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**Abstract**

**Vertical Antitrust Policy as a Problem of Inference: The Response of the American Antitrust Institute**

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This paper offers a critique of a recent paper on vertical restraints by four Federal Trade Commission staff members. The FTC staff based much of their analysis on a survey of 22 previously published case studies. We argue that the sample of 22 is biased toward cases in which vertical restraints had benign effects and show that, even in that biased sample, there were more anti-consumer effects than the paper authors imply. We then review several other important cases in which vertical restraints clearly reduced economic efficiency and/or injured consumers. We conclude from this analysis that the rule of reason approach should be continued and articulate some indicia that need to be considered in choosing cases for enforcement.

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## **VERTICAL ANTITRUST POLICY AS A PROBLEM OF INFERENCE: THE RESPONSE OF THE AMERICAN ANTITRUST INSTITUTE**

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### Introduction

In November of 2004, four members of the Federal Trade Commission staff, including the current director of the Bureau of Economics (hereafter, Cooper et al.), distributed an analysis of and proposal for vertical antitrust policy.<sup>1</sup> Because we believe the paper rests on a one-sided view of the relevant legal and economic literature and therefore reaches mistaken policy inferences, we write this comment.

Our paper is sponsored by the American Antitrust Institute, of whose Advisory Board we are members. In addition, we are all former staff members of the Bureau of Economics at the Federal Trade Commission. Both Scherer and Comanor served previously as Bureau director. From our vantage point, the critical issue raised by Cooper et al. is whether the long-standing belief that vertical restraints and other vertical arrangements can with significant frequency have anti-competitive, consumer welfare-reducing consequences should be overturned and that antitrust standards should be amended accordingly.

At the outset of their paper, Cooper et al. acknowledge that theoretical analyses yield “fragile” or “ambiguous” conclusions. Some publications suggest that vertical relationships may be benign and/or promote competitive and consumer welfare, while others imply anti-competitive effects. Cooper et al. express their a priori belief that few anti-competitive problems stem from vertical relations, but acknowledge that the theoretical literature is not determinative. On the theory we agree. Because the theoretical guidance is ambiguous, Cooper et al. rely mainly on their review of some empirical studies to reach the conclusion that “vertical restraints are likely to be benign or welfare enhancing.”

In this comment, we adopt the same empirical focus. However, consulting a wider population of case studies, we discern more varied outcomes than they report. From reviewing the original materials underlying the 22 studies covered by Cooper et al., we also find that the evidence is not as one-sided as they imply.

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<sup>1</sup>James C. Cooper, Luke M. Froeb, Dan O’Brien, and Michael G. Vita, “Vertical Antitrust Policy as a Problem of Inference,” working paper, Federal Trade Commission, November 8, 2004; revised version February 18, 2005.

## The 22 Studies

In Section III of their paper, Cooper et al. claim to "summarize existing empirical studies of vertical integration and vertical restraints... [but] limit our review to those papers that address issues of explicit antitrust policy interest." From their sample of 22, they identify only a single case "where vertical integration was harmful to consumers." Overall, they conclude that "the studies in Table 1 appear to provide strong support for the proposition that vertical integration/vertical restraints often help solve double markup problems, and/or reduce costs in other ways." However, the studies they review are less than consistent with a one-sided conclusion on the issue.

A striking feature of the 22 studies is that fully ten of them, or nearly half, deal with only two industries: gasoline and cable television. In gasoline distribution, most stations have traditionally been operated as "lessee dealerships," where the operator is both the tenant of a major oil company and the distributor of its products. These joint relationships have long been ridden with tension. Diverse policy proposals have been advanced to limit the contractual provisions defining refiner-franchisee interactions. As some of the cited studies reveal, many of these proposals are more likely to increase consumer costs than reduce them.<sup>2</sup> However, many emerged outside the domain of antitrust policy. Furthermore, one of the papers cited by Cooper et al. has no direct bearing on vertical restraints as such. In that paper, Justine Hastings examines the price effects resulting when a set of "Thrifty" gasoline stations were purchased by and converted to ARCO stations.<sup>3</sup> Hastings reports:

The results indicate that stations competing with a Thrifty station had a significant increase in price, relative to unaffected stations, after the independent Thrifty was converted to an ARCO station. This increase was not dependent on whether the new ARCO station was company-operated or not, indicating that local price increases can be attributed to the loss of an independent, unbranded competitor.<sup>4</sup>

Hastings emphasizes the price competitive effects of independent stations and contrasts them with the pricing of "branded" stations affiliated with the major oil companies. Hastings makes

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<sup>2</sup>In a study not cited by Cooper et al., one of us reached a similar conclusion. See William S. Comanor and Jon M. Riddle, "The Costs of Regulations: Branded Open Supply and Uniform Pricing of Gasoline," International Journal of the Economics of Business, vol. 10 (July 2003), pp. 135-155.

<sup>3</sup>Justine S. Hastings, "Vertical Relationships and Competition in Retail Gasoline Markets: Empirical Evidence from Contract Changes in Southern California," American Economic Review, vol. 94 (March 2004), pp. 317-328.

<sup>4</sup>Ibid., p. 318.

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.)”

Turning to the four surveyed papers that deal with the cable television industry, similar questions arise. Those papers were largely stimulated by a 1992 law which required cable systems to carry the programming of local broadcasters. One study found that the regulation could restrict consumer preferences, rather than limiting the exercise of cable systems' market power. Although possible, that judgment has little bearing on the efficacy of vertical restraints. Another paper concluded that the integration of programming and distribution services in the cable television industry had harmful effects in excluding unaffiliated 'program offerings, but these were offset by efficiency enhancements. Consumers served by integrated companies were said to be “weakly better off, and statistically no worse off.”<sup>5</sup> Still another cited study reached more negative conclusions. It examined the effects of vertical integration between cable systems and program content providers and concluded that "vertical integration is found to decrease social welfare."<sup>6</sup> This evidentiary conflict is correctly reported by Cooper et al., who distinguish it as the only one revealing no harm to consumers.

In this short comment it is not possible to review here all 22 studies cited by Cooper et al. Nevertheless, one additional paper deserves mention.<sup>7</sup> In their precis of the article, Cooper et al. write: "Evidence rules out the dealer cartel explanation for RPM; it is consistent with both efficiency and manufacturer cartel explanations." However, that statement does not reflect the cited author's own conclusions. In the final section of his paper, he writes:

[T]he relationship between these structural characteristics [of the firms and industries studied] and the estimated share price responses were [sic] consistent with the dealer cartel, manufacturer cartel, and transactions costs with marketing inertia hypotheses. These results imply that structural characteristics of firms and industries may be used to help to identify the effects of RPM in particular circumstances.... [T]he findings of this study do not support recent recommendations that RPM should enjoy benign treatment under contemporary antitrust policy.... RPM sometimes causes allocative distortions in manufacturing and distribution. When RPM appears to promote efficiencies in the distribution process, its use is outlived and persists only because of

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<sup>5</sup>Tasneem Chipty, “Vertical Integration, Market Foreclosure, and Consumer Welfare in the Cable Television Industry, American Economic Review, vol. 91 (June 2001), pp. 428-453.

<sup>6</sup>George S. Ford and John D. Jackson, “Horizontal Concentration and Vertical Integration in the Cable Television Industry,” Review of Industrial Organization, vol. 12 (1997), p. 516.

<sup>7</sup>Thomas W. Gilligan, “The Competitive Effects of Resale Price Maintenance,” RAND Journal of Economics, vol. 17 (Winter 1986), pp. 544-556.

marketing inertia.<sup>8</sup>

This brief review of the publications cited by Cooper et al. yields a somewhat different picture than the one they portray. While there are indisputably instances where vertical restraints and/or integration enhanced efficiency and promoted consumer welfare, there are also examples in what appears to be a biased sample chosen by Cooper et al. where such relationships increased monopoly control and imposed consumer harm. The task of an effective antitrust policy is to distinguish between the two sets of cases. The studies selected do not support the authors' flat conclusion that vertical restraints are typically benign or welfare-enhancing.

### Studies Ignored by the Authors

A striking feature of the Cooper et al. paper is that it ignores published studies of important cases that point in a different direction. Those that follow were selected using the same criterion allegedly applied by Cooper et al. – that they were of explicit antitrust policy interest.

One such analysis, drawn from a textbook written by one co-author of this paper, pertains to the United States soft drink industry.<sup>9</sup> In the early decades of the 20th century, Coca-Cola, Pepsi-Cola, and other syrup makers assigned their franchised bottlers exclusive territories on the basis of demand and cost conditions prevailing at the time. But with the shifting emphasis from bottles to cans, general advances in bottling technology, and the gradual decline in transportation costs as interstate highway networks were improved, the minimum efficient scale of a soft drink bottling plant rose sharply, and as a result, the old territorial allocations became wildly uneconomic. Also, the rise of supermarket chains offered potential economies through shipping soft drinks from the bottling plants to supermarket warehouses for final distribution. But the chains' warehouse delivery territories did not coincide with bottling company territorial assignments, and rigidities in the soft drink makers' franchise contracts made it difficult to rectify the imbalances, so more costly bottler-to-store delivery persisted.

The syrup makers could have been rescued from this obsolete equilibrium when the Federal Trade Commission declared their exclusive franchise arrangements illegal in 1978.<sup>10</sup> However, the bottlers - a powerful lobby - secured from Congress in 1980 special legislation invalidating the FTC's decision. The syrup makers were forced to attack their problem in a different way, buying out franchised companies or having their largest franchisees acquire them at prices reflecting the acquired entities' local monopoly power. Then, after the mergers were consummated, obsolete plants were closed and territories were reallocated.

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<sup>8</sup>Ibid., pp. 554-555.

<sup>9</sup>This account is drawn from F. M. Scherer and David Ross, Industrial Market Structure and Economic Performance (third edition; Boston: Houghton-Mifflin, 1990), pp. 559-560.

<sup>10</sup>In the Matter of Coca Cola Co. et al., 91 F.T.C. 517; in the Matter of Pepsico Inc., 91 F.T.C. 680 (1978). The syrup makers surreptitiously encouraged the FTC's action, but pressures from bottlers compelled them formally to oppose it.

That a similar geographic exclusivity system harmed consumers is clear from Willard Mueller's analysis of the Sealy case.<sup>11</sup> Sealy had granted exclusive territorial franchises to some 29 geographically dispersed manufacturers of mattresses carrying the Sealy brand and meeting Sealy design specifications. This company in turn was owned by eight of the licensees, so decisions to maintain territorial exclusivity (and also to set resale prices) were taken by agents of franchisees whose competition among themselves was restricted by their decisions. Viewing the arrangements as "an aggregation of trade restraints," including unlawful price fixing and policing, the Supreme Court pronounced it per se illegal. Sealy thereupon adopted a new and more complex set of licensing practices, including payments by licensees whose territories were invaded, that preserved the spirit of the old exclusive territory system.

However, a few aggressive Sealy licensees saw the territorial limitations as an impediment to their efficiency and growth. They sought to avoid the restraints by shipping into others' territories, opening bulk warehouses where production facilities were prohibited by their franchise terms, and merging with other franchise holders. More litigation ensued, leading to rulings that the new system also violated the Sherman Act. Mueller's analysis of the litigation record revealed that prices were lower, and Sealy's share of the relevant markets was higher, in cities where competitive inter-territorial penetration was most extensive. Consumers gained from the erosion of vertically-imposed exclusivity.

In the United States, the exclusive dealership system formerly maintained by the Big Three automobile producers has broken down completely. Individual dealers now sell multiple brands, often from competing manufacturers. Protected by Supreme Court decisions, dealers compete on a price basis to win orders outside the immediate geographic proximity of their dealership sites. Consumers are the clear beneficiaries.

For many years European Commission authorities have indicated concern that auto dealers have not penetrated each others' national markets, and as a result the Law of One Price has not operated within the Common Market. Beginning in October 2005, Common Market auto manufacturers will no longer be permitted legally to limit the territories within which their dealers can sell. In anticipation of the changes, a March 2005 Commission report states, the price differentials for given automobile brands have begun to narrow.<sup>12</sup>

U.S. automobile manufacturers sought in the past to increase the profitability of their

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<sup>11</sup>Willard F. Mueller, "The Sealy Restraints: Restrictions on Free Riding or Output?" Wisconsin Law Review, vol. 1989, no. 5. This account is summarized from Scherer and Ross, op. cit., pp. 560-561.

<sup>12</sup>David Lawsky, "EU New Price Gap Narrows," Reuters dispatch received via Internet, March 8, 2005. Cooper et al. acknowledge EU concern with the conflict between exclusive territories and the EU's "paramount goal" of market integration, which they imply to be an oddity.

franchised dealers by refusing to supply so-called "crash parts" directly to independent body shops, which engaged in active price competition with the franchised dealers. Instead, they insisted that the independent body shops buy parts from franchised dealers, who purchased the parts from the manufacturers at prices considerably lower than the prices paid by the independent shops. As a consequence, the independent shops were placed at a competitive disadvantage. This system was challenged by the Federal Trade Commission, although a majority of the Commission later chose not to require direct sales from General Motors warehouses to independent body shops.<sup>13</sup>

In the United States, lobbying in favor of state and federal laws authorizing resale price maintenance (RPM) was led by the National Association of Retail Druggists.<sup>14</sup> A U.S. government task force report found that passage of the RPM laws during the 1930s was a significant factor in the cessation of chain drug store growth.<sup>15</sup> Although "fair trading" had eroded despite legal permissiveness in most product lines, it continued to be applied widely in pharmaceuticals when Federal support for RPM was withdrawn in 1975. The average retail margin on pharmaceutical product sales in 1966, before RPM was outlawed, conformed to the traditional 40 percent.<sup>16</sup> Average prescription prices in chain drug stores then were only 2.3 percent lower than in independent stores. By 1989, following the demise of RPM, average prescription drug margins at retail had declined to the 31 to 32 percent range.<sup>17</sup> And by 2003, according to the National Association of Chain Drug Stores, margins had dropped further to an average of 20 percent.<sup>18</sup> Some of this decrease from 40 to 20 percent would undoubtedly have come even if RPM had not been outlawed as RPM contracts were overridden by Medicaid requisites and the bargaining of Pharmacy Benefit Managers. A 20 percentage point reduction in pharmacists' margins, all else equal, implies consumer (or payer) savings at 2003 pharmaceutical volume levels of \$40 billion.

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<sup>13</sup>In re General Motors Corporation, 99 F.T.C. 464 (1982). On the feasibility of direct sales, see F. M. Scherer, "Retail Distribution Barriers to International Trade," Antitrust Law Journal, vol. 67, no. 1 (1999), pp. 97-98.

<sup>14</sup>See F. M. Scherer, "How U.S. Antitrust Can Go Astray: The Brand Name Prescription Drug Litigation," International Journal of the Economics of Business, vol. 4 (1997), pp. 244-245.

<sup>15</sup>U.S. Department of Health, Education, and Welfare, Task Force on Prescription Drugs, The Drug Makers and the Drug Distributors (Washington: 1968), p. 68.

<sup>16</sup>Ibid., pp. 54-55.

<sup>17</sup>Scherer, "How U.S. Antitrust Can Go Astray," p. 245.

<sup>18</sup>[www.nacds.org/wmspage.cfm?parm1=507](http://www.nacds.org/wmspage.cfm?parm1=507) (March 5, 2005).

Another important example is that of the Levi Strauss case and the market for jeans.<sup>19</sup> In response to a complaint issued by the Federal Trade Commission in 1976, Levi Strauss ended its policy of vertical price fixing, but was permitted to retain its distribution restraints. Without RPM, the selling prices of Levi's jeans and retailers' gross margins plunged. Similar declines occurred in the prices and margins of competing jeans because Levi's prices held an umbrella over their prices and dealer markups.<sup>20</sup> Our best estimate is that in men's jeans, where the price reductions were most pronounced, there was a gain in consumers' surplus of approximately \$200 million during the 18 months following mid-1977, when price cutting became pervasive.<sup>21</sup>

Still another neglected analysis concerns the market for light bulbs.<sup>22</sup> The "Big Three" lamp manufacturers had required retailers to stock only a single Big Three brand and no others and to offer the items at maintained retail prices. In 1973 the Department of Justice prevailed in a suit to have these practices declared illegal.<sup>23</sup> However, at first there was little change, and supermarket light bulb departments were able to average an unusually high 55 percent gross margin while manufacturers enjoyed a price/cost margin 82 percent above the average of all manufacturing industries. Under prodding from FTC staff and the U.S. Office of Consumer Affairs, some major grocery chains introduced lower-priced private label bulbs. The combination of intrabrand price competition among stores on leading brands and side-by-side interbrand price competition on retail shelves between leading brands and generics led to substantial declines in the average price to consumers. For example, in the Washington, DC, market, the price of the General Electric soft white 4-pack in the major supermarkets plunged from \$3.40 in 1980 to \$1.99 by November 1981, with private label bulbs retailing for \$1.49. A Federal Trade Commission survey found that such reductions were common where chain stores had introduced private label offerings. Later surveys by one of us established that declines in factory prices and retailer gross margins persisted and increased in the 1981-2002 period.<sup>24</sup>

### Findings From Two FTC Reports

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<sup>19</sup>Robert L. Steiner, "The Nature of Vertical Restraints," The Antitrust Bulletin, vol ... (Spring 1985), pp. 178-183.

<sup>20</sup>Ibid., p. 180.

<sup>21</sup>Robert L. Steiner, "Jeans: Vertical Restraints and Efficiency," in Larry Duetsch, ed., Industry Studies (Englewood Cliffs: Prentice-Hall, 1993), pp. 202-203.

<sup>22</sup>Robert L. Steiner, "Exclusive Dealings + Resale Price Maintenance: A Powerful Anticompetitive Combination," Southwestern University Law Review, vol. 33 (2004), pp. 468-475.

<sup>23</sup>U.S. v. General Electric Co., 358 F. Supp. 731 (1973).

<sup>24</sup>Steiner, "Exclusive Dealings," op. cit., p. 475.

In the early 1980s, the Federal Trade Commission published two staff reports synthesizing empirical evidence on the effects of vertical restraints and vertical relationships. It is useful here to recall their principal findings.

The first, by Thomas Overstreet, summarized with admirable even-handedness a substantial body of evidence on resale price maintenance.<sup>25</sup> From his review, the author concluded that "RPM can have diverse effects, and the empirical evidence suggests that, in fact, RPM has been used in the U.S. and elsewhere in both socially desirable and undesirable ways."<sup>26</sup> On this point, we have no disagreement. Overstreet reported further, "The price surveys indicated that RPM in most cases increased the prices of products sold with RPM, although that was not always the case." He goes on to recognize that price-raising under RPM could also have diverse effects on the quantities sold of fair-traded products, although on this, the evidence was more ambiguous. Citing articles reflecting the state of theoretical thinking at the time, Overstreet infers that "the welfare effects of RPM have varied considerably."<sup>27</sup> We agree on the diversity conclusion, which is inconsistent with the principal impression conveyed by Cooper et al. However, when the Overstreet report and the studies it summarizes were written, it was generally believed (e.g., from the writings of Robert Bork<sup>28</sup>) that manufacturers would not adopt vertical restraints unless they led to increased product sales volume, and that output expansion necessarily meant improved consumer welfare. A few years later, two of us demonstrated that the output expansion conclusion does not hold as a general proposition. Whether welfare, conventionally measured, rises or falls with RPM-induced output expansion depends critically upon the configuration of the demand shift.<sup>29</sup> It is quite possible to have increased output as a result of RPM and at the same time reduced consumer welfare.

Section 2E of the Overstreet report considers the effects of RPM on innovation and efficiency in distribution. This is an important issue which Cooper et al. do not address. In the view of some writers, including one of us, RPM and other vertical distribution restraints have been

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<sup>25</sup>Thomas R. Overstreet, Resale Price Maintenance: Economic Theories and Empirical Evidence, Bureau of Economics Staff Report to the Federal Trade Commission, November 1983.

<sup>26</sup>*Ibid.*, p. 163.

<sup>27</sup>*Ibid.*, p. 161.

<sup>28</sup>Robert Bork, The Antitrust Paradox (New York: Basic Books, 1978), pp. 290 and 295-296.

<sup>29</sup>F. M. Scherer, "The Economics of Vertical Restraints," Antitrust Law Journal, vol. 53 (1983), p. 697-704; and William S. Comanor, "Vertical Price Fixing, Vertical Price Restrictions, and the New Antitrust Policy," Harvard Law Review, vol. 98 (March 1985), pp. 983-1002.

adopted by manufacturers to retard the growth of new and more efficient forms of retailing that can operate profitably at lower markups and consumer prices than traditional incumbent dealers can.<sup>30</sup> Manufacturers do this because, when the new retailing formats still have a small market share, they fear that they will lose more coverage and support from incumbents than they will gain through lower retail prices in innovative outlets. This imposes a dynamic efficiency loss on the economy.

The second FTC volume, published a year later, sought to evaluate the effects of some prior Commission actions on vertical restraints, mostly taken against RPM.<sup>31</sup> Its stated conclusion was:

The consultants concluded that the FTC's interventions were probably harmful in two industries (five cases), and probably improved social welfare in three industries (ten cases)... [T]hese five studies comprise a significant portion of the rigorous empirical evaluations of the effects of vertical restraints.<sup>32</sup>

Again, this conclusion is hardly consistent with the almost uniformly benign view taken by Cooper et al. Extending their overview to the policy domain, the editors reject making RPM per se illegal, but acknowledge that “there are legitimate reasons for debate and disagreement over the optimal enforcement policy toward vertical restraints.”<sup>33</sup>

It is worth noting that the conclusions of Cooper et al. are at odds with the most recent fully litigated FTC enforcement action concerning vertical restraints. In October 1998, the Commission issued its order in the Toys R Us (TRU) case.<sup>34</sup> It rejected the “free rider” defense offered by the respondent and instead concluded that TRU had entered restrictive vertical agreements with its suppliers in order to deny the most popular toys to a new, vigorously price-competitive class of rival distributors, the warehouse clubs. The Commission found that TRU's actions had allowed TRU to reverse prior downward price revisions responding to club competition, and that there were no offsetting gains to consumers justifying that consequence. This finding was endorsed powerfully by the Seventh Circuit Court of Appeals.<sup>35</sup> Plainly, the

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<sup>30</sup>See Steiner, supra note 19.

<sup>31</sup>Ronald N. Lafferty, Robert H. Lande, and John B. Kirkwood, eds., Impact Evaluations of Federal Trade Commission Vertical Restraints Cases, Bureau of Competition and Bureau of Economics, Federal Trade Commission, August 1984.

<sup>32</sup>Ibid., pp. 38-39.

<sup>33</sup>Ibid., p. 44.

<sup>34</sup>126 F.T.C. 415 (1998).

<sup>35</sup>Toys R Us, Inc. v. Federal Trade Commission, 221 F. 3<sup>rd</sup> 928 (2000).

FTC's judicially sustained analysis is inconsistent with the Panglossian position taken by Cooper et al.

### Conclusion

Although the Cooper et al. paper purports to characterize the current debate over vertical restraints even-handedly, in fact it is severely one-sided. Proposing to adopt a Bayesian approach to the question, the authors let their priors override the evidence. Their review of the empirical literature is incomplete and biased toward studies in which vertical restraints plausibly (or sometimes, implausibly) yielded consumer gains. It is not a balanced view of a complex phenomenon. Furthermore, it ignores carefully considered recent FTC actions and decisions. And asserting that cases should be prosecuted only when “natural experiments” reveal significant anti-competitive effects – a luxury seldom likely to be available in the real world – the authors ignore the fact that the careful factual analyses that typically precede and follow filing of an antitrust complaint can reveal much about a restraint’s effects.

Getting the facts and balance right is important. The U.S. Antitrust Modernization Commission is reviewing current policies toward vertical restraints, as are several foreign governments. It would be unfortunate if they were led astray by a biased analysis. Our own view is that vertical restraints can have favorable effects, but alternatively, they can have significant anti-consumer effects. In screening industry practices prior to initiating a more complete investigation on what would undoubtedly be a small subset of cases whose negative consequences warrant intervention, the antitrust enforcement authorities should focus their efforts on cases in which the restraints represent more than the strategy initiative of a new or small firm seeking to obtain or retain a market foothold, the extent to which the firms engaging in restraints command a substantial share of relevant markets, the degree to which oligopolistic sellers follow the leaders’ practices, the availability to consumers of good substitute products through unrestricted channels, the extent to which reluctant participants were subject to coercive enforcement measures, and the availability of alternative, less restrictive means to induce provision of desired services, such as promotional allowances or contracts obliging retailers to provide the services in order to obtain the manufacturer’s line.