

Ch.6: Vertical restraints and vertical mergers

Vertical restraints = contract and clauses to try to control for the externalities created by the parties' actions at successive stages of the production process

Vertical mergers = merger between firms operating at successive stages of the production process

Example of externality between manufacturer and retailer: the manufacturer would like the retailer to make a lot of effort in marketing its product (advertise its product, put it in evidence in the shelves, pre- and post-sale assistance) but the retailer has lower incentives as effort and services are costly to provide. Free-riding problem in providing those services if other retailers carry the same brand within the same region. Vertical restraints can induce higher effort from the retailer (ex: exclusive area....)

Plan of the talk

1. Different types of vertical restraints

2. **Intra-brand competition:** relationship between firms that produce and distribute the same brand (abstracting from the effect of competing brand producers or distributors)
→ rationalization of the vertical chain

3. **Inter-brand competition:** relationships between vertical chains (producers e distributors of different brands)
→ it may reduce the competition in the market

4. **Exclusionary effects:** vertical restraints may preempt efficient entry into an industry (*foreclose* an input)

5. **Policy implications:** trade-off between efficiency and anti-competitive effects → it is better a *rule of reason*.
Intervention only in case of large market power

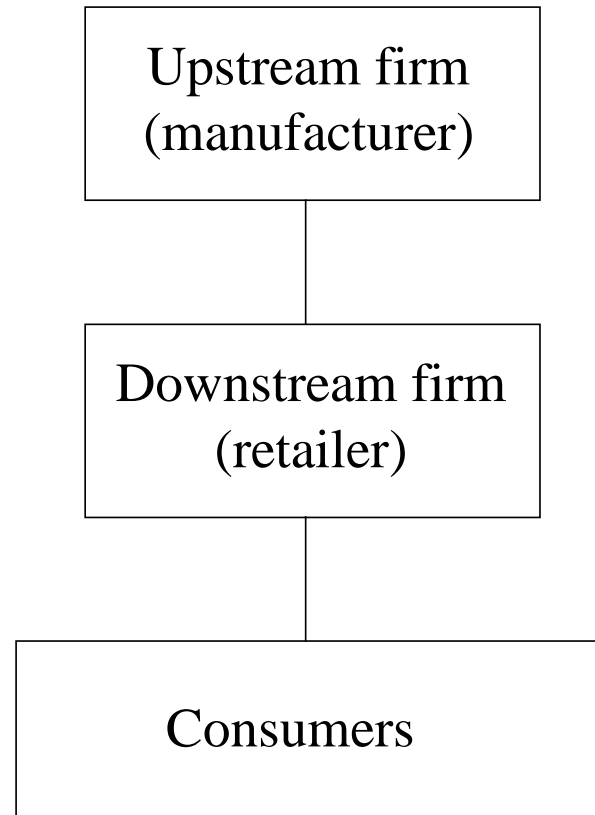
1. Type of vertical restraints

Depending on the information on the relevant variables, the absence of arbitrage (buy when the price is low and sell when it is high), etc...:

- Non-linear pricing (two-part tariffs or franchise fee)
- Quantity discounts
- Resale price maintenance (RPM), *price floor*, *price ceiling*;
- Quantity fixing, quantity forcing, quantity rationing
- Exclusivity clauses: exclusive territory (ET) (producer serves only 1 retailer), exclusive dealing (retailer carries only 1 brand), selective distribution (only certain types of retailers)
- Vertical mergers (vertical integration)

2. Intra-brand competition, I

Double marginalisation
problem



Double marginalization

When both the upstream and the downstream firm have market power, both charge a positive mark-up, resulting in too-high market prices for the vertical chain.

See the figure.

- Bargaining power could be asymmetric.
- Efficiency can be restored if both or one of firms internalize this externality. For example if the retailer has NO market power. In contrast an exclusive territory clause aggravates the problem.

Possible solutions:

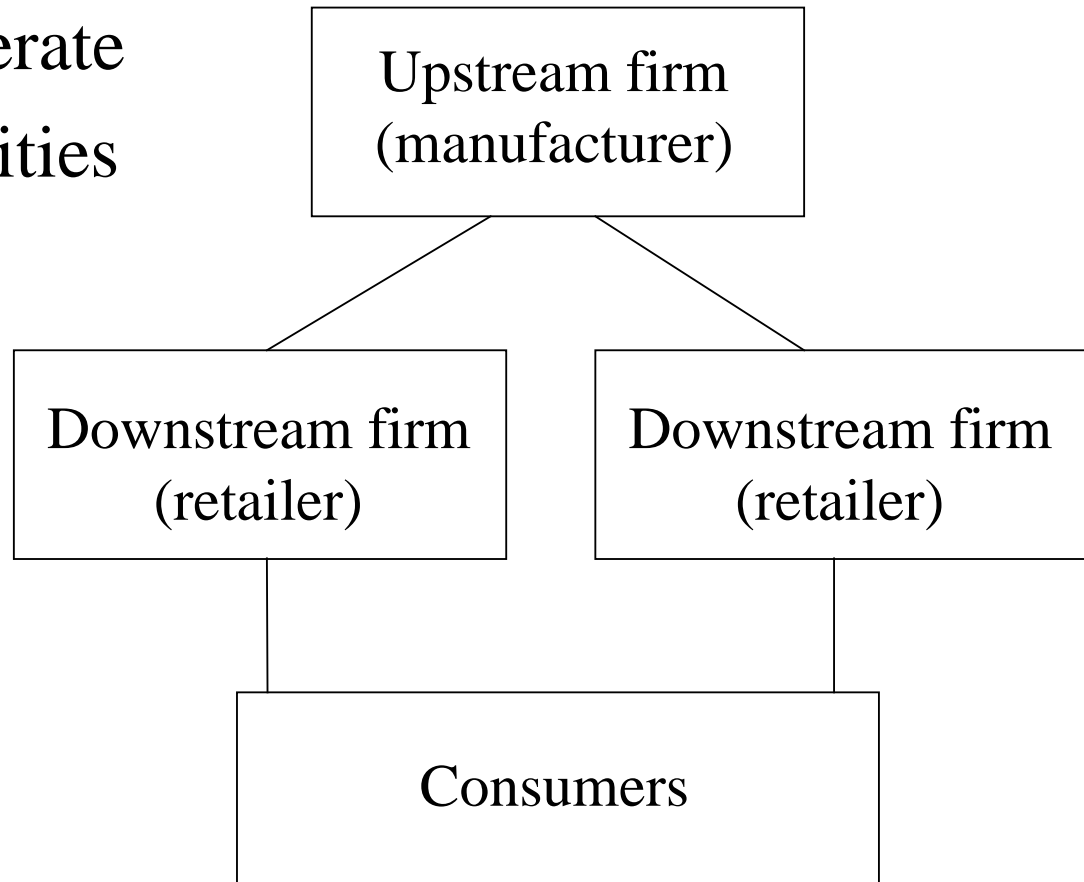
- Vertical merger
- RPM (ceiling): retailer's price must be lower than under monopoly,
- Quantity fixing (minimum): retailer's quantity must be higher than under monopoly;
- Non-linear pricing: the manufacturer imposes $F+wq$ with $w=c$, the retailer becomes the *residual claimant* of all the profit generated by the vertical chain



The market price decreases, PS and CS increase. Therefore SW does.

Intra-brand competition, II

Interaction between
retailers can generate
negative externalities



Free riding among retailers

- The same brand is carried by more retailers: it implies free-riding and under-provision of services (*spillover effects* among retailers)
- pre- and post- sale services, advertising: generally NOT observable from the producer
- The higher the spillovers the lower the incentives to invest in these activities. In the limit, if a provider has to charge a higher price, he loses his customers.
- This is sub-optimal for the producer but also for consumers.

Solutions: vertical restraints

- ET (each retailer has the incentive to offer brand-supporting services, if rivals are far away), RPM (price floor, rival retailers – who do not offer the service - cannot undercut the price), VI (the producer owns all the shops and internalizes the externalities) N.B.: substitutability among vertical instruments
- Vertical integration and variety

The number of retailers is usually **endogenous**. Without VI there are too many retailers and possibly excess of variety (duplication of fixed costs). Variety implies an \uparrow CS and \downarrow PS. With VI the externalities among retailers are internalized.

Other efficiency considerations

- Retailers offer quality certification: luxury and quality services and goods, specific investments. Solutions: RPM and selective distribution.
- Free-riding among producers (which use the same retailers): exclusivity clauses stimulate producers' investments in **retailers' services**.
- Long-term contracts (exclusive dealing, exclusive territory) can remove opportunistic behavior and promote *specific investments* (producer's brand promotion, investments in technologies for intermediate goods). **Helpful especially in the presence of uncertainty about costs and demand.**

Intra-brand competition, IV

- Vertical restraints can also have anti-competitive effects. It occurs in particular in case of: the commitment problem. It is about the (monopolist) upstream firm that provide an input.
- In the absence of commitment the monopolist cannot exert his market power: incentive to renegotiate (temporal inconsistency). Consequence: too much input sold and downstream prices decrease. Downstream firms are worst off.
- Same problem as for the durable good monopolist. Consumers anticipate and prefer to wait. Coase pointed out this problem.

- The problem gets worse in case of asymmetric information.
- In contrast, upstream competition (more upstream suppliers) can reduce it

Solution to this problem:

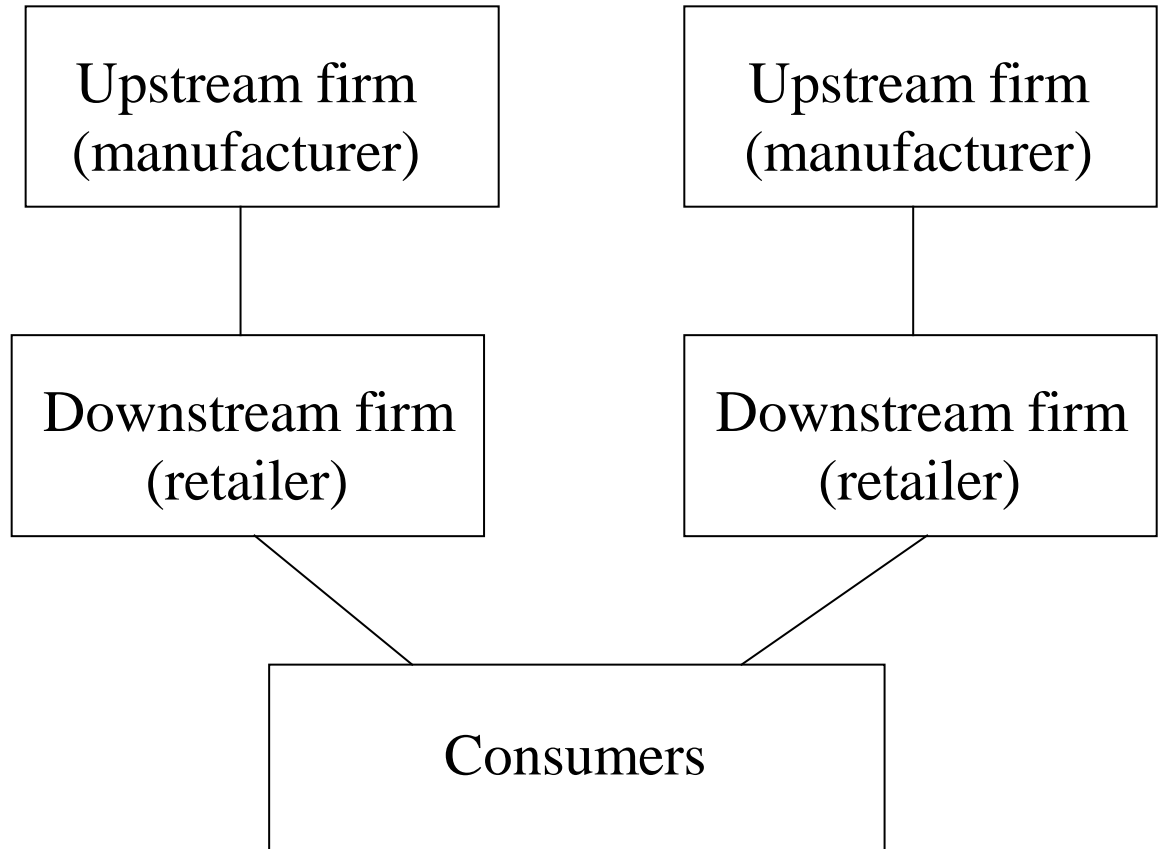
Vertical integration

Exclusive territories: commitment

Resale price maintenance: (books, pharmaceuticals) the producer has no incentive to cut wholesale prices because it would only increase the retailer's profit margin.

3. Inter-brand competition

Illustration of
inter-brand
competition



Strategic use of vertical restraints

- Two upstream firms U1,U2 sell differentiated goods.
- Each firm sells through a retailer (R1,R2 resp.)
- It can be shown that U1 and U2 can use vertical restraints (through a *delegation* mechanism) to increase their profits.
- Non-linear prices: if $U \uparrow w$, $R \uparrow p$.
- Exclusive territorial contracts: it removes intra-brand competition.
- Vertical integration and RPM, instead, cannot be used as strategic restraints (they do not delegate R1,R2 to set prices).
- Here non-linear prices and exclusive territory harm welfare (especially if upstream competition is mild)

Vertical restraints as collusive devices

- RPM increases price observability (prices are not set by R1 and R2 anymore) so that deviations from the cartel made by U1 and U2 can be punished in an easier and faster way.
- If U1 and U2 sell their goods to the same retailer R and each applies a two-part tariff with $w_i = c_i$, R sets p_1 and p_2 maximising the joint profit of U1 and U2 (double marginalization): this way you get the collusive price.

4. Exclusionary effects

- Anticompetitive effects of **vertical restraints**: they can be used to deter the entry of rival firms
- Chicago school / recent approach
- Exclusive contracts: the distribution network as crucial input → foreclosure. Possible in the presence of positive externalities for the incumbent in the relation incumbent/retailer (ex. Scope economies in a second market). Or with many NOT coordinated retailers and the entrant which is constrained to produce a minimal quantity (to recover fixed entry costs). Justification for the existence of *central agencies for purchases*.

- Anticompetitive effect of **vertical mergers**
- Chicago school: *single monopoly profit*. Vertical mergers do not increase market power of the upstream monopolist and so they are efficient. This holds when retailers are perfectly competitive firms.
- Recent approach: with perfect competition upstream and / or downstream, a vertical merger can result in a *foreclosure*. The upstream firm has incentive to stop supplying rival retailers or to charge them a higher price for the input (the result depends on the possible existence of other upstream suppliers).

5. Policy implications

- In many situations vertical restraints increase efficiency (double marginalization, free riding of downstream firms...).
 - The anti-competitive effects exist only if they involve upstream firms with significant market power.
 - What matters is market power, not the type of vertical restraint (there is substitutability among vertical restraints).
- (=> *new approach in EC to VR, 20-30% threshold for the market share. Except for RPM, that are still black-listed*)
- When the market share is high it is advisable to use a *rule of reason*, valuing the benefits in terms of efficiency and costs in terms of anticompetitive effects of the VR.