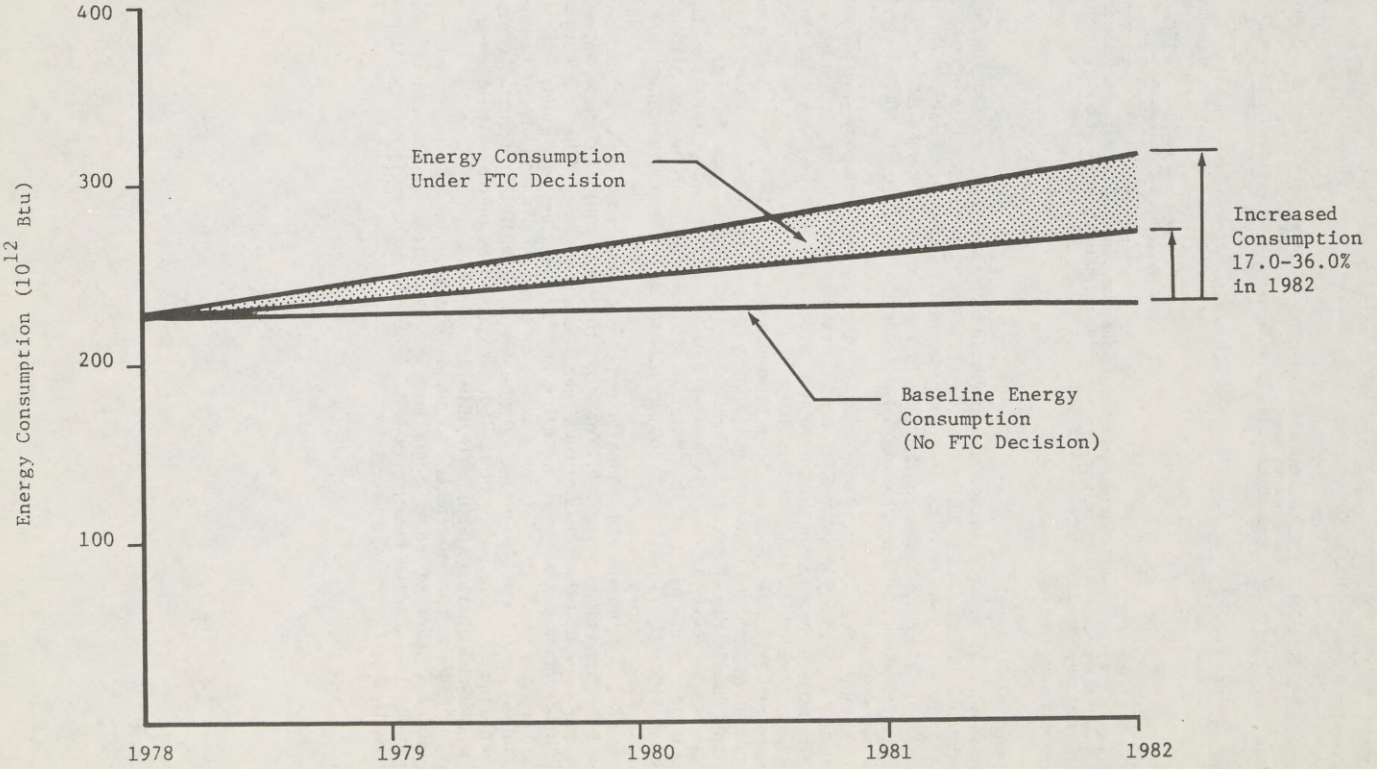


Figure I-2. The effects of the FTC decision scenarios on annual energy consumption in the soft drink industry.

TABLE I–1. SUMMARY OF CUMULATIVE ENERGY IMPACTS ASSOCIATED WITH THE EFFECTS OF 3 SCENARIOS ON SOFT DRINK CONTAINER MARKET SHARES

Impact category	Increased energy consumption [1] (10^{15} Btu)	Equivalent units	Remarks
Total energy	102 to 206	9,267,000,000 to 18,533,000,000 kWh.	Equivalent to the electrical energy consumed by a city of 100,000 in 34 to 69 yr.
Natural Gas	35 to 70	33,000,000 to 66,000,000 ft³.	Equivalent to the natural gas requirements for heating 100,000 Midwestern homes for 2.4 to 4.9 yr.
Petroleum	19 to 39	3,400,000 to 6,800,000 bbl.	Equivalent to 3.8 to 7.6 days of Iranian oil imports or 65,000,000 to 129,000,000 gallons of gasoline.
Coal	37 to 74	1,400,000 to 2,900,000 tons.	If placed in a coal train, the train would stretch 331 to 686 mi, or a maximum distance extending from Washington, D.C., to Chicago.

[1] The range represents the increased consumption of energy associated with expected decreases in refillable container market shares (5 to 10 pct annually). The low is for a 5-pct annual phaseout; the high is for a 10-pct annual phaseout of refillables. Values represent cumulative increases through 1982.

Source: Franklin Associates, Ltd.

Environmental Impacts

Environmental impacts include the discharge of pollutants as well as the consumption of valuable raw materials (except energy, which is tabulated separately). Table I–2 summarizes the environmental impacts associated with the three scenarios. Again, note a considerable increase in each impact category. The equivalencies shown in this table allow the reader to visualize the magnitude of the impacts to some extent.

The annual effects of the decision on each impact category are shown graphically in Figure I–3 for pollution and waste generation and in Figure I–4 for natural resource consumption. For each impact category, the percent increase in the impact which is due to the FTC decision is quantified for 1982. The percent increases are expressed as a range, representing the 5 to 10 percent scenarios. The maximum percent of this range is important because it is this value which will approximate the effect of the decision beyond 1982. If one assumes other factors such as recycling rates, container market shares, and pollution control attain a near equilibrium at this point in time, the annual impacts will not change significantly beyond 1982, but the difference between the scenarios will accumulate indefinitely.

Table I–3 is a summary of the maximum percent increases which are projected for each impact category in 1982. Note that the consumption of glass sand is increasing much less than each of the other impact categories. This is because a nonrefillable glass container is replacing a refillable glass container, both of which use glass sand. The difference is not as large as for iron ore or bauxite (aluminum), which are also replacing refillable glass bottles. In terms of energy consumption and waste generation, all are expected to increase by about one-third as compared to baseline impacts in 1982.

The increases in raw materials and energy consumption can be viewed from an additional point of view. Some fraction of increased consumption will undoubtedly be imported because each of these commodities is a large import item (particularly crude oil and bauxite).

CONCLUSION

The projected container market shares developed by Sanford C. Bernstein & Co., Inc., show the FTC decision could lead to a significant increase in the impact on resources and the environment in every impact category which was examined.

The scenarios evaluated indicate a growth in the use of types of containers which are less resource and environmentally efficient than the refillable containers they would displace.

TABLE I–2.—SUMMARY OF THE CUMULATIVE ENVIRONMENTAL IMPACTS ASSOCIATED WITH THE EFFECTS OF THE FTC-DECISION SCENARIO ON SOFT DRINK CONTAINER MARKET SHARES

Impact category	Increased waste generation or consumption [1]	Remarks
Air pollution	385,000,000 to 773,000,000 lb	Equivalent to 1.2 to 2.4 yr of emissions from a 1,000-MW coal-fired powerplant.
Water pollution	67,000,000 to 186,000,000 lb	Equivalent to 3.2 to 8.9 yr of emissions from a 1,000-MW coal-fired powerplant.
Solid waste: [2]		
Trash can volume	30,000,000 to 87,000,000 yd^3	Equivalent to 30 to 87 fillings of the Orange Bowl in Miami, Fla.
Landfill volume	12,000,000 to 30,000,000 yd^3	Equivalent to 12 to 30 completely filled medium-sized city landfills.
Water consumption	43,000,000,000 to 87,000,000,000 gal	Equivalent to 2.8 to 5.3 yr of domestic water use in the city of Washington, D.C.
Raw materials:		
Bauxite	2,114,000,000 to 4,253,000,000 lb	Equivalent to 7 to 15 pct of bauxite imports in 1976.
Iron ore	2,373,000,000 to 4,775,000,000 lb	Equivalent to 2 to 5 pct of iron ore imports in 1976.
Glass sand	635,000,000 to 1,296,000,000 lb	Equivalent to the sand in a beach 100 ft wide and 2 ft deep stretching 6.1 to 12.5 mi long.

[1] Values represent cumulative increases through 1982.
[2] Trash can volume represents the actual waste density at the time of disposal, while landfill volume represents the compacted waste density following conventional landfill disposal procedures.

Source: Franklin Associates, Ltd.

TABLE I–3.—*Percent increases in annual energy and environmental impacts for soft drink under three-decision scenarios—1982*

Impact Category:	*Maximum pecent increase in 1982*
Total energy	36.0
Air pollution	37.6
Water pollution	28.7
Solid waste	34.8
Raw materials:	
Bauxite	47.0
Iron ore	37.3
Glass sand	9.6
Process water requirements	30.4

SOURCE.—Calculated by Franklin Associates, Ltd., based upon beverage container market shares obtained from Sanford C. Bernstein & Co., Inc.

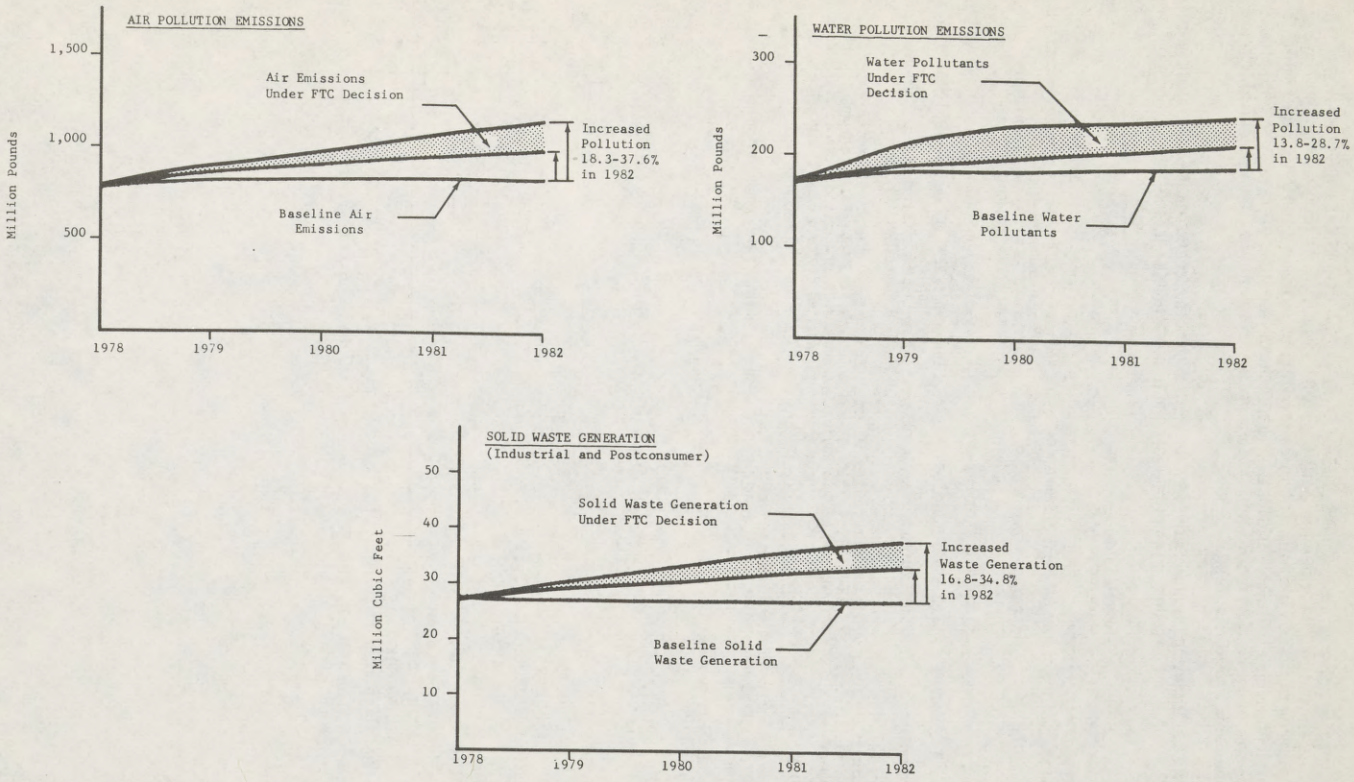
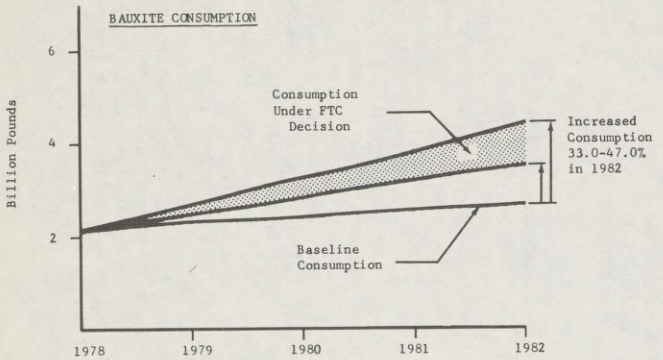
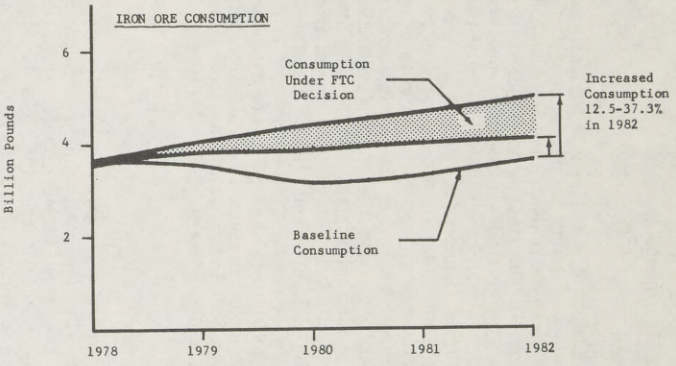
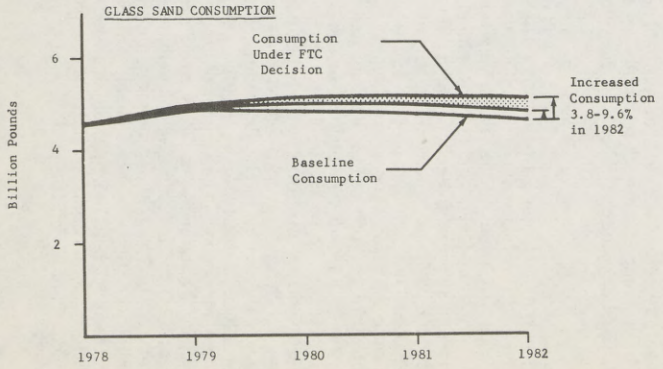


Figure I-3. The effects of the FTC decision scenarios on annual pollution emissions and waste generation in the soft drink industry.







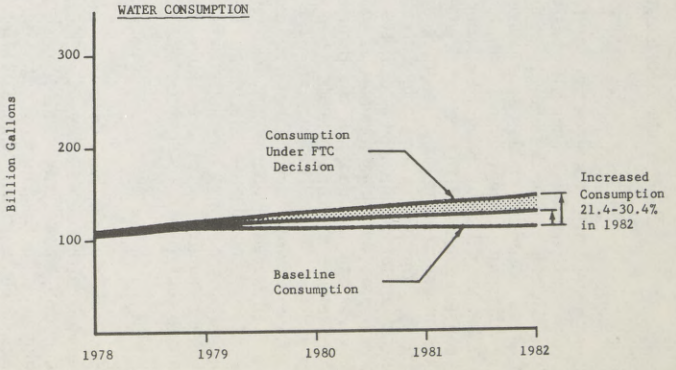


Figure I-4. The effects of the FTC decision scenarios on annual natural resource consumption for the manufacture of soft drink containers.

Chapter II

Study Approach and Methodology

INTRODUCTION

The purpose of a resource and environmental profile analysis is to determine the comparative effects that alternative conditions have on environmental conditions. In this study the overall environmental effects associated with specific soft drink container market shares are compared. The various container market share alternatives represent baseline growth projections as well as container scenarios provided by Sanford C. Bernstein and Company which could reflect the consequences of the recent Federal Trade Commission (FTC) Decision.

The unique feature of a resource and environmental profile analysis is that it does not focus on a single manufacturing operation, nor on a single resource or environmental effluent. Instead, the beverage container is viewed as a system which begins with the removal of raw materials from the earth (by mining or harvesting), includes all the intermediate manufacturing, transporting, and use sequences, and finally ends when the container is returned to the environment for final disposal or recycling (Figure II–1). For each step in the system, resource use and environmental impacts are determined. Resource use is expressed in terms of energy and materials; environmental impacts are expressed in terms of pollutants discharged to the common media—air, water, and land. The final step of the analysis is a direct comparison of the environmental impacts associated with the delivery of soft drink to the consumer for each beverage container market share scenario.

PURPOSE OF STUDY

The purpose of this study was to determine the total environmental impacts associated with the delivery of soft drink to the consumer under baseline conditions and to compare that impact with projected impacts under scenarios developed as an estimate of the impact of the FTC decision. The baseline impact levels represent a continuation of the historical trends in beverage container market shares while the scenarios result in a projected decline in refillable container shares. Three scenarios have been developed. They result in projected decreases in refillable container market shares equal to 5, 7, and 10 percentage points annually of total soft drink consumption.

Direct comparisons were made between scenarios for the purpose of determining the potential effect of the changes on overall environmental quality.

BASIC APPROACH

The approach used to quantify the energy and environmental impacts associated with soft drink delivery is based upon an input-output materials flow analysis. In such an analysis, master flowsheets are developed for each container option (REF glass, NR glass, aluminum cans, etc.) which consist of numerous processes, each being a phase of container manufacture or beverage distribution. Each process in a given beverage container system is analyzed as a separate, independent step in the total sequence of steps producing the desired end product. This process analysis involves determining all material and energy inputs into the process as well as determining the product output quantity and any waste materials generated in the process. All inputs and outputs are specifically categorized as to their nature. For example, waste materials are classified as either air pollutants, water pollutants, industrial solid waste, or postconsumer solid waste. Additionally, the type of pollutant is also noted. Air pollution generated from a particular industrial process will be classified into one of several itemized categories, such a s hydrocarbons, sulfer oxides, etc.

For each process, the impacts associated with a standard unit of 1,000 pounds of output is determined. Following the calculation of this detailed impact information for each process, the master flowsheet for each beverage container system is utilized. This master flowsheet allows the researcher to correctly weigh the extent to which each process is used and thus calculate the impact associated with delivering 1,000 gallons of packaged soft drink in each type of container. The summary of these impacts for each container system served as the base from which the various scenario impacts were calculated.

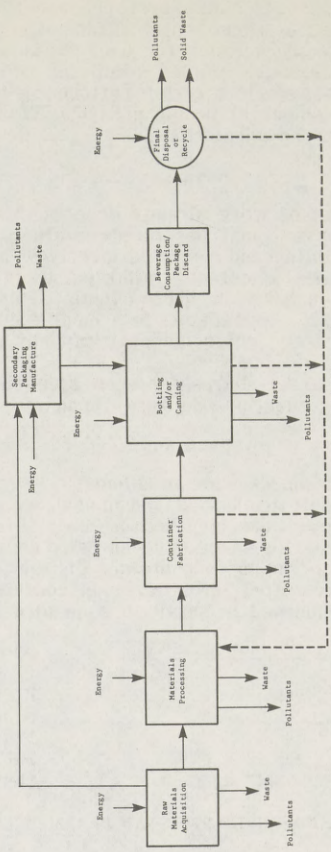


Figure II-1. Flow scheme for resource and environmental impacts of beverage container manufacture and use.

The enviromnmental impact summary procedure for each container system involved a complicated series of calculations. Literally, thousands of calculations were necessary to correctly account for each manufacturing process of each beverage container system. A complex computer program was designed for Franklin Associates, Ltd. specifically for performing the calculations relevant to a resource and environmental profile analysis. This computer program was used to carry out many of the calculations.

DATA SOURCES

Because of the amount of work already done in this field, the derivation of impact data for the conventional beverage containers was based on previous studies. Thus, the 1977 data base consisted largely of a modification of a study performed for an industrial client of Franklin Associates, Ltd.[1] Environmental impact data for the projected years were calculated based upon industrial and governmental expectations. Appendix G is a complete discussion of the anticipated trends in resource and environmental impacts associated with beverage delivery.

Beverage container market shares for each scenario were obtained from a private, independent organization, Sanford Bernstein and Company.

DATA MODIFICATION

The container market shares were modified by Franklin Associates, Ltd. to represent the volume of soft drink packaged in each selected container type. This modification procedure was necessary because only three container distinctions were provided in the scenarios whereas seven basic containers were selected for inclusion in the analysis. The three container distinctions shown below on the left, were further differentiated into the seven container types shown on the right. This process is explained in detail in Appendix H.

Cans	Aluminum Cans
	2-Piece Bimetal Cans
	3-Piece Bimetal Cans
One-Way Containers	Nonrefillable Glass Bottles
	Plastic-Coated Glass Bottles
	PET (plastic) Bottles
Refillable Containers	Refillable Glass Bottles

RESOURCE AND ENVIRONMENTAL PARAMETERS INCLUDED

For each process, the following seven parameters were determined.

(*1*) *Energy.*—Energy in million Btu is reported as a total requirement and in terms of specific components. The energy components are reported in the following six categories: Natural gas, petroleum, coal, hydropower, nuclear, and wood (self-generated power in pulp mills).

The energy components used in each operation, including transportation, for a given product output were determined. Process energy used by the actual manufacturing operations were included. That used for space heating of buildings and other miscellaneous categories was excluded wherever possible. The energy content of certain organic raw materials was included in energy summations. The second-order energy necessary to extract, process, and transport fuels was included as well as the heat of combustion of the specified fuels used in a system. The energy value assigned to electricity use was the energy associated with the consumption of fuels necessary to deliver electricity to the consumer (see Appendix A for more details).

(*2*) *Raw Materials.*—The quantity in pounds and the type of virgin raw materials input to each operation were determined in terms of a given product output. Materials not intended to become a part of the finished product, such as cooling water and fuels, were excluded from raw materials. Other raw materials, such as additives, which aggregate to less than 5 percent of the total weight of the finished container were included in this category by reporting their weight in the finished product. This provides an estimate of the virgin raw materials

[1] Bider, W. L. and R. G. Hunt, "Family-Size Soft Dring Containers—A Comparative Energy and Environmental Impact Analysis," prepared for the Goodyear Tire & Rubber Co. by Franklin Associates, Ltd., November 1977.

which should be allocated to materials used in low quantities in the finished product.

(3) *Air Pollutants.*—The emissions in pounds of substances classified as pollutants were determined per unit of product output. Fourteen identifiable pollutants were considered for each operation—particulates, nitrogen oxides, hydrocarbons, sulfur oxides, carbon monoxide, aldehydes, other organics, lead, reduced sulfur, ammonia, hydrogen fluoride, mercury, chlorine, and sulfides. The amounts reported represent actual discharges into the atmosphere after existing emission controls have been applied. It was assumed that all processes are currently meeting 1977 air pollution standards. All atmospheric emissions were considered on an equal basis; no attempt was made to determine the relative environmental effects of each of these pollutants.

(4) *Water Pollutants.*—This category includes the water pollutants in pounds from each operation per unit of product output. The effluent values are those after wastewater treatment has been applied and represent discharges into receiving waters. All waterborne effluents are assumed to meet 1977 guidelines as specified by the U.S. EPA. Nineteen specific pollutants are included—BOD, COD, suspended solids, dissolved solids (oil field brine), oil, fluorides, phenol, sulfides, acid, alkalinity, metal ions, cyanide, ammonia, iron, ferrous sulfate, chromium, tin, phosphates, and others. Other factors such as turbidity and heat were not included because usable data were not available.

(5) *Industrial Solid Wastes.*—The volume of solid waste per unit of product output which must be landfilled or disposed of in some other way was determined also. Three categories were measured: process losses, fuel discards—includes wastewater treatment sludges, solids resulting from air pollution control, and trim and waste materials from manufacturing operations which are not recycled. Fuel combustion residues are ash generated by coal combustion. Mining wastes are primarily materials discarded due to raw ore processing and do not include overburden removed to expose ore.

(6) *Postconsumer Solid Wastes.*—The volume of solid wastes generated by disposal of the container and its associated packaging was determined. This is solid waste which most likely would be discarded into municipal solid waste streams. Correction for recycling and reuse rates have been incorporated into net solid waste totals.

(7) *Water Consumption.*—The volume of process water in thousand gallons discharged per unit of product output from each operation was reported. An alternative measure of water is the actual volume consumed or removed from natural water cycles. However, such data are not available for every system. This category considers *water discharged* only, not what is discharged from a process into the water in the form of pollutants. (This factor is covered separately.)

ASSUMPTIONS

Some assumptions are always necessary to limit a study to reasonable scope, and it is important to know what assumptions have been made. The principal assumptions and limitations for this study are discussed below.

Data Sources

The basic data for 1977 were taken from a study performed by Franklin Associates, Ltd. for the Goodyear Tire and Rubber Company which was previously cited. Data in that study were collected from a variety of sources, including published technical literature, reports of previous energy and environmental studies, and personal interviews within the various industries involved. Because of the cooperation of managers in the industries involved, it was possible to obtain national average or "typical" data specific to the container systems. It was assumed that the data supplied by the various industries are accurate and representative.

Geographic Scope

Impacts associated with imported materials are included. In most cases, it was assumed that foreign impacts would be similar to comparable activities in the U.S.; thus U.S. data were applied to foreign operations. For instance, iron ore mined in Canada was assumed to produce the same impacts on a 1,000 pound basis as domestic iron ore.

Secondary Energy Requirements

The energy content of fuels was assumed to include the energy requirements for extraction, processing, and transporting of fuels, in addition to the primary

energy of a fuel resulting from its combustion. However, impacts for manufacture of capital equipment were not included, nor was the energy for heating and lighting of buildings included.

Small Quantities of Materials

The impacts associated with materials which aggregate to less than 5 percent by weight of the container were not included. The list of materials which comprise the "less than 5 percent" category was examined to insure that no known "high environmental impact" materials were excluded from the analysis. This inspection insures that the values from this assumption do not lead to an error of greater than 5 percent in the final results.

Electricity

For most industries, electricity is a minor source of energy, and detailed data do not exist on the fuels used to generate this electricity for each industry. Therefore, the national average energy expenditure of 11,027 Btu per kilowatt-hour (1977) was used for most industries (see Appendix A). However, the aluminum industry is based on electrochemical processes and is, therefore, electricity-intensive. Aluminum smelting plants are generally located close to specific electricity power sources (e.g., hydropower). Thus, a set of regional grids was developed from published data to reflect the actual power grids from which aluminum smelters draw their energy. A discussion of those energy values compared to those obtained with national grid calculations is included in Appendix A.

Energy Content of Material Resources

The primary material resources for plastic products are natural gas and petroleum, and the principal use of these materials in this country is as fuels. Thus, the total energy requirement for plastic products is treated as being the energy value of the fuels used as materials, plus the fuels used in the manufacturing processes.

Point Sources of Pollution

The burden on specific ecosystems was not considered—i.e., at specific point sources or geographic locations. It was assumed that the operations took effect on the environment everywhere, not just where specific manufacturing operations are presently located.

Consumer Impacts

Impacts related to consumer activities such as transporting a beverage home from the retail store were not included. It was assumed that trips to retail stores are necessary for other reasons, and should not be attributed to the container systems. Other consumer impacts (except disposal of the container) relate to the beverage itself, not the container.

Chapter III

Results and Discussion

Introduction

This chapter summarizes the energy and environmental impacts associated with projected effects of the recent Federal Trade Commission (FTC) decision on the soft drink industry. A baseline soft drink container market share is first considered assuming no FTC decision. This is represented by a continuation of the historical trends in individual container growth rates. The impacts associated with the baseline shares are directly compared to the impacts associated with possible container market shares under the FTC decision. Three container market share scenarios have been developed for conditions under this decision. The scenarios, as developed by Sanford C. Bernstein and Company, represent an expected decline in refillable bottle market shares equal to 5, 7, and 10 percentage points annually.

The calculated results of energy and environmental impacts are presented in two ways in this chapter. The first method is a presentation of the raw impact data quantified in appropriate technical terms such as Btu for energy, pounds for air pollutants, and so forth. To assist in understanding the magnitude of the very large numbers in the raw data a second method of presentation of the impact data was used. Analogies have been drawn which represent equivalent expressions of the various impacts. These analogies are intended to help the reader to visualize or better understand impact data which would otherwise be expressed only in technical terms.

SOFT DRINK CONTAINER MARKET SHARES

The environmental impacts which could arise from the recent FTC decision depend on the effects of the decision on soft drink container market shares. Three scenarios were developed by the staff of Sanford C. Bernstein and Company which project container market shares through 1982. Based on these projections, staff of Franklin Associates developed a data base which quantified the volume of soft drink packaged in seven basic container types during the period 1978 to 1982.

Selection of Representative Containers

Although only seven basic container types are used to package soft drink there are numerous sizes for each type. Ideally, in an analysis of this type each size distinction would be accounted for separately with a specific volume being designated to each size. No attempt to project container size distribution was included in the scenarios, however. For this reason it was necessary to select representative container sizes for each container type. Table III–1 shows the selected container volume and weight for each of the seven basic container types.

TABLE III–1.—REPRESENTATIVE SOFT DRINK CONTAINERS

Basic Container Type	Container volume (fluid ounces per container)	Container weight [1] (ounces per container)
Aluminum can	12	0.67
3-piece bimetal can	12	1.50
2-piece bimetal can	12	1.38
NR glass	16	10.40
Plastic-coated glass (PCG)	2-liter	32.32
REF glass	16	17.40
PET (plastic)	2-liter	3.00

[1] Weights represent 1977 national averages based upon information obtained from several soft drink and container companies.

Source: Franklin Associates, Ltd.

The soft drink volume packaged in each of the container types for each scenario is presented in Table III–2. For a complete discussion of the procedure used in performing these calculations see Appendix H.

ENERGY AND ENVIRONMENTAL IMPACT DATA FOR CONTAINER SYSTEMS

Each of the selected container types and sizes described in Table III–2 is related to specific impacts on the environment. These impacts depend on the manufacturing processes which are a part of each beverage container system. The environmental impacts associated with various processes differ significantly so that the impacts associated with each soft drink container system also differs.

A short discussion of the relative energy and environmental impacts associated with the selected container systems will follow. In addition, the impacts resulting from the delivery of 1,000 gallons of soft drink to the consumer in each container type is shown for 1978 in Table III–3. These data have been included to facilitate discussion of the impact data for each container system. Similar data for 1979 through 1982 are presented in Table H–4 of Appendix H.

TABLE III–2.—VOLUMETRIC DISTRIBUTION OF PACKAGED SOFT DRINK IN EACH CONTAINER TYPE

[In millions of gallons]

Scenario: No Change in Refillable Bottle Share

	1978	1979	1980	1981	1982
Aluminum cans	761	999	1,031	1,161	1,284
2-piece bimetal cans	410	540	669	795	922
3-piece bimetal cans	1,374	1,213	1,063	918	779
NR glass	811	862	908	955	934
PCG glass	254	176	100	19	0
REF glass	2,499	2,599	2,709	2,820	2,927
PET	116	194	270	315	437
Total packaged volume	6,225	6,483	6,750	7,091	7,283

TABLE III–2.—VOLUMETRIC DISTRIBUTION OF PACKAGED SOFT DRINK IN EACH CONTAINER TYPE—Continued

[In millions of gallons]

Scenario: 5 Pct Annual Decline in Refillable Bottle Share

	1978	1979	1980	1981	1982
Aluminum cans	761	971	1,206	1,451	1,780
2-piece bimetal cans	410	583	783	994	1,226
3-piece bimetal cans	1,374	1,310	1,244	1,148	1,036
NR glass	811	931	1,062	1,194	1,261
PCG glass	254	190	117	24	0
REF glass	2,053	2,287	2,031	1,777	1,464
PET	116	210	316	439	590
Total packaged volume	5,779	6,482	6,759	7,027	7,285

Scenario: 7 Pct Annual Decline in Refillable Bottle Share

	1978	1979	1980	1981	1982
Aluminum cans	761	1,007	1,268	1,567	1,887
2-piece bimetal cans	410	605	823	1,073	1,355
3-piece bimetal cans	1,374	1,359	1,307	1,239	1,145
NR glass	811	965	1,117	1,289	1,392
PCG glass	254	197	123	26	0
REF glass	2,053	2,157	1,761	1,354	878
PET	116	217	332	474	651
Total packaged volume	5,779	6,507	6,731	7,022	7,308

Scenario: 10 Pct Annual Decline in Refillable Bottle Share

	1978	1979	1980	1981	1982
Aluminum cans	761	1,052	1,371	1,742	2,144
2-piece bimetal cans	410	632	890	1,193	1,540
3-piece bimetal cans	1,374	1,419	1,414	1,377	1,301
NR glass	811	1,000	1,208	1,433	1,578
PCG glass	254	204	133	29	0
REF glass	2,053	1,949	1,355	705	0
PET	116	225	359	527	739
Total packaged volume	5,779	6,481	6,730	7,006	7,302

Source: Franklin Associates, Ltd., calculated from scenario data obtained from Sanford C. Bernstein and Co., Inc., and references (H–1) and (H–2).

TABLE III–3.—ENERGY AND ENVIRONMENTAL IMPACTS ASSOCIATED WITH SOFT DRINK DELIVERY IN SELECTED BEVERAGE CONTAINERS, 1978

[Impact per 1,000 gal]

Impact category	Aluminum cans	2-piece bimetal cans	3-piece bimetal cans	NR glass (16-oz)	PCG (2-liter)	REF glass (16-oz)	PET (2-liter)
Total energy, million Btu's	54.8	47.5	48.4	53.4	42.9	16.2	27.0
Raw materials, pounds	2,069	3,137	3,211	6,804	4,979	1,284	317
Air Pollutants, pounds	230	179	177	168	137	59	91
Water Pollutants, pounds	44	42	42	29	22	16	16
Industrial solid waste, cubic feet	28	138	141	21	17	8	3
Postconsumer solid waste, cubic feet	17	56	86	165	93	43	74
Water Consumption, gallons	15,000	32,000	34,000	28,000	26,000	9,000	11,000
Energy profile, million Btu:							
Natural Gas	19.9	14.4	15.0	28.0	22.5	7.4	8.0
Petroleum	13.3	8.9	8.9	14.6	12.0	5.4	12.4
Coal	14.6	20.5	20.6	6.2	4.7	2.2	3.5
Hydropower	3.3	1.4	1.5	.4	.4	.1	.3
Nuclear	3.0	1.6	1.7	1.0	.9	.3	.6
Wood	.7	.7	.7	3.2	2.4	.8	2.2

Source: Franklin Associates, Ltd.

Energy Impacts

The energy and environmental impacts shown in Table III–3 represent recycling and reuse rates for 1978. Table G–2 of Appendix G shows expected recycling and reuse rates for each container type through 1982. Recycling and reuse play a major role in determining the impacts associated with specific container types. In all cases environmental impacts decrease if recycled materials are used in manufacturing processes as opposed to virgin raw materials. This is particularly true for metal cans which can avoid the energy intensive processes required to refine metallic ores. The energy savings associated with reusing glass bottles (as refillables) are even more significant because of the avoidance of manufacturing new bottles for each filling.

For the recycling and reuse rates in 1978, refillable glass bottles were clearly the most energy efficient container which could be utilized from an energy consumption point of view. The closest container is the family-sized PET (plastic) bottle but it still requires 67 percent more energy than the refillable glass bottle. The remaining container types require significantly more energy, ranging from 2.6 times more energy for plastic-coated glass to 3.4 times more energy for aluminum cans. The primary reason for such a favorable condition for refillable glass is the use of a 10-trip bottle as the average trip rate. This is equivalent to a 90 percent return rate which is considerably higher than those rates experienced by all of the alternative containers. The highest recycling rate among the other containers is for aluminum which is returned and recycled at nearly 30 percent.

The variation in energy requirements for container systems other than refillable glass is primarily due to differences in raw materials processing. A large fraction of total system energy for various container types is consumed in the materials processing stages of container manufacture. For example, the refining of bauxite into molten aluminum metal requires several times the energy of any other step in the aluminum can soft drink system.

The degree and type of raw material processing greatly influences the overall energy profile for the container system. Materials processing requirements significantly influence the type of fuels which supply the total system energy. Some containers, particularly aluminum cans, use large amounts of electricity in their materials processing stages, therefore, coal which is a major electrical utility fuel source is a significant contributing energy source. Glass container raw materials processing requires little electricity so coal use is low. Large quantities of natural gas are used in the processes, however.

The relative ranking of containers in terms of total system energy does not necessarily hold true for specific energy sources. Refillable glass does remain the most favorable for each energy source (even natural gas), but other container rankings change for specific fuels. For example, plastic-coated glass which ranks third in terms of total energy requirements ranks sixth in terms of natural gas requirements. Only nonreturnable (NR) glass is lower. For further details of energy profiles see Table III–3.

Air and Water Pollutants

The air and water pollution generated from each container system depends on the manufacturing processes in the systems and on the energy profile of the system. The emission of various pollutants from manufacturing processes depends heavily upon the type of fuels used to supply energy to the process. For example, the container systems which use large quantities of coal (i.e., cans) are highest in air pollution emissions.

The relative ranking of container systems in terms of air and water pollution are basically the same as for energy consumption.

Industrial and Postconsumer Solid Waste

The industrial solid waste associated with beverage container systems is closely related to the energy consumption. However, the nature of the basic raw materials used to manufacture the containers is also important. The refining of virgin raw materials usually results in the generation of large amounts of industrial waste. Iron ore refining generates extremely large quantities of waste which is the reason for such high industrial solid waste totals for bimetal can systems. On the other hand, processing glass sand into glass produces little waste. The PET container which is made up of petrochemical feedstock produces still less waste.

Postconsumer solid waste is that waste associated with the used container and any secondary paper or plastic packaging (e.g., six pack carriers). The compactability or structural strength of the empty container determines the landfill volume which would be occupied by a given number of containers. Some containers such as glass tend to break if sufficient pressure is applied, while others such as cans are merely deformed. Using compacted container densities as obtained from landfill sampling (see appendices for each container material) it can be summarized that aluminum cans compact the best followed by bimetal cans, plastic bottles, and lastly glass bottles.

Water Consumption

The water consumed by soft drink beverage container systems is most significantly influenced by materials processing operations. Large quantities of water are required in steel mills as pickling liquors and cooling water, thus the high values for bimetal cans (see Table III–3).

Energy requirements also influence water requirements. The relatively low energy requirement for refillable bottles is the primary reason behind the low water consumption for the refillable system. The PET plastic bottle requires about 20 percent more water per 1,000 gallons than refillable glass but this is considerably less than the alternative containers.

ENVIRONMENTAL IMPACTS ASSOCIATED WITH EACH SCENARIO

Raw Impact Data

The energy and environmental impact data for the 1,000 gallons systems can be applied to total volume shares in Table III–2 to result in the total soft drink industry impacts for each scenario.

Energy Consumption. Table III–4 is a summary of overall energy consumption by the soft drink industry for each scenario. These data are graphically displayed in Figure III–1 to facilitate the comparison of the relative effects of the FTC decision scenarios on energy consumption. As can be seen from the table and figure, the effects of the decision become more pronounced with time. Each year refillable glass bottles are losing market share under each scenario. As was shown in the previous discussion on beverage container environmental impacts, the replacement of refillable containers with any alternative container would result in a net increase in overall energy consumption. In this case refillables are being replaced with cans and one-way bottles ("throw aways").

Under the maximum decline scenario (10 percent annually) refillables will have disappeared by 1982. Under this condition the energy consumed by the soft drink industry will be approximately 36 percent higher than under continued baseline growth patterns. This increase in energy use will continue beyond 1982, however the magnitude of the increases will be subject to changes in container recycling rates and technological innovation.

The increased energy consumed under the FTC decision scenarios can be examined from a cumulative point of view also. Figure II–2 is a visual presentation of the projected increase while the data from which the curves are drawn are shown in Table H–7 of Appendix H.

The shift away from refillable containers which is expected under the conditions of the FTC decision will increase industrial requirements of all fuel sources. Table III–5a shows these increases in Btu while Table III–5b shows the percent increases in fuel consumption with respect to the baseline. Electricity use and the fuels associated with its generation are increasing by the highest percents. Additionally, substantial quantities of coal are used directly in steel can manufacturing operations. The increase in nonreturnable glass bottles in place of refillable glass which can be reused results in the increase in natural gas use. As previously discussed, the manufacture of glass containers requires relatively large quantities of natural gas with respect to other container types.

Pollutant Emissions. Table III–6 is a summary of the effects of the FTC decision scenarios on the generation of air and water pollution by the soft drink and assorted industries. While total pollution generation is expected to increase under baseline conditions, this increase is small compared to the increase under FTC decision scenarios.

TABLE III-4.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON ENERGY CONSUMPTION IN THE SOFT DRINK INDUSTRY

Scenario	Total energy consumption (10^{12} Btu)									
	1978	Percent change from base-line	1979	Percent change from base-line	1980	Percent change from base-line	1981	Percent change from base-line	1982	Percent change from base-line
Baseline	225	--------	229	--------	230	--------	232	--------	322	--------
5 pct annual decline in refillables	225	0	239	4.4	251	9.1	263	13.4	272	17.2
7 pct annual decline in refillables	225	0	244	6.6	258	12.2	275	18.5	290	25.0
10 pct annual decline in refillables	225	0	249	8.7	271	17.8	293	26.3	315	35.8

Source: Franklin Associates, Ltd., calculated from data in tables III-2 and -III3.

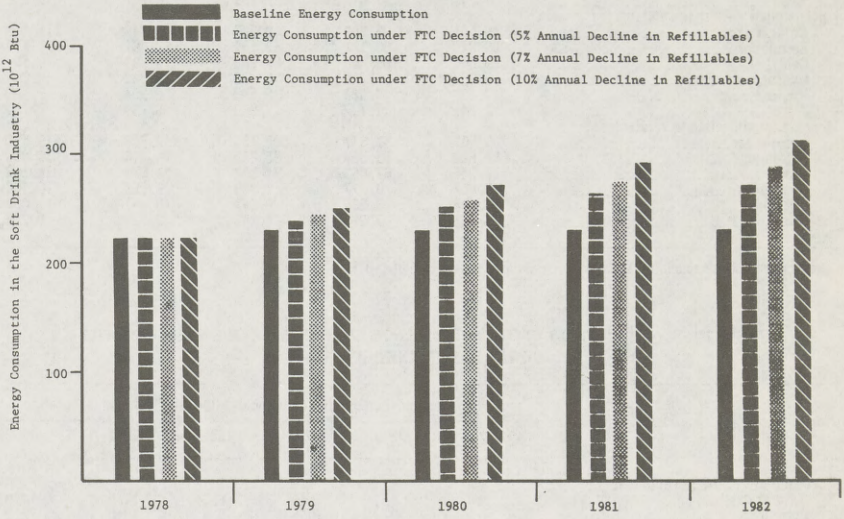


Figure III-1. The effects of the FTC decision scenarios on energy consumption in the soft drink industry.

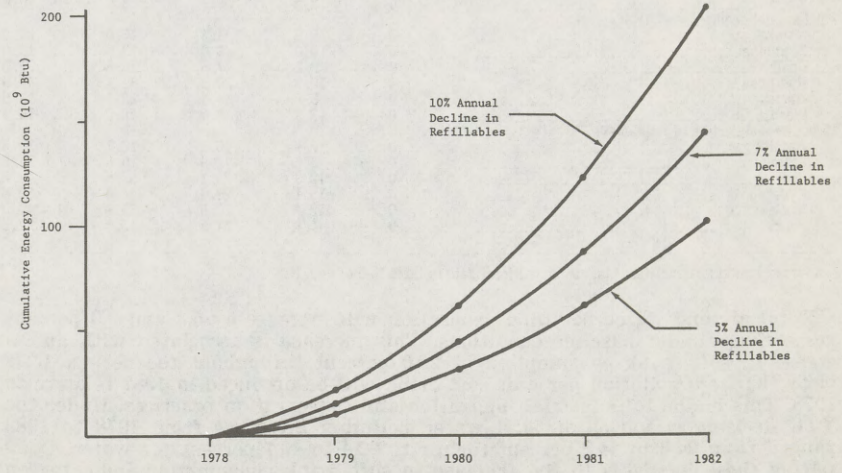


Figure III-2. Cumulative increase in energy consumption in the soft drink industry associated with the FTC decision scenarios.

TABLE III-5a.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON THE ENERGY PROFILE OF THE SOFT DRINK INDUSTRY

	Energy consumption for each fuel source (10^{12} Btu)				
	1978	1979	1980	1981	1982
Baseline:					
Natural gas	89,501	90,542	91,214	91,827	91,749
Petroleum	55,820	57,246	58,274	59,262	59,969
Coal	59,946	59,932	59,566	59,319	58,923
Hydropower	5,857	6,064	6,176	6,280	6,519
Nuclear	7,134	7,328	7,330	7,429	7,487
Wood	7,241	7,438	7,324	7,464	7,540
5 pct. annual decline in refillables:					
Natural gas	89,501	93,991	98,531	102,371	105,080
Petroleum	55,820	59,071	62,264	65,160	67,702
Coal	59,946	63,583	67,303	70,477	73,290
Hydropower	5,857	6,497	7,112	7,678	8,428
Nuclear	7,134	7,759	8,236	8,761	9,233
Wood	7,241	7,617	7,773	8,107	8,342
7 pct. annual decline in refillables:					
Natural gas	89,501	95,904	100,882	106,548	111,445
Petroleum	55,820	60,121	63,507	67,491	71,378
Coal	59,946	65,466	69,969	74,929	79,557
Hydropower	5,857	6,717	7,439	8,233	9,249
Nuclear	7,134	7,981	8,543	9,294	9,999
Wood	7,241	7,727	7,910	8,359	8,756
10 pct. annual decline in refillables:					
Natural gas	89,501	97,677	105,125	112,716	119,550
Petroleum	55,820	61,024	65,813	70,916	76,053
Coal	59,946	67,653	74,502	81,578	88,269
Hydropower	5,857	6,977	7,989	9,068	10,406
Nuclear	7,134	8,236	9,074	10,087	11,058
Wood	7,241	7,793	8,168	8,729	9,239

Source: Franklin Associates, Ltd., taken from data in table H-5 in app. H.

TABLE III-5b.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON THE ENERGY PROFILE OF THE SOFT DRINK INDUSTRY

	Precent increase in fuel consumption with respect to baseline				
	1978	1979	1980	1981	1982
5 pct annual decline in refillables:					
Natural gas	0	3.8	8.0	11.5	14.5
Petroleum	0	3.2	6.8	10.0	12.9
Coal	0	6.1	13.0	18.8	24.4
Hydropower	0	7.1	15.2	22.3	29.3
Nuclear	0	5.9	12.4	17.9	23.3
Wood	0	2.4	6.1	8.6	10.6
7 pct annual decline in refillables:					
Natural gas	0	5.9	11.4	16.0	21.5
Petroleum	0	5.0	9.0	13.9	19.0
Coal	0	9.2	17.5	26.3	25.0
Hydropower	0	10.8	20.5	31.1	41.9
Nuclear	0	8.9	16.5	25.1	33.6
Wood	0	3.9	8.0	12.0	16.1
10 pct annual decline in refillables:					
Natural gas	0	7.9	16.1	22.7	30.3
Petroleum	0	6.6	12.9	20.0	26.8
Coal	0	12.9	25.1	37.5	49.8
Hydropower	0	15.1	29.4	44.4	59.6
Nuclear	0	12.4	23.8	35.8	47.7
Wood	0	4.8	11.5	16.8	22.5

Source: Franklin Associates, Ltd. calculated from data in table H-5 of app. H.

Total air and water pollution generation will increase by 5.3 and 9.3 percent respectively under baseline conditions. This increase is associated with an increase in soft drink consumption of 26.0 percent throughout the period. It is clear that less pollution per unit soft drink will be produced in 1982 relative to 1978. This is due to industrial innovation and conservation practices. Under the FTC decision scenarios air and water pollution increases from 1978 to 1982 ranged from 24.6 to 44.8 percent for air to 22.4 to 40.7 percent for water. Comparing these increases to the increase in soft drink consumption indicates an

TABLE III-6.—THE EFFECTS OF THE FTC DECISION SCENARIOS OF THE GENERATION OF AIR AND WATER POLLUTION IN THE SOFT DRINK INDUSTRY

[In millions of pounds]

Scenario	Total air pollutant emissions									
	1978	Percent change from baseline	1979	Percent change from baseline	1980	Percent change from baseline	1981	Percent change from baseline	1982	Percent change from baseline
Baseline	794	----------	829	----------	834	----------	837	----------	836	----------
5 pct annual decline in refillables	794	0	865	4.3	913	9.5	954	14.0	989	18.3
7 pct annual decline in refillables	794	0	885	6.8	939	12.6	1,000	19.5	1,058	26.6
10 pct annual decline in refillables	794	0	905	9.2	985	18.1	1,069	27.7	1,150	37.6
	Total water pollutant discharges									
	1978	Percent change from baseline	1979	Percent change from baseline	1980	Percent change from baseline	1981	Percent change from baseline	1982	Percent change from baseline
Baseline	172	----------	182	----------	182	----------	185	----------	188	----------
5 pct annual decline in refillables	172	0	189	3.8	196	7.7	205	10.8	214	13.8
7 pct annual decline in refillables	172	0	192	5.5	200	9.9	213	15.1	226	20.2
10 pct annual decline in refillables	172	0	212	16.5	232	27.5	237	28.1	242	28.7

Source: Franklin Associates, Ltd.

increase in pollution per unit soft drink. The effects of the FTC decision scenarios clearly increase the level of pollution emissions from the soft drink container industry.

Raw Materials Consumption. Numerous raw materials are required to manufacture the soft drink packaging associated with each beverage container system. For simplicity an analysis such as performed in this study combines each type of raw material into one total. Of these many types of raw materials the total is dominate by a few major materials. For example, bauxite dominates the raw materials used to manufacture aluminum cans and iron ore dominates for steel cans. Rather than comparing total raw materials consumption under baseline and FTC decision scenarios only three major materials will be considered. These materials are bauxite, iron ore, and glass sand. Table III–7 has been included to show the increases in consumption of each these materials under each scenario. The data represent the cumulative increase of materials through 1982.

TABLE III–7.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON RAW MATERIALS CONSUMPTION IN THE SOFT DRINK CONTAINER INDUSTRY

[In millions of pounds]

Scenario	Cumulative increase in raw material consumption through 1982		
	Bauxite	Iron ore	Glass sand
5 pct annual decline in refillables	2, 114	2, 373	635
7 pct annual decline in refillables	2, 980	3, 349	968
10 pct annual decline in refillables	4, 253	4, 775	1, 296

Source: Franklin Associates, Ltd.

The large increase in raw materials requirements is due to the replacement of a reusable container for a throw away container. Metal cans which are expected to increase under each scenario account for the large increase in bauxite and iron ore consumption. These increases are important not only from an environmental point of view but also from a balance of trade standpoint. Both of these raw materials are imported to a high degree. Nearly 50 percent of all iron ore consumed in the U.S. is imported and more than 85 percent of the bauxite is imported. An increase in consumption would probably increase imports.

Solid Waste Generation. As with the other environmental impact categories the decrease in refillabe containers which is expected under the FTC scenarios proves unfavorable in terms of solid waste generation. Both industrial and postconsumer waste will increase with respect to baseline generation rates. Table III–8 shows the waste generation under each scenario and compares it with the expected baseline generation.

While both industrial and postconsumer waste increase under the FTC scenarios indusrtial waste increases significantly more. The industrial waste generated from metal can beverage container systems is relatively high compared to alternative systems. Since cans are expected to increase, industrial solid waste will also increase. One may expect postconsumer solid waste to increase even more because returnable containers are being replaced by throw aways under the FTC scenarios. This is true to a certain extent. However, aluminum cans are growing substantially under the scenarios and they are a favorable container from a postconsumer solid waste point of view. Approximately 30 percent of the containers are recycled and thus are not disposed of in a conventional manner and the remaining 70 percent compact quite well due to the nature of an aluminum can. These characteritsics of aluminum cans has kept the growth of postconsumer solid waste to less than half of that of industrial solid waste.

Water Consumption. Even though a returnable bottle requires washing before it can be reused, the quantity of water associated with this procedure is small compared to water requirements in container manufacturing operations. For example, about 2,000 gallons of water are required to wash 1,000 pounds of steel strip from ingots. Table III–9 shows water consumption under the baseline and each FTC decision scenario through 1982.

Environmental Impact Analogies

The environmental impact data presented in the preceding sections quantified the impacts in terms such as Btu, pounds, cubic feet, and percent changes. While

TABLE III-8.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON SOLID WASTE GENERATION IN THE SOFT DRINK CONTAINER INDUSTRY

Scenario	Industrial solid waste generation (10^6 ft^3)									
	1978	Percent change from baseline	1979	Percent change from baseline	1980	Percent change from baseline	1981	Percent change from baseline	1982	Percent change from baseline
Baseline	313		313		312		313		313	
5 pct annual decline in refillables	313	0	334	6.7	355	13.8	377	20.4	397	26.8
7 pct annual decline in refillables	313	0	345	10.2	371	18.9	403	28.8	433	38.3
10 pct annual decline in refillables	313	0	357	14.1	396	26.9	447	42.8	484	54.6

Scenario	Postconsumer solid waste generation (10^6 ft^3)									
	1978	Percent change from baseline	1979	Percent change from baseline	1980	Percent change from baseline	1981	Percent change from baseline	1982	Percent change from baseline
Baseline	427		435		439		445		448	
5 pct annual decline in refillables	427	0	447	2.8	465	5.9	481	8.1	492	9.8
7 pct annual decline in refillables	427	0	454	4.4	472	7.5	496	11.5	515	15.0
10 pct annual decline in refillables	427	0	460	5.7	487	10.9	516	16.0	542	21.0

Source: Table H-5 of app. H.

TABLE III-9.—THE EFFECT OF THE FTC DECISION SCENARIOS ON WATER CONSUMPTION IN THE SOFT DRINK CONTAINER INDUSTRY

[In billions of gallons]

Scenario	Water consumption									
	1978	Percent change from baseline	1979	Percent change from baseline	1980	Percent change from baseline	1981	Percent change from baseline	1982	Percent change from baseline
Baseline	108		112		112		112		112	
5 pct annual decline in refillables	108	0	116	3.6	121	8.0	125	11.6	128	14.3
7 pct annual decline in refillables	108	0	119	6.3	124	10.7	130	16.1	136	21.4
10 pct annual decline in refillables	108	0	121	8.0	130	16.1	138	23.2	146	30.6

Source: Table H-5 of app. H.

the meaning of such terminology is not complex, the numbers are very large and may be confusing as to the true impact which is being exerted. For this reason a series of analogies have been developed which represent equivalent expressions of many of the impacts.

The development of equivalent expressions require the use of conversion factors. Table III–10 is a presentation of the conversion factors used to perform these calculations. These factors were developed from several sources which are listed in Table III–11 along with additional notes and assumptions.

Discussion as to why environmental impacts are greater under the conditions of the FTC scenario will not be repeated here, as they were discussed when raw impact data were presented in the previous analysis.

Enerky Equivalencies. The energy impacts associated with the FTC decision scenarios are presented as increased Btu requirements through 1982. Total Btu have been calculated as well as the Btu of each energy source. This section will present equivalent expressions of total energy impacts as well as expressions for each specific energy source. Table III–12 shows several equivalent expressions of the total energy impact associated with each FTC scenario.

This type of analysis in which all energy sources are grouped together to give a total energy impact tends to invoke criticism from certain people. They feel it is an injustice to combine Btu of coal with Btu of natural gas because of varying levels of availability and cost. Because of this problem, total energy is broken into an energy profile which quantifies the impact of the FTC decision scenarios on specific energy sources. Table III–13 shows the direct impact on natural gas consumption in the soft drink industry. Table III–14 shows petroleum impacts and Table III–15 shows coal impacts.

Solid Waste Equivalencies. The changes in soft drink container market shares which are expected under FTC decision conditions result in significantly higher quantities of waste to be disposed of. The increased solid waste volumes are expressed in terms of compacted landfill volume. This may be an adequate way of considering industrial solid waste which undergoes little compaction in a landfill because of its original dense state (2,025 lb/cubic yd), however post-consumer solid waste which is basically used containers, undergoes a considerable change in density going from the trash can to the landfill. For this reason, two separate waste volumes will be developed for each scenario. The first will be called "trash can" volume and the second "landfill" volume. Each of these separate values will be used to develop solid waste equivalencies.

TABLE III–10.—*Conversion factors used to develop equivalent expressions for environmental impacts*

	Source
1 barrel of crude oil=5.83×10^6 Btu	1
1 kwh of electricity=11,002 Btu	2
Average per capita electricity consumption: residential use only=2,680 kwh/capita/year; residential, commercial, and industrial use=8,580 to 9,440 kwh/capita/year	2
Total foreign oil imports=6.5 million barrels/day	2
Iranian oil imports=0.9 million barrels/day	2
One train carload of coal=83,000 lb coal (50 feet long)	3
Average home natural gas consumption=135,000 cubic feet per year (1,500 sq ft home)	4
One barrel of oil yields 19 gallons of gasoline	5
U.S. 1976 foreign trade deficit=$9,300 million	3
Volume of the Orange Bowl=approximately 1 million cubic yards	6
Volume of a medium sized city landfill=approximately 1 million cubic yards	7
Container compaction ratios in landfill disposal	8
Glass=4.28.	
Steel=5.00.	
Aluminum=13.74.	
Plastic=5.70.	
Water consumption=150 gallons/person/day (40 percent for domestic purposes)	9
United States population=220,000,000 persons	3
Cost of imported raw materials in 1976	2, 3
Crude oil: $13.48 per barrel.	
Natural gas: $1.72 per 1,000 cubic feet.	
Bauxite: $21.82 per ton.	
Iron ore: $18.18 per ton.	

Table III–11

Notes and References for Conversion Factors in Table III–10

1. Combustion Engineering, Inc., *C. E. Natco Handbook.*
2. Franklin Associates, Ltd., based upon electrical energy fuel mix presented in *Monthly Energy Review*, U.S. Department of Energy, April 1978.
3. U.S. Department of Commerce, *Statistical Abstract of the United States, 1977.*
4. This average natural gas consumption rate was developed based upon data obtained from a large midwestern natural gas company. The average represents annual consumption in a temperate climate region.
5. American Petroleum Institute, *Petroleum Facts & Figures*, 1971 Edition.
6. The volume of the Orange Bowl was calculated by Franklin Associates based upon photographs of the stadium. Specific dimensions in the photographs were known and used to estimate other dimensions.
7. Assumed by Franklin Associates based upon a survey of several landfills in Greater Kansas City.
8. Hunt, Robert G. and W. L. Bider, "Analysis of Environmental and Economic Impacts of Waste Reduction Procedures and Policies," prepared for the U.S. Environmental Protection Agency by Franklin Associates, Ltd., December 14, 1977.
9. Gehn, Harry W. and J. I. Bregman, *Handbook of Water Resources and Pollution Control*, Van Nostrand Reinhold Company, New York, 1976.

TABLE III–12.—EQUIVALENT EXPRESSIONS OF TOTAL ENERGY IMPACTS ASSOCIATED WITH EACH FTC DECISION SCENARIO [1]

Scenario	Increased energy consumption (10^{12} Btu)	Barrels of oil equivalent (millions)	Days of foreign imports 1977 rate	Equivalent electrical energy (10^{6} kWh)	Years of electricity supply for a city of 100,000 persons (residential use only)
5 pct annual decline in refillables	102.2	17.2	2.8	9,267	34
7 pct annual decline in refillables	145.2	24.9	3.9	13,166	49
10 pct annual decline in refillables	205.5	35.2	5.6	18,633	69

[1] Cumulative energy impact through 1982. Calculated based upon the annual energy consumption in the soft drink industry under baseline conditions compared to the FTC decision scenario.

Source: Franklin Associates, Ltd.

TABLE III–13.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON NATURAL GAS CONSUMPTION [1]

Scenario	Increased consumption of natural gas (10^{12} Btu)	Cubic feet natural gas (millions)	Percent of 1977 imports	Years of heating 100,000 Mid-western homes
5 pct. annual decline in refillables	34.6	32.7	3.2	2.4
7 pct. annual decline in refillables	49.4	46.7	4.6	3.5
10 pct. annual decline in refillables	69.7	65.8	6.5	4.9

[1] Cumulative impacts through 1982.

Source: Franklin Associates, Ltd.

TABLE III–14.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON PETROLEUM CONSUMPTION [1]

Scenario	Increased consumption of petroleum (10^{12} Btu)	Barrels of oil equivalents (millions)	Days of Iranian oil imports	Gallons of gasoline (millions)	Months of total fuel requirements for 100,000 passenger cars [2]
5 percent decline in refillables	19.4	3.4	3.8	64.6	9
7 percent decline in refillables	27.7	4.8	5.3	91.2	13
10 percent annual decline in refillables	39.1	6.8	7.6	129.2	18

[1] Cumulative impacts through 1982.
[2] Calculated based upon an average fuel efficiency of 14 mi/gal and 12,000 mi/car/yr.

Source: Franklin Associates, Ltd.

TABLE III–15.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON COAL CONSUMPTION [1]

Scenario	Increased consumption of coal (10^{12} Btu)	Tons of coal (millions)	Length of coal train (miles)	Approximate distances for coal train length
5 pct annual decline in refillables	36.9	1.4	331	Cincinnati to St. Louis. Cleveland to Chicago. Miami to Jacksonville. Tallahassee to Palm Beach. Cleveland to Washington, D.C.
7 pct annual decline in refillables	52.2	2.0	473	Cincinnati to Memphis. Cleveland to New York. Miami to Savannah. Jacksonville to Raleigh. Cincinnati to Washington, D.C.
10 pct annual decline in refillables	74.3	2.9	686	Cincinnati to Minneapolis. Toledo to Kansas City. Miami to Atlanta. Orlando to Jackson, Miss. Washington, D.C. to Chicago.

[1] Cumulative impacts through 1982.

Source: Franklin Associates, Ltd.

Table III–16 is a summary of the total additional solid waste which would be generated by 1982 under each of the FTC decision scenarios. Note that the trash can volume for postconsumer solid waste is considerably higher than landfill volume (about 5 times higher). The solid waste totals shown as million cubic yards in Table III–16 can be used directly to represent equivalent expressions. The trash can volume totals can serve as equivalent expressions of the number of times the Orange Bowl in Miami, Florida could be filled by the waste. With a 5 percent annual decline in returnables the cumulative solid waste impact by 1982 would fill the stadium 30 times. Under the 10 percent scenario the waste would fill the stadium 87 times.

The landfill volume totals (also in million cubic yards) can be thought of as representing medium-sized city landfills. A typical city landfill receiving about 500 tons per day will last about three years if its capacity is one million cubic yards. Although the generation of beverage container waste will be distributed throughout the whole country, it will be considered as a single quantity in this analysis. The total solid waste would completely fill 12 to 30 landfills. This impact is especially significant if the cost and availability of adequate landfill space is considered.

TABLE III–16.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON SOLID WASTE GENERATION [1]

	Increased solid waste generation scenario		
	5 pct. decline in refillables	7 pct. decline in refillables	10 pct. decline in refillables
Industrial solid waste, 10,000,000 ft^3	212	311	433
Postconsumer solid waste, 10,000,000 ft^3:			
Trash can volume	585	805	1,916
Landfill volume	117	160	378
Total solid waste:			
Trash can volume:			
10,000,000 ft^3	797	1,116	2,349
10,000,000 yd^3	[2] 30	[2] 41	[2] 87
Landfill volume:			
10,000,000 ft^3	329	471	811
10,000,000 yd^3	[3] 12	[3] 17	[3] 30

[1] Cumulative impacts through 1982.

[2] Values also represent equivalent expressions of the number of times the Orange Bowl of Miami, Fla., could be filled by this waste volume.

[3] Value also represents equivalent expressions of complete landfills which would be filled by this waste volume.

Source: Franklin Associates, Ltd.

Air and Water Pollution Equivalencies—The changes in soft drink container market shares which are expected under the conditions of the FTC decision result in increased air and water pollution emissions. The actual emissions from the soft drink industry are quantified in pounds in Table III–6. Table III–7 presents these levels of pollution in equivalent terms; the emissions from a conventional coal fired power plant. The emissions from such plants were determined from data in Appendix A of this report. The equivalent untit of measurement was chosen to be years of emissions from a 1,000 megawatt power plant operating at 60 percent capacity. The electrical energy which would be generated under such operating conditions would be 5,256 million kilowatt-hours per year.

Note that the increased air pollution emissions are equivalent to 1.2 to 2.4 years emissions from the 1,000 Mw power plant.

It should be stressed that coal fired power plants generate large quantities of air pollutants (about 61 pounds per 1,000 kwh). The increased water pollution is equal to 3.2 to 8.9 years of power plant emissions.

TABLE III–17.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON AIR AND WATER POLLUTION EMISSIONS[1]

Scenario	Increased air pollution emissions (10,000,000 lb)	Years of air pollution emissions from a 1,000-MW power plant[2]	Increased water pollution emissions (10,000,000 lb)	Years of water pollution emissions from a 1,000-MW power plant[2]
5 pct annual decline in refillables	385	1.2	67	3.2
7 pct annual decline in refillables	520	1.6	94	4.5
10 pct annual decline in refillables	773	2.4	186	8.9

[1] Cumulative impact through 1982.
[2] Calculated based upon a 1,000-MW coal-fired powerplant operating at 60 pct capacity (5,256,000,000 kWH per year).

Source: Franklin Associates, Ltd., calculated from data, in table III–6 and app. A.

Water Consumption Equivalencies.—The additional water which would be consumed under each FTC decision scenario is shown in billion gallons in Table III–9. The totals can be made more understandable by equating the volumes to total use in a representative city. Washington, D.C. was selected for this purpose.

The average water consumption per person is about 150 gallons per day (see Table III–10 for reference), with approximately 40 percent of this total being used for domestic purposes. The population of Washington, D.C. is about 714,000 persons. Table III–18 is a summary of the water consumption impacts based upon the above assumptions.

TABLE III–18.—EQUIVALENT EXPRESSIONS OF THE IMPACT OF THE FTC DECISION SCENARIOS ON WATER CONSUMPTION[1]

Scenario	Increased water consumption (10,000,000,000 gal)	Years of total water use in Washington, D.C.	Years of domestic water use in Washington, D.C.
5 pct annual decline in refillables	43	1.1	2.8
7 pct annual decline in refillables	61	1.6	4.0
10 pct annual decline in refillables	87	2.1	5.3

[1] Cumulative impact through 1982.

Source: Franklin Associates, Ltd.

Impact of FTC Decision on U.S. Balance of Trade

While it is difficult to accurately predict the effects of the FTC decision scenarios on the U.S. balance of trade, it will have some adverse effect. Energy and raw materials consumption will increase under each of the developed scenarios. Some, if not all, of the increased consumption will be associated with imported products, especially petroleum, natural gas, bauxite, and iron ore. It is difficult to estimate the fraction of the additional consumption which will need to be imported. At a minimum it was assumed that the imported fraction will be

equal to the current ratio of imports to total domestic consumption. At a maximum all additional consumption will be imported.

The ranges of increased imports will be used to determine the effects of the FTC decision on the United States balance of trade. The 1976 dollar value of the cumulative increased imports through 1982 was compared to the trade deficit in 1976. The purpose of this procedure is to provide a frame of reference from which the magnitude of increased raw materials consumption can be better understood. Also, the impact of this increase can be observed from a national interest point of view. One must be careful however to recognize that there are uncertain factors which can influence the accuracy of this type of analysis, particularly inflationary trends.

Table III–19 shows the expected value (in 1976 dollars) of the increased imports under each scenario. This dollar value is compared with the 1976 trade deficit in terms of percentages. Note that the value of these increased imports range from about 0.5 to 2.0 percent of the trade deficit for all scenarios.

TABLE III–19.—THE EFFECTS OF THE FTC DECISION SCENARIOS ON U.S. FOREIGN TRADE

Scenario	Increased consumption associated with scenario	Percent imported	Value of imports (10^6 1976 dollars)	Percent of 1976 U.S. trade deficit
5 pct annual decline in refillables:				
Petroleum	3,400,000 bbl	39–100	18–46	0.19–0.49
Natural gas	32,700,000 ft³	5–100	[1] NEG	
Bauxite	2,114,000,000 lb	86–100	20–23	.21–.25
Iron ore	2,373,000,000 lb	48–100	10–22	.11–.24
Total			48–91	.51–.98
7 pct annual decline in refillables:				
Petroleum	4,800,000 bbl	39–100	25–65	0.27–0.70
Natural gas	46,700,000 ft³	5–100	NEG	
Bauxite	2,980,000,000 lb	86–100	28–32	.30–.34
Iron ore	3,349,000,000 lb	48–100	14–31	.15–.33
Total			67–128	.72–1.37
10 pct annual decline in refillables:				
Petroleum	6,800,000 bbl	39–100	36–92	0.39–0.99
Natural gas	65,800,000 ft³	5–100	NEG	
Bauxite	3,253,000,000 lb	86–100	40–46	.43–.49
Iron ore	4,775,000,000 lb	48–100	20–44	.22–.47
Total			96–182	1.04–1.95

[1] Insignificant with respect to other imported raw materials.

Source: Franklin Associates, Ltd., calculated from data in tables III–7, III–10, III–13, III–14.

PREPARED STATEMENT OF EMANUEL GOLDMAN, SENIOR RESEARCH ANALYST, SANFORD C. BERNSTEIN & CO., INC.

My name is Emanuel Goldman. I am a securities analyst specializing in the soft drink and brewing industries, employed by Sanford S. Bernstein & Co., Inc., in New York City.

My academic background includes bachelor and graduate degrees in physics from the University of California and an MBA in Business Management from Fairleigh Dickinson University. I have been asked to express an opinion on the probable effect of enforcement of the FTC orders in the soft drink cases on the package mix between returnable bottles, on the one hand, and metal cans and nonrefillable bottles, on the other. In performing this study, I undertook an analysis of industry statistics and conducted a series of interviews with soft drink syrup manufacturers and bottlers. My opinion follows:

Implementation of the FTC order invalidating exclusive territories for throwaway containers will result in a drastic change in the soft drink industry's package mix. The proportion of soft drink volume sold in refillable bottles will plummet, while the amount sold in throwaways will increase dramatically. As a result, the number of throwaway containers produced for soft drink usage will rise by a startling amount—in fact, by tens of billions of containers.

Underlying this shift to throwaways are two factors—first, the elimination of territorial exclusivity for throwaways, and second, the clear, and understand-

able, desire of large food stores to rid themselves of the costs, manpower, time and effort incurred in handling refillable bottles.

Historically, territorial exclusivity for packaged soft drinks, irrespective of container type, has meant that each supermarket has had only one source for each major brand of soft drink; i.e., only one Coke bottler, or Pepsi bottler, for example, would be available for servicing a particular supermarket. Consequently, with store door delivery, the bottler has been in a position to provide a substantial measure of control over the mix of soft drink packages available in each supermarket.

For example, if consumers in a particular market are receptive to soft drinks sold in refillable containers, the bottler stocks the shelves with a high proportion of refillables. Significantly, this occurs even though supermarkets would prefer to handle throwaways only. However, since a supermarket can purchase a given soft drink brand from one and only one bottler, he is in no position to dictate to which container type a bottler is to allocate the greatest shelf space. On the contrary, the bottlers are in the stronger position, and are thus able to stock the shelves with refillable bottles in spite of supermarket aversity to the handling, sorting, extra storage space and manpower associated with refillables. In fact, approximately half of all soft drinks sold in the larger food stores are packaged in refillable containers, and, in some parts of the country, this proportion is well in excess of fifty percent.

In contrast, implementation of the FTC order will provide chain stores with the leverage to finally indulge their long-standing, strong aversion to returnables, simply by ordering all their soft drinks from other—possibly more distant—sources, whereas now they are under pressure to accept the package mix of the local, exclusively franchised bottler for each brand. Interestingly, not even the FTC's proviso permitting continued territorial exclusivity for refillables alone will be able to save the refillable bottle, since it will not affect the supermarket's ability to order its entire requirements in the form of nonreturnable bottles and cans shipped from outside the territory.

In short, then, the supermarket will be able to control the types of soft drink packages sold in its store. Indeed, it is clear that supermarket preferences will precipitate a move away from refillables toward throwaway containers—notably, cans and plastic bottles, since both packages lend themselves to long-distance transport. Since refillable soft drinks sold in supermarkets account for about half of all the refillable volume sold nationally, elimination of supermarkets as a source of refillable soft drink sales will strongly discourage bottlers from reinvesting in their "float," that is, in the total inventory of refillable bottles in the possession of bottlers, retailers, and consumers. In fact, once the FTC order is implemented, we believe that bottlers will simply stop replenishing their refillable bottle "float."

We estimate that the number of refillables in circulation amounts to about a four years supply. With half of the float attributable to supermarket sales, the supply theoretically could last eight years were the FTC order implemented. In such a situation, an additional 32 billion throwaway containers would be needed during the first four years alone to carry the volume previously accounted for by the returnables. This rather startling figure arises from the fact that each refillable bottle is used about twenty times before it breaks, is discarded or is lost. In reality, the decline of the refillable bottle as a viable container could proceed even more rapidly than we have indicated, because of the loss of economies of scale to the bottler when supermarket chains are no longer viable customers for those packages. The estimate of 32 billion additional containers thus is probably quite conservative. Indeed, if the refillable were to disappear over about a four-year period as a result of the dramatically changed economics of manufacture, we estimate that 64 billion additional throwaways will have to be produced. In summary, then, even under a conservative set of assumptions, implementation of the FTC order will result in a huge increase in the number of throwaway containers produced for the soft drink industry. Under a more realistic set of assumptions, the increase in throwaways is even more dramatic.

Senator METZENBAUM. We are very happy to have Prof. Eleanor Fox, New York University School of Law who is an outstanding authority in the field of antitrust legislation and law who served on the President's Antitrust Commission and we are happy to welcome you back again to our subcommittee.

TESTIMONY OF ELEANOR M. FOX, PROFESSOR OF LAW, NEW YORK UNIVERSITY SCHOOL OF LAW

Ms. Fox. Thank you, Mr. Chairman and members of the committee. I am very happy to be here and I will try to be very brief.

I suspect that from all we hear and read about the bill, it would never have been introduced for the benefit of consumer interests and it would never have been introduced for the benefit of the environmental interest. And I think it would never have been introduced for the benefit of the business and the health of our economy in the long run. Senator Cochran made an important observation when he identified as an issue, the protection of the investment of the little bottler in this industry. I think that that is the issue, and I certainly hope that Congress would handle that issue in a way less likely to have a dramatic impact on competition and the health of the economy.

Senator BAYH. I don't intend to ask questions in the interests of time, but I must say that I don't think that is the only reason, the only issue. I don't think you can separate the financial consequences of the small bottler from what is going to happen if the small bottler disappears namely the large bottlers are going to be in charge and you are going to have less competition and the consumer will be less well off. So I think if you address this question——

Ms. Fox. That is an interesting point. Who would take over when the inefficient or less efficient bottler would drop out? My own view is that more efficient companies will take over. They will not have more market power than the competitors have now, but less. They will be checked by both interbrand and intrabrand competition of more efficient firms.

My major observation on the whole matter is this: There is new, dynamic competition straining to enter this market; straining to enter the protected territories, and the restraints that wall-out the competition must be to the detriment of the consumer. Incidentally, they are also to the detriment of the innovative, effective business, big and small. It is the freedom of the efficient business to compete on the merits that Justice Marshall meant to protect in the Topco case.

I believe it is in the long-run interests of the country to work with the new efficiencies that are emerging; to work with the innovation and to work with the tide; not to resist efficiencies.

I will turn now to a critique of the bill itself, in the interests of time I will only be about 2 more minutes.

Senator METZENBAUM. Well, as a matter of fact, it isn't fair to cut you off; I want you to conclude, but I also don't want to cut you off. I know that you came at some personal inconvenience to this subcommittee hearing; you are an authority in the field, so don't take 2 minutes, take 3. [Laughter.]

Ms. Fox. Looking at the bill itself, I believe that section 2 does reverse the usual presumptions and the usual inferences that one would make from an economic view point. It presumes that even tight territorial restrictions on trademarked soft drink products—and even those imposed by the market leaders—are positive and valid. In fact, such restrictions do threaten harm to competition if applied to market leaders in relatively concentrated markets with relatively differentiated products, as in the soft drink industry.

Such market leaders tend to have a great amount of pricing power. The licensor can pass on this discretionary power to an individual bottler assigned to a territory if the territory is protected against intrabrand competition. But, if the territory is not protected, intrabrand competition will come in, where interbrand competition is not totally effective, and it will create the competitive pressure to keep the price in line.

This analysis is contemplated by Sylvania. The bill allows territorial restraints only if competition is "substantial and effective," and in theory these words could be used in the way contemplated by Sylvania. But they could be interpreted to give much more protection to a bottler who wants to be insulated from competition.

I am afraid that the words will be used to look more at the number of sellers selling products of the same kind, than at what competition and price would look like if the world were otherwise; what it would look like if the barriers were torn down. Antitrust should consider this. I think it does. I think the courts probably would not under bill, and that therefore the bill would create an exemption.

I have a second major concern with section 2 of the bill. I believe that it would immunize, subject to the proviso, even horizontal restraints. That is, restraints by agreement, among bottlers expressed or implied, to keep out their competitors. This is a horizontal restraint. It was what was condemned in the *Topco* case among others. It is orderly marketing among competitors, allowing no one to make incursions into the territory of another. It is one of the worst restraints in antitrust, because it really does effectively stifle competition. In fact, we have all been talking a good deal about Sylvania and I wonder if we shouldn't be thinking more about Topco. If we look where the interest in the restraint comes from, it may become clear that the interest comes from competitors who want protection against competition, not from licensors who want efficiency in distribution. The bill itself may actually be legalizing cartel behavior.

Senator METZENBAUM. Professor Fox, briefly, for the record, would you explain what Topco held.

Ms. Fox. In Topco, there were small and medium sized supermarkets who wanted jointly to merchandise private label brands, and in connection with their joint venture to do so they agreed to stay out of the territory of one another. The case went up to the Supreme Court and it was held to be a *per se* illegal violation of the antitrust laws. Quite frankly, I think that it may have been and should have been OK to seek efficiency. But the competitors did not have to and should not have agreed to stay out of one another's territory. The antitrust laws abhor such agreements, because they frustrate competition from the most likely sources.

My remaining comment on the bill is on section 3, the damage problem. I believe this is a troublesome departure from treble damage principles. It virtually relieves the bottlers of any liability for treble damages over the years. Some say is it unfair to subject them to liability, since they have had this practice for 75 years. I look at it the other way around. For perhaps the last 20 years they have known that the restrictions were probably illegal. If it wasn't clear from earlier Warren court decisions, it was surely clear in 1967, when the court held territorial confinement per se illegal in *Schwinn*.

Maybe there is something I am missing, but I don't understand why it wasn't perfectly clear from 1967 to 1977, when territorial confinement was not only a restraint, but a per se illegal restraint of trade. In 1977, the court decided *Sylvania*, but Sylvania did not give immunity or per se legality to territorial restraints, so even since 1977 there should have been sensitivities to antitrust.

Looking at it this way, it is fair to allow the usual remedy to persons injured, rather than to allow the bottlers to profit from fencing out alternative, low-cost distribution.

Senator METZENBAUM. Professor Fox, as a student of the law, do you find the fact that the Burger Court in the *Sylvania* case adopted rules which permit effective enforcement of the antitrust laws, although overruling the *Schwinn* case?

Ms. Fox. This is how I would analyze the two. I think that *Sylvania* is a serious cutback of the proenforcement position in *Schwinn*. But it didn't cut back in the area we are talking about. At least, in this area, there remains the serious possibility of liability.

In *Sylvania* the Court was only dealing with the small competitor, not with concentrated markets or dominant firms whose pricing power isn't sufficiently moderated by the others in the market.

Senator METZENBAUM. Well, in *Sylvania*, isn't it a fact that Sylvania itself had only a total of 2 percent of the entire market in the country?

Ms. Fox. That's right. I have no quarrel with the law that a location clause imposed by a small firm is perfectly legal; but that is not what we are talking about here.

Senator METZENBAUM. Is it likely that any of the territorial restrictions in the soft drink industry will ever be held unlawful under the test in S. 598?

Ms. Fox. I would think that it is not; of course, one could quarrel with the language of the bill but it certainly seems to me that they will not. I am concerned that the bill may be construed to reflect legislative factfinding, right here and now, of substantial and effective competition.

Senator METZENBAUM. The industry points out that the territorial restrictions enhance the value of the bottling companies. Is it unfair to require the bottlers to give up this extra value if the territorial restrictions do, in fact, suppress competition?

Ms. Fox. There are several questions of fairness. I cannot say it is unfair. This is the same question that arises in connection with regulated industries—and deregulation. The public interest lies on the side of competition, but somebody is caught in the middle; somebody has made an investment. I don't view the bottlers as caught much in the middle because of *Schwinn*. If they were really caught in the middle, or if they are, then maybe they are entitled to something; but not at the expense of competition.

For example, if the licensor were to invade and take away the territories of the bottler the legislature could require it to pay for the goodwill it is taking away. However, apart from this goodwill, there is a monopoly value; and they are not entitled to the monopoly value of the territory. It doesn't belong to them, under principles of competition.

Senator METZENBAUM. Senator Cochran.

Senator COCHRAN. Thank you, Mr. Chairman, I know it is about the termination of the hearing, but I do want to state, for the purpose of the record, if we have some questions, we would like to have the opportunity to submit them to the witness and we express our appreciation here for her being here.

In reference to the considerations that go into the legislation and the supporting of it, by not only me but the distinguished Senator from Indiana, and many others, I think we are all concerned with the consequences of legislation, both to consumers and to those who are involved in a business that might be regulated. Failure to consider any of those factors, I think, would be certainly a failure to perform a duty by someone who is involved in Government. However, if there is any one consideration that overwhelms the others, but I think that all taken together, the Government ought to indicate, through its action, a sensitivity of the consequences of signing the legislation. I think all too often, we see a lot of ivory tower theories that look good and are good but when enacted into law have consequences that are quite adverse to the citizens of this country.

I think that is the duty of the Congress—to be careful and cognizant of what the results will be. If we have this Federal Trade Commission decision stand, or be affirmed by the court, we can only suppose and try to predict the impact with resort to the experience of those in business, the consumers, and those who have acted in the community to try to figure out the answer to that. That is what we are trying to do right now.

I would say that in terms of legislative fact-finding, if there is such, it was the same fact that was found by the Administrative Law Judge of the Federal Trade Commission. I think that the committee has benefited from these hearings, Mr. Chairman, and I would like to congratulate you and thank you again for conducting them and we look forward to further consideration of the record in trying to come to grips with this very important issue.

Thank you very much, Mr. Chairman.

Senator METZENBAUM. Dr. Fox, one last question. There seems to be considerable talk about the small bottler, the independent bottler, the parent company. In a number of areas in the country, the parent company owns the franchise. Even if you can justify the exemption for the independent bottler, does it make sense to provide this same kind of territorial protection for the syrup manufacturer too, and would it not be appropriate that if this subcommittee sees fit to move the bill that we make a distinction on the subject between the parent companies and the bottlers?

Ms. Fox. Yes, that is a distinction that could well be made, because of course it is the bottler who is thought to need the protection.

Senator METZENBAUM. Certainly, the parent company needs no protection except to see to it that the parent company not discriminate against the bottler who may come in and compete in a competitive market with the parent company.

Ms. Fox. Yes.

Senator METZENBAUM. I don't know any reason under the sun why the parent would need any protection from free competition against an economically viable bottler.

Ms. Fox. That seems right to me. At least it needs no more protection than general antitrust principles would allow.

Senator METZENBAUM. Thank you very much.

Ms. Fox. Thank you.

[Ms. Fox's prepared statement follows:]

PREPARED STATEMENT OF ELEANOR M. FOX

Mr. Chairman and members of the subcommittee: My name is Eleanor Fox. I am a Professor of Law at New York University School of Law. Before joining the law school faculty, I practiced law for many years as a litigator and counselor, with emphasis on antitrust. I am immediate past Chairman of the Antitrust Section of the New York State Bar Association. Last year I served as a member of the National Commission for the Review of Antitrust Laws and Procedures.

I am pleased to accept the invitation of the subcommittee to testify on S. 598, a bill which would favor territorial restrictions in the distribution of trademarked soft drink products.

S. 598 is a bill intended to safeguard an industry of many small, competing bottlers, accustomed to territorial restraints that protect them from intrabrand competition and a bill to protect the investments of the existing small bottlers. It is feared that if the territorial restraints are lifted, and if bottlers and distributors of a single brand can freely move in and out of the territories of one another, larger integrated franchise companies, food chains, marketing corporations, and syrup manufacturers themselves will move into the bottling industry, and large integrated bottlers will expand their territories, offering the big customers better service at a lower price, and displacing and transforming this industry of small, local bottlers. The bottlers predict not only destruction of their own businesses, but also aggravation of environmental problems through stimulation in the use of nonreturnable bottles.

S. 598 would compromise conflicting interests of consumers, existing small business establishments, and environmentalists by changing the antitrust standard of illegality that governs the validity of territorial restraints in trademarked soft drink licensing contracts. The Bill effects the compromise by providing a more pro-defendant standard than current principles of antitrust allow. That is, the defendant in a case challenging territorial restrictions in bottlers' contracts would be more likely to prevail if the Bill is adopted. Since the general antitrust principles are designed to promote consumer welfare, the Bill leans against consumer welfare and toward protection of existing business establishments.

I. THE STANDARD OF LEGALITY: THE STANDARD UNDER THE SHERMAN ACT VS. THE STANDARD UNDER THE BILL

We might first ask how the standard of legality contained in the Bill differs from currently applicable principles of antitrust law; for if it does not differ, the Bill would not be necessary; and if it does differ, we should understand how.

The Sherman Act prohibits unreasonable restraints of trade. Contract restraints that significantly hinder competition are unreasonable restraints of trade.

Agreements among competitors to divide up territories and to agree to stay out of the territory of one another are and have long been illegal *per se*. They reflect one of the most egregous restraints of trade. This is so even though the competitors are intra-brand competitors. *Timken Roller Bearing Co.* v. *United States*, 341 U.S. 593 (1951); *United States* v. *Topco Assoc.*, 405 U.S. 596 (1972).

In 1967 the Supreme Court held, in *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365 (1967), that contract restraints imposed by a manufacturer limiting resellers of its product to particular territories were illegal *per se* under the Sherman Act. Ten years later, the Supreme Court overruled *Schwinn in Continental TV* v. *GTE Sylvania*, 433 U.S. 36 (1977). *Sylvania*, which is now our guide to antitrust legality of vertically-imposed territorial restraints, holds that such restraints are to be judged under a rule of reason. The Supreme Court did not give clear direction as to how the rule of reason would be applied; but it did give some direction. Let me first state some of the Court's observations in *Sylvania* and then suggest how antitrust principles may be applied to this industry.

The Court in *Sylvania* reflected the view that in general the manufacturer/licensor should have the autonomy to determine how its product should be distributed, for it will generally maximize distributional efficiencies; but there are limits to its autonomy when competition is restrained. The Court noted that interbrand competition is the primary concern of antitrust laws (433 U.S. at 52, n. 19); and that "interbrand competition . . . provides a significant check on the exploitation of intrabrand market power because of the ability of consumers to substitute a different brand of the same product." *Id.* However, the Court recognized that there may be cases in which intrabrand competition is an important force, and it suggested that restrictions that completely eliminate intrabrand competition should be analyzed differently from (*semble*, treated more harshly than) those that "merely moderate intrabrand competition." 433 U.S. at 52.

Translated into the language of the soft drink industry, this means that, if the restraint is vertically-imposed (by the licensor in its interest), the major concern of antitrust is the competition among sellers of different soft drink products, rather than the competition among the bottlers of one brand. If there is such intense intrabrand competition faced by a distributor of one brand that it is forced by the market to achieve maximum efficiencies and to keep price down to cost (including a reasonable profit), competition can ask little more. But if interbrand competition does not do this job, intrabrand competition may.

Intrabrand competition is likely to be important as a check on firms with market power in concentrated markets, especially where such power is accompanied by a high degree of product differentiation. In such case, by fencing out intrabrand competition—that is, by providing a bottler with an insulated territory, the syrup manufacturer can pass on its market power to the bottler, who can enjoy the power to price above a competitive level.

This, however, is only one of the possible problems in the soft drink industry. Given the historical setting, it is probably short-sighted to look at the restraints in this industry as vertically-imposed by the licensor pursuant to the licensor's current plan for most efficient distribution of its product. The restraints were imposed by licensors in perpetuity three-quarters of a century ago. Since that time, many more efficient distribution methods and systems have arisen. Were it not for the territorial barriers, bottlers could much more efficiently serve supermarket central warehouses, which serve stores located in more than one territory, and the more efficient bottlers and distributors could compete for sales, and expand their sales, across territory lines. The insulated territory is a wall against efficiency, and its very existence prevents the growth of dynamic, new, lower-cost forms of competition.

Given this unusual history regarding the imposition and perpetuity of the restraint, the presumption on which the *Sylvania* analysis proceeds cannot stand. I refer to the presumption that the manufacturer/licensor can be counted on to impose territorial restraints only if they will maximize efficiencies in the distribution of its product to the customer. Since that presumption is applicable to this idustry, it is appropriate to look beyond *Sylvania* to see whether efficiencies are being walled out. It seems clear that they are; and it seems clear that the territorial barrier is preventing the consumer from realizing the benefits of the cost-savings promised by the dynamic, new competition that is being shunted aside.

Antitrust law would promote these efficiencies. S. 598, to the contrary, would suppress them.

II. THE FACTS OF THE BOTTLING INDUSTRY

I have suggested that the Bill would change the applicable standard of legality.

If the bill is not intended to change applicable standards of legality, but rather is intended to reflect legislative fact fiding (*e.g.*, that lifting the territorial barriers will not result in a lower-price alternative to the consumer), I believe that this Bill in this form should not be enacted because the language of the Bill does vary applicable standards of law. I also do not believe that such fact-finding would represent reality.

III. ENVIRONMENTAL INTERESTS

Some have suggested that the competition interest conflicts with the environmental interest and that the environmental interest should be preferred. The suggestion is that a preference for efficiency will result in the demise of the returnable bottle, and the increase of nonreturnable containers will cause a serious environmental problem.

If there is a serious and paramount environmental problem, I would suggest that Congress consider a more clearly targeted statute to protect the environment, rather than an antitrust law which addresses the problem only within the most narrow range of territorial restrictions, and which even then would abandon the environmental concerns if too much competition is lost.

I doubt that the Bill would significantly affect environmental concerns. Neither the law as it now stands nor the Bill would compel territorial restraints. The Bill simply gives the manufacturer or licensor greater choice to decide whether to impose territorial restraints on the basis of its own profit interests. The environmental interest is said to lie with imposition of territorial restraints, but the Bill does not impose them. If this Bill had as a major purpose protection of environmental interest, it would be a weak bill indeed.

Second, I do not think we should assume that efficiency interests run against the returnable bottle. The returnable bottle is cheaper. The container costs less. Seeing its advantage, competitors would maximize this efficiency in a free market. Big retailers may have an additional efficiency in merchandising the returnable bottle; through their central warehouses they would have economies of scale in cleaning and restoring returnables. These efficiencies may counterbalance the cost of handling returnables.

I believe that if there is a environmental problem, it is probably not aggravated by existing antitrust standards; and it is not confronted by this Bill.

IV. THE BILL: A CRITIQUE

To the extent that this Bill is meant to be an antitrust bill to protect competition, I think the Bill would be counterproductive, and I would not support it.

The law as it now stands—the Sherman Act as interpreted by *Sylvania*—reflects a pro-competition and pro-consumer policy. S. 598 would shift the standard away from the consumer interest.

S. 598 reverses pro-competition presumptions of the law. First, it presumes that tight territorial restrictions of trademarked soft drink products, even by market leaders, are valid. In fact, such restrictions threaten harm to competition. The proviso of section 2 of the bill—immunizing the restraint as long as the product is "in substantial and effective competition" with other products of the same general class—could be read to reflect the teaching of *Sylvania;* but in fact, I believe the Bill is intended to be much more receptive to the restraint than is *Sylvania.* "Substantial and effective competition" may be taken to refer simply to existing numbers of competitors, rather than the dynamism of price and related competition as it is with the restraint compared with what it would be without the restraint. "Products of the same class" is likewise troublesome because of its vagueness. It should not be taken to include such drinks as iced tea, milk and orange juice.

Moreover, section 2 of the bill contains a loophole that could be a gaping exception to current antitrust law. It would seem to provide virtual immunity or horizontally-imposed restraints, if only the language of restraint is contained in the licensing contract. In other words, it could authorize cartels among bottlers; conduct which is clearly illegal *per se. United States* v. *Topco Assocs. Inc.*, 405 U.S. 596 (1972).

Section 3 is also a troublesome departure from general principles of antitrust law. It would virtually eliminate treble damages for illegal territorial restrictions in trademark licensing agreements for soft drink products, since the remedy would not be available prior to any final determination, and the practice would probably be discontinued after adjudication of illegality. This means that such territorial restraints would be insulated from private challenge, since it is the prospect of treble damages that provides the incentive to bring most private lawsuits.

I believe strongly in the private lawsuit as an important supplement to the Government's arsenal of enforcement weapons. The victim of a violation feels the harm sooner and more strongly than anyone else, and is most likely to identify the harm and the probable violation, and to sue. Elimination of this remedy undermines the effective enforcement of antitrust.

The bottlers persist in asserting that their territorial restrictions cause no harm. If this is so they should not worry about suits by injured persons; Section 3 would be unnecessary.

CONCLUSION

I understand that the bottlers would like greater certainty, and they would like a law to protect and maximize the value of their investments. These are

desires not unique to the bottlers. I have sympathy with these desires, but I have greater priority for effective and uniform principles of antitrust.

In conclusion, I believe S. 598 would create more harm and havoc than good. Thank you.

Senator METZENBAUM. Our last witness today is Mr. Silbergeld, who will represent and is Washington director of the Consumers Union. We are very happy to have you with us, Mr. Silbergeld and since I know that all those people seated in the audience are all constituents of yours and advocates of the Consumers Union, we are happy to welcome you. I assume they are all that.

TESTIMONY OF MARK SILBERGELD, DIRECTOR CONSUMERS UNION WASHINGTON OFFICE

Mr. SILBERGELD. Thank you, Mr. Chairman. Obviously, within the time left, I am going to be unable even to highlight all of my assessment of this bill. Much of what I have to say has been assessed by Professor Fox, by the representative of the Federal Trade Commission and the Justice Department. I would like to say, therefore, only three things.

First: I would like to say that the Consumer Federation of America authorizes me to say that they join me in my prepared statement and in the remarks that I make this morning.

Second: I would like to say that because of the tremendous importance of our economic system of antitrust laws and the tremendous importance—beyond this Federal Trade Commission case and beyond this industry—that the antitrust remain whole and effective, not only is this the wrong bill, but this is the wrong time in the process, for the legislative branch to be trying to sort out operating facts about particular industries on the basis of these hearings and, in effect, telling the administrative process and the judicial review process before it is even completed: "You have got the wrong results."

Congress has enacted the antitrust laws with the understanding that there would be a quasi-judicial administrative process utilizing adversary kinds of proceedings which Congress, in their own judgment, thinks best designed to test the validity of the particular factual economic and other evidentiary assertions that are placed before the decisionmaker. The witnesses are questioned, not only, by the decisionmaker but by the other side. At least, at the very least, until that process is completed and we have a decision after review by the judicial branch, it seems to be that this is absolutely the wrong time if Congress intends to signal that the antitrust laws are still playing a primary role in assuring competition in our economy and so to be telling the system that part of that process is being shut down before it is even completed.

I would like to focus, however, Mr. Chairman, just a few moments on the small business nature of the industry. Much has been made of that. The committee well knows that there has been an effort since 1972 to obtain the various forms of legislative relief for the soft drink industry. That effort by the industry has focused on the argument that it is characterized by small business. While there are certainly small businesses in the industry, they do not characterize it, they do not dominate it, they do not produce most of the output. Most of the

output is produced by a small number of the total financial holdings in the industry. The industry has, under the present territory franchising system, become increasingly concentrated ever since World War II. I would be glad to answer any questions in writing or submit views as to perhaps why that is true. But the fact is, the system this legislation seeks to preserve has not prevented the elimination of most of the small businesses from this industry. Indeed, Beverage Industry, a trade magazine which is highly knowledgable about the workings of this industry says "Further concentration in this industry is inevitable."

Furthermore, we talk about giving antitrust exemptions not only to the small businesses in the industry but to the entire industry. If we are going to do that, we had better look at who is going to get the antitrust exemptions. The largest bottlers in the country are PepsiCo., Inc. and Coca-Cola Co., the parent companies that manufacture syrup as well as operate territory franchises. They would get antitrust exemptions under this bill.

Some of the large independent bottlers are huge corporations, including Coke of New York, and Coke of Los Angeles and several other bottlers in this industry. They are tremendous corporations; bids on Coke of Los Angeles have been made which indicate that its holding are worth many, many millions of dollars. Indeed, Coke of Los Angeles itself in a period of only 11 months last year spent $80 million to acquire other bottlers in order to enlarge the size of its empire.

Furthermore, we have a number of very, very large number of conglomerate firms holding franchises from the syrup manufacturers operating this industry. These include the Liggett Group, better known as "Liggett & Myers", General Tire, Illinois Central Industries, IC, Division of ITT, Beatrice Foods Corp., Warner Communications, and Twentieth Century-Fox.

Senator METZENBAUM. Did you for some reason skip Norton Simon and General——

Mr. SILBERGELD. Norton Simon, and there are others and they are in my complete statement.

Senator METZENBAUM. General Cinema? These are all franchise holders?

Mr. SILBERGELD. That's right, Mr. Chairman. I take that back, Norton Simon, I believe, is both a syrup manufacturer and a bottler.

Senator METZENBAUM. Warner Communications is a franchise holder?

Mr. SILBERGELD. Yes.

Senator METZENBAUM. Twentieth Century-Fox is a franchise holder?

Mr. SILBERGELD. Exactly, Mr. Chairman.

Senator METZENBAUM. Those are hardly small business.

Mr. SILBERGELD. Exactly, Mr. Chairman, and that is why Consumers Union and Consumer Federation of America are extremely concerned about special antitrust treatment for this practice by firms of that size and that nature—above and beyond our general concern, giving any special antitrust treatment where competition should be the rule.

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Senator METZENBAUM. Do you have any thoughts as to how we could draft this legislation so that those franchises which are held by economic giants would be subjected to competition, while we talk about protecting the so-called "Mom and Pop" bottling operations?

Mr. SILBERGELD. I don't, Mr. Chairman, for the same reasons that the Justice Department had none to offer and that is we recommend strongly against any bill for two reasons:

One: We don't think proponents have met the tremendous burden of justifying any antitrust exemption, even if there are some arguments on each side which sponsors of the bill and the chairman can debate. All that shows is that there is a debate and not that the tremendous burden, which the ABA, the American Bar Association—long interested in antitrust matters—and the National Commission on Antitrust Law and Procedures say must be carried by any for special enforcement of antitrust legislation:

Two: And because as we said before, this is the wrong time for the Congress to step into this kind of thing. The court of appeals is not yet finished and there is still a possibility of appeal to the Supreme Court.

Senator METZENBAUM. Mr. Silbergeld, I hear exactly what you are saying and I understand your opposition. The Chair is also aware of the fact that Senator Thurmond has pointed out that substantially more than majority Members of the Senate are indicating their support. Be that as it may, that doesn't mean that this subcommittee intends to give up its prerogatives with respect to the legislation, nor with respect to the right to amend it.

I think that there is a distinction between a small local operation and a company owned by some of the giants whose names you just mentioned. Therefore, without compromising your position and being opposed to the legislation generally, I would be, the subcommittee would appreciate your views as to any amendments that might be considered which would distinguish between certain categories of the bottling industry.

Mr. SILBERGELD. Mr. Chairman, I will be glad to submit new criteria for, when I return to correct the transcript from this morning's hearing.

Senator METZENBAUM. Do you have anything further, Mr. Silbergeld?

Mr. SILBERGELD. No, thank you Mr. Chairman.

Senator METZENBAUM. I think I have a couple of questions. Specifically, how are consumers hurt by the territory restrictions in the soft drink industry?

Mr. SILBERGELD. Territorial restrictions restrain intrabrand competition which, in light of the conditions in the entire industry—which includes both the bottlers and the syrup manufacturers—should serve to enhance competition. Indeed, according to the figures presented by Dr. Comanor this morning, the high level of concentration at the manufacturers' level of course results in higher prices to consumers. The Federal Trade Commission, indeed, in 1972 at the first hearings before this subcommittee on legislation on this subject estimated the cost, I believe, conservatively, at one-quarter million dollars. And certainly, inflation since that time has run that figure far higher.

Senator METZENBAUM. How do you respond to the bottlers' argument that the elimination of territorial restrictions will mean the disappearance of returnable bottles?

Mr. SILBERGELD. To be quite frank, I have seen Mr. Koons' more lengthy presentation including the substantial printed booklet and I don't find that the argument is convincingly made. Second, I would like to clear up one point that was raised previously and that is the committee should know that one of the reasons for the popularity of the returnable bottles is lower price. As I understand from Mr. Koons' slide show, one of the reasons for the lower price is that the nonreturnable containers are subsidizing promotional costs of the returnable bottles. That explains one of the reasons why consumers buy it but they don't want to return the bottles. Part of the cost of promoting the returnable bottles is carried in the higher cost of the nonreturnables. Consumers may prefer returnable bottles but there are two questions:

(1) At what price?

(2) Would they prefer it at the price that it would have to be marketed at the full cost of marketing as well as the production?

If we are to protect the returnable bottles, there are more effective ways to do it then to hand out a far broader than necessary antitrust exemption. One of those ways is to consider a direct ban on nonreturnables, through mandatory cost legislation.

Senator METZENBAUM. Senator Cochran?

Senator COCHRAN. It sounds awfully inconsistent with your statement on how you stand where you say you would need to study that to see whether it would result in the elimination of the type of bottles. Here you are talking about subsidizing returnable bottles by this and I am not sure this is realistic. There has been a study made by the Office of Technology Assessment to which you refer in your statement.

Mr. SILBERGELD. Senator, I think.

Senator COCHRAN. You quote from it and it comes to the conclusion that "if upheld by the courts and not amended by the Congress, the recent FTC decision which outlaws territorial franchise restrictions for trademarked soft drinks in nonreturnable containers could lead to rapid concentration in that industry. The outcome would be an industry with only a few firms having a few large plants as well as the rapid disappearance of the refillable bottle for soft drinks.

If we have any questions, we will submit them in writing, Mr. Chairman, in the interests of time.

Mr. SILBERGELD. I will be glad to respond to them.

Senator COCHRAN. I express my appreciation to Mr. Silbergeld for being here and contributing to the hearing.

Senator METZENBAUM. There may be other members of the subcommittee, like Senator Bayh and Senator Thurmond, who may desire to submit questions to you as well as to the other witnesses. That is the usual practice of the committee, and I am sure you will be glad to cooperate in that respect.

Mr. SILBERGELD. I will be glad to cooperate.

Senator METZENBAUM. Thank you very much, Mr. Silbergeld. Your entire statement will be included in the record.

That concludes the hearing in connection with this particular matter.

[Whereupon, at 12:23 p.m., the hearing was adjourned.]

[Questions submitted by Senators Bayh and Metzenbaum with responses and Mr. Silbergeld's prepared statement follow:]

CONSUMERS UNION,
Washington, D.C., October 12, 1979.

Hon. BIRCH BAYH,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BAYH: This letter provides answers, for inclusion in the hearing record, to questions posed to me in your letter of October 3. As you have indicated, I regret that the brief time available for questions when I testified on September 26 before the Subcommittee on Antitrust, Monopoly & Business Rights on the subject of territorial franchising practices in the soft drink industry did not permit us to explore at that time the questions which you raise. This letter will provide you with my full views on these subjects.

1. *If bottler territories were eliminated, would there be a further reduction in the number of bottlers?* There will be a further reduction from the present number of bottlers *whether or not* the territories are eliminated. This has been the trend in the industry since the end of World War II, when there were more than three times the number of bottlers which now operate. The Coca-Cola Co., before the issue became sensitive as a result of proposed legislation, maintained a "Bottlers Consolidation" division to assist its franchised bottlers in arranging acquisitions and mergers. It planned to reduce the number of franchised Coca-Cola dealers substantially, from several hundred to an eventual target of about 90 franchises which would service the entire nation. *Beverage World* states that continuation of this trend toward acquisition and merger in the industry is "inevitable." The more important question for consumers is not whether, e.g., 1200 instead of 990, bottlers eventually will supply the nation with soft drinks, but whether the prices for the industry's products will be set competitively. In our view, elimination of the restraints would help to improve substantially inadequate price competition in the soft drink bottling industry.

2. *If bottler territories were eliminated, would the market position of bottlers owned by large companies increase or decrease.* The answer to this question depends upon information which does not, to my knowledge, exist. The bottlers which would be eliminated from the industry in the face of open intrabrand competition would be the least efficient ones. I know of no study which compares the efficiency of bottlers owned by small companies with those owned by large ones. To consumers, the more important questions are whether bottlers realize economies of scale which reduce production costs and whether these products are competitively priced. I believe that this can best be achieved by open intrabrand competition in the industry. Indeed, one highly plausible explanation for the very substantial increase in concentration of the industry since 1946 through acquisition and merger is that the exclusive territory franchise system otherwise would have prevented realization of economies of scale made possible by improved transportation and bottling equipment.

3. *If bottler territories were eliminated, which group would probably experience an enhanced market position—independent bottlers or bottlers owned by large companies?* Please refer to my response to the first question. I know of no data comparing efficiency by size of the bottlers' parent financial interest. The group which would realize enhanced market position on a national basis would be defined primarily by degree of efficiency, rather than by size of ownership. However, the relevant market is not now national and is not likely to become national if territories are eliminated. It is presently defined with respect to intrabrand sales by territories and with respect to interbrand sales by the overlapping territories of bottlers of competing brands. The markets obviously would be redefined if territories were eliminated, as the present contractual definitions are artificially. However, it is unlikely that markets would become national if territories were eliminated, due to diseconomies in distributional costs. Markets, rather, would likely become regional. But it is difficult to determine how consumers could be worse off under changed inter- or intrabrand market concentration projected as resulting from territory elimination, whatever redefinitions of markets occur. That is because at present the product is produced by an industry which is insufficiently competitive at the interbrand level, according to the FTC, and 100 percent concentrated on a market-by-market (i.e., bottler territory) basis at the intrabrand level.

4. *Provide any data which refutes the finding of the FTC administrative law judge that over 80 percent of bottlers of Coca-Cola have less than 100 employees.* I know of no data which would refute this finding. However, the finding is not dispositive of the far broader issues raised by the proposed legislation. Further, most of the industry's output is produced by a small number of large firms in the industry, as indicated in my prepared testimony. And the small firms have been and continue to be faced with the long-term prospect of acquisitions and mergers which have increasingly concentrated the industry since World War II. Indeed, *Beverage Industry* states that continuation of this trend is inevitable. Thus, retention of the territorial system would not preserve the number of small businesses presently active in the industry. But it would continue to have adverse effects on the prices which consumers pay for the industry's products.

5. *Provide any data which refutes the finding of the FTC administrative law judge that in 1974 there were 343 bottlers of Coca-Cola which sold less than 2 million cases of soft drinks a year.* I know of no data which would refute this finding. However, for the reasons stated in response to both these questions, this fact is not dispositive of the broad issues involved. Further, this question and the previous one implicitly assume that smaller bottlers are less efficient than bottlers owned by larger firms. I know of no evidence to support this assumption. Further, if it is nonetheless assumed for the purpose of discussion to be correct, then the remedy of preserving territories becomes one of protecting inefficiency. This policy is a sure prescription for inflation in our economy. A free enterprise market system assumes that competition creates the efficiency necessary to restrain prices at the level sufficient to assure a sufficient supply of goods and services. To legislate away this basic operating assumption of the market system serves neither consumer nor business well.

If I can provide further information or views with regard to the subject matter of the hearings, please do not hesitate to let me know.

Sincerely,

MARK SILBERGELD, *Director.*

CONSUMERS UNION,
Washington, D.C., October 12, 1979.

HON. HOWARD M. METZENBAUM,
Chairman, Subcommittee on Antitrust, Monopoly and Business Rights,
Committee on the Judiciary,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request during the September 26 hearings on S. 598 for my recommendation as to how the provisions of that bill might be amended to make the bill more acceptable, should the Subcommittee decide to approve some measure on the subject of soft drink territories. I would like to reiterate that Consumers Union is opposed to the enactment of any bill modifying the Federal Trade Commission's action on this subject, and especially until judicial review of FTC's action has been completed.

However, recognizing that the Subcommittee may nonetheless decide to take action and that, as stated in the testimony of Professor Eleanor Fox during the hearings on the 26th, the present approach of the bill is particularly egregious, I would like to suggest some alternatives to the approach presently embodied in S. 598.

It would be advisable to limit any action the Subcommittee may take to the claims made on behalf of the bill by its proponents. The two reasons which have been advanced for passage of the bill are (1) that it is necessary to preserve small firms' continued participation in the soft drink industry and (2) it is necessary to preserve the returnable soft drink package.

As pointed out in my prepared testimony presented on September 26, while there are small firms in the soft drink industry, they do not characterize the industry and there is no hard evidence that they are inefficient or could not continue to compete effectively if territories were eliminated. Nonetheless, if the Subcommittee disagrees with the evidence supporting this view, it should limit any action taken to "preserve small businesses" in the soft drink industry to just that purpose. It should not grant a blanket protection of existing territorial restrictions to all firms in the industry, including the syrup manufacturers, giant independent bottling interests and large conglomerates, as would S. 598.

For this reason, a small business approach to amendment of S. 598 should assure that only territories served by small businesses as of the effective date

of the Act are permitted to be subject to exclusively agreements, and then only for so long as the franchise holder continues to meet an appropriate definition of small business. Or, the Subcommitee might adopt a conjunctive dollar volume/single line of business definition.

In no event should the definition of small business adopted under the proposed legislation permit a firm to qualify for exemption if it has more than 100 employees. In D. 8855, *Coca-Cola Co.*, the FTC Administrative Law Judge found that over eighty percent of Coca-Cola bottlers employ 100 or fewer employees. These firms would qualify for an exemption under the proposed Act. But there would be no point to amended S. 598 if the remaining approximately twenty percent also were to qualify for exemption; seventeen percent of the industry products sixty-five percent of the industry's product. Presumably, it is this high volume production segment of the industry which small bottlers and the sponsors of S. 598 argue they wish to prevent from taking over the small, lower-volume firms in the industry.

Further, it should be clear that the firm which must qualify as a "small business" is not merely the bottling firm but the firm which includes the bottling firm and all other financial holdings of related firms. For example, the bottling subsidiary of a $2 billion dollar conglomerate corporation should not be permitted to qualify as a small business for purposes of the proposed legislation merely because the conglomerate has acquired and operates a bottler which employs 95 workers. This would be in accordance with principles utilized in determining eligibility under Small Business Administration loan programs.

As I stated in my testimony on September 26, the case has not been made that legislation modifying the FTC's action is necessary to preserve the returnable soft drink bottle. Indeed, the FTC itself considered arguments regarding the need for exclusive territories to preserve the use of returnables and, deciding that these arguments have merit, ordered that territorial restrictions for sale of soft drinks in returnable containers are reasonable under a rule of reason test. Thus, the FTC action preserves territorial agreements in order to protect the returnable container. No case has been made that this action is insufficient for its purposes.

However, should the committee nontheless decide to take some action on the grounds of assuring the continued use of returnable soft drink containers, an amendment to S. 598 should assure that syrup manufacturers and bottlers who receive protection for their actions in entering into exclusive territory agreements are required to distribute an appropriate minimum percentage of their finished product in returnable containers. Unlike H.R. 3573 and similar bills, this approach would assure that the bill effectuates its ostensible purpose, rather merely then serving as a respectable cover for granting special antitrust treatment to the industry.

As I have stated, we strongly urge that consumers who pay for soft drinks are best served by *no bill at all* to modify the FTC's orders involving soft drink industry exclusive territory franchising practices. Nonetheless, should the Subcommittee determine to take some action on this subject, the approaches I have indicated would be less egregious than that of S. 598.

I hope that these views meet your request for recommendations and will be of assistance to you if the Subcommittee does act to recommend some legislation on this subject. If I can be of further assistance to you or your staff, please do not hesitate to call on me.

Sincerely,

MARK SILBERGELD, *Director.*

PREPARED STATEMENT OF MARK SILBERGELD

Mr. Chairman and members of the subcommittee, Consumers Union[1] greatly appreciates your invitation to testify on S. 598, a bill which would grant a

[1] Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education, and counsel about consumer goods and services and the management of the family income. Consumers Union's income is derived solely from the sale of *Consumer Reports*, its other publications and films. Expenses of occasional public service efforts may be met, in part, by nonrestrictive, noncommercial grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports*, with over 2 million circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

special exemption from the antitrust laws to producers and distributors in the soft drink industry. Consumers Union strongly opposes this Bill.

This legislation would protect the exclusive territory franchising practices of the soft drink industry from application of the antitrust laws, designed to protect and foster competition, despite the fact that the Federal Trade Commission has examined this territorial allocation system under a "rule of reason" test and finds no economic justification for the practice—except with respect to returnable bottles. The Bill's basic assumption is that competition is an economic disease. We believe, to the contrary, that competition is the tonic that keeps the economy healthy.

Not only would this legislation prevent an infusion of competition into the soft drink industry; it also could start a flood of demands for equal treatment by other industries which do or could utilize, as a marketing tool, this form of agreement not to compete. These include the automobile industry, the bicycle industry, the mattress industry, the independent grocers, and others which either have lost cases related to similar marketing arrangements, or which at present utilize similar arrangements.

When this legislation was first proposed, the monopoly overcharge attributed to the effects of the exclusive territory system in the soft drink industry was estimated by the Federal Trade Commission to be approximately one quarter billion dollars annually. The high level of inflation in the ensuing seven years justifies a very hefty increase in the level of those estimates. *But*—we can be certain—the costs of this legislation eventually will go far beyond those involving the soft drink industry. For, once these exemptions have been granted, it will be difficult, if not impossible, to say "no" to those other industries which will be in a position to demand the equal right to stand under that umbrella which provides a shield against full and effective competition.

This proposed legislation would overturn a decision of the Federal Trade Commission which is now under judicial review before the U.S. Court of Appeals for the District of Columbia Circuit. The FTC and Court of Appeals reviews—as will be the Supreme Court review, if judicial review reaches that level—are based on an extensive hearings record. The industry now asks the Congress based on highly selective arguments called from the record and on assertions not even contained in the record to reverse the FTC decision. These will not be subject to the same rigorous, adversarial examination afforded by the FTC's administrative process. In fact, the legislation now before you would shortcut the Congressionally-established process for determining such complex questions of economic fact and law. This, in itself, is reason not to act on this legislation, at least until the judicial review process has been completed.

It is fair to state that the soft drink exemption legislation would never have reached this point but for a massive, extended lobbying campaign directed at virtually every Member who has served in the Congress since 1972. This campaign has been relatively successful primarily because of the geographical distribution of the soft drink industry, which has at least one, and in many cases several, bottling entities doing business in every Congressional district. Had the industry involved consisted of a few producers located in a few districts, it seems safe to assert, the legislation would not have come this far on its own merits. A look at the merits of the arguments underlying this campaign is appropriate—and revealing.

The industry's approach to the Congress is cloaked in the guise of an industry consisting substantially of small, family-operated businesses which could not survive under conditions of competition. The argument advanced is that only preservation of the exclusive territory franchise system will preserve the small businesses in this industry. Quite aside from long-standing public policy which assumes competition to be a healthy and necessary condition, rather than a fatal disease, this representation is simply inaccurate.

The soft drink industry is no longer characterized by small businesses. The number of small businesses has declined drastically since the end of World War II. These have given way to large, conglomerate firms and to very large bottling interests with substantial multiple-plant, multiple-territory, multi-state franchise holdings.

In 1950, there were more than 6,000 soft drink plants in operation. By 1960, there were less than 4,600. Presently, the number barely exceeds 2,000. Indeed, as recently as June 1977, *Beverage Industry*, a trade publication knowledgeable about the soft drink trade, stated that the trend is irreversible. The National Soft Drink Association reports that from 1970–77, 890 bottling and canning

plants went out of production. And over 70 soft drink firms were acquired by other companies during the period 1970–77, according to the American Institute of Food Distribution.

Until the controversy over this legislation in the early 1970s made the fact notorious, the Coca Cola Company maintained a "Bottler Consolidations" unit, designed to assist mergers and acquisitions among bottlers, pursuant to a plan to reduce the number of its franchisees from several hundred to less than one hundred. Four and one-half percent of all bottling plants produced almost thirty percent of industry output and seventeen percent of the plants produced about sixty-five percent of output, as of 1973.

Thus, whatever effect may be predicted as a result of the FTC's ruling, one thing is clear. The soft drink industry under the territorial franchising system is increasingly concentrated and decreasingly small business. Preservation of the system FTC has found unlawful will not prevent this trend.

The corporations which would receive antitrust exemption under the proposed legislation include the nation's two largest soft drink bottlers—the Coca-Cola Company and PepsiCo, Inc., which reserve for themselves some of the nation's choice geographical markets in which to bottle and wholesale soft drinks. There is a very good argument that the p rimary effect of the exclusive territory agreements is to protect Pepsi and Coke from competition at the bottling level of soft drink production.

Other so-called "small businesses" engaged is soft drink bottling under franchises from one or more of the nation's eight largest soft drink syrup producers—or from themselves as one of those eight—which would benefit from protection under S. 598 include:

The Liggett Group (Liggett & Myers) (Pepsi Cola), General Tire and Rubber Co. (Pepsi Cola), IC (formerly Illinois Central Industries) (Pepsi Cola), Cantrell & Cochrane (Division of ITT) (Cott), Norton Simon, Inc. (owner and bottler of Canada Dry), General Cinema Corp. (Pepsi Cola, Seven-Up, Dr. Pepper), Southdown, Inc. (Royal Crown), Beatrice Foods (Royal Crown Cola), Warner Communications (Coca Cola), and Twentieth Century Fox (Coca Cola).

Even companies which are engaged *primarily* in bottling can be very large. Two firms, Associated Coca-Cola Bottling Co. and Coca-Cola Bottling Co. of N.Y. have cartelized the bottling of Coca-Cola across huge portions of the populous state of New York. A very few companies control the territories for the bottling and sale of Coca-Cola, Pepsi-Cola, or each of these brands, in market areas of heavy population density or heavy tourist trade, including Southern California, the vacation and retirement areas of Florida and Nevada, and the northeast corridor from New York to Boston.

The size and power which an independent bottling company can attain under the exclusive territory franchise system—which supposedly protects small bottlers—is best ilustrated by the 1977–78 acquisition efforts of the Coca Cola Bottling Co. of New York. This giant firm spent $85 million over eleven months to acquire bottling companies in Maine, Kentucky, Kansas, Nebraska and Colorado. Other large interests merged during this period, as another giant, Coca Cola Bottling Co. of Los Angeles purchased more than 98.3 percent of Coca-Cola Mid-America.

In view of these trends, it seems clear that the only way—if, indeed, there remains a way—for a small bottler to survive eventual extinction is to overcome the diseconomies of small scale operation by increasing its volume of business. And, with a leveling off of population growth, this is precisely what territorial restrictions prevent. Thus, small businesses' chance for survival can only be hurt, not helped, by these restrictions.

One segment of the small business community which has been little heard from on this issue is the small businesses which retail soft drinks and cannot find price-competitive sources for the popular brands of soft drinks they sell. These small businesses, as well as the consumers they serve, are entitled to competition among their suppliers. But the exclusive territory franchise system, by eliminating intrabrand competition, denies them that right in great part.

The American Bar Association as well as antitrust specialists long have held to the principle that those who seek special antitrust treatment bear a very heavy burden of proof. What justification—other than the spurious small business plea—can be made for the grant of some form of antitrust exemption, as this legislation proposes? The evidence relating to this industry, to the contrary, seems to call for just the antitrust enforcement action which the FTC has taken, rather than for legislatively-mandated antitrust forbearance.

A primary economic justification offered is that there is sufficient inter-brand competition to assure competitive pricing of soft drinks. However, the FTC has ruled that this is not the case. Little wonder. 1978 data shows that the brands franchised by the two largest syrup manufacturers—the Coca Cola Co. and PepsiCo, Inc.—hold 59.6 percent of the national market. And the brands franchised by the four largest syrup manufacturers hold 73.1 percent of the national market.

The relevant markets, of course, are the local or regional markets, for most of which concentration figures are not readily available. But to the extent that the national market figures overstate concentration in some markets they must understate them in others. And the national figures meet and surpass standard industrial analysis criteria for shared oligopoly.

The other primary justification which has been advanced is that the territorial system is necessary to survival of the returnable bottle. But the FTC order permits exclusive territories to be maintained for this submarket because it finds that the hearing record provides reasonable justification for this claim. One bill which has been introduced, H.R. 3573, claims to provide for protection of the returnable bottle as an energy efficient and ecologically sound package for soft drinks. Both the bill's "findings" section and its "declaration of policy" section propound at length on these subjects. *However*, the *operative* section of the bill, while providing strong standards for preservation of exclusive franchise territories, makes no mention of the returnable bottle. This form of soft drink package could disappear from the market and the protective standards of that bill would remain. Should a similar bill be introduced into the Senate, we would urge the subcommittee to look very closely at this curious feature.

It is theoretically possible that some optimal mix of returnables in the totality of soft drink consumer packages—perhaps containing more returnables than the present mix—would yield a lower weighted average retail price for soft drinks than would mere prohibition of exclusive territory franchising. This possibility is based on the claimed lower production costs for returnables. However, to evaluate this claim thoroughly would require an independent, thorough economic inquiry into a number of relevant factors. These include, among other considerations, the recovery rate for returnables, the effect of returnables on backhauling by soft drink delivery vehicles, the shifting of some marketing costs of returnables into the price of non-returnables, as well as the cost of producing returnables and non-returnables.

Additionally, in order to consider a public policy ensuring an optimal mix of returnables, it would be necessary to compare such alternatives as a ban on non-returnables, a requirement for a minimum percentage of returnables in each bottlers' mix and a federal deposit law.[2] Without consideration of these factors, any action related to the use of returnable soft drink containers can address only the bottling industry's special interests, not the consumer's interest in an optimal balancing of competitive prices, energy conservation and the ecology of solid waste control. And, at that, the industry still would carry the very heavy burden of justifying an exception to the antitrust laws.

In conclusion, Mr. Chairman, we oppose S. 598. It is not the small business protection measure that the soft drink industry claims it to be. Indeed, it cannot be so, because the industry is now characterized primarily by large—and some giant—corporations.

Further, enactment of this legislation at this time would interfere with the established process of judicial review of agency decisions before that process is completed. This would signal that every FTC antitrust action not to the liking of the industry involved is fair game for political reversal. To give such a signal would threaten FTC enforcement of the antitrust laws and their restraining effect on inflation. And, because the American consumer is the ultimate beneficiary of these laws, it would add to the already heavy burden of high prices and inflation now borne by consumers. The antitrust laws are key to assuring the lowest prices consistent with a fair return on investment. We urge the subcommittee *not* to undercut their purpose through recommendation of S. 598.

Thank you, Mr. Chairman.

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[2] See *Materials and Energy From Municipal Waste—Beverage Container Deposit Legislation*, Office of Technology Assessment, July 1979.

APPENDIX

A Rule of Reason Decision Model After Sylvania

(By Eugene F. Zelek, Jr.*, Louis W. Stern**, and Thomas W. Dunfee***)

Writing for the Court twenty years ago, Justice Black characterized economic inquiry in antitrust cases as "often wholly fruitless," while stating that rules of per se illegality not only avoid most of this "incredibly complicated and prolonged" analysis, but also provide more certainty to those concerned.[1] Later, Justice Marshall expressed the Court's reluctance to "ramble through the wilds of economic theory" in *United States* v. *Topco Associates, Inc.*,[2] noting that "courts are of limited utility in examining difficult economic problems."[3] In laying down a per se rule,[4] the majority stated that the judiciary's "inability to weigh destruction of competition in one sector of the economy against promotion of competition in another sector" is a key factor in the formulation of such rules.[5] Overall, the Court felt that it was "ill-equipped and ill-situated for such decision-making."[6]

Ironically, the Supreme Court's return to a rule of reason standard for cases involving vertical restraints[7] in *Continental T.V., Inc.*, v. *GTE Sylvania, Inc.*[8] requires precisely the sort of economic investigation and balancing shuned by *Topco* only five years earlier.[9] Yet, as several commentators have pointed out, no analytic structure exists to accomplish this task, leaving lower courts with little

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[1] *Northern Pac. Ry.* v. *United States*, 356 U.S. 1, 5 (1958). Justice Black also articulated the classic justification for per se rules: "[T]here are certain agreements or practices which because of their pernicious effect on competition and lack of any redeeming virtue are conclusively presumed to be unreasonable and therefore illegal without inquiry as to the precise harm they have caused or the business excuse for their use." Id.

[2] 405 U.S. 596, 609 n. 10 (1972).

[3] Id. at 609.

[4] See notes 91–96 and accompanying text infra.

[5] 405 U.S. at 609–10. But see *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. 365, 381–82 (1967) where such analysis was done with regard to restrictions in consignment and agency agreements.

[6] 405 U.S. at 611. In his dissent, Chief Justice Burger noted the seeming inconsistency implicit in the Court's handling of *Topco* and another antitrust case decided the same day where the lower court was commended for its approach to a problem involving "predictions and assumptions concerning future economic and business events." Id. at 622 n. 10 (Burger, C. J., dissenting) (citing *Ford Motor Co.* v. *United States*, 405 U.S. 562, 578 (1972)).

[7] Vertical restrictions are those imposed by agreement among firms or individuals at successive stages of distribution, such as those between a manufacturer and a distributor or dealer. In contrast, horizontal restrictions usually involve competitors or those economic entities at the same level in the distribution chain. *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 378–79; *United States* v. *Sealy, Inc.*, 388 U.S. 350, 352–54 (1967). Although it is often important from an antitrust point of view to distinguish these types, such categorization is not always an easy matter. See notes 91–96 and accompanying text infra.

[8] 433 U.S. 36, 59 (1977).

[9] See id. at 57 n. 27. Shortly after deciding *Sylvania*, the Court used the economic complexity rationale in an entirely different context to deny indirect purchasers the right to sue under the antitrust laws. For a criticism of this approach, see Dunfee, "Privity in Antitrust," *Illinois Brick Co.* v. *Illinois*, 16 Am. Bus. L.J. 107, 112–115 (1978).

guidance in the matter.[10] This article will attempt to provide such a framework in the form of a rule of reason decision model applicable to the antitrust analysis of vertical restraints and focusing on territorial and customer restrictions in particular. In addition, application of the model will be demonstrated in the context of the Federal Trade Commission's decision in *Coca-Cola Co.*,[11] currently before the District of Columbia Circuit on appeal. However, before these steps can be accomplished, some preliminary points on vertical restraints and the law in the area must be set out.

VERTICAL RESTRAINTS ON COMPETITION

The long-term viability of the firm hinges on the ability of its distribution system to compete effectively with the systems of rival firms.[12] The dominant firm in the distribution channel—usually the supplier—seeks to influence the channel to the greatest extent possible[13] so that it presents a united front against competitive brands consistent with the supplier's goals. For example, the supplier would much rather have its distributors compete with those of other brands than to slug it out among themselves.[14] In addition, the supplier wishes to retain control over the channel by assuring that no distributor or group of distributors becomes too powerful.[15] At the same time, it desires to foster good relations with its distributors by insuring them adequate profits in return for adhering to its policies regarding such elements as promotional effort and customer service.

The supplier may use its power to impose restrictions on its distributors in order to coordinate the channel and maximize the chances for attaining its own goals.[16] These restraints may lead to more effective interbrand competition, but

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[10] ABA Antitrust Section, Vertical Restrictions Limiting Intrabrand Competition 54 (Monograph No. 2, 1977) [hereinafter cited as ABA Monograph] ; Pitofsky, "The Sylvania Case : Antitrust Analysis of Non-Prile Vertical Restrictions," 78 Column. L. Rev. 1, 34 (1978) ; Posner, "The Rule of Reason and the Economic Approach : Reflections on the Sylvania Decision," 45 U. Chi. L. Rev. 1, 13–16 (1977) ; [hereinafter cited as The Supreme Court]. See *Kestenbaum* v. *Falstaff Brewing Corp.*, 575 F. 2d 564, 570 (5th Cir. 1978).

[11] 91 F.T.C. 517 (1978), appeal docketed, No. 78–1364 (D.C. Cir. ——— 1978). PepsiCo, Inc., 91 F.T.C. 680 (1978), appeal docketed, No. 78–1544, 78–1545 (D.C. Cir. ——— 1978), was issued the same day as Coca-Cola and in both opinions, the FTC found the companies' territorial restrictions to be unlawful under a rule of reason test. See notes 179–249 and accompanying text infra.

[12] L. Stern & A. El-Ansary, Marketing Channels 6 (1977). Each distribution system is composed of at least one marketing channel which is defined as the "set of interdependent institutions and agencies involved with the task of moving anything of value from its point of conception, extraction, or production to points of consumption." Id. at 4. Thus, a hypothetical manufacturer's distribution system could be comprised of several channels involving the movement of goods from the manufacturer (1) directly to end-users, (2) through wholesalers to end-users, and (3) through wholesalers and retailers to end-users. Of course, many more channels and channel configurations are possible, often operating concurrently within the same distribution system.

To simplify discussion, the term *supplier* will refer to the firm on the selling side of the market, while distributor will refer to the reseller-buyer. See generally Preston, "Restrictive Distribution Arrangements : Economic Analysis and Public Policy Standards," 30 Law & Contemp. Prob. 506, 507 n.4 (1968).

[13] A supplier could achieve complete control over its distributors through vertical integration, but this alternative is not always feasible because of significant integration diseconomies :

> First, distribution is a relatively low-profit activity ; if a supplier can obtain the desired degree of control without assuming full investment responsibility, he may be able to employ his capital more profitably elsewhere. Second, distribution is typically a multiproduct activity, with the product mix of distributors substantially different from that of any one supplier ; vertical integration under these circumstances involves a substantial broadening of a supplier's product responsibility as well as his functional role. Finally, the local managerial problems and personal service content of distribution discourage suppliers from integrating forward when other alternatives are available.

Preston, *supra* note 12, at 512 (footnotes omitted). Under these circumstances, the supplier will choose to deal with independent distributors.

[14] Stern, Agodo, & Firat, "Territorial Restrictions in Distribution : A Case Analysis," 40 J. Marketing 69, 69 (April 1976).

[15] Id. at 70.

[16] Channel power is "the ability of one channel member to get another channel member to do what the latter would not otherwise have done." L. Stern & A. El-Ansary, *supra* note 12, at 286 (footnote omitted). This power may be based on rewards, coercion, expertness, identification, and legitimacy. *Id.* at 288–91 (citing, French & Raven, "The Bases of Social Power," in Studies in Social Power 150–67 (D. Cartwright ed. 1959)). Note that distributors may exercise their power and negotiate certain restrictions as a quid pro quo to the supplier's demands. In some cases, this can lead to an antitrust violation. See, e.g., *United States* v. *General Motors Corp.*, 384 U.S. 127 (1966).

they usually involve a lessening of intrabrand competition.[17] From an antitrust perspective, this result may be somewhat troublesome, since the law, unlike the supplier, is interested in protecting competition among all brands, including the supplier's own.[18]

Vertical restrictions can be broken into four general classifications that vary in their form and can vary in their anticompetitive impact. The first two of these—vertical price fixing[19] and product restrictions[20] are outside the scope of this article. The last two types involving restraints on customers[21] and territories,[22] are sufficiently analogous to be examined together.[23]

Territorial restrictions range from absolute confinement of distributor sales intended to completely foreclose intrabrand competition[24] to the "lesser" territorial restrictions designed to inhibit such competition.[25] These lesser restrictions include areas of primary responsibiltiy,[26] profit pass-over arrangements,[27]

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[17] Competition among suppliers or distributors of *different* brands is referred to as interbrand competition, while that among sellers of the same brand is intrabrand competition. ABA Monograph, supra note 10, at 3 n.4; L. Stern & A. El-Ansary, supra note 12, at 326, 318. See *Continental T.V., Inc.* v. *GTE Sylvania, Inc.*, 433 U.S. 36, 52 n. 19 (1977).

[18] See *Continental T.V., Inc.* v. *GTE Sylvania, Inc.* 433 U.S. at 51–59; *United States* v. *Arnold Schwinn & Co.*, 388 U.S. at 382; *Cernuto, Inc.* v. *United Cabinet Corp.*, 1979–1 Trade Cas. ¶62,509 at 76,965 n.11 (3d Cir. 1979); *Martin B. Glauser Dodge Co.* v. *Chrysler Corp.*, 570 F.2d 72, 82 (3rd Cir. 1977), cert. denied, 98 S.Ct. 2253 (1978); *Sandura Co.* v. *FTC*, 339 F.2d 847, 858 (6th Cir. 1964).

[19] Also known as resale price maintenance, this vertical restraint limits distributors in their pricing flexibility and, therefore, may severely impinge on this primary aspect of competition. It is generally considered per se illegal under § 1 of the Sherman Act, 15 U.S.C. § 1 (1976). See notes 97–106 and accompanying text infra.

[20] Several restraints can be listed under this heading, including tying and exclusive dealing. Broadly speaking, tying by the supplier is the practice of conditioning the sale of a good or service to a distributor on its purchase of another good or service. Exclusive dealing consists of prohibiting a distributor from selling the goods or services of competing suppliers as a condition of doing business with a particular supplier. These restraints may impair competition among distributors and suppliers by foreclosing access to the market. See *Preston*, supra note 12, at 507–08. For a discussion of the applicable legal standards, see *Tampa Elec. Co.* v. *Nashville Coal Co.*, 365 U.S. 320 (1961) (exclusive dealing); *Northern Pac. Ry.* v. *United States*, 356 U.S. 1 (1958) (tying); *Times-Picayune Publishing Co.* v. *United States*, 345 U.S. 594 (1953) (tying); *Standard Oil Co.* v. *United States*, 337 U.S. 293 (1949) (exclusive dealing).

[21] Customer restrictions prohibit distributors from selling to specific customers or classes of customers regardless of the location of the potential customers. Note, "Restricted Channels of Distribution Under the Sherman Act," 75 Harv. L. Rev. 795, 796 (1962) [hereinafter cited as "Restricted Channels"]. For example, in *White Motor Co.* v. *United States*, 372 U.S. 253, 257 (1963), a truck manufacturer reserved national accounts, fleet accounts, and government business for itself.

[22] Territorial restrictions either prevent or discourage sales by a distributor outside a particular geographic area. See notes 23–29 infra. See also "Restricted Channels," supra note 21, at 796.

[23] When territorial restrictions require confinement of the sales of each distributor to a particular area, the distributors are prevented from competing with each other for the same customers, much like the effect of customer limitations. Thus, intrabrand competition is eliminated and each distributor has a "monopoly" in the supplier's product. Comanor, "Vertical Territorial and Customer Restrictions: White Motor and Its Aftermath," 81 Harv. L. Rev. 1419, 1422 (1968).

[24] Such confinement involves a promise by the distributor that it will not sell outside its assigned territory. Often combined with such a promise is a pledge by the supplier not to sell to anyone else in that territory. See "Restricted Channels," supra note 21, at 796. This latter practice is known as the granting of an exclusive franchise or exclusive distributorship. It is virtually per se legal due to judicial recognition of the seller's right to choose the buyers with which it will deal in the absence of monopolistic purpose or anticompetitive effect. See *United States* v. *Colgate & Co.*, 250 U.S. 300, 307 (1919); *United States* v. *Arnold, Schwinn & Co.*, 38 U.S. at 376; *Oreck Corp.* v. *Whirlpool Corp.*, 579 F.2d 126, 131 n.6, 133 (2d Cir.) (en banc), cert. denied, 47 U.S.L.W. 3302 (Oct. 30, 1979); *Packard Motor Car Co.* v. *Webster Motor Car Co.*, 243 F.2d 418, 420 (D.C. Cir. 1957), cert. denied, 355 U.S. 822 (1957); Louis, "Vertical Distribution Restraints Under Schwinn and Sylvania: An Argument for the Continuing Use of a Partial Per Se Approach," 75 Mich. L. Rev. 275, 286 (1976).

Absolute confinement coupled with an exclusive distributorship creates a territory which is exclusive or closed or what Pitofsky calls airtight. Pitofsky, supra note 10, at 4 n. 10. But see ABA Monograph, supra note 10, at 4 n. 9, where assigned territories alone are referred to as exclusive. There is no real difference in these definitions as long as the supplier assigning the territory sells to no other distributor in that area as a matter of course.

[25] See generally Pollock, "Alternative Distribution Methods After Schwinn," 63 Nw. U.L. Rev. 595 (1968).

[26] An area of primary responsibility requires the distributor to use its best efforts to maintain effective distribution of the supplier's goods in the territory specifically assigned to it. Failure to meet performance targets may result in termination, but that distributor is free to sell outside its area and other distributors may sell in its territory ABA Monograph, supra note 10, at 3 n. 6.

[27] These arrangements require a distributor that sells outside its territory to compensate the distributor in the territory in which the customer is located. Such compensation is ostensibly to reimburse the second distributor for its efforts to stimulate demand in its territory and for the cost of providing services upon which the first distributor would otherwise capitalize. *Id.* at 4 n. 7. See notes 164–71 and accompanying text infra.

and location clauses.[28] Theoretically, they are less restrictive than territorial confinement, but the Supreme Court in *Sylvania* has cast some doubt on this generalization.[29]

Although vertical restrictions in various forms have been widely used for many years, they have only relatively recently become a target of direct antitrust attack.[30] It wasn't until 1963 in *White Motor Co.* v. *United States*[31] that the Supreme Court faced the issue of the legality of territorial and customer restraints absent price fixing.[32] There, despite the Government's urging, the Court refused to lay down a per se rule, noting that it knew "too little of the actual impact" of these restrictions on the evidence before it.[33] Instead, the Court ordered a trial on the merits,[34] but the issue was not resolved as the case was ultimately settled by consent decree.[35]

In 1967, this issue surfaced again in *United States* v. *Arnold, Schwinn & Co.*,[36] and this time the court formulated a standard. The defendant bicycle manufacturer primarily utilized three channels of distribution:[37] (1) sales to distributors that resold to franchised retailers, (2) consignment or agency arrangements with distributors that sold to retailers, and (3) direct shipment to retailers under the consignment-like "Schwinn Plan."[38] Through an apparent combination of territorial confinement and exclusivity, each distributor was given a closed territory in which it could only sell to franchised accounts.[39] Each authorized dealer was

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[28] A location clause specifies the physical site of the distributor's place of business. ABA Monograph, supra note 10, at 3 n. 5. In effect, the distributor may sell to any customer walking through its door.

[29] See notes 50–52 and accompanying text infra. In addition, it should be noted that lesser restraints can be combined with other restrictions to produce a greater overall anticompetitive effect. For example, exclusive distributorships can be protected by location clauses which may effectively confine a distributor to its own territory. As indicated in note 24 supra; the resulting exclusive territory or closed territory can also be achieved by using absolute territorial confinement in place of the location clauses. See *Sandura Co.* v. *FTC*, 339 F.2d at 856; Louis, supra note 24, at 288 n. 73. See also Louis, "Vertical Distribution Restraints After Sylvania: A Postscript and Comment," 76 Mich. L. Rev. 265, 275–77 (1977).

[30] During the first 60 years of the Sherman Act, the Government did not challenge vertical restraints, while private suits sustained their validity except in the presence of price fixing or supplier monopoly. See Pollock, "Franchising, Customer Restrictions and Building a Better Mousetrap," 46 Chi. B. Rec. 378, 381 (1965). In 1944, the Supreme Court held that vertical restrictions were unlawful per se if they were an essential part of an overall price-fixing arrangement. *United States* v. *Bausch & Lomb Optical Co.*, 321 U.S. 709, 720–23 (1944). Four years later, the Justice Department stated its view that restrictions totally barring intrabrand competition were themselves per se violations. As a result, a number of consent decrees were obtained. ABA Monograph, supra note 10, at 7 and nn. 16–17.

[31] 372 U.S. 253 (1963).

[32] The district court had granted the Government's motion for summary judgment on a theory of per se illegality with respect to the defendant's territorial and customer restrictions and resale price maintenance. On appeal, the lower court's action on the price-fixing issue was not challenged, and the defendant argued that the price agreements were merely "adjunct" to the other restraints. Id. at 257. Thus, the Court only had the issue of territorial and customer restrictions before it.

[33] Id. at 261.

[34] Id. at 264, according to the Court:

> A vertical territorial limitation may or may not have [the] purpose or effect [of stifling competition]. We do not know enough of the economic and business stuff out of which these arrangements emerge to be certain. They may be too dangerous to sanction or they may be . . . within the "rule of reason." We need to know more than we do about the actual impact of these arrangements on competition to decide whether they . . . should be classified as per se violations of the Sherman Act.

Id at 263 (citations omitted).

[35] *United States* v. *White Motor Co.*, 1964 Trade Cas. ¶ 71,195 (N.D. Ohio 1964). The company agreed to abandon its territorial and customer restraints.

After *White Motor*, two appellate courts upheld such restrictions under a rule of reason analysis. *Sandura Co.* v. *FTC*, 339 F.2d 847 (6th Cir. 1964); *Snap-On Tools Corp.* v. *FTC*, 321 F.2d 825 (7th Cir. 1963).

[36] 388 U.S. 365 (1967). This case has received extensive treatment in the literature. For more detailed analysis than is possible here, see the sources listed in *Sylvania*, 433 U.S. at 48 n. 13, and in ABA Monograph, supra note 10, at 9 n. 24.

[37] Id. at 370. Schwinn also sold its bicycles through hardware jobbers and B.F. Goodrich stores, and these sales most resembled those to Schwinn distributors. B.F. Goodrich was originally a defendant in the case, but it negotiated a consent decree with the Government before the case came to trial. Id. at 367 n. 1.

[38] The Schwinn plan involved direct shipment by the manufacturer to the retailer with Schwinn invoicing the dealers, providing credit, and paying a commission to the distributor writing the order. Id. at 370.

[39] Id. at 371.

required to purchase only from or through the distributor in its area, and it could only sell to the public, and not to unfranchised retailers.[40] In addition, each dealer was subject to a location clause.

Writing for the majority, Justice Fortas drew a distinction between sales made by consignment, where the supplier retains ownership, and those where the supplier parts with it based on the "ancient rule against restraints on alienation." [41] Applying a rule of reason analysis to the former, the Court found Schwinn's customer and territorial restrictions lawful.[42] However, with respect to the latter, the majority held:

"Once the manufacturers has parted with title and risk, he has parted with dominion over the product, and his effort thereafter to restrict territory or persons to whom the product may be transferred—whether by explicit agreement or by silent confirmation or understanding with his vendee—is a per se violation of § 1 of the Sherman Act." [43]

Thus, a per se rule was established, but the diverse interpretations present in the cases following *Schwinn* reflect the extent of judicial dissatisfaction with such a rule and the creative means of circumventing it.[44]

The law remained unsettled for ten years until the Supreme Court brought it full circle in *Continental T.V., Inc.*, v. *GTE Sylvania, Inc.*[45] by announcing a "return to the rule of reason that governed vertical restrictions prior to *Schwinn*." [46] Calling *Schwinn* "an abrupt and largely unexplained departure from *White Motor*," [47] Justice Powell's opinion expressly overruled the *Schwinn* per se rule.[48] At issue in the case was the legality of a location clause used by a television set manufacturer and imposed on its retail franchises.[49] Such clauses had come under judicial scrutiny both before and after *Schwinn* and had been found lawful under a rule of reason standard.[50] In addition, lesser territorial restric-

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[40] Id. at 370–71.

[41] Id. at 378–80. This aspect of the opinion has been heavily criticized as being wholly irrelevant to the concerns of the antitrust laws. See, e.g., Baker, "Vertical Restraints in Times of Change: From White to Schwinn to Where?" 44 Antitrust L. J. 537, 537–38 (1975); Pollock, "The Schwinn Per Se Rule: The Case for Reconsideration," 44 Antitrust L.J. 557, 561–71 (1975). For additional citations, see ABA Monograph, supra note 10, at 10 n. 25.

[42] Id. at 380–82. According to Justice Fortas:

> Where the manufacturer retains title, dominion and risk with respect to the product and the position and function of the dealer in question, are in fact, indistinguishable from those of an agent or salesman of the manufacturer, it is only if the impact of the confinement is "unreasonably" restrictive of competition that a violation of § 1 results from such confinement, unencumbered by culpable price fixing.

Id. at 380 (citation omitted).

[43] Id. at 382. Earlier in its decision, the Court stated: "Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it." *Id.* at 279 (citations omitted).

[44] The *Schwinn* rule was applied as the Court stated it in a number of cases, but many courts "struggled to distinguish or limit *Schwinn* in ways that are a tribute to judicial ingenuity." Robinson, "Recent Antitrust Developments: 1974," 75 Colum. L. Rev. 243, 272 (1975). For an extensive review of Schwinn's progeny, see ABA Monograph, supra note 10, at 10–20. At least one commentator predicted the confusion in this area after *Schwinn*. Pogue, "Vertical Restrictions on Price, Territory and Customers—The Certainty of Uncertainty." 29 Ohio St. L.J. 272, 289 (1868).

[45] 433 U.S. 36 (1977). A growing body of legal literature provides a more detailed analysis of this case than is necessary for the purposes of this article. *E.g.*, Maher, "On the Path from White to Schwinn to Sylvania to . . . ?," 82 Dick L. Rev. 433 (1978); Pollock, "Antitrust, the Supreme Court, and the Spirit of '76," 72 N.W. U.L. Rev. 631, 632–40 (1977); Note, "Sylvania and Vertical Restraints on Distribution," 19 B.C.L. Rev. 751 (1978); Note, "Vertical Restrictions and the Distribution Process: A Practical Review of Economics and the Rule of Reason after Sylvania," 38 La. L. Rev. 1022 (1978); 1977 Wis. L. Rev. 1240 (1977).

[46] 433 U.S. at 59.

[47] Id. at 47.

[48] Id. at 58.

[49] There were no other restraints present, including exclusive distributorships. Id. at 38.

[50] Before *Schwinn*, *Boro Hall Corp.* v. *General Motors Corp.*, 124 F.2d 822, 823–24 (2d Cir. 1942), cert. denied, 317 U.S. 695 (1943) upheld the reasonableness of location clauses. After *Schwinn*, several courts specifically distinguished this restraint from the customer and territorial restrictions in *Schwinn* and continued to approve it under a rule of reason analysis. E.g., *Salco Corp* v. *General Motors Corp.*, 517 F.2d 567, 575–76 (10th Cir. 1975); *Sheldon Pontiac* v. *General Motors Corp.*, 418 F. Supp. 1024, 1036 (D.N.J. 1976), aff'd without opinion, 566 F.2d 1170 (3d Cir. 1977); *Kaiser* v. *General Motors Corp.*, 396 F. Supp. 33, 39–41 (E.D. Pa. 1975), aff'd without opinion, 530 F.2d 964 (3d Cir. 1976). In *Sylvania*, the Court noted that it had "never given plenary consideration to the question of the proper antitrust analysis of location restrictions." 433 U.S. at 42 n. 11. Cf. *United States* v. *General Motors Corp.*, 384 U.S. 127, 139–40 (1966) (court refusal to consider their validity).

tions, including location clauses, had been allowed as alternatives to prohibited territorial and customer restraints.[51]

However, by equating location clauses with the restraints in *Schwinn*,[52] the *Sylvania* Court not only dispelled the presumption of their less restrictive effect,[53] but also brought other vertical restraints, except price maintenance,[54] into issue. This permitted the court to hold that all nonprice vertical restraints are subject to the rule of reason,[55] and indicated judicial endorsement of all such "reasonable" restraints.[56] Finally, the majority left the door open to utilization of a per se rule in unspecified circumstances.[57]

THE RULE OF REASON

On its face, the Sherman Act outlaws "every contract, combination . . ., or conspiracy in retraint of trade. . . ." [58] Realizing that literal application would effectively prohibit all contracts, the Supreme Court in *Standard Oil Co.* v. *United States*[59] held then only "unreasonable" restraints were illegal.[60] Several years later, Justice Brandeis in *Chicago Board of Trade* v. *United States*[61] characterized the rule of reason in language that has since become the judicial standard:

"The true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to the business to which the restraint is applied; its condition before and after the restraint was imposed; the nature of the restraint and its effect, actual or probable. The history of the restraint, the evil believed to exist, the reason for adopting the particular remedy, the purpose or end sought to be attained, are all relevant facts. This is not because a good intention will save an otherwise objectionable regulation or the reverse; but because knowledge of the intent may help the court to interpret facts and to predict consequences." [62]

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[51] Although Schwinn was forced to give up its territorial customer restrictions, the district court approved location clauses and areas of primary responsibility. *United States* v. *Arnold, Schwinn & Co.*, 291 F. Supp. 564, 565–66 (N.D. Ill. 1968). Accord, *United States* v. *Topco Assocs., Inc.*, 1973–1 Trade Cas. ¶74,391 (N.D. Ill.), *modified*, 1973–1 Trade Cas. ¶74,485 (N.D. Ill), aff'd mem., 401 U.S. 801 (1973).

[52] According the opinion:

> In intent and competitive impact, the retail-customer restriction in *Schwinn* is indistinguishable from the location restriction in the present case. In both cases the restrictions limited the freedom of the retailer to dispose of the purchased products as he desired. The fact that one restriction was addressed to territory and the other to customers is irrelevant to functional antitrust analysis and, indeed, to the language and broad thrust of the opinion in *Schwinn*.

433 U.S. at 46 (footnote omitted). Pitofsky argues that with this language, the Court "pumped up *Schwinn* to its broadest possible reading, thereby producing an easy target to puncture and deflate." Pitofsky, supra note 10, at 8.

[53] Consistent with its return to the rule of reason, the Court has indicated that it will look to market realities rather than to theoretical differences in determining market impact. See id. at 46–47.

[54] The majority noted that: "As in *Schwinn*, we are concerned here only with nonprice vertical restrictions. The per se illegality of price restrictions has been established firmly for many years and involves significantly different questions of analysis and policy." *Id* at 51 n. 18. But see *Eastern Scientific Co.* v. *Wild Heerbrugg Instruments, Inc.*, 572 F.2d 883, 885–86 (1st Cir. 1978), where the court held that the rule of reason applies when price maintenance is used to enforce territorial restrictions. See notes 97–106 and accompanying text infra.

[55] A number of lower courts have applied this principle. See, eg., *H & B Equip. Co.* v. *International Harvester Co.*, 577 F.2d 239, 246 (5th Cir. 1978); *General Beverage Sales Co.* v. *East-Side Winery*, 1978–1 Trade Cas. ¶ 61,815 at 73, 397–98 (7th Cir. 1978); *Adolph Coors Co.* v. *A & S Wholesalers, Inc.*, 561 F.2d 807, 813–14 (10th Cir. 1977); *Newberry* v. *Washington Post Co.* 438 F. Supp. 471 474 (D.D.C. 1977).

[56] See 433 U.S. at 57–58. Hopefully, this determination will end the debate concerning the abstract economic validity of vertical restraints and properly focus attention on their effect in the market at issue. Compare *Comanor*, supra note 23, at 1423–27, 1436–37 (condemning vertical restrictions) with *Preston*, supra note 12, at 520, 522 (praising them).

[57] The Court stated: "[W]e do not foreclose the possibility that particular applications of vertical restrictions might justify per se prohibition under *Northern Pac R. Co.*" 433 U.S. at 58. See note 1 supra.

[58] 15 U.S.C. § 1 (1976).

[59] 221 U.S. 1 (1911). See *United States* v. *Trans-Missouri Freight Ass'n*, 166 U.S. 290 (1897).

[60] 221 U.S. at 59–63.

[61] 246 U.S. 231 (1918).

[62] Id. at 238.

At best, this formulation provides only general guidance, and it is dependent on subsequent application for development and meaning.[63]

However, relatively few courts have applied the rule of reason in section 1 Sherman Act cases,[64] and fewer have considered vertical restraints under this standard. Those post-*White Motor* cases that have utilized the rule follow the gist of *Chicago Board of Trade*, but do so without systematically identifying relevant economic criteria and integrating them into any sort of analytic structure.[65] Even *Sylvania*, in returning to the rule of reason, ignored this problem.[66]

Given the Court's traditional emphasis on gradual change, the absence of such a framework is understandable in light of the relatively short judicial history of vertical restrictions and the truncated development of the rule of reason due to *Schwinn*. In addition, this area is a particular troublesome one in antitrust law, as there has been little historical consensus among economists as to the theoretical value of such restrictions.[67] Moreover, it is difficult to judge a restraint which may have manifestly anticompetitive results at one level and strongly procompetitive effects at another level in the same application. This problem is only compounded by the presence of several restraints in a package. Not unexpectantly, the courts are hesitant to build a framework without knowing how the pieces fit or where they should go. It is tempting to focus on one level of competition and apply a per se approach to it.[68]

In requiring a rule of reason in *Sylvania*, the Supreme Court is in the same place it was 15 years ago after *White Motor*, only now the court has determined that it knows enough about vertical restrictions to evaluate them under a reasonableness standard. As it stands, such a rule has been criticized as forcing courts to "muddle through" [69] analyses and as one that necessarily involves "a substantial volume of protracted litigation that will consume substantial . . . resources and that frequently cannot yield results that are 'accurate,' 'consistent,' or 'predictable.' " [70] Perhaps, these sentiments indicate frustration with a rule that lacks both structure and development. In the following section, a model will be constructed that can be used by courts and antitrust counsel in applying the rule of reason after *Sylvania*. Hopefully, the presence of this framework will make the task somewhat easier.

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[63] ABA Monograph, supra note 10, at 53–54.

[64] Posner, supra note 10, at 14.

[65] As the ABA's Antitrust Law Section has noted:

> [T]hose few cases which have considered vertical distribution restraints under a rule of reason have frequently quoted Mr. Justice Brandeis' classic expression of rule of reason, recounted general economic facts of the industry, reviewed the purposes of the restraint, and made conclusions about the relative effects of the restriction on dampening intrabrand competition while promoting interbrand competition. These cases typically do not consider in depth such questions as relevant market, market power, product differentiation, ease of entry, or structural or behavioral indicators of competition or its absence. Nor do they contain a detailed consideration of the effect of the restraint on price, production levels, product quality, service competition, etc.

ABA Monograph, supra note 10, at 54.

Although the ABA publication fails to cite any cases in support of this statement, it does cite one opinion as an exception to it. In *American Motor Inns, Inc.* v. *Holiday Inns, Inc.*, 521 F. 2d 1230 (3d Cir. 1975), the court employed economic analysis as part of its application of the rule of reason to an exclusive dealing arrangement considered under the Sherman Act.

After *White Motor* and before *Sylvania*, there were only two principal rule of reason decisions involving customer and territorial restrictions, *Sandura Co.* v. *FTC*, 339 F.2d 847 (6th Cir. 1964) and *Snap-On Tools Corp.* v. *FTC*, 321 F.2d 825 (7th Cir. 1963). Despite the fact that each court goes somewhat farther than the monograph's description, neither case sets out an analytical framework.

[66] See note 10 supra.

[67] For examples of the divergence in economic thought, see the authorities cited in ABA Monograph, supra note 10, at 5, 37–42 and in Note, "Territorial and Customer Restrictions: A Trend Toward a Broader Rule of Reason," 40 Geo. Wash. L. Rev. 123, 146 (1971) [hereinafter cited as territorial and customer restrictions].

[68] One commentator has argued that the Court in *Schwinn* opted for a per se rule in part because of its difficulties in reconciling the beneficial and detrimental effects of vertical restrictions. McLaren, "Marketing Limitations on Independent Distributors and Dealers—Prices, Territories, Customers and Handling of Competitive Products," 13 Antitrust Bull. 161, 168–69 (1968). See also *GTE Sylvania, Inc.* v. *Continental T.V., Inc.*, 537 F. 2d 980, 1030 (9th Cir. 1976) (enbanc) (Duniway, J., dissenting), aff'd, 433 U.S. 36 (1977).

[69] Louis, supra note 24, at 278.

[70] *Id.* at 277–78 (footnotes omitted). See Pitofsky, supra note 10, at 2; Posner, supra note 10, at 16–17.

Since complex and esoteric models often are an anathema to those charged with "real life" decision making, it is appropriate at the outset to question whether the courts or other decision makers are capable of making the judgments required to apply the proposed model.[71] There is, however, a sound basis for believing that such a model can be practically employed. First, most of the criteria incorporated in it have long been satisfactorily utilized in previous antitrust cases; the courts simply have never delineated a comprehensive framework that connects the pieces. Second, such criteria are stated in generalized legal terms that will continue to provide the judiciary with considerable flexibility in this area. Finally, in most situations likely to arise, the necessary information should be readily ascertainable.

Step 1: Identification

The first step sets the stage for the adjudicative analysis that will follow. The distribution practices in question are examined with the purpose of identifying the parties involved and their relationships to each other, as well as the restraints used and how they have operated. Tracing the evolution of distribution restrictions in the industry is also important, as the manner in which such practices have been established and enforced is often of legal significance. Thus, information is needed regarding how the restraints came to be implemented in addition to how they currently function.

This identification procedure can be relatively straightforward in the presence of written agreements or well-documented interaction; it is more complicated when the nature of the arrangements must be inferred from conduct. Restrictions may be established through contract or through *Colgate*-type[72] unilateral announcements. They may involve vertical/horizontal overlaps as in the case of a joint branding and buying association[73] or a group of small manufacturers jointly setting manufacturing specifications under a common branding program.[74] The restrictions may include specific price-setting, maximum or minimum price-limiting, exclusive geographic territories, location clauses, consignment authority, profit pass-over arrangements, and so on.

Where the distribution system under scrutiny is complex, and particularly when it involves multiple channels, the relevant market should be identified early so that subsequent analysis may be limited to appropriate areas.[75] Although this concept has never been fully articulated in territorial restraints cases under the rule of reason, it was utilized in several pre-*Sylvania* decisions, including *Schwinn*,[76] and it has been specified in a number of rule of reason opinions after *Sylvania*.[77] In contrast, relevant market definition is well-developed in other antitrust contexts, especially monopolization cases under section 2 of the Sherman Act.[78]

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[71] This introductory paragraph is largely taken from an earlier attempt to construct a judicial decision model based on potential entry concepts in conglomerate mergers. Dunfee & Stern, "Potential Competition Theory as an Anti-Merger Tool Under Section 7 of the Clayton Act: A Decision Model," 69 Nw. U.L. Rev. 821, 854 (1975).

[72] See note 24 supra.

[73] *United States & Topco Assocs., Inc.*, 405 U.S. 596 (1972).

[74] *United States* v. *Sealy, Inc.*, 388 U.S. 350 (1967).

[75] In the absence of such complexity, it may be sufficient at this point to define the "relevant market" in terms of the restraints facing certain distributors. The formal determination of relevant market may then be postponed until step 4 of the model if preceding steps do not terminate the inquiry.

[76] 388 U.S. at 381–82; *Sandura Co.* v. *FTC*, 339 F.2d at 880–83; *Snap-On Tools Corp.* v. *FTC*, 321 F. 2d at 833.

[77] *Gough* v. *Rossmoor Corp.*, 1978–2 Trade Cas. ¶ 62,202 at 75,354 (9th Cir. 1978), cert. denied, 47 U.S.L.W., 3437 (Feb. 26, 1979); *Lee Klinger Volkswagen, Inc.* v. *Chrysler Corp.*, 1978–2 Trade Cas. ¶ 62,150 at 75,077 (7th Cir. 1978), cert. denied, 47 U.S.L.W. 3391 (Dec. 4, 1978); *Columbia Metal Culvert Co.* v. *Kaiser Alum. & Chem. Corp.*; 579 F. 2d 20, 26–27 (3d Cir. 1978), cert. denied, 47 U.S.L.W. 3225 (Oct. 2, 1978); *Northwest Power Prods., Inc.* v. *Omark Indus., Inc.*, 576 F. 2d 83, 85 (5th Cir. 1978); *Martin B. Glauser Dodge Co.* v. *Chrysler Corp.*, 570 F.2d 72, 81 (3d Cir. 1977), cert. denied, 98 S.Ct. 2258 (1978).

[78] 15 U.S.C. § 2 (1976). See, e.g., *United States* v. *Grinnell Corp.*, 384 U.S. 562, 571–77 (1966). In *Columbia Metal Culvert*, the court recognized the difference between the uses of the revelant market concept in § 2 and § 1 Sherman Act cases:

> The § 2 market definition looks to the existence of competitors as evidence of countervailing power which would preclude monopolization. § 1, in contrast is concerned with patterns of competition as a means of judging whether a restraint of trade is unreasonable. Thus, rival products might provide sufficient competition to foreclose a finding of monopolization, yet the degree of insularity of the initial product might allow a finding of illegal restraint of trade in regard to restrictions imposed within that initial market. For instance, stifling intra-brand competition may violate § 1 while "monopoly" over a given brand would clearly not run afoul for § 2.

579 F. 2d at 27 n. 11.

The first aspect of the relevant market issue is the product market which identifies competitors on the basis of the "reasonable interchangeability of their products for the purposes for which they are produced as price, use and qualities considered." [79] Ideally, such products can be found in the basis of cross-elasticities of demand or "the responsiveness of the sales of one product to price changes of the other." [80] Although there are significant theoretical and methodological controversies surrounding their application.[81] the criteria developed by the courts for determining relevant product markets in monopolization and other antitrust cases [82] are, for the most part, suitable in this context and should be used.

The second part of the investigation concerns the geographic market, defined as "the area of effective competition" or the "area in which the seller operates, and to which the purchaser can practicably turn for supplies." [83] This definition makes it possible to exclude firms that may pass the product market test, but sell in geographic areas that do not overlap to any appreciable extent. In the end, determining the relevant market along these dimensions will yield a reasonably good understanding of what the competition is on both the intraband and interbrand levels.[84]

Step 2: Per se tests for horizontal conspiracies and vertical price fixing

Existence of a horizontal combination or conspiracy

If the facts reveal a de facto or de jure scheme among competitors to divide markets,[85] fix prices,[86] or cut off competitors,[87] a horizontal combination or conspiracy is present that is per se violative of the Sherman Act. The crucial element in each of these is the fact of firms or individuals on the same distribution level agreeing on a common course of action.[88] Thus, the per se rule applies when several distributors combine to initiate and police the supplier's boycott of other distributors,[89] but the rule of reason is used to judge the situation when a lone distributor asks for and receives an exclusive franchise at the expense of the other distributors in town.[90]

As the *Sylvania* court recognized, it is not always a simple matter to differentiate between horizontal and vertical arrangements.[91] Perhaps this line drawing is most difficult in "mixed" cases where the territorial restraints are vertically imposed, but the distributors own and control the supplier. Under these circumstances, the courts have uniformly focused on the control ingredient to find a horizontal agreement,[92] a principle apparently left undisturbed by *Syl-*

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[79] *United States* v. *E. I. duPont De Nemours & Co.*, 351 U.S. 377, 404 (1956). The *Schwinn* Court clearly adopts this standard: "[T]here is no showing that [other bicycles] are not in all respects *reasonably interchangeable* as articles of competitive commerce with the Schwinn product." 388 U.S. at 381 (italic supplied).

[80] *United States* v. *E. I. duPont de Nemours & Co.*, 351 U.S. at 400. Note that *Grinnell* has subsequently made the *duPont* language equally applicable to services. 384 U.S. at 572–73.

[81] 2 P. Areeda & D. Turner, Antitrust Law 346–88, 406–31 (1978); Day, Massy, & Shocker, "The Public Policy Context of the Relevant Market Question," in Marketing and the Public Interest 51–67 (J. Cady ed. 1978).

[82] Exclusive dealing cases under § 3 of the Clayton Act, 15 U.S.C. § 14 (1976), and merger cases under § 7 of the act, id. § 18, also provide guidance in this area. See, e.g., *Brown Shoe Co.* v. *United States*, 370 U.S. 294, 325 (1962) (merger); *Tampa Electric Co.* v. *Nashville Coal Co.*, 365 U.S at 327 (exclusive dealing).

[83] *Tampa Elec. Co.* v. *Nashville Coal Co.*, 365 U.S. at 327. For an implicit application of a similar definition in a monopolization case, see *Grinnell*, 384 U.S. at 575–76.

[84] For the remainder of this discussion, it will be assumed that both the product market and the geographic market have been identified. Thus, the other economic criteria set out are implicity explored in the context of the relevant market.

[85] *United States* v. *Topco Assocs., Inc.*, 405 U.S. at 608 n. 9; *Timken Roller Bearing Co.* v. *United States*, 341 U.S. 593, 598 (1951); *Addyston Pipe & Steel Co.* v. *United States*, 175 U.S. 211, 240–41 (1899).

[86] *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 223–26 & n. 59 (1940); *United States* v. *Trenton Potteries Co.*, 273 U.S. 392, 397–98 (1927).

[87] *United States* v. *General Motors Corp.*, 384 U.S. at 146; *Klor's Inc.* v. *Broadway-Hale Stores, Inc.*, 359 U.S. 207, 212 (1959).

[88] In contrast, the essense of a vertical restraint is the primary role played by the supplier. See *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 378 ("[W]e are dealing here with a vertical restraint embodying the unilateral program of a single manufacturer."); *Newberry* v. *Washington Post Co.*, 438 F. Supp. 471, 474 n. 5 (D.D.C. 1977) ('Notwithstanding the dealers' willing participation. . . . the scheme was initiated and orchestrated by the Post, and thus was vertical in effect as well as appearance."). See also *White Motor Co.* v. *United States*, 372 U.S. at 267 (Brennan, J., concurring); *Sandura* v. *F.T.C.*, 339 F. 2d at 858.

[89] *United States* v. *General Motors Corp.*, 384 U.S. 127 (1966).

[90] *Packard Motor Car Co.* v. *Webster Motor Co.*, 243 F.2d 418 (D.C. Cir.), cert. denied, 355 U.S. 822 (1957).

[91] 433 U.S. at 58 n. 28.

[92] *United States* v. *Topco Assocs., Inc.*, 405 U.S. at 599–600; *United States* v. *Sealy, Inc.*, 388 U.S. at 352–353; *United States* v. *Serta Assocs., Inc.*, 296 F.Supp. 1121, 1127–28 (N.D. Ill.), aff'd per curiam, 393 U.S. 534 (1969).

vania.[93] However, it has been asserted that under the *Sylvania* analysis, consideration of the source of the restraint should be subordinated to an examination of its effect,[94] and, at the very least, a rule of reason should now apply to certain mixed cases.[95] Until this contention can be tested, the per se rule must still be used, largely on the belief that horizontal arrangements in any form are unavoidably destructive of competition.[96]

The presence of price fixing

With few exceptions, vertical price maintenance has been per se unlawful under the Sherman Act since 1911.[97] Because of its presumed ruinous effect on competition,[98] the very presence of price fixing has been sufficient to infect any accompanying territorial restrictions and turn them into per se violations.[99] This is true whether the price fixing was an integral part of the whole distribution system [1] or the territorial restraints were merely ancillary to the price scheme.[2]

The Supreme Court in *Sylvania* did nothing to change the law in this area, noting that its concern was with non-price vertical restrictions.[3] In a footnote, the court endorsed the view that the intrinsic harm in price maintenance is greater than that in territorial restrictions, since both interbrand and intrabrand injury are inherent in the former, while only intrabrand competition is potentially damaged by the latter.[4]

However, it now appears that the scope of a price-fixing-based per se rule must be redefined. In *Eastern Scientific Co.* v. *Wild Heerbrugg Instruments, Inc.*,[5] the First Circuit held that the use of resale price maintenance to enforce territorial restrictions should be tested under the rule of reason. In *Heerbrugg*, a distributor was limited to Rhode Island and could price at any level with that State. If the dealer wanted to sell outside its territory, it had to sell at or above list price. The district court instructed the jury on a per se theory, but the appellate court reversed, holding that the case should be tried on a rule of reason standard as a result of *Sylvania*. It reasoned that the maximum effect of such a restriction

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[93] 433 U.S. at 57 n. 27, 58 n. 28.

[94] See *Posner*, supra note 10, at 18–20. For a criticism of the *Sylvania* court's distinction between vertical and horizontal restraints, see *Pitchford Scientific Instruments Corp.* v. *Pepi, Inc.*, 435 F. Supp. 685, 687 (W.D. Pa. 1977).

[95] Slater argues that "[t]o avoid the anomalous result of per se illegality along with pri-competitive effect" the rule of reason approach in *Sylvania* should be used in mixed cases like *Topco* where there is no price fixing. Address by Professor Paul E. Slater, Vertical Territorial Restraints: *Schwinn Reconsidered* (Oct. 12, 1977) reprinted in 2 The Sixteenth Annual Corporate Counsel Institute 1–19 at 1–12 (Northwestern University School of Law, 1977) (mimeo). See Handler, "Changing Trends in Antitrust Doctrines: An Unprecedented Supreme Court Term—1977," 77 Colum. L. Rev. 979, 987 (1977); Posner, supra note 10, at 9–10; Weisberg, *Continental TV* v. *GTE Sylvania:* "Implications for Horizontal as Well as Vertical Restraints on Distributors," 33 Bus. Law. 757 (1978). See also *Topco Assocs., Inc.*, 405 U.S. at —— —— (Burger, C. J., dissenting); *United States* v. *Sealy, Inc.*, 388 U.S. at 362 (Harlan, J., dissenting); *United States* v. *Topco Assocs., Inc.*, 319 Supp. 1031, 1038–43 (N.D. Ill. 1970), rev'd, 405 U.S. 596 (1972); "Territorial and Customer Restrictions," supra note 67, at 149–50. See generally *Louis*, supra note 24, at 281.

[96] See Restricted Channels, supra note 21, at 800.

[97] *Dr. Miles Medical Co.* v. *John D. Parke & Sons* 224 U.S. 373, 408 (1911). The State statutory exceptions to this rule, known as fair trade laws, lost their federal authorization as a result of the Consumer Goods Pricing Act of 1975, Public Law No. 94–145, §§ 2–3, 89 Stat. 801 (amending 15 U.S.C. §§ 1, 45(a) (1970)). Court-created exceptions based on consignment sales, as in *United States* v. *General Elec. Co.*, 272 U.S. 476 (1926), and on unilateral refusals to deal, as in *United States* v. *Colgate & Co.*, 250 U.S. 300 (1926), have been substantially eroded. See *Albrecht* v. *Herald Co.*, 390 U.S. 145 (1968) (refusals to deal); *Simpson* v. *Union Oil Co.*, 377 U.S. 13 (1964) (consignments); *United States* v. *Parke, Davis & Co.*, 362 U.S. 29 (1960) (refusals to deal).

[98] See, e.g., *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. 150, 224–26 & n. 59 (1940).

[99] *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 375–76. This statement is entirely consistent with *White Motor*, as the court there considered only territorial and customer restraints. See note 32 supra. The key concept here is the notion of accompaniment. The presence of vertical price fixing with regard to one distributor, but not others, contaminates only the territorial and customer restraints of that distributor. See *Newberry* v. *Washington Post Co.*, 438 F. Sup.. 471 (D.D.C. 1977)

Several cases involving horizontally imposed territorial restrictions and price fixing have held that such restrictions are per se unlawful as part of an "aggregation of trade restraints." *United States* v. *Sealy, Inc.*, 388 U.S. at 356–57; *Timken Roller Bearing Co.* v. *United States*, 341 U.S. at 598; *United States* v. *Serta Assocs.*, 296 F. Supp. at 1128.

[1] *United States* v. *Bausch & Lomb Optical Co.*, 321 U.S. at 720.

[2] *White Motor Co.* v. *United States*, 372 U.S. at 260; *Copper Liquor, Inc.* v. *Adolph Coors Co.* 506 F.2d 934, 938 (5th Cir. 1975); *Pitchford Scientific Instruments Corp.* v. *Pepi, Inc.*, 435 F. Supp. at 689.

[3] 433 U.S. at 51 n.18.

[4] Id.

[5] 572 F.2d 883 (1st Cir. 1978).

would be to limit sales to the set territories, a result that *Sylvania* explicitly holds should be tested under a rule of reason standard.

The idea that contractually imposed "partial" resale price maintenance is not per se illegal may be shocking to antitrust traditionalists. But in fact, such a program may not have a significant negative effect on intrabrand competition. More information is needed to judge the situation. It is important to determine whether such partial price maintenance is part of a comprehensive system of vertical price fixing enforced by coercion and wrongful termination. Alternatively, it may be that restrictive territories based on price restraints make distributors more effective at the interbrand level. These questions could be effectively dealt with at the fact-finding stage under a rule of reason standard. However, this entire issue, may well be moot in that, after *Sylvania*, a supplier may contractually enforce territorial confinement and need not resort to the circuitous enforcement system used in *Heerbrugg*.

Pending further clarification, it can be assumed that the traditional per se rule regarding vertical price setting stands subject to future limiting interpretations.[6] Thus, the existing per se standard would be applied to determine whether there is a contractual or coercive arrangement compelling independent distributors to price at a specified level or within an established range.[7]

Step 3: Negative impact on intrabrand competition

In the absence of horizontal conspiracy or illegal price fixing, the next step is to determine whether the restraints in question impact negatively on intrabrand competition. Such an effect is present when any restriction significantly inhibits or impedes a distributor carrying a particular brand from attempting to win away customers seeking that brand from another distributor carrying it. If the restraint imposed can be shown to have no negative impact whatsoever on intrabrand competition, then there is no need to proceed with the anaysis.[8]

Step 4: Importance of intraband competition

Where there has been a negative intrabrand effect, the court should next focus its attention on whether, from the point of view preserving competition in the relevant market, it is necessary to have substantial intrabrand rivalry. In order to make this determination one must assess whether the relevant market contains a sufficient amount of interbrand competition. If it does not, then the only form of rivalry left for the courts to protect is that of the intrabrand variety, and any significant restraints impeding it should be ruled illegal.

A structural analysis is used to evaluate the strength of interbrand competition in the relevant market.[9] It begins by examining (1) the level of concentra-

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[6] There is a considerable difference of opinion as to how much the Court's analysis in *Sylvania* undermines the per se illegality of vertical price fixing despite its language to the contrary. Dismissing the Court's price/nonprice distinctions and relying on its economic emphasis, Posner asserts his customary view that resale price maintenance should be subjected to the rule of reason, claiming that *Dr. Miles* and *Albrecht* are now "endangered precedents." Posner, supra note 10, at 7–13. Pitofsky agrees that the theoretical justifications in *Albrecht* for a per se rule in maximum resale price fixing situations have been jeopardized, but he contends that the disparate effect of minimum resale price maintenance still warrants per se treatment. *Pitofsky*, supra note 10, 14–17 n.50, 32–33.

Notwithstanding *Heerbrugg*, there is some evidence to indicate that the courts still view arrangements involving price with suspicion, especially where more traditional price fixing may be involved. In *Cernuto, Inc.* v. *United Cabinet Corp.*, 1979–1 Trade Cas ¶ 62,509 (3d Cir. 1979), the court held that the termination of the plaintiff distributor at the behest of another distributor could make out a per violation where such action was motivated by the plaintiff's discount selling.

At the same time, the Supreme Court has examined situations with price overtones more carefully and has applied the rule reason rather than immediately resorting to a per se label as in the past. Compare *United States* v. *Socony-Vacuum Oil Co.*, 310 U.S. at 224–26 n.59 with *Broadcast Music, Inc.* v. *Columbia Broadcasting System., Inc.*, 1979–1 Trade Cas. ¶ 62,558 (April 17, 1979) (blanket licensing) and *National Soc'y of Professional Eng'rs.* v. *United States*, 435 U.S. 679 (1978) (bidding restrictions).

[7] See, e.g., *Simpson* v. *Union Oil Co.*, 377 U.S. 13 (1964) : *United States* v. *Parke, Davis & Co.*, 362 U.S. 29 (1960) : *Cernuto Inc.* v. *United Cabinet Corp.*, 1979–1 Trade Cas. ¶ 62,509 (3d Cir. 1979) : *Sahn* v. *V–1 Oil Co.*, 402 F.2d 60 (10th Cir. 1968).

[8] Theoretically, every vertical restraint may have some negative impact on intrabrand competition. However, there is no need to burden the courts with those de minimis restrictions that do not have a materially adverse effect on intrabrand competition in the context in which they operate. For example, under certain circumstances, the requirement that a distributor devote its best efforts to a specific area may have little anticompetitive effect on the intrabrand level. See generally *Pitofsky*, supra note 10, at 4–5.

[9] If determination of the relevant market has been postponed as discussed in note 75 supra, it should be completed at this point before proceeding. See notes 76–84 and accompanying text supra.

tion, (2) the extent of product differentiation, and (3) the height of entry barriers in the market. Once this is completed, the next step is to evaluate the market power of the defendant. All of these four factors, viewed holistically, will provide a relatively clear picture—even in the absence of bright-line rules—as to whether the relevant market contains a sufficient amount of interbrand competition.

Industry concentration

Courts often look at the number and size distribution of firms in an industry as a measure of its competitive vitality.[10] In general, economic theory suggests that an inverse relationship exists between the degree of industry concentration and the vigor of interbrand competition, other things, such as the degree of product differentiation and the height of entry barriers, being equal.[11] Thus, as an industry tends toward oligopoly, [12] the corresponding level of interbrand competition diminishes until it disappears altogether when monopoly is reached.[13]

This idea is particularly significant in the context of vertical restraints. As the level of interbrand competition falls, the significance of interbrand competition increases as a means of preserving industry competition. In turn, there is a direct relationship between the extent of concentration and the overall importance of intrabrand competition.[14]

Product differentiation

The second important element that must be considered is the extent and significance of product differentiation within the relevant market. Chamberlin, the first economist to explore the subject of product differentiation fully, observed that:

"A general class of product is differentiated if any significant basis exists for distinguishing the goods of one seller from those of another. Such a basis may be real or fancied, so long as it is of any importance whatever to buyers and leads to a preference for one variety of the product over another. Where such differentiation exists, even though it be slight, buyers will be paired with sellers, not by chance and at random but according to their preferences." [15]

Thus, the degree of product differentiation refers to or measures the extent to which "buyers differentiate, distinguish, or have specific preferences among the competing outputs of the various sellers established in an industry." [16]

A well-differentiated product or brand will make a seller's demand curve much less elastic, i.e., a supplier's product which is perceived to be distinct from competing brands may have its price raised without losing a substantial amount of business.[17] In fact, a high degree of product differentiation in a market will usually lead to, or be associated with, high seller concentration.[18] Following this reasoning, the higher the level of product differentiation in a market, the less prevalent will be the incidence of intense interbrand competition, especially price competition.

Entry barriers

An analysis of entry barriers provides information about the degree of difficulty facing a potential newcomer to a market.[19] In effect, barriers to entry are the advantages established sellers have over potential rivals. Among the most

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[10] See e.g., *American Inns, Inc.* v. *Holiday Inns, Inc.*, 521 F.2d at 1247–48; *Sandura Co.* v. *FTC*, 339 F.2d at 852.

[11] F. Scherer, Industrial Market Structure and Economic Performance 50 (1970); Demsetz, "Industry Structure, Market Rivalry and Public Policy," 16 J.L. & Econ. ——, —— (April 1973); Esposito & Esposito, "Foreign Competition and Domestic Industry Profitability," 53 Rev. Econ. & Stat. 343 (Nov. 1971).

[12] For a definition of oligopoly, see note 129 infra.

[13] F. Scherer, supra note 110, at 10; Saving; "Concentration Ratios and the Degree of Monopoly Power," 11 Int'l Econ. Rev. 139 (Feb. 1970).

[14] See *Martin B. Glauser Dodge Co.* v. *Chrysler Corp.*, 570 F. 2d at 84. Preston argues that intrabrand restrictions may also become more useful in concentrated industries when they foster greater market coverage, thereby injecting product alternatives into limited product markets. *Preston*, supra note 12, at 522. See G. Stigler, The Organization of Industry 303 (1968); O. Williamson, Markets and Heirarchies: Analysis and Antitrust Implications 116 (1975).

[15] E. Chamberlin, The Theory of Monopolistic Competition 56 (7th ed. 1958).

[16] J. Bain, Industrial Organization 223 (2d ed. 1968).

[17] F. Scherer, supra note 110, at 341; Brozen, "Entry Barriers: Advertising and Product Differentiation," in Industrial Concentration: The New Learning, 117 (H. Goldschmid, H. Mann & J. Weston eds. (1974) (hereinafter cited as Industrial Concentration); Pitofsky, supra note 10, at 37.

[18] J. Bain, supra note 115, at 249.

[19] L. Stern & J. Grabner, Jr., Competition in the Marketplace 24 (1970).

common entry barriers are scalar economies, absolute cost barriers, and product differentiation barriers.[20] Technically, barriers permit established sellers to obtain prices at least somewhat above a "pure" competitive level without attracting new rivals. The higher the barriers to entry, the more insulated are in-market firms from external threats. Therefore, one would expect the intensity of interbrand competition to be higher when entry barriers are low (so as to discourage potential rivals) and lower when barriers are high (because the threat of entry is minimal.)

In general, if concentration, product differentiation, and entry barriers in the relevant market are all high, then the extent of interbrand competition is likely to be low, indicating that there will be strong potential benefits from preserving intraband competition. Even under such a scenario, however, it is possible that vertical restraints could be procompetitive, depending on the market power of the firm imposing the restraints.

The amount of the market power [21] a firm possesses is chiefly dependent on its market share or the extent to which its product is differentiated, or both of these factors.[22] The larger the share of the market, the greater the necessity for intraband competition to maintain effect price competition.[23] The larger the share of the market, the greater the necessity for intraband competition to maintain effect price competition.[24] If a supplier's market power is low, then establishing restraints may enhance its ability to compete against the brands of other firms and thereby foster what little interbrand competition may exist in the market. If its market power is high, and it is one of the firms comprising the ologopolistic core of the market, then the restraints are likely assisting it to retain or improve its already strong position. Regardless of industry concentration, the greater a firm's market power, the better it can insulate itself from interbrand competition. As might be expected, this effect necessarily causes intraband competition to play an increasingly larger role in assuring marketplace rivalry. Although sometimes used interchangeably in economic literature,[26] market power and monopoly power can be very different in the eyes of the law. One fortunate difference is that gauging the degree of the former is not nearly so complicated as determining the latter.[25]

Courts have frequently mentioned and applied market dominance as a criterion for judging the reasonableness of territorial restraints,[27] but no bright-line standard has ever been established to indicate how big a share must be before the restrictions at issue become unreasonable.[28] The reluctance of the judiciary to promulgate such a rule is due in part to a need to preserve flexibility, but it also indicates that the significance of market share must be evaluated in light of many other considerations.[29] For example, a 10 percent share may be enormously significant in a severely fragmented industry but may indicate little market power in an industry with three firms holding the other 90 percent.

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[20] Id. at 25–29.

[21] This term is broadly defined as power over price. F. Scherer, supra note 110, at 10.

[22] *Continental T.V., Inc.* v. *GTE Sylvania, Inc.*, 433 U.S. at 64 (White, J., concurring) (citing F. Scherer, supra note 110, at 10–11). Justice White uses these indicators to conclude that *Sylvania* "is distinguishable from *Schwinn* because there is less potential for restraint of intrabrand competition and more potential for stimulating interbrand competition." 433 U.S. at 59 (White, J., concurring). See also *Snap-On Tools Corp.* v. *FTC*, 321 F.2d at 833.

[23] Mann, "Advertising, Concentration and Profitability: The State of Knowledge and Directions for Public Policy." in Industrial Concentration, supra note 116, at 141; Weiss, "The Concentration-Profits Relationship and Antitrust" in Industrial Concentration, supra note 116, at 193.

[24] See, e.g., *Adolph Coors Co.*, 83 F.T.C. 32, 195–96 (1973), aff'd, 497 F.2d 1178 (10th Cir. 1974), cert. denied, 419 U.S. 1105 (1975); *Pitofsky*, supra note 10, at 35.

[25] F. Scherer, supra note 110, at 10.

[26] L. Sullivan, Handbook of the Law of Antitrust 192 (1977). Monopoly power in the relevant market is one of two elements that must be shown to succeed in a monopolization case. The other is willful acquisition or maintenance of that power. *United States* v. *Grinnell Corp.*, 384 U.S. at 570–71. Monopoly power is defined as "the power to control prices or exclude competition." *United States* v. *E. I. duPont de Nemours & Co.*, 351 U.S. at 391 (footnote omitted).

[27] E.g., *United States* v. *Topco Assocs., Inc.*, 405 U.S. at 622–23 (Burger, C. J., dissenting); *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 374–75, 381; *United States* v. *Sealy, Inc.*, 388 U.S. at 361 and n. 2 (Harlan, J., dissenting); *American Inns, Inc.* v. *Holiday Inns, Inc.*, 521 F. 2d at 1247–48; *Newberry* v. *Washington Post Co.*, 438 F. Supp. at 474–75.

[28] ABA Monograph, supra note 10, at 63–64 (footnote omitted).

[29] For example, in a post-*Sylvania* case, *Newberry* v. *Washington Post Co.*, 438 F. Supp. 471 (D.D.C. 1977), the defendant newspaper had a de facto monopoly in its relevant market. However, territorial and customer restrictions developed by a course of conduct were upheld on the grounds that the *Post's* dominant status was lawfully attained and the restraints were necessary to properly distribute the paper. Id. at 474–77.

Taken together, if the four market structure variables indicate that the industry in which the restraint is imbedded can be typified as a tight-knit oligopoly,[30] and if the firm imposing the restraint is a member of the oligopolistic core, then the court should declare the restraint per se illegal[31] in the absence of any of the special considerations discussed below.[32] Such a determination is entirely consistent with *Sylvania's* ground rules for the imposition of a per se rule.[33] In the situation described, vertical restrictions "have or are likely to have a 'pernicious effect on competition' or . . . 'lack . . . any redeeming virtue' " [34] because interbrand competition is very weak. Under such circumstances, intrabrand rivalry is necessary to have any degree of competition in the relevant market.[35] Far from being based on "formalistic line drawing," this approach is grounded on "demonstrable economic effect." [36]

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[30] An oligopolistic industry is defined as one in which there are a few large sellers, each of which suppies enough of the total market output to influence market price with output adjustments at its command and will thus anticipate reactions by its rivals to its output and price adjustments. A tight-knit oligopoly is a structural condition where the four-firm concentration ratio is over 50 (four firms account for more than 50 percent of industry sales), product differentiation is substantial, entry barriers are high, and evidence exists of consciously parallel action in the marketing behavior of the firms comprising the core of the industry. J. Bain, supra note 113, at 28–29, 137–40; W. Shepard, The Economics of Industrial Organization 63 (1979); L. Stern & J. Grabner, Jr., supra, note 118, at 40–46.

[31] Threshold factual issues must often be proven in order to activate a per se rule. For instance, although tying agreements are generally considered per se illegal, the Sherman Act requires proof that the seller has economic power over the tying product and does a not insubstantial amount of its business in the tied product before the per se rule is available. See, e.g., *Fortner Enterprises, Inc.* v. *United States Steel Corp.*, 394 U.S. 495, 499 (1969); *Northern Pac. Ry.* v. *United States*, 365 U.S. at ——. Similarly, group boycotts are also viewed as per se violations, but proof of anticompetitive intent is relevant which always leads to an examination of the marketplace before the rule can be applied. See, e.g., *E. A. McQuade Tours, Inc.* v. *Consolidated Air Tour Manual Comm.*, 467 F. 2d 178 (5th Cir. 1972); *Joseph E. Seagram & Sons., Inc.* v. *Hawaiian Oke & Liquors, Ltd.*, 416 F. 2d 71 (9th Cir. 1969).

Referring to this approach as the "qualified per se rule," Slater notes that, while unannounced, it has been applied for some time in one form or another as an intermediate alternative to both the rule of reason and the per se rule:

> Many courts have never compartmentalized their antitrust decisions nearly as much as the two pronged doctrine would seem to require. Their analysis has often been incomplete under a full rule of reason, but too extensive for a strict per se rule. . . . The lack of formal recognition has probably prevented this approach from obtaining its full significance. The greatest importance of *GTE Sylvania* may turn out to be that it was a step toward that recognition.

Slater, supra note 85, at 1–13. (citing *United States Steel Corp.* v. *Fortner Enterprises, Inc.*, 429 U.S. 610 (1977); *United States* v. *Philadelphia Nat'l Bank*, 374 U.S. 321 (1963); *Fashion Originators Guild of America, Inc.* v. *FTC*, 312 U.S. 457 (1941); *Moore* v. *Jas. H. Matthews & Co.*, 550 F.2d 1207 (9th Cir. 1977)).

[32] Exceptions to per se rules have been utilized for sometime. Several tying cases have found that product quality considerations justify the use of what might otherwise be an illegal restraint. See e.g., *Dehydrating Process Co.* v. *A.O. Smith Corp.*, 292 F.2d 653 (1st Cir.), cert. denied, 368 U.S. 931 (1961); *United States* v. *Jerrold Electronics Corp.*, 187 F.Supp. 545 (E.D. Pa. 1960), aff'd per curiam, 365 U.S. 567 (1961). In a post-*Sylvania* case, a Tenth Circuit panel reversed the lower court and held that the supplier's territorial and customer restrictions must be judged under the rule of reason, taking into account its quality preservation claims. *Adolph Coors Co.* v. *A&S Wholesalers, Inc.*, 561 F.2d 807, 813–14 (10th Cir. 1977).

[33] Notwithstanding the Court's apparent intent to retain some vestige of a per se rule, see note 57 supra.

> [i]t is conceivable that Sylvania will eventually be interpreted to have moved the law back to *White Motor*—an agnostic position as to whether a per se rule would apply to any or all nonprice vertical restrictions. If so, the [preceding] arguments . . . might prove persuasive in supporting limited per se applications. However, even if *Sylvania* makes it virtually impossible to impose per se rules against nonprice vertical restrictions for the immediate future, the [preceding] discussion should at least indicate those [situations] where vertical restrictions are least defensive and should be least likely to survive under a rule of reason.

Pitofsky, supra note 10, at 28. See generally *Handler*, supra note 95, at 982–83; Posner supra note 10, at 13.

[34] 433 U.S. at 58 (quoting *Northern Pac. Ry.* v. *United States*, 356 U.S. at 5). See *United States* v. *White Motor Co.*, 372 U.S. at ——; *Lamp Liquors, Inc.* v. *Adolph Coors Co.*, 563 F.2d 425, 432 (10th Cir. 1977); *Sandura Co.* v. *FTC*, 339 F.2d at 858.

[35] Pitofsky argues that a per se rule should be applied to: the "vertical" case where there is airtight or substantiallly airtight territorial or customer confinement: (2) the "price" case where restrictions help maintain minimum prices; and (3) the "horizontal" cases where either a supplier retains an exclusive area or category of customers and prevents dealers from competing with it on the intrabrand level or a supplier imposes restrictions at the behest of dealer cartels. Pitofsky, supra note 10, at 28–33. The proposed model provides more flexibility than this approach, but is not necessarily incompatible with it.

[36] 433 U.S. at 59. At the same time, the Court noted that:

> [p]er se rules . . . require the court to make broad generalizations about the social utility of particular commercial practices. . . . Cases that do not fit the generalization may arise, but a per se rule reflects the judgment that such cases are not sufficiently common or important to justify the time and expense necessary to identify them.

433 U.S. at 50 n. 16. See Pitofsky, supra note 10, at 12–13.

If intrabrand competition is essential to the preservation of competition generally and it has been significantly impaired, the court must still examine several exceptional factors before declaring the restraints illegal. However, where there is a substantial amount of interbrand competition in the market and/or the supplier has limited market power, the court should next go to step 5 of the model.

Special considerations

There are certain special circumstances in which vertical restraints should be permissible, even when interbrand competition is very weak. These occur when the firm instituting the restraints is a new entrant to the market or a failing company.[37] Such restraints may also be sanctioned when there are important concerns with product safety and quality or with broad societal issues. The reasoning for each of these exceptions follows.

New entrants.—It would be highly unusual to find that a new de novo entrant to a market typified by differentiated oligopoly had been able to secure membership in the core of that industry in the short-term. If this happens, it is likely that the newcomer has created considerable turbulence in the market and that this turbulence will produce the effect generally found in situations where interbrand competitions is vigorous. If the newcomer's entry has been made possible by the restraints it has imposed (resale restrictions) or the rewards it has granted (exclusive territories), then the positive benefit of its entry will doubtless outweigh the restrictive nature of its distribution policies, at least until the market settles down into an equilibrium state.

It is easy to overestimate the ease of entry into a market. Start up capital costs can often be appraised, but successful new entry also requires competent management and access to reseller outlets. A firm with capital and a strong product may nevertheless find itself facing a well-established distribution channel in which few existing distributors are willing to consider additional or alternative lines. One way in which to induce a distributor to carry the new line is to promise exclusive rights for a certain period of time. That way the distributor is assured that if it is successful in establishing the line in its area, it will reap the benefits of its efforts. Such an incentive may be necessary for the new entrant to have any chance of success. Vertical restrictions used by new entrants into established markets can be assumed to have procompetitive effects at the interbrand level, irrespective of the market share achieved by the entrant in the short-term. By the same token, it should be noted that the new entrant exception is temporary in nature, *i.e.*, when the circumstances change, this justification evaporates. The same is true for the next consideration.

Failing companies.—Even within a tight-knit differentiated oligopoly, the failure of a firm decreases the number of sellers in a market and thereby may decrease the already low level of interbrand competition. A firm may have significant market power and still be in danger of going out of business, e.g., Lockheed, W. T. Grant. In order to maintain itself, the failing company may resort to changes in its distribution and market structure in hopes of turning the situation around, and therefore, it may implement restraints. While failing firms with significant market power are unlikely defendants in antitrust cases centering on vertical restrictions, a failing firm justification should be recognized whenever applicable to the factual situation before the court.

Product safety and quality.—In 1970, the Third Circuit in *Tripoli Co.* v. *Wella Corp.*[38] held that a supplier's interest in protecting the public from injury and itself from liability was a "lawful purpose" which justified the use of customer restrictions.[39] The *Sylvania* Court seemed to endorse this approach by citing *Tripoli* with approval and stating that "[m]arketing efficiency is not the only

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[37] Beginning with *White Motor,* courts and commentators have argued that short-term intrabrand competition can be sacrificed in the name of long-term interbrand competition where the supplier is failing or where it is a new entrant in the product or geographic market. See, e.g., *United States* v. *Topco Assocs., Inc.*, 405 U.S. at 613 (Burger, C. J., dissenting); *United States* v. *Arnold, Schwinn & Co,* 388 U.S. at 374–75, 379–80; *United States* v. *White Motor Co.*, 372 U.S. at 262–63; Louis, supra note 24, at 293; Pitofsky, supra note 10, at 29 n. 85, 35. However, no decision has ever upheld such a defense. ABA Monograph, supra note 10, at 16. The *Sylvania* majority may have indicated that the issue is not worthy of separate or special consideration, 433 U.S. at 58 n. 29, but Justice White's concurrence extended the principle to include a "faltering" firm, like Sylvania, which was "a . . . manufacturer with a 'precarious' position in a generic product market dominated by another firm." Id. at 65.

[38] 425 F.2d 932 (3d Cir.), cert. denied, 400 U.S. 831 (1970).

[39] Id. at 939. The court applied the rule of reason rather than the *Schwinn* per se doctrine to find that a hair preparation supplier's restriction on resales to licensed professionals was ancillary to its overall purpose.

legitimate reason for a manufacturer's desire to exercise control over the manner in which his products are sold and serviced.[40] Where a product has significant potential for physical harm if improperly distributed, public policy mandates that suppliers be allowed to restrict its sales in a manner decreasing the chance of user injury.[41] It should be clear, however, that the product does have significant potential for harm and that the restraint clearly reduces it.

Certain products require special handling in order to preserve their quality. For example, nonpasteurized beer must be refrigerated, house plants need particular lighting, and the shipment of farm machinery necessitates controlled interconnecting. One way such special treatment can be assured is to place customer, or, rarely, territorial restrictions on distributors. In at least one case under the *Schwinn* doctrine, this justification was disregarded, but after *Sylvania*, it has become a proper factor as courts recognize that damaged products are not in the consumer's best interest.[42]

As with product safety, the need for the protection of product quality must be clearly established. The product involved should be subject to some significant change if not properly cared for, and the restriction imposed must clearly reduce the chances of this change.[43] Alternatively, some suppliers might seek to justify a restraint on the basis that they are trying to maintain uniform quality throughout the country. Such an argument is most likely to be raised in franchising the sale of a retail product, particularly fast food. Since the Lanham Act requires that the trademark owner or franchisor exercise control over the quality of the licensed product,[44] a vertical restriction may be justified if it is necessary for this reason.

Broad societal issues.—The viability of social justification and social impact as factors in litigation testing the antitrust validity of vertical restrictions is problematic. At one level, consideration of purposes and effects outside of competition could swing the rule of reason balance one way or another, all other things being equal. At a different, more troubling, level, such consideration could validate an otherwise anticompetitive restraint or condemn an otherwise procompetitive arrangement. The controversy centers on what one is willing to accept as the underlying goals of the antitrust laws and their role in adjudication.

While it is clear that competition is a primary objective of the antitrust laws,[45] some maintain that social and political goals are also relevant.[46] There is some support for the social view in at least two Sherman Act cases, *Chicago Board of Trade* and *Appalachian Coals*.[47] However, more modern cases have moved away from this position and toward the competition-based focus embodied in *Standard Oil Co.*, the original rule of reason case.[48] As Sullivan has written: "Courts are loath to accept a ministerial discretion to decide when a trade has purchased the right to restrict competition by proffering social gains." [49]

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[40] 433 U.S. at 55 n. 23. In a post-*Sylvania* decision, the Court appeared to qualify its approval while citing *Tripoli*:

> Courts have . . . upheld marketing restraints related to the safety of a product, *provided that they have no anti-competitive effect and that they are reasonably ancillary to the seller's main purpose of protecting the public from harm or itself from product liability.*

National Soc'y of Professional Eng'rs v. *United States*, 435 U.S. at 696 n. 22 (italic supplied) (defendant had argued that safety considerations were the purpose of its competitive bidding proscription).

[41] See generally Pitofsky, supra note 10, at 23–25.

[42] Compare *Adolph Coors Co.* v. *FTC*, 497 F.2d 1178, 1186–87 (10th Cir. 1974), cert. denied, 419 U.S. 1105 (1975) with *Adolph Coors Co.* v. *A&S Wholesalers, Inc.*, 561 F.2d 807, 813–14 (10th Cir. 1977).

[43] See generally *Dehydrating Process Co.* v. *A. O. Smith Corp.*, 292 F.2d 653 (1st Cir.), cert. denied, 368 U.S. 931 (1961); *United States* v. *Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), off'd per curiam, 365 U.S. 567 (1961). See note 140 supra.

[44] 15 U.S.C. §§ 1055, 1127 (1976). See, e.g., *Siegel* v. *Chicken Delight, Inc.*, 448 F.2d 43 (9th Cir. 1971); *Dawn Donut Co.* v. *Hart's Food Stores, Inc.*, 267 F.2d 358 (2d Cir. 1959).

[45] In *Northern Pac. Ry.* v. *United States*, the Court stated:

> The Sherman Act was designed to be a comprehensive charter of economic liberty aimed at preserving free and unfettered competition as the rule of trade. It rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.

356 U.S. at 4. See Posner, *supra* note 10, at 13–16.

[46] *See* ABA Monograph, supra note 10, at 27–29 and the sources cited therein. As pointed out by Pitofsky, these contrasting viewpoints are manifested in *Sylvania* by tension between the majority opinion and Justice White's concurrence. Pitofsky, supra note 10, at 3 n. 7.

[47] *Appalachian Coals, Inc.* v. *United States*, 288 U.S. 344 (1933). See L. Sullivan, supra note 125, at 171–87.

[48] L. Sullivan, supra note 125, at 186–87.

[49] Id. at 186.

Nonetheless, social benefits unrelated to competition and arising from restraints may be significant, especially in the context of the time in which they arise. Ecological and energy-saving concerns, for example, may well outweigh the competitive aspects of a case, even when a tight-knit differentiated oligopoly is present and when the firm instituting the restraints has substantial market power. The door must be left open to the court to balance social forces against economic ones in highly special circumstances.

If the oligopolistic supplier cannot avail itself of any of the preceding special considerations, the restraints imposed by it are unlawful and inquiry with regard to them ends at this point. On the other hand, if such a supplier has been able to find refunge in one or more of them, the court must move on to the next step.

Step 5: Assessing the effects on interbrand competition

If, in the preceding portion of the model, it has been demonstrated that intrabrand competition is unnecessary to preserve market competition or special considerations preclude a finding of per se illegality, the court must now determine what the impact of the restraints has been and is likely to be on interbrand competition in the relevant market.[50] As the *Sylvania* court recognized, interbrand rivalry is "the primary concern of antitrust law." [51] The presence of a reasonably competitive market, as determined in step 4 through the structural analysis suggested there, is at least a start toward justification of the restrictions. Thus, all of the indices examined in step 4 with regard to the relavant market—concentration, product differentiation, entry barriers, and market power—are meaningful here.

Several additional factors may be considered which typically arise as the asserted purpose for imposing vertical restraints. While reliance on purported business justifications is often misleading,[52] examination of purpose can be relevant under the rule of reason and may be helpful in properly evaluating the restrictions.[53] Particularly useful is a standard for evaluating the necessary scope of the restraint as measured against the factors discussed below. Assuming that a justification appears applicable to the circumstances under scrutiny, the test is simply whether the restraints used are reasonably necessary to make use of it.[54]

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[50] An examination of the effect of the restrictions under scrutiny is central to every rule of reason application. See, e.g., *United States* v. *Arnold Schwinn & Co.*, 388 U.S. at 373–74, 380; *Chicago Bd. of Trade* v. *United States*, 246 U.S. at 238; *American Motor Inns, Inc.* v. *Holidays Inns, Inc.*, 521 F. 2d at 1247. Its primary role makes a great deal of sense from the perspective of the aims of antitrust law. As Sullivan has noted: "There is an implacable logic in condemning conduct on the basis of ill effects. . . . It is, in the end, effects—impacts upon the competitive process—which are of social consequence." L. Sullivan, supra note 125, at 194.

On purely economic grounds, it could be argued that the fact that a restraint has no adverse effect on interbrand competition is insufficient to avoid an antitrust violation. Regardless how liberal one's views might be relative to vertical restrictions, they still represent a blatant private regulation of trade. Therefore, their existence should be shown to have had some positive benefits for interbrand competition; otherwise, there is no justification for their existence.

[51] 433 U.S. at 52 n. 19. Of course, intrabrand competition is still important. See the sources cited in note 18 supra.

[52] One commentator has noted: "The primary problem with evidence of purpose—to put the matter bluntly—is that in modern antitrust cases, such evidence will often reflect what counsel advise businessmen their purpose should have been." Pitofsky, supra note 10, at 35. See also Louis, supra note 24, at 280.

[53] As Justice Brandeis stated in *Chicago Board of Trade*, "[K]nowledge of the intent may help the court to interpret facts and to predict consequences." 246 U.S. at 238. See *White Motor Co.* v. *United States*, 372 U.S. at 259–64; *Kestenbaum* v. *Falstaff Brewing Corp.*, 575 F.2d at 573; *Martin B. Glauser Dodge Co.* v. *Chrysler Corp.*, 570 F.2d at 82–83.

Without anticompetitive effect, unlawful intent will not establish a rule of reason violation. See, e.g., *H&B Equipt. Co.* v. *International Harvester Co.*, 577 F.2d at 246; *Northwest Power Prods., Inc.* v. *Omark Indus., Inc.*, 576 F.2d at 90. At the same time, while essentially self-serving conduct may produce procompetitive outcomes, economic self-interest without this result is not enough to permit restraint of trade. See, e.g., *United States* v. *Arnold Schwinn & Co.*, 388 U.S. at 375; *Hecht* v. *Pro-Football, Inc.*, 570 F.2d 982, 996 (D.C. Cir. 1977).

[54] See *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 380–81; *American Motor Inns, Inc.* v. *Holiday Inns, Inc.*, 521 F.2d at 1248–49; *Munters Corp.* v. *Burgess Indus., Inc.*, 450 F. Supp. 1195, 1209–11 (S.D.N.Y. 1978); *Newberry* v. *Washington Post Co.*, 438 F. Supp. at 475; Pitofsky, supra note 10, at 36–37; Posner, supra note 10, at 11–12.

Several courts and commentators have argued that a least restrictive alternative test should apply, see, e.g., *Copper Liquor, Inc.* v. *Adolph Coors Co.*, 506 F. 2d at 947; *Sandura Co.* v. *FTC*, 339 F. 2d at 756; ABA Monograph, supra, note 10, at 58 n. 229. 59 n. 233. but the better view is that the existence of less restrictive alternatives is relevant but not determinative. See, e.g., *White Motor Co.* v. *United States*, 372 U.S. at 271 (Brennan, J., concurring); *American Motor Inns, Inc.* v. *Holiday Inns, Inc.*, 521 F. 2d at 1248–50; *Snap-on Tools Corp.* v. *FTC*, 321 F. 2d at 832.

The presence of restrictions that go beyond the supplier's need invites suspicion that the real purpose of imposing the restraints is anticompetitive.[55]

Restraint universality

If all the suppliers in an industry impose similar restraints on a standard basis, manipulated so as to limit competition at other levels of distribution. On the other hand, if a firm is seeking access to a market and if exclusive territories or other inducements are typically granted to distributors, then it may be necessary for the entering firm to set up such territories in order to attract resellers' attention.[56]

Market coverage

In many industries, there is significant competition for quality distributors. The firm having the better group of distributors is likely to be more profitable. The handling of certain products or services may require a substantial initial investment on the part of the distributor, so prospective distributors are likely to weigh that start-up cost against the prospective return. The future, of course, can only be estimated, but that future may seem more certain if the prospective distributors know they will have contractual protection with regard to certain types of intrabrand competition. In such contexts, imposition of vertical restraints may increase the interbrand competition effectiveness of the supplier's distribution system.

Court widely recognize that territorial restraints may be useful or even crucial in helping a supplier obtain a market presence [57] or maintain one.[58] Such restrictions can serve as a quid pro quo to distributors willing to take the risk associated with new products or those with a declining market share.[59] Some commentators argue that territorial inducements are unnecessary and that natural market forces ought to be allowed to channel resources into those opportunities which represent the best investment.[60] Although this contention may have some merit in certain cases,[61] it ignores the fact that many markets are not perfectly competitive. Suppliers and their distributors may face such realities as concentration coupled with entry barriers, or differentiation and entrenched brand loyalty.

One step beyond the objective of securing market presence is the related goal of increasing it. Preston has asserted that total market coverage can be expanded by dividing the more profitable "cream" accounts among distributors and protecting such divisions with territorial restraints.[62] In this way, distributors will endeavor to sell the less profitable accounts which otherwise would be neglected during the intrabrand battle over the better buyers. Those advocating the free market approach take issue with this rationale,[63] but at least one post-*Sylvania* decision has expressly found market penetration to be a lawful purpose.[64]

Stimulating supportive activity

The *Sylvania* Court acknowledged that vertical restraints may enhance interbrand competition when they are used "to induce retailers to engage in promo-

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[55] See *White Motor Co.* v. *United States,* 372 U.S. at 270 n. 9 (Brennan, J., concurring).

[56] In the latter case, the intrabrand restraint raises the cost of market entry and therefore heightens entry barriers generally. See generally Louis, supra note 29, at 272; Posner, supra note 10, at 17–18.

[57] *Continental T.V., Inc., v. GTE Sylvania, Inc.,* 433 U.S. at 55; *White Motor Co.* v. *United States,* 372 U.S. at 263; id. at 269 (Brennan, J., concurring); *United States* v. *Topco Assocs., Inc.,* 319 F. Supp. at 1043. See ABA Monograph, supra note 10, at 68–69; Louis, supra note 24, at 296–99; Preston, supra note 12, at 511.

[58] *White Motor Co.* v. *United States,* 372 at 263; *Sandura Co.* v. *FTC,* 339 F.2d at ——; *Snap-On Tools Corp.* v. *FTC,* 321 F.2d at 832; *Newberry* v. *Washington Post Co.,* 438 F. Supp. at 475.

[59] See Louis, supra note 24, at 297–99. According to the author, this point is supported by the virtual per se legality of exclusive franchises. Id. at 286–87. See note 24 supra.

[60] Comanor, supra note 23, at 1429; Pitofsky supra, note 10, at 18–19; "Hearings on S. 2548 Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm.," 89th Cong., 2d Sess. 1088 (1966) (Statement of Donald F. Turner) (hereinafter cited as 1966 Hearings).

[61] For example, this approach could be applied to suppliers with market power. In this situation, the presence of exceptionally high profits would naturally attract economic resources.

[62] Preston, supra note 12, at 511–19. See ABA monograph, supra note 10, at 40, 67–68; Louis, supra note 24, at 296.

[63] Comanor, supra note 23, at 1431–32; Pitofsky, supra note 10, at 18–19. 1966 Hearings, supra note 159, at 1088.

[64] *Newberry* v. *Washington Post Co.,* 438 F. Supp. at 475.

tional activities or to provide service and repair facilities." [65] The majority also noted that all distributors could benefit if such supportive activity were undertaken by each of them, but market imperfections like the free rider effect can block independent adoption.[66] For example, one distributor may provide advertising and showrooms only to discover that the consumer, after taking advantage of these services, makes its purchase at a nearby distributor which forgoes such services and offers the product at a lower price.[67] Eventually, all distributors may lower their service levels, despite the fact that the supplier considers such amenities necessary from an interbrand perspective.[68]

Critics of this argument agree that distributor promotion and services can be procompetitive, but they question the across the board imposition of vertical restraints to accomplish this. At the extreme, Comanor maintains that this justification is merely an excuse to amass market power through the differentiative activities encouraged by excessive distributor markups.[69] The solution, according to Comanor and others,[70] is to let the market determine which services should be offered, rather than packaging products and services together. Other commentators take a more conservative view, recognizing that not all industries or products are prone to free riders.[71] In addition, free riders may be eliminated in a less restrictive fashion by offering such services at separate cost or by manufacturer subsidization of supportive activity.[72]

Additional factors

Many other relevant considerations can be identified, especially for unique products or services or channels of distributions. The discussion in this article is not intended to be all inclusive. Instead, major factors have been indicated, and by considering them, courts are likely to be led to the others. It is important to realize that there are countless ways to market and distribute the wide variety of goods and services available to American consumers. Competition is not a homogeneous commodity. The nature of competitive interaction will vary according to market context, and any accurate assessment of competitive impacts must take this into consideration.

At this point, an assessment of competitive effects on both the intrabrand and interbrand levels has been made.[73] According to *Sylvania*, the next step is to balance these effects [74] to determine whether the restraints at issue are "unreasonably restrictive of competition," [75] i.e., whether "the effect upon competition in the marketplace is substantially adverse." [76] Thus, after considering all of the factors outlined above, if it cannot be shown that the restraint is presently having or is likely to have a substantial positive effect on interbrand competition, it should be judged illegal.

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[65] 433 U.S. at 54–55. See *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 383–84 (Stewart, J., concurring and dissenting); *White Motor Co.* v. *United States*, 372 U.S. at 269 (Brennan, J., concurring); *Snap-On Tools Corp.* v. *FTC*, F.2d at 832; ABA monograph, supra note 10, at 40, 68; Louis, supra note 24, at 296; Preston, *supra* note 12, at 511–12.

[66] 433 U.S. at 55. See also the sources cited in note 158 supra.

[67] These are essentially the facts of *National Auto Brokers* v. *General Motors Corp.*, 572 F. 2d 953 (2d Cir. 1978) where a broker and its franchisees sued GM and some of its franchised dealers alleging a conspiracy to boycott the broker system. See *United States* v. *General Motors Corp.*, 384 U.S. 127 (1966) (boycott of discounters). See also *Blackwelder Furniture Co.* v. *Selig Mfg. Co.*, 550 F.2d 189 (4th Cir. 1977) (prior to termination, North Carolina furniture distributor sold to mail-order customers in Washington, D.C. as much as 30 percent below manufacturer's suggested prices).

[68] Louis, supra note 24 at 300.

[69] Comanor, supra note 23, at 1429–30.

[70] Id. at 1432–33; 1966 Hearngs, supra note 159, at 1088.

[71] Pitofsky, supra note 10, at 21–22; The Supreme Court, supra note 10, at 236.

[72] Besides making this point, Pitofsky raises the fundamental issue of whether the additional profits facilitated by vertical restrictions will be used to provide the level of services desired by the supplier. Pitofsky, supra note 10, at 21–23. In Posner's view, distributors will furnish such services rather than pocket additional profits out of fear that they will be replaced by those which will comply with the supplier's wishes. Posner, supra note 10, at 4.

[73] Other factors include: (1) avoidance of duplication, (2) market segmentation, (3) distributor economies of scale, and (4) protection of exclusive distributorships. See Pitofsky, supra note 10, at 25–26.

[74] See 433 U.S. at 57 n. 27. See also *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 374, 382; *White Motor Co.* v. *United States*, 372 U.S. at 266 n. 3 (Brennan, J. concurring); *Martin B. Glauser Dodge Co.* v. *Chrysler Corp.*, 570 F.2d at 82; *Elfman Motors, Inc.* v. *Chrysler Corp.*, 1977–2 Trade Cas. ¶ 61,650 at 72, 683 (E.D. Pa. 1977); *United States* v. *Topco Assocs., Inc.*, 319 F. Supp. at 1043.

[75] *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 380.

[76] Id. at 375. See *Kestenbaum* v. *Falstaff Brewing Corp.*, 575 F.2d at 572; *Hecht* v. *Pro-Football, Inc.*, 570 F.2d at 995–96.

However, just as in step 4, there may be special circumstances in which such vertical restraints are permissible, even without a positive effect on interbrand rivalry. These special off-setting factors are identical to those which would have been raised in step 4, if it has been found that intrabrand competition was necessary to preserve competition in the relevant market.[77] They include questions about whether the defendant is a new entrant or a failing company and whether there are important issues of product safety and quality. In addition, the area of broad societal concerns may involve consideration of the preservation of small business firms,[78] as well as national crisis situations, such as energy or inflation. The special factors can even extend to the development of new technology, as it may be necessary for a firm with a new product or service in a technologically sophisticated industry to tightly control its distribution channels so as to insure that it receives necessary technical feedback.[79]

If none of the special off-setting factors is compelling, then the judgment of illegality should be upheld.

APPLICATION OF THE RULE OF REASON DECISION MODEL

An appropriate test of the proposed model is provided by the Federal Trade Commission's complaint and subsequent decisions regarding the territorial restrictions currently imposed on independently owned, licensed bottlers of soft drinks sold under Coca-Cola and PepsiCo trademarks.[80] On April 28, 1978, the FTC ruled that such restrictions are unreasonable and anticompetitive.[81] Since the case is on appeal, and because of the obvious need for additional clarification of matters pertaining to distribution channels and vertical restraints, the likelihood is high that it will eventually come before the Supreme Court. The following discussion presents a topical example of how the proposed general model could be applied by the court in specific commercial situations where customer and/or territorial restrictions are being challenged.

In the discussion below, reference is made only to The Coca-Cola Company's distribution system, as differences in the distribution systems of Coca-Cola and PepsiCo are not significant enough to warrant separate examination of each here. This narrow focus is supported by PepsiCo's agreement that the decision in its case before the FTC could be based upon the completed trial record of the Coca-Cola matter.[82]

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[77] See notes 136–48 and accompanying text supra.

[78] One of the most common social benefits asserted is the preservation of small business through franchising and its attendant vertical restraints. See, e.g., *Continental T.V., Inc.*, v. *GTE Sylvania, Inc.*, 433 U.S at 57 n. 26; *United States* v. *Arnold, Schwinn & Co.*, 388 U.S. at 386–87 (Stewart, J., concurring and dissenting); ABA monograph, supra note 10, at 70–71. Adherents to this point of view paint the world without franchising as one dominated by large corporate empires that have wiped out small business through vertical integration and economic muscle. See Keck, the *Schwinn case*, 23 Bus. Law. 669 (1968); Pollock, supra note 25, at 608–10. However, this argument misses the point that integration is not always sound business policy. See Comanor, supra note 23, at 1435–36; Preston, supra note 12, at 512. Moreover, economic Darwinism can often be checked by less restrictive means through the merger laws. Even if franchising is accepted as the last stronghold of free enterprise, it must be understood that it may carry with it the social cost of building in economic inefficiency. Indeed, it is possible that, after the *Sylvania* court's reliance on economic rationale, "the aesthetic delights of smallness and the yearning to resurrect a nation of sturdy Jeffersonian yeomen will not be permitted to decide antitrust cases." Posner, supra note 10, at 13.

A second frequently cited social benefit is the preservation of economic liberty and opportunity, sometimes called the right to contract or business autonomy. See *Continental T.V., Inc.* v. *GTE Sylvania, Inc.*, 433 U.S. at 66–69 (White, J., concurring); *United States* v. *Topco Assocs., Inc.*, 405 U.S. at 610–11; ABA Monograph, supra note 10, at 29–31. However, the shiney attractiveness of this platitude may be tarnished by the reality of bargaining power distribution in many franchise relationships. Moreover, the concept of total economic self-determination is antithetical to the rule of reason. Handler, supra note 95, at 988. See *Kestenbaum* v. *Falstaff Brewing Corp.*, 575 F.2d at 572 ("While the antitrust law has given more than a mere nod to the importance of business autonomy, respect for independence cannot justify finding a violation when no adverse impact on competition is shown.")

[79] This type of extracompetitive justification was expressly recognized in the context of servicing tie-ins in *United States* v. *Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), aff'd per curiam, 365 U.S. 567 (1961).

[80] *Coca-Cola Co.*, 91 F.T.C. 517 (1978), appeal docketed, No. 78–1364 (D.C. Cir. —— 1978) [hereinafter cited as *Coca-Cola*]; *PepsiCo, Inc.*, 91 F.T.C. 680 (1978), appeal docketed, No. 78–1544, 78–1545 (D.C. Cir. —— 1978). (Hereinafter cited as *PepsiCo.*)

[81] *Coca-Cola*, 91 F.T.C. at 674; *PepsiCo*, 91 F.T.C. at 696–97.

[82] *PepsiCo*, 91 F.T.C. at 692.

Step 1: Identification

Coca-Cola is a diversified corporation with sales in excess of $1 billion.[83] In its Coca-Cola USA Division, the corporation manufactures and sells the soft drink syrups and concentrates used in the processing of finished flavored carbonated soft drinks sold under a number of trade names[84] licensed by Coca-Cola to approximately 700 bottlers operating slightly more than 800 bottling plants. Its syrup sales to these bottlers exceed $250 million. Not only does the corporation sell syrup to independent bottlers, but it also operates 27 bottling plants itself. All bottlers, whether independent or wholly owned by Coca-Cola, have been assigned exclusive territories.[85]

Historical context of territorial restrictions [86]

The bottling of flavored soft drinks began in the United States in the later half of the nineteenth century. Prior to that time, syrup had been used almost exclusively as a base for soft drinks served for immediate consumption at soda fountains. During this period, a growing number of extract or syrup manufacturers, including the Coca-Cola Company, entered the industry and began to develop and introduce many new proprietary flavors. Numerous companies franchised the right to bottle their common law trademarked products.

In 1899, The Coca-Cola Company granted an exclusive trademark license to J. B. Whitehead and B. F. Thomas to produce and sell bottled Coca-Cola in most States. Ancillary to the trademark licensing agreement, Coca-Cola specified an exclusive geographic territory in which only Whitehead and Thomas could vend bottled soft drinks under the Coca-Cola trademark. Because of the size of the territory, the company created by Whitehead and Thomas in turn franchised hundreds of independent local bottlers to produce and sell bottled Coca-Cola in exclusive geographic territories within that part of the country covered by the Whitehead and Thomas license. Other proprietary syrup companies soon followed Coca-Cola in franchising independent bottlers to produce and sell their trademarked soft drinks in exclusive geographic territories.

At this time, syrup companies were, for the most part, owned by entrepreneurs with limited capital and therefore were largely small operations.[87] Establishing territorial restrictions which prohibited intrabrand competition encouraged greater initial development of marketing and distribution efforts during this early phase of the industry's life, because exclusive licensees knew that their licensors and other licensees could not obtain a free ride on their efforts. In addition, the restrictions facilitated the licensor's maintenance of quality control, permitted better production planning by enabling greater accuracy in forecasting syrup demand within territories, reduced the selling cost of the product by avoiding duplication of territorial sales effort, and encouraged the bottler to develop the potential of its territory to the fullest. During these early years, most businesspeople "probably considered soft drink bottling little more than a newfangled invention with a questionable future." [88] Therefore, viewed in its historical context, the territorial exclusively awarded to Whitehead and Thomas, and subsequently awarded to others, was no doubt important in attracting the manufacturing and distribution capital necessary to develop a new business and to expand the sale of a new product—finished Coca-Cola in bottles—into new markets.

Since its inception, the system of exclusive territorial licenses has been consistently employed in the manufacture and distribution of bottled soft drinks.[89] There are currently more than 50 syrup companies, and 36 of them operate nationwide. These firms market more than 150 different soft drink brands through 7,500 written agreements with 2,300 bottlers.[90] In sum, Coca-Cola, along with

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[83] *Coca-Cola*, 91 F.T.C. at 527, 607.

[84] Such names are: Coca-Cola or Coke, TAB, Sprite, Fresca, Fanta, Simba, Santiba, and Mr. PiBB. *Coca-Cola*, 91 F.T.C. at 527.

[85] *See* note 24 *supra*.

[86] This history is found in *Exclusive Territorial Allocation Legislation: Hearings on S. 3040, S. 3166, S. 3133, S. 3145 and S. 3587 Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 92nd Cong., 2d Sess. 1, 605 (1972) (Part 2: Appendix) [hereinafter cited as *1972 Hearings*].

[87] *Coca-Cola*, 91 F.T.C. at 532; 1972 Hearings, supra, note 185, at 606.

[88] *Coca-Cola*, 91 F.T.C. at 612 n. 12.

[89] Id. at 532.

[90] *Coca-Cola*, 91 F.T.C. at 532; 1972 Hearings, supra note 185, at 588, 606.

other syrup manufacturers, have contractually imposed and enforced territorial restrictions for nearly eight decades. The interactions between The Coca-Cola Company and its bottlers relative to these restrictions are well-documented and not disputed.[91]

Relevant market

Coca-Cola and its allied products compete with local-, regional-, and national-brand carbonated beverages; private label soft drinks; and, to some extent, powdered mixes and noncarbonated drinks.[92] This broad market can be considered the global market for Coca-Cola based on subjective and objective estimates of the cross-elasticities of demand between Coca-Cola's products and the other products listed.[93] However, it is also likely that, within this global market, there exists a relevant submarket comprised only of carbonated flavored beverages. The marketing managers of the various soft drink companies (e.g., Coca-Cola, PepsiCo, Royal Crown, 7-Up) direct the bulk of their energies and attentions to serving this submarket.[94] Thus, the suppliers to this submarket are the primary actors in the competitive arena relative to marketing decisions.[95]

The geographic markets for these products are circumscribed artificially. Local markets,[96] not national markets, are the loci of competition in soft drink bottling because territorial restrictions confine bottlers to competing in local markets.[97] It is now known exactly how widely shipments might be made if territorial restrictions were lifted.[98] When initially set, the territorial boundaries reflected the likely potential market out-reach of bottlers, given existing production, marketing, and transportation technologies.[99] However, with present day technologies, it is not impossible to consider almost all bottlers of soft drinks as potential competition, irrespective of location, especially if nonreturnable containers are being shipped.

Within the relevant product submarket as defined above, a major question is whether to include post-mix syrup sold by independent wholesalers for use primarily at soda fountains and in cup vending machines.[1] It could be argued that the entire bottling industry exists because of its ability to service the demand for soft-drinks in take-home packages. If one accepts this argument, the likely conclusion is that, in the sale of soft drinks in bottles or cans for home consumption which the bottler alone is uniquely equipped to serve, intrabrand competition from postmix wholesalers is virtually nonexistent. Furthermore, bottlers seldom make attempts to sell fountain syrup to the on-premise consumption market[2] because of the extent of price competition in that market.

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[91] *Coca-Cola*, 91 F.T.C. at 540–43, 607–09.

[92] Id. at 619 n. 21, 634–35, 643.

[93] Id. at 619 n. 21.

[94] Id.

[95] This submarket determination is essentially the same as that adopted in *Borden, Inc.*, 89 F.T.C. 207 (1977) (interlocutory order) (*ReaLemon* case and *Kellogg Co.*, 91 F.T.C. 704 (1978) (interlocutory order) (*Cereal* case). It is, however, not quite as restrictive as in these cases. If it were, the relevant submarkets might be sugar-free and regular carbonated beverages.

[96] Local markets are generally considered to be major metropolitan areas or, at most, entire States.

[97] 1972 Hearings, supra note 185, at 223.

[98] This point is illustrated by the fact that Shasta, a company which sells only on a warehouse delivery basis, ships its products several hundred miles. "Shasta's Difficult Sales Goal," Bus. Week, Dec. 5, 1977, at 125. See 1972 hearings, supra note 185, at 589.

[99] *Coca-Cola*, 91 F.T.C. at 623.

[1] The administrative law judge found that "Coca-Cola sold by licensed bottlers in bottles, cans and premix containers is subject to vigorous intrabrand competition from postmix Coca-Cola sold by independent wholesalers," id. at 563, but the Commission rejected his conclusion. Id. at 620. It noted that Coca-Cola and its bottlers view the wholesaling of postmix syrup as distinct from the soft drink bottling business and said that such distinction is a valid one. Id. Although the Commission recognized that some soft drink retailers may choose "either finished packaged soft drinks * * * or postmix syrup which they can mix with carbonated water," id., it found that "the intrabrand competition which may exist between syrup jobbers and bottlers is confined to a limited, rather well-defined class of customers who cater to the cold drink market." Id. at 621.

In discussing the competition between the syrup jobbers and the bottlers, neither the administrative law judge nor the Commission confronted directly the question of whether postmix syrup belonged in the relevant product market. Postmix syrup was included in the complaint's definition of soft drink products, id. at 518, and the Commission noted that "the trial below explored the implications of these restraints in an exceedingly broad framework which encompassed interbrand competition within the total context of the soft drink industry." Id. at 619 n. 21.

[2] Included in this market are restaurants, fast-food retailers, cafeterias, sports stadiums, and other types of outlets which serve soft drinks in cups, bottles, or cans for immediate consumption.

While it is probably correct to view the premix and postmix markets as separate competitive arenas given the present situation, the separation is an artificial one. Because postmix wholesalers do not have protected territories, they are subjected to both interbrand and intrabrand competition. Bottlers, on the other hand, have complete protection from intrabrand competition. It is, therefore, not surprising that they have chosen to devote little attention to the postmix market. If territorial restrictions were removed, it is likely that, in the ensuing scramble for business brought about by the intrusion of competitors into previously protected territories, bottlers would find the postmix market segment increasingly attractive.

Given this argument, the appropriate relevant market is the sale of carbonated flavored beverages, including postmix sales by wholesalers, because there is presently some competitive overlap between firms involved in marketing postmix and premix soft drink items and because considerably more overlap would likely result from the removal of territorial restrictions. Within this market, a relevant submarket is the sale of Coca-Cola products by licensed bottlers in cans, bottles, and other premix containers. This submarket can be segregated on the basis of its size and the commonality of distribution methods employed within it. Although the FTC chose to focus solely on this submarket, this is probably too narrow a view. However, it has also been adopted here, because data regarding the competitive significance of postmix wholesalers are not in the public record or otherwise readily available. Such data could, of course, be obtained by an investigator buttressed with subpoena power.

Step 2: Per se tests for horizontal conspiracies and vertical price fixing

Existence of a horizontal combination of conspiracy

Coca-Cola's ownership of 27 bottling plants,[3] indicates that the company is engaged in dual distribution—it is vertically integrated, on the one hand, and employs independent bottlers, on the other. While dual distribution is not a commercial curiosity or in any way unique, the issue raised in this case is whether Coca-Cola, in its role as a bottler, has somehow combined with other bottlers to divide markets through the use of territorial restrictions and exclusive distributorships which prohibit intrabrand competition.

In its opinion, the FTC explicitly recognized the seriousness of this issue. It distinguished the Coca-Cola situation from Topco's with the following reasoning:

"The Coca-Cola Company's forward integration by acquisition into the bottling industry did not alter in a substantive way either the nature of the restraints or the implementation [of] policies employed by the Coca-Cola Company with respect to established bottling territorial relationships. These restraints were in place nationwide for several years prior to Coca-Cola's entry into bottling. When it acquired a bottler, the Coca-Cola Company itself became subject to the same territorial limitations it has previously imposed upon the acquired bottler. * * * While it is true that respondents may at times resolve border disputes involving bottlers, unlike *Topco*, it has not been established on this record that the independent bottlers exercise control over any respondent or the way in which a respondent implements the territorial aspects of its trademark licensing programs."[4]

It would, however, be somewhat naive to believe that the intrusion of a major corporation with franchisor status onto the plane of distribution occupied by less powerful concerns with franchisee status would not have some phychological, if not actual operating, effect on the latter. The fact that Coca-Cola was joining an already existing system rather than creating one upon entry makes it no less a participant in the market division.

The question of the existence of a horizontal combination is, therefore, debatable rather than as the Federal Trade Commission has indicated, excusable. If there is sufficient evidence of a horizontal combination, the conflict with the FTC's position may force the Court to consider, for the first time in recent history, the possible "reasonableness" of such a combination. Thus, rather than adopt a per se standard, the court might ask whether the combination is truly "pernicious" and "without redeeming virtue" if the purpose of the combination is to establish exclusive territories with the aim of promoting more effective interbrand competition.[5] Such an inquiry may also prompt the court to investigate whether there is

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[3] *Coca-Cola*, 91 F.T.C. at 527, 607.

[4] Id. at 612–13.

[5] This issue should have been dealt with more explicitly in *Topco*, and after *Sylvania* the court may be forced to reexamine its holding in that case. See notes 91–96 and accompanying text supra.

any difference in ultimate market effects between vertically and horizontally imposed and policed territorial restraints. The results of a horizontal division of markets may be indistinguishable from those gained under a vertically imposed division.

The presence of price fixing

There is no evidence that resale price maintenance has been practiced by Coca-Cola in its dealings with its bottling network.[6] Apparently, the company has not used its power as a franchisor to set prices at the wholesale level, i.e., between the bottlers and their customers (grocery stores, restaurants, etc.). There is no justification, therefore, under the proposed decision model, for a per se ruling on this issue. From a managerial perspective, however, it should be noted that the need for any form of price maintenance is usually found when protection against intrabrand price competition is desired by either the dealers or by the manufacturer seeking to maintain an "orderly" distribution system at the wholesale or retail level. Because intrabrand competition is eliminated via territorial restrictions, resale price maintenance would be a superfluous policy.[7]

Step 3: Negative impact on intraband competition

Because there exists no intrabrand competition within the territories assigned to its bottlers by the Coca-Cola Company, the impact of the restriction on intrabrand competition is clearly above the threshold required for proceeding with application of the model.

Step 4: The importance of intrabrand competition

The structural dimensions of particular importance in antitrust situations involving vertical restraints are basically those which would be important in any antitrust action in which restraint of trade is alleged. As indicated above, information with respect to the extent of economic concentration, the degree of product differentation, and the height of entry barriers is necessary in order to assess whether the relevant market contains a sufficient amount of interbrand competition such that the existence of intrabrand competition is relatively unimportant to the preservation of commercial rivalry in the market.

Industry concentration

Within the relevant product submarket, the level of concentration is quite high. The top four syrup manufacturing firms competing for the flavored carbonated soft drink market account for about 70 percent of the nationwide sales.[8] While this figure varies by market area, the significance of it is that the industry can be characterized as oligopolistic in nature, and therefore, one would expect a high degree of mutually recognized interdependence in the setting of nonprice strategies and in pricing.[9]

The level of concentration is also high among bottlers within relevant geographic markets. According to the Bureau of the Census, the four largest bottlers in nine large metropolitan areas had, on the average, 68 percent of the market in 1964.[10] Although the number of brands available to the consumer in local markets is generally large,[11] concentration among bottlers is high because of "piggybacking," a practice which involves the production and sale by a bottler of soft drink brands trademarked by two or more syrup companies. Piggybacking is used extensively in the soft dring industry [12]—so extensively, in fact, that despite the proliferation of brands, a small number of bottlers usually account for over 50 percent of any metropolitan market.

The potential consequences of this market structure are profound. First, one would expect to find territorial restrictions applied industry-wide, given the oligogolistic nature of the industry, and indeed, this is the case.[13] This means

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[6] *Coca-Cola*, 91 F.T.C. at 582, 615–16.

[7] If the purpose of price maintenance is to "assure" that dealers earn a reasonable profit so that they can provide reasonable services in the face of severe interbrand competition, then price maintenance may be desired by manufacturers, even in the absence of intrabrand competition.

[8] 1972 hearings, supra note 185, at 223–24.

[9] See Stern & Morgenroth, "Concentration, Mutually Recognized Interdependence, and the Allocation of Marketing Resources," 41 J. Bus. U. Chi. 56 (1968) (nonprice aspects); Washburn, "Price Leadership," 63 Va. L. Rev. 691 (1978) (pricing).

[10] *1972 Hearings, supra* note 185, at 223–24.

[11] *Coca-Cola*, 91 F.T.C. at 548–49, 628.

[12] *Id.* at 636 n. 38.

[13] *Id.* at 640.

that, in any given territory occupied by a Coca-Cola bottler, it is unlikely that there will be more than two Pepsi Cola bottlers striving for business, depending of course on how the territories are drawn, and if there are two, they will not be competing against one another but will be competing in different areas within the Coca-Cola bottler's territory. Because concentration among bottlers is high, the industry-wide territorial restriction policy limits the extent of interbrand competition by limiting the total number of competitors in any given market area. Admittedly, competition may be intense with only a few sellers in the market, but the smaller the number of sellers, the more likely that the competition will be of a nonprice nature. Evidence indicates that prices in the industry are uniform among the major brands within particuar territories.[14]

Second, the share of the market held by Coca-Cola bottlers, as indicated by their frequent number one position in their territories and by the concentration ratios reported above, is such that intrabrand rivalry, if it existed would likely be procompetitive. Given its strong position in the market, what happens to Coca-Cola affects the entire sphere of competition in the flavored carbonated soft drink market.

Product differentiation

The major syrup companies have devoted a large amount of money and energy in differentiating their brands from those marketed by smaller syrup companies and their affiliated bottlers.[15] While prices within the oligopolistic core of the industry tend to be similar or identical due to the extent of mutually recognized interdependence which exists among the brands promoted by the major syrup producers, they are higher than those of the lesser-known brands because of the extent of differentiation which has been achieved. Moreover, the prices set for Coca-Cola and its closest competitors are higher than they would be in the absence of territorial restrictions. Key management personnel of The Coca-Cola Company and representatives of various bottling companies have predicted reductions in wholesale prices of the restrictions are lifted.[16] Lower prices for Coca-Cola would, in turn, exert enormous downward pressure on the price of other flavored carbonated beverages.

On the basis of these predictions, it is possible to conclude that the product differentiation achieved by Coca-Cola and the other major syrup companies for the end products made with their ingredients, combined with the existing territorial restrictions, have resulted in a pricing situation indicative of a significant amount of market power on the part of these companies and their franchised bottlers. As noted above, the greater the degree of product differentiation, the greater the importance of intrabrand competition in preserving vigorous commercial rivalry in an industry.

Entry barriers

The existing territorial restrictions, are in themselves, barriers to the entry of new bottlers of current brands. For syrup manufacturers, entry is also blockaded but not as severely. To enter a market, a new entrant must either convince an existing bottler to "piggyback" its brand, or the entrant must establish a bottling network of its own to produce and distribute its product.[17] In the former case, potential competition is limited by existing management policies. For example, bottlers often produce and distribute only one brand of any given flavor. If a bottler is already marketing an orange-flavored soft drink, for instance, it will not accept directly competitive brands into its line. In the latter case, the absolute costs associated with purchasing high-speed bottling equipment alone are often prohibitive,[18] not to mention all of the other costs required to establish a bottling network. Therefore, significant efforts must be put forth to attract entrepreneurs and/or venture capital, and these efforts are likely to be time-consuming, expensive, and risky.[19]

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[14] *Id.* at 640–41. However, monopoly profits do not appear to exist, as prices are relatively low. Also, there are numerous price promotions in the industry.

[15] Id. at 643–44. See Abrams & Koten, "Soda Showdown, Soft Drink Companies Prime Their Weapons in Market-Share Battle," Wall St. J., April 26, 1979, at 1, col. 6.

[16] *Coca-Cola*, 91 F.T.C. at 642–43.

[17] Id. at 636–39.

[18] 1972 hearings, supra note 185, at 198.

[19] In this respect, it will be instructive to follow the success (or lack of it) of a new soft drink brand as it seeks bottlers. Abrams, "Pepsi, Coke, Veterans Launch King-Cola, Plan Soda Pop War," Wall. St. J., Sept. 14, 1978, at 16, col. 2.

Even in the presence of these barriers, it has been shown that achieving distribution through existing bottlers is not uncommon.[20] However, the extent of advertising and other marketing efforts required to establish a brand in a territory is likely to be high, given the present mode of competition in the industry.[21] Clearly, Coca-Cola's success has established a model for potential new entrants which is difficult to emulate without a vast outpouring of promotional expenditures.[22] Even without the territorial restrictions, it would be difficult to enter the carbonated soft drink industry, quite apart from the difficulty involved in securing production and then adequate distribution in retail stores, restaurants, and vending machines. Thus, extensive product differentiation not only affects the wholesale or retail price level, but also the height of the entry barriers in the industry.

Market power

It would be difficult for anyone familiar with the soft drink industry or soft drinks generally to argue that the Coca-Cola Company and its individual bottlers do not have substantial market power. Simply on the basis of brand recognition alone, the success of Coca-Cola is nearly unparalleled. Nationally, Coca-Cola has achieved over a 20 percent share of total domestic food store sales of flavored carbonated soft drinks.[23] While market shares vary from region to region, it is clear that, despite some softness in its market share in recent history due to aggressive promotional efforts by Pepsi Cola, Coca-Cola is the leading member in an industry which, on the basis of the structural analysis outlined above, can be typified as a tight-knit oligopoly.

Even though numerous fringe firms exist within the industry, it is possible to conclude from the preceding discussion that intrabrand competition would be beneficial, from a social welfare perspective, to the preservation and fostering of commercial rivalry among the major brands of soft drinks, given the restricted nature of interbrand competition. Aside from the questions raised about a horizontal combination, the restrictions on intrabrand competition which the Coca-Cola Company has imposed are clearly not producing countervailing benefits for interbrand competition.

The structure of the market is such that bottlers should be free to sell wherever they please in order to promote more vigorous price competition on the wholesale level among the major brands and thereby enhance an efficient and equitable allocation of resources throughout the industry and on the retail level.[24] Thus, in the absence of applicable special considerations, the current territorial restrictions employed by Coca-Cola are per se illegal.

Special considerations

The Coca-Cola Company is neither a new entrant nor a failing company. While one of its independent bottlers may fail from time to time, the Coca-Cola Company has not hesitated to acquire it in the past[25] and could be expected to play a like role in the future without restoring to territorial restrictions as a means for propping up a financially distressed bottler in its network. Therefore, only the remaining two special considerations will be addressed here—product safety and quality and broad societal issues.

Product safety and quality.—While there are no apparent questions concerning product safety, there are issues of product quality in the Coca-Cola situation. However, the major concern here is whether territorial restrictions are reasonably necessary to assure quality. Presumably, the restrictions induce bottlers to manufacture a high-quality product and ensure that it is subsequently stored and merchandised in a way which prevents the buildup of stale inventory at retail outlets. While it may indeed be the case that the restrictions provide an incentive to bottlers to perform these necessary functions in soft drink production and distribution, there is little doubt that quality can be assured

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[20] For examples of piggybacking with limited capital investment, see *Coca-Cola*, 91 F.T.C. at 569. However, this analysis ignores the promotion costs necessary to establish the various brands mentioned in each market.

[21] See Larner, "The Economics of Territorial Restrictions in the Soft Drink Industry," 22 Antitrust Bull. 145, 147–48 (1977).

[22] It is surprising that neither the administrative law judge nor the Commission addressed this critical issue directly. Therefore, there is no evidence presented as to the exact amount of expenditures required to introduce a new brand into a metropolitan area.

[23] *Coca-Cola*, 91 F.T.C. at 571.

[24] For concurrence, see Larner, supra note 219, at 145–46.

[25] *Coca-Cola*, 91 F.T.C. at 528.

through much less anticompetitive means. The FTC opinion provides an excellent set of arguments in this respect, so they have been paraphrased below, with a few elaborations where needed.[26]

First, the Coca-Cola Company has instituted an elaborate and excellent inspection and sampling program relative to bottlers' manufacturing operations. The presence of intrabrand competition within a territory would have little, if any, effect on this program. Second, stock rotation at the retail level is also important for quality control purposes. Both of these functions assure that consumers will be receiving uniformly high-quality products consistent with the image of the Coca-Cola trademark. A store-door delivery system by bottlers permits the maintenance of appropriae stock rotation policies, because the driver-salespeople go into the stores periodically to check on the stock.

Under a system where territorial restrictions were eliminated, there would undoubtedly be more shipments of Coca-Cola made directly to grocery chain warehouses by bottlers located outside existing territories. The chains would then take the responsibility for delivering the product to individual stores. Driver-salespeople would play a limited role, and therefore, stock rotation might be less consistent relative to past behavior, given the number of items in the average supermarket which must be attended to by retailer-employed clerks.

There is no question that maintenance of quality control at the retail level is critical and that territorial restrictions aid in achieving it. However, quality control can be accomplished through a less restrictive alternative. The Coca-Cola Company could increase its sampling program in retail outlets, and each bottler could place an identification mark of its product so that it can be traced. Also, bottlers could employ a container dating system which consumers and retailers could decipher with ease, thus permitting them to monitor and detect product age.[27] Finally, there is nothing to prevent the Coca-Cola Company from insisting that, as part of its franchise arrangement, bottlers must assume the responsibility for the quality of their products all the way through to the ultimate consumer, irrespective of the delivery system employed.

It is likely that the increased inspection and coding required will raise costs and that these costs will be reflected in the price of Coca-Cola and its allied products. However, the increase in competition when territorial restrictions are eliminated will serve to keep prices in line. The net effect to consumers and to the industry in general will be beneficial.

Broad societal issues.—In the Coca-Cola situation, three broad macro issues are of some importance, aside from the micro issues referred to above. The potential effect of eliminating territorial restrictions should be examined with respect to (1) retail prices, (2) small bottlers, and (3) the ecosystem.[28]

(1) Potential Effect on Retail Prices. There appears to be general agreement among supporters and opponents of territorial restrictions that the abolition of such restraints would lead to reductions in retail prices paid for soft drinks. There is, however, disagreement as to the amount, extent, and duration of such price reductions.

The staff of the FTC has estimated that if territorial restrictions were eliminated, the average price of soft drinks would fall by as much as 5 percent, saving consumers $250 million per year.[29] Comanor, an opponent of the restrictions, has quoted two separate amounts—$100 million and $1.5 billion—as potential consumer savings that might result from their elimination.[30] The lower figure was suggested by *Preston*,[31] a proponent of the restraints, while the latter was developed by government officials opposing the restraints.

Although supporters of restrictions appear to concede potential price reductions, their admission is not without reservations. In fact, Preston questions whether the potential price reductions at the wholesale level would automatically be passed along to consumers.[32] At the same time, the president of the National Soft Drink Association contends that any price reductions to the consumer would be short-lived.[33] Indeed, he has suggested that if exclusive territorial

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[26] *Id.* at 631–34.
[27] *Id.* at 632 n. 35.
[28] The discussion of the potential effect on retail prices and small bottlers of the removal of territorial restrictions has been drawn from Stern, Agodo & Firat, supra note 14, at 72–74.
[29] 1972 hearings, supra note 185, at 224.
[30] Id. at 453.
[31] Id. at 396, 453.
[32] Id. at 396.
[33] Id. at 18.

arrangements did fall, pressures would be generated that would tend to increase the costs of soft drinks to the consumer at an accelerated rate.[34]

By and large, the issue of potential effect on prices presents a notably vulnerable point in the defense of territorial restraints. It is also a key issue over which there is some measure of agreement in the opinions of both supporters and opponents of territorial restrictions, in spite of the qualifying reservations of the former. The arguments that wholesale price reductions might not be passed along to consumers and that price reductions would be short-lived are, while plausible, not strongly convincing. In an industry as highly competitive as food retailing, it is difficult to imagine a wholesale price decline of 4 percent or 5 percent not being passed along to consumers, either in whole or in part.

The notion that consumer price reductions would be short-lived is partly predicated on the assumption that the larger bottlers would drive the smaller bottlers out of business in the long run through price competition. Once this market "shakeout" occurred, the larger bottlers would supposedly be left in monopoly positions, allowing them to charge monopoly prices. However, a market shakeout is already occuring in the soft drink industry via mergers, consolidations, and the like, and it will simply be accentuated if territorial restrictions are removed. It is too simplistic to argue that the shakeout is and will be the result of price competition alone. Instead a series of market forces are at the base of the changing conditions in the soft drink industry, including the growth of chain grocers, the increased use of nonreturnable containers and private labels, the restructuring of consumer markets, and the growth in industry sales.[35] During a prolonged period of market readjustment, the prime beneficiaries of the price competition that is induced will be ultimate consumers, who should receive lower prices as a result.

Two major sources of downward pressure on the retail prices are noteworthy. First, intrabrand and interbrand price differentials of up to 30 percent have been found to exist between contiguous territories.[36] These differentials reflect, in part, the fact that some territories are simply not large enough to offer operating economies of scale to bottlers attempting to serve them. Such scale economies will be achievable as territories are expanded once territorial restrictions are lifted. They will be a potent force in lowering costs at the wholesale level and thereby lowering consumer prices. Second, because the elimination of restrictions will enable retail grocery chains to deal with distant, price-competitive bottlers shipping one-way containers on a large-lot, warehouse-delivery basis, the lowered distribution cost should lead to reduced consumer prices.

(2) Potential Effect on Small Bottlers. It has been suggested that if territorial restraints were removed, some of the largest bottlers would grow at the expense of small bottlers, which would lead to an increase in concentration in bottling on both a nationwide and a regional basis. It has further been suggested that the number of different bottlers in any specific local market area would probably decline, decreasing the number of brands available in those areas and lessening interbrand competition.[37]

On the other hand, it has already been observed that there is currently a high level of market concentration in the soft drink industry at both local and national levels. At the bottling level, this is, in part, attributable to piggybacking. Elimination of territorial restrictions would probably bring about a reductions in the number of bottling firms but would also, in the period of market adjustment, generate more competition among the surviving firms than now exists. In the absence of restrictions, chain grocers and other retailers would be free to make their soft drink purchases from whichever bottlers offered the lowest prices and most attractive services. This factor would almost certainly lead to the elimination of price differentials among contiguous territories and to lower consumer prices.

In addition, the small bottler faces a rather untenable position in the present system.[38] Given the changes in its market, in the products available (package sizes, brands, etc.) to better serve it and in increased labor and transportation costs, among other factors, the small bottler is faced with a major invest-

[34] Id. at 19.
[35] See Stern, Agodo & Firat, supra note 14, at 71.
[36] *1972 Hearings, supra* note 185, at 224.
[37] *Id.* at 395.
[38] See Larner, supra note 219, at 153–54.

ment problem. As pointed out by the president of Coca-Cola Bottling of Los Angeles during Senate hearings on exclusive territorial allocation legislation:

"[N]ewer and faster canning and bottling lines are required in order to reduce production costs and to offset labor rates which * * * are among the highest in the nation. Equipment becomes obsolete more rapidly with changes in container sizes and packaging innovations. A high speed soft drink can line today costs between $750,000 and $1 million depending on the size and support equipment. To justify this investment requires an annual volume of 4 to 5 million cases. It is obvious that these installations become possible only for the large volume entities * * * a situation not envisioned in the early years of the industry when franchise boundary lines were established." [39]

Thus, if the small bottler is to serve its market area in a satisfactory manner, it will have to undertake some costly plant modernization. This process will result in increases in the rate output of its bottling operation that can only be absorbed by increasing the size of its territory. It is obvious, therefore, why there have been numerous mergers among bottlers in continguous territories. The small bottler can either merge with another bottler and thereby become a "large" bottling operation, join a cooperative, or, without new investment and larger territories, it can slowly, but surely, fade from the market as its ability to serve its market becomes weakened and its labor and transportation costs increase. While it would be preferable to give the small bottler which can update its equipment and pursue competitive markets a fighting chance, the territorial restrictions do not provide it. Under this system, the small bottler must allocate resources inefficiently, and, as a result, it is faced with redundancy, eventual bankruptcy, or disappearance a sa separate independent entity through merger.

There is no doubt that abolishing the existing system of restrictions will serve to accelerate the rate of decline in the number of bottlers, especially small bottlers. However, those bottlers that are eliminated will be those that natural market forces have determined to be allocating scarce resources inefficiently. The existing system does not appear to support or encourage the very conditions or qualities that make for an efficient and growing operation. Thus, it does not really protect or aid the small, inefficient bottler, even if that were socially desirable. Instead, it limits the competitiveness and opportunities for growth of the efficient bottler, irrespective of size.

(3) Potential Effect on the Ecosystem. One of the major consequences attending the removal of territorial restrictions will be the shipment of soft drinks in non-returnable containers across previously defined territorial boundaries to the warehouses of grocery wholesalers and retail chains. While soft drinks packaged in nonreturnable or nonrefillable containers already account for 45 percent of the sales of Coca-Cola in bottles and cans on a volume basis,[40] this percentage would be expected to grow as bottlers begin to compete for one another's customers. In other words, once territorial restrictions were eliminated, market outreach would be expanded. As outreach expands, it would become increasingly difficult for bottlers to serve distant customers on a store-delivery basis, which is the common form of distribution when "returnables" or "refillables" are used.

Aside from the retail price considerations addressed earlier, there are important ecological considerations which should be confronted. For example, a nonrefillable bottle is not designed to withstand the punishment of reuse. In its opinion, the FTC noted:

"Made of thinner glass than the refillables, products liability considerations dictate that it be used only as a one-way, one-fill container * * *. While some jurisdictions have enacted litter laws which require the consumer to pay a deposit, which is refundable upon the return of the nonrefillable bottles and cans, the containers reclaimed are not returned to the bottler for reuse. Instead, the nonrefillable bottlers recovered from post-consumer waste streams are processed or recycled into crushed glass or cullet for glassmaking processes." [41]

Thus, there are two environmental concerns noted here. One is the problem of litter, especially in those cases where jurisdictions have not passed so-called "bottle bills" which require deposits on nonrefillable soft drink and other beverage containers. The other is the problem of material waste associated with the inability to reuse the containers, except through an expensive recycling process.

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[39] 1972 hearings, supra note 185, at 198.
[40] *Coca-Cola*, 91 F.T.C. at 645 n. 48.
[41] Id. at 647 n. 51.

At the same time, consideration must be given to energy and other resources (e.g., water) consumed in the returnable and nonreturnable systems. For example, returnable containers are heavier and are transported in small trucks within limited geographic regions for the purpose of servicing individual outlets directly. The lighter weight nonreturnables are transported for longer distances in larger vehicles. Therefore, the petroleum consumption associated with the former system will undoubtedly be higher than with the latter, even when accounting for deliveries from the wholesale or chain warehouses to local food stores once the soft drinks are shipped to the warehouses by the bottlers. The tradeoffs are significant, and only a full-scale impact analysis could foretell the net ecological damage or benefits accruing from the elimination of territorial restrictions, under the assumption that elimination of the restrictions will encourage greater usage of nonreturnable containers. Such an analysis is beyond the scope of this article. However, it will be assumed that this special factor is unavailable.

Given the history of intrabrand restraints in the soft drink industry, it is clear that they played an important role in fostering interbrand competition when the industry was in its infancy. But since it is also clear that the extent of interbrand competition—as measured by the traditionally applied market structure variables—is limited, it would be a rather futile exercise to attempt to show the procompetitive effect of the intrabrand restraints. After examining and rejecting the special considerations, analysis should end, and the court should declare the restrictions illegal. Nevertheless, in the interest of illustrating the proposed model fully, the next part will be applied.

Step 5: Assessing the effects on interbrand competition

The extent to which restraints foster interbrand competition is only relevant when intrabrand competition is unnecessary to the preservation of effective commercial rivalry in the marketplace or when intrabrand competition is essential but a special consideration saves restrictions from the per se rule. Besides the structural measures investigated in the previous step, it is appropriate at this point to consider the universality of the restraint within the industry as well as the issue of whether market coverage and the provision of supportive activities might be enhanced by the existence of the territorial restrictions.

Restraint universality

Within the soft drink industry, every major producer of soft drink syrup which employs a bottler network for the manufacture and distribution of its brand(s) has adopted the policy of establishing exclusive territories. The universality of this policy is predictable, due to the structure and, in particular, the economic concentration of the industry. As shown earlier, the widespread use of such restraints has a depressing effect on interbrand competition because they generally serve to limit the number of bottlers competing for customers in any one territory.

Market coverage

Relative to inducing a market presence, it has been argued that because the soft drink industry is capital intensive, territorial restrictions preventing intrabrand competition create a climate conducive to capital investment.[42] Indeed, it is possible that territorial restrictions have been an effective instrument in encouraging the development of the deepest distribution and the highest level of product availability possible, because they have assured potential investors monopolies with respect to the marketing of individual brands. In this way, exclusive territories were an incentive used to lure and motivate franchises. The consequence of taking away the right to provide this stimulus could result in a diminishing of the attractiveness of bottling with a concomitant disinvestment and/or merger period, leading to a lower level of market penetration.[43]

While this argument is relevant to some extent for an emerging industry or distribution system, it has little support in the case of an established, ongoing situation, such as Coca-Cola's, where profits are positive. Territorial restrictions on competition are not needed to induce capital investment in the Coca-Cola bottling system, because real investment in such activities will continue whenever the prospective rate of return exceeds the cost of additional capital.[44]

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[42] Id. at 626–27; 1972 hearings, supra note 185, at 36–37.
[43] 1972 hearings, supra note 185, at 36–39.
[44] Id. at 446. See also Stern, Agodo & Firat, supra note 14, at 74.

So long as the return from bottling operations is sufficiently high, entrepreneurs recognize that profits can be earned by the investment of funds obtained either from internal sources or from the capital markets.

Moreover, as demand expands in some markets, and contracts in others, the return on investment varies accordingly. When increased consumer demand calls for further investment in bottling facilities, the normal functioning of the market creates temporarily higher markups and increased bottler profits. These increased profits, rather than restrictions on intraband competition, serve as a signal for new investment. Eliminating Coca-Cola's territorial restrictions is not likely to affect significantly the level of investment in Coca-Cola bottling operations.

Alternatively, one could effectively argue that territorial restrictions might be needed if they were the only means by which a new syrup manufacturer could secure entry into the industry. After all, it is likely that the territorial protection given to bottlers in the early years impelled market presence and penetration. However, as the FTC eloquently observed in its opinion:

"While capital investment considerations . . . may justify a territorial restriction imposed by a new entrant or a failing or faltering firm, we do not, in applying section 5 ordinarily distinguish between capital-intensive and less capital-intensive businesses by applyng different antitrust standards to them, granting the former license to restrain trade because it promotes capital investment while mandating, in the case of the latter, that competition should be preserved." [45]

Relative to market coverage, territorial restrictions historically have provided incentives for bottlers to secure every conceivable location for soft drink sales. According to this argument, if an in-market bottler were not protected from intrabrand competition, its major accounts would be in jeopardy due to aggressive marketing practices of bottlers located outside its territory.[46] Without the major accounts, an in-market bottler would not be able to serve some of its smaller and unprofitable or marginally profitable accounts. Instead, the bottler would have to seek major account business elsewhere or else give away its profits to retain existing, but threatened, large accounts. Even now, it is maintained that bottlers serve many vending machine accounts, small outlets, and "special events" which they claim are unprofitable.[47] Presumably, they do this in order to obtain "paid sampling" of their products. The increase in product awareness through sampling supposedly makes the larger accounts profitable.[48]

Indeed, it is a rather curious argument that the interests of bottlers are somehow furthered if all possible outlets, regardless of their profitability, are somehow permitted to receive deliveries of Coca-Cola. Perhaps the syrup manufacturers might desire such coverage because of the increased sales of syrup this policy might generate, but it would seem to be an unwise approach for bottlers to pursue over the long run. If the bottlers choose to serve such accounts because of the promotional advantages obtained,[49] then perhaps they can write off the losses sustained as an expense. The justification for using territorial restrictions for either market presence or market coverage has very little support in the Coca-Cola situation, or for that matter in many other situations, unless a new entrant or a failing company were involved.

Stimulating supportive activity

By prohibiting intrabrand competition, Coca-Cola hopes that all of its bottlers will provide the promotional and delivery services necessary to stimulate consumer demand, on the one hand, and adequately control the distribution process to and through retail outlets, on the other. The territorial restrictions are incentives or rewards; they are induce the "appropriate" behavior from bottlers. Their uniform application is designed to avoid the free-rider problem. If all

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[45] *Coca-Cola*, 91 F.T.C. at 626.
[46] See Preston, supra note 12, at 512–19.
[47] *Coca-Cola*, 91 F.T.C. at 627–28. See Posner, supra note 10, at 6.
[48] *Coca-Cola*, 91 F.T.C. at 628.
[49] Typically, a petroleum company will establish many more retail outlets than are necessary to adequately service a given market. Bes'des providing extra stations for consumers convenience, outlet proliferation carries with it the promotional advantages of keeping the company's name before the public. The cost of this approach is written off as promotional expense even when franchises are involved, as the company supports its dealers w'th sign programs and the like. The same type of promotional strategy is used by the bakers of white bread as route salespeople generally put many more loaves on the supermarket shelves than will be purchased before they return. The objective is to maintain as many facings as possible, even though a large number of loaves may have to be taken back and disposed of at a loss.

distributors were not properly motivated to provide the necessary promotion and delivery services, then some of the distributors would want to take a free ride the efforts of those which do by selling at lower prices in the territories cultivated and stimulated by the service-minded bottlers. In other words, some of the bottlers would let others provide the supportive activities desired by Coca-Cola and supposedly needed by the market. Like parasites, they would simply erode the market once the market has been made by the others.

The free-rider problem is undoubtedly significant for all manufacturers seeking to construct an effective and efficient distribution system. However, there are several critical considerations which must be addressed in assessing this justification for using territorial restrictions. First, if the services provided are important to some retail customers and household consumers but not to others, then certain bottlers will want to provide them to certain market segments while other bottlers will want to serve segments which do not desire them. The latter will charge lower prices commensurate with the fact that they are offering reduced services.

In fact, this may eventually be the case with regard to warehouse delivery of soft drinks and store-door delivery, if territorial restrictions are disallowed. That is, certain Coca-Cola bottlers will offer to ship large lots over long distances to retailers' warehouses at reduced prices. The retailers will then be responsible for store delivery and maintenance of shelf space.[50] Other bottlers will continue to offer in-store services and direct-to-the-store delivery to those retailers who do not wish to assume the distribution functions associated with marketing soft drinks effectively.

This segmentation outcome is already feasible. Bottlers can provide both warehouse delivery of Coca-Cola in certain types of packages, such as cans, and store-door delivery of bottles. As pointed out by the FTC opinion:

"[T]here appears to be a significant market among high-volume retailers for various delivery options. As a consequence, the competitive opportunities for small bottlers in open markets include not only the business which might evolve from central warehousing, but also the store-door trade to chain store outlets both within and outside their present territorial borders.

"[Furthermore,] many small bottlers would, absent territorial restrictions, have access to huge metropolitan markets in which thousands of soft drink retailers not serviced by central warehouses for other food items presently obtain Coca-Cola and allied products on a store-door delivered basis. * * * [S]tore-door delivery of nonrefillable containers in these metropolitan areas still holds substantial opportunities for growth and market expansion by small bottlers." [51]

The problem with advertising, as opposed to delivery systems, is that advertising is a public good. That is, once a product is advertised to consumers, demand is likely to be stimulated globally for the product; it will not, in the case of Coca-Cola, be particularized to a specific bottler. Therefore, any bottler permitted to do so could capitalize on the expenditure of another. Given this free-rider potential, it is to be expected that if territorial restrictions were eliminated, many bottlers would become less and less interested in providing promotional services and that the Coca-Cola Company would have to absorb more of the promotional function in local market areas. This may even have ramifications for sign programs, point-of-purchase displays, local contests, and the like. There is little doubt that competition among bottlers would evolve rapidly into a more price-oriented rivalry than previously. Given the already high awareness level for Coca-Cola products, it is possible that this result will be more beneficial than detrimental. Whether increased promotional efforts on the part of bottlers are really as essential as they once were is questionable.

Additional factors

If it were shown in step 4 of this model that intrabrand competition is unnecessary because interbrand competition is reasonably vigorous or because the market power of the defendant is slight, then the broad societal issues outlined in this part would now be considered. However, as has been observed, there is no need to undertake step 5 or to examine additional factors as part of it in the situation currently under scrutiny because intrabrand competition was found to be critical, and none of the special considerations are relevant.

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[50] King-Kola is planning to adopt a warehouse delivery system. See Abrams, supra note 217, at 16, col. 2. Shasta already delivers on this basis only. See note 197 supra.

[51] *Coca-Cola*, 91 F.T.C. at 660–61.

Overall, it is difficult to find a great deal of justification for the continued use of territorial restrictions by the Coca-Cola Company. Even if the restrictions were not viewed as being illegal based on the first four steps, and were judged solely on the basis of the information generated in step 5, it is apparent that the prevention of intrabrand competition in the marketing of Coca-Cola and its allied products is unwarranted.

CONCLUSION

The *Sylvania* decision requires that a rule of reason standard be applied in the judicial evaluation of vertically imposed restraints. The primary focus of such a standard is an evaluation of both the intrabrand and interbrand competitive impacts of the challenged restrictions. Yet, at this point, there is no accepted analytical framework for the courts to follow in judging these restraints. It may be reasonably expected that an extended trial-and-error period will pass while many of the specifics of the rule are worked out, a process which fails to provide much practical guidance until it is virtually complete.

This article presents a rule of reason framework grounded on antitrust precedents and economic principles which is designed to assist the judiciary and antitrust counsel in assessing vertical restraints in the particular context in which they are found. The steps in the model are as follows:

1. Identification and description of the restrictions at issue, including a definition of the relevant market.

2. Application of the per se rule if there is evidence of horizontal conspiracy or price fixing.

3. Determination of substantial negative impact on intrabrand competition. (If none, analysis ends.)

4. Assessment of intrabrand competition in the relevant market.

(*a*) Consideration of industry characteristics—

(i) concentration, (ii) product differentiation, and (iii) entry barriers.

(*b*) Determination of market power.

(*c*) If restraints are imposed by a core member of an oligopolistic industry, they are per se illegal unless saved by Special Considerations below. If not, proceed to Step 5.

(*d*) Special considerations—

(i) new entrant, (ii) failing company, (iii) product safety and quality, and (iv) broad societal concerns.

5. Assessment of effects on interbrand competition and final evaluation.

(*a*) Consideration of factors in light of reasonably necessary standard—

(i) restraint universality, (ii) market coverage, (iii) stimulation of supportive activity, and (iv) additional factors, including those of step 4(d).

(*b*) Final balance.

The last part of the article applies the proposed decision model to the facts of the FTC's Coca-Cola decision. Based on record and material from other public sources, the territorial restrictions imposed by Coca-Cola violate the standard proposed here based on *Sylvania*.

FEDERAL TRADE COMMISSION,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C., February 12, 1979.

Hon. THAD COCHRAN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR COCHRAN: I understand that some of your constituents have expressed interest in the Commission's recent decisions involving territorial restrictions imposed by certain soft drink bottlers. Those decisions, involving Coca Cola Company and PepsiCo, Inc., currently are on appeal in the U.S. Circuit Court for the District of Columbia. The orders will not become final until after the court renders its decisions on those appeals.

Enclosed is a fact sheet, prepared by the FTC staff, that outlines the Commission's recent decisions and provides some background to our involvement in this area. I hope this information will assist you and your staff in respond-

ing to questions and concerns that your constituents have raised. Should you have further questions on these issues, please feel free to contact me (523–3620) or Kevin Cronin (523–3779), of my staff.

Cordially,

WILLIAM J. BAER,
Acting Assistant General Counsel
for Legislation and Congressional Relations.

Enclosure.

FACTSHEET

FTC DECISIONS CONCERNING TERRITORIAL RESTRAINTS ON BOTTLERS OF COKE AND PEPSI

In April, 1978, the Federal Trade Commission issued final orders and opinions in two companion cases, the *Coca-Cola Company*, Docket No. 8855, and *PepsiCo, Inc.*, Docket No. 8856. In the opinions, the Commission held that for the most part the territorial restraints imposed by Coke and Pepsi on their bottlers were anticompetitive and in violation of Section 5 of the Federal Trade Commission Act. The Commission's decisions, which are not final until they are reviewed, are now before the Court of Appeals for the District of Columbia. Until the judicial review process is completed the Commission's orders have no effect.

Background—the soft drink companies and their bottlers

The Coca-Cola Company (Coke) and PepsiCo, Inc. (Pepsi) market most of their soft drink products by selling soft drink syrups and concentrates (syrup) to independent bottlers. The bottlers usually add carbonated water to the syrup and package the soft drinks for delivery and sale at the wholesale level.

The relationship between Coke or Pepsi and most of their individual bottlers is a contractual one. Under the terms of the contracts, Coke's bottlers receive a license to sell Coca-Cola (and Coke's other soft drinks, e.g., Tab); Pepsi's bottlers receive a license to sell Pepsi (and Pepsi's other soft drinks, e.g., Teem). Also under the terms of the contract, the soft drink companies and their bottlers agree to territorial restraints. In other words, the bottlers agree not to operate their business outside specified boundaries. These exclusive territorial restraints prompted the Commission to issue complaints.

The problem with territorial restraints

Territorial restraints have economic consequences akin to those of resale price maintenance. In the case of resale price maintenance, manufacturers or producers are able to fix the prices at which their products are sold. The result is that consumers usually end up paying higher prices for the finished product. The same is true with territorial restraints.

When producers and distributors agree among themselves that only one distributor will operate in a given geographic area, the agreement effectively eliminates competition among distributors of the product. Producers and distributors are free to charge retailers higher prices so long as consumers differentiate the product from others. In other words, because of lack of competition among distributors, producers can charge higher prices, and in the end, consumers pay more.

Commission proceedings

An administrative law judge (ALJ) first heard the complaint against Coke and ruled that an inquiry into the reasonableness of the territorial restraints was required. During the inquiry, an extensive record was compiled consisting of some 4,000 pages of testimony and more than 4,000 pages of exhibits. Meanwhile, because of the similarity of issues, the parties in the proceeding against Pepsi agreed to let the determination of the reasonableness of Pepsi's territorial restraints rest on the record in the Coke proceeding along with some additional testimony. At trial, representatives of local bottlers were allowed to intervene as parties with full rights to present evidence and arguments and to cross-examine witnesses.

In October, 1975, the ALJ issued simultaneous decisions concluding that neither Coke nor Pepsi violated the law by imposing territorial restraints on their bottlers. This initial decision was vacated by the Commission which heard oral arguments on two separate occasions and then issued its own rulings on

April 7, 1978. The Commission decision came on a 2–1 vote with Commissioner Clanton dissenting. Chairman Pertschuk nad Commissioner Pitofsky did not participate.

The Commission's opinion

(a) The Commission found that Coke and Pepsi and the parties who joined them did not justify the territorial restraints on bottlers in the case of soft drinks packaged in nonrefillable containers such as cans and non-returnable bottles (nonreturnables). The Commission concluded that these territorial restraints were unlawfully anticompetitive chiefly for the following reasons:

The territorial restraints prevented the bottlers of Coke from competing among themselves; likewise, they prevented the bottlers of Pepsi from competing among themselves (intrabrand competition);

The territorial restraints prevented the bottlers from expanding beyond their agreed-upon territories thus eliminating potential competition;

The territorial restraints indirectly lessened competition in delivery services of the soft drinks; and

The territorial restraints deprived consumers of the benefits of open intrabrand competition.

(b) The Commission also found that Coke and Pepsi did justify the territorial restraints on bottlers in the case of soft drinks packaged in refillable, returnable bottles (returnables). The Commission concluded that territorial restraints in the case of returnables were not in violation of the law because the restraints are necessary for the bottlers to identify their own bottles for return to the bottling facilities in order to be refilled.

What happens next

The Commission's rulings are final agency decisions in these adversary litigation matters but the orders are not final until reviewed and sustained on appeal. The Commission's decisions have been appealed by Coke, Pepsi, the bottlers and bottlers' associations. They are now pending in a consolidated proceeding before the United States Court of Appeals for the District of Columbia.

THE WHITE HOUSE,
Washington, D.C., December 10, 1979.

Hon. HOWARD METZENBAUM,
U.S. Senate,
Washington, D.C.

DEAR SENATOR METZENBAUM: I understand that the Senate Judiciary Committee will soon consider S. 598, the Soft Drink Interbrand Competition Act, which was approved recently by your Antitrust Subcommittee.

I know that you have expressed concern about the legislation. While I have not had an opportunity to study it thoroughly, I am familiar with its intent, and I, too, am concerned about its probable effects, if enacted.

S. 598 would create a broad antitrust exemption for the territorial restrictions that characterize the soft drink industry. I believe restrictions of this kind tend to be anticompetitive, particularly when applied by the dominant firms in an industry as concentrated as this one, and tend to raise prices.

Whether there are offsetting considerations in the soft drink industry is a question I have not yet had an opportunity to examine; and I do not mean to prejudge the evidence before you. But I view the dangers as particularly serious in view of the very high rates of inflation we are experiencing in our country today, and the recent increases that have occurred in the prices for soft drinks specifically—a concern I expressed last week in a meeting I convened with representatives of this industry. For the past 13 months, cola prices, as measured by the CPI, increased 11.2 percent; in the last 2 months, the rate of increase has accelerated to 3 percent. Increases for other carbonated drinks have been less dramatic, but substantial nevertheless.

These increases alone are reason for concern. In view of the very real possibility that S. 598 would make matters worse, I urge you and your colleagues to proceed very cautiously as you consider this proposed legislation.

Sincerely,

ALFRED E. KAHN,
Advisor to the President on Inflation.

Mr. ALFRED E. KAHN,
Advisor to the President on Inflation,
The White House,
Washington, D.C.

DEAR MR. KAHN: Thank you for your December 10 letter concerning S. 598, the Soft Drink Interbrand Competition Act. As you know, I share your concern that providing a statutory exemption from the antitrust laws for the territorial restrictions of the soft drink industry may well be anticompetitive and result in excessive prices for soft drinks. I was particularly interested to learn that you recently met with representatives of the soft drink industry to discuss the recent inflationary increases in soft drink prices.

The Committee on the Judiciary voted to report S. 598 to the Senate on December 18, 1979. I read your letter to the members at that time and I plan to express our joint concerns to my colleagues again when the bill receives consideration on the Senate floor.

Very sincerely yours,

HOWARD M. METZENBAUM,
Chairman, Subcommittee on Antitrust, Monopoly and Business Rights.

FEDERAL TRADE COMMISSION,
OFFICE OF THE GENERAL COUNSEL,
Washington, D.C., January 2, 1980.

Hon. HOWARD METZENBAUM,
Chairman, Subcommittee on Antitrust, Monopoly and Business Rights,
Committee on the Judiciary,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This letter is in response to several questions raised by Senator Cochran in hearings on S. 598, the Soft Drink Interbrand Competition Act, before the Subcommittee on Antitrust, Monopoly and Business Rights.

Senator Cochran's questions were in connection with a letter and fact sheet (see enclosed) I sent out on February 12, 1979, in response to numerous requests for information about the *Coke* and *Pepsi* cases (dockets 8855 and 8856).

Prior to the February date our office received an unprecedented number of requests for information about the two Commission cases. Because of this unprecedented congressional interest, I decided to send an explanation of the cases to each and every Congressman and Senator.

The fact sheet was specifically geared to answer the questions asked of us. It sets forth a brief history of Commission involvement with the issue of territorial restraints, summarizes the Commission's opinion and indicates the status of the Commission's rulings. Neither the letter nor the fact sheet addresses legislation nor were they intended to do so.

My responses to Senator Cochran's questions are attached.

If you have further questions pertaining to this matter, please do not hesitate to contact me.

Sincerely,

WILLIAM J. BAER,
Assistant General Counsel for Legislation and Congressional Liaison.

Enclosure.

Question. Is it a common practice for the Commission to attempt to influence votes of Congress on legislative issues?

Answer. No.

Question. Were Government funds used in sending out this material?

Answer. Yes.

Question. Did all members receive the letter? If not, why not?

Answer. Yes; all members received the material.

Question. Who authorizd the mailing of the letter?

Answer. I authorized the mailing.

Question. How many times in the past 5 years have similar letters gone out?

Answer. Routinely, the Commission provides members of committees with oversight responsibilities with explanatory information concerning significant FTC actions. In this case, because an unusually large number of offices requested explanatory information, I thought it appropriate to provide every congressional office with information to assist in their responses to constituent inquiries.

Question. Was the mailing requested by any Member of Congress?

Answer. The mailing was in response to the numerous Congressional requests this office received for information about the *Coke* and *Pepsi* cases. A cover letter explained that the fact sheet was being sent to assist staff "in responding to questions and concerns that your constituents have raised."

Question. Why was there no reference to the legislation which had been introduced at the time?

Answer. The purpose of sending a fact sheet was not to address legislation but to answer questions that a large number of congressional offices had raised concerning the Commission's decisions involving territorial restraints in the soft drink bottling industry. The Commission does not comment on proposed legislation unless requested to do so.

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