The goal of our paper[1] was to review the empirical evidence provided by the modern *economics literature* on the competitive effects of vertical integration/vertical restraints. We attempted to review every recent empirical study (not just a "sample") of vertical integration/vertical restraints that has been published in a *peer-reviewed economics journal*. As far as we (or our critics) can determine, we were fairly successful in that endeavor, though we concede the possibility that we may have missed an article or two.[2] We adopted this criterion unapologetically for a reason: we regard recent studies that are peer-reviewed by professional economists as constituting the highest standard of evidence on empirical economic issues. We think most of our colleagues in the economics profession would agree.

This means we exclude, among other things: (1) book chapters (they typically do not undergo rigorous peer review); (2) law review articles (they are refereed by law students, not professional economists); and (3) working papers (they have not yet undergone peer review).[3] Unlike AAI, we also do not view court decisions as constituting independent economic evidence on this (or any other) economic question. Relying on judicial opinions to infer the competitive consequences of (and the appropriate legal standard toward) vertical restraints is, among other things, tautological (e.g., vertical restraints must be anticompetitive because courts have ruled them illegal).

Though acknowledging that they actually have read very few of the studies that our paper reviews, the authors of the AAI critique attempt to show, via use of selective quotations, that we somehow have misrepresented the findings of the papers we cite. For example, they suggest that we have misrepresented Chipty's (2001) finding that vertical integration between cable TV systems and programmers is efficient. In fact, however, her conclusions about the competitive effects of vertical integration could not be more clear: (2001, p. 450):

> "The empirical evidence presented in this paper shows clearly that vertical integration between cable system operators and program services results in efficiency gains. Integrated operators are better at promoting their products than unintegrated operators."

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[1] Cooper, Froeb, O'Brien, Michael G. Vita (2005).

[2] The AAI critique notes that we failed to cite Comanor and Riddle (2003). We apologize for this inadvertent omission. Of course, as AAI notes, this study supports our principal conclusions.

[3] We note, however, that had we chosen to include working papers, this would have meant more evidence on the "procompetitive" side of the ledger. *See*, *e.g.*, Asker (2004) (empirical study found that exclusive dealing arrangements between brewers and their distributors increased welfare).

> "Up until now, the theoretical debate over the practice of foreclosure has wrestled with its existence but has been silent on the issue of consumer welfare. Policy makers, on the other hand, have scrutinized vertical mergers that are likely to result in foreclosure out of concern that they will decrease consumer welfare. The analysis presented in this paper offers a methodology to evaluate the net effect of vertical integration on consumer welfare. In the case of cable television, the analysis shows that the harmful effects of integration due to foreclosure are offset by the efficiency-enhancing effects of integration."

AAI implies that we have misrepresented Gilligan (1986). However, we report in both our table *and* our text that he finds results consistent with both pro- and anticompetitive rationales for the use of RPM. Specifically, we note:

> "A few studies obtained results consistent with both pro- and anticompetitive characterizations of vertical restraints. Gilligan's event study (1986) obtained negative abnormal returns upstream when RPM contracts were challenged, a result consistent with efficiency and manufacturer collusion explanations for RPM (because manufacturer profits would be expected to fall under either of these possibilities)."

From this, Gilligan concludes the following: "Calls for the *per se* legality of RPM must, given the findings of this study, be based on grounds other than economic efficiency." It is true that we don't report his (arguably unjustified) conclusion. Our goal in writing the paper was to report each study's *evidence* (i.e., does the practice in question raise or lower welfare?), *not* each study's conclusions (if any) as to enforcement policy (e.g., vertical practice X should be illegal *per se*). Even a casual perusal of our literature review would verify this.

Last, the AAI critique goes to great lengths to portray us as misrepresenting Hastings (2004) paper on retail gasoline competition. According to the AAI critique:

> "Hastings makes no explicit statement, despite the assertion by Cooper et al. that she does, that her evidence `does not support 'divorcement' restrictions (i.e., proscriptions on the vertical control of gasoline refiners by refiners.)."

Here is what Hastings says in her paper (204, p.328):

> "The analysis does not find evidence that increases in the market share of company-op stations leads to higher prices. These results have important implications for legislation aimed at lowering retail gasoline prices through the regulation of refiner-retailer contracts."

True, she never says explicitly what those implications are; this is because the implications are obvious. If increases in the share of vertically-integrated retailers does not increase prices, it follows that divorcement policies – which purportedly reduce prices by reducing the share of company-operated stations – do not make any economic sense.

Interestingly, two academic economists (Francine La Fontaine of Michigan, and Margaret Slade of Warwick (UK)) also have reviewed the literature on vertical restraints for the forthcoming *Handbook of Antitrust Economics*. Their conclusion is remarkably similar to ours (2005, p. 22):

> "While different theoretical models frequently yield diametrically opposed results as to the welfare effects of vertical restraints, we find that in the setting that we focus on, namely manufacturer/retailer or franchisor/franchisee relationships, the empirical evidence concerning the effects of vertical restraints on consumer wellbeing is surprisingly consistent. Specifically, it appears that when manufacturers choose to impose such restraints, not only do they make themselves better off, but they also typically allow consumers to benefit from higher quality products and better service provision. In contrast, when restraints and contract limitations are imposed on manufacturers via government intervention, often in response to dealer pressure due to perceptions of uneven bargaining power between manufacturers and dealers, the effect is typically to reduce consumer welfare as prices increase and service levels fall. The evidence thus supports the conclusion that in these markets, manufacturer and consumer welfare are apt to be aligned, while interference in the market is accomplished at the expense of consumers (and of course manufacturers). In other words, manufacturers have every incentive to develop lean and efficient distribution systems to reach ultimate consumers. This entails imposing vertical restraints on retailers when such restraints enhance dealer services and efficiency more generally, and encouraging retailer competition by eschewing restraints when such competition yields lower distribution and sales costs."

Perhaps it is time for AAI to concede that the empirical evidence provided by modern economic analysis simply doesn't support their hostility towards vertical restraints.

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