Vertical Restraints and Vertical Mergers

What are vertical restraints?

- Often production in several stages
- Vertical restraints:

  “contractual agreements between vertically related firms”
- Example: manufacturer and retailer
  - Retailer’s advertisement help its competitors too
  - Retailer may have low incentives to advertise
  - Exclusive area and other vertical restraints may help induce effort
- In this chapter…
  - Identify vertical restraints
  - Analyze welfare effects
  - Analyze vertical integration or vertical mergers

Examples

- Non-linear pricing:
  - Also called franchise fee or two-part contracts
  - Fixed amount plus a variable component
- Quantity discounts
  - Also called progressive rebates
  - Larger the quantity the cheaper the transaction
- Resale price maintenance (RPM):
  - Manufacturer fixes the retail price
  - Recommended price, minimum or maximum resale price
- Exclusivity clauses:
  - Exclusive territory
  - Exclusive dealing
  - Selective distribution

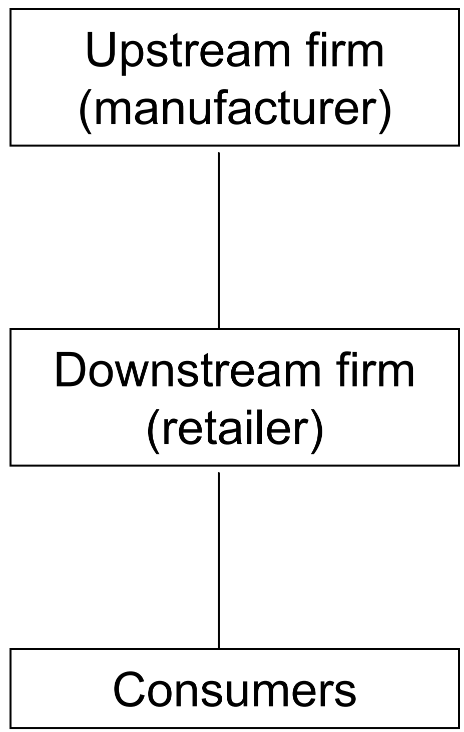
Effectiveness

- Observability:
  - Manufacturer should observe final price if it employs RPM
  - Otherwise, use others like quantity fixing
- Arbitrage:
  - Exclusive territory may not be useful if buyers would buy between territories
  - Quantity discounts not effective if retailers can sell to each other

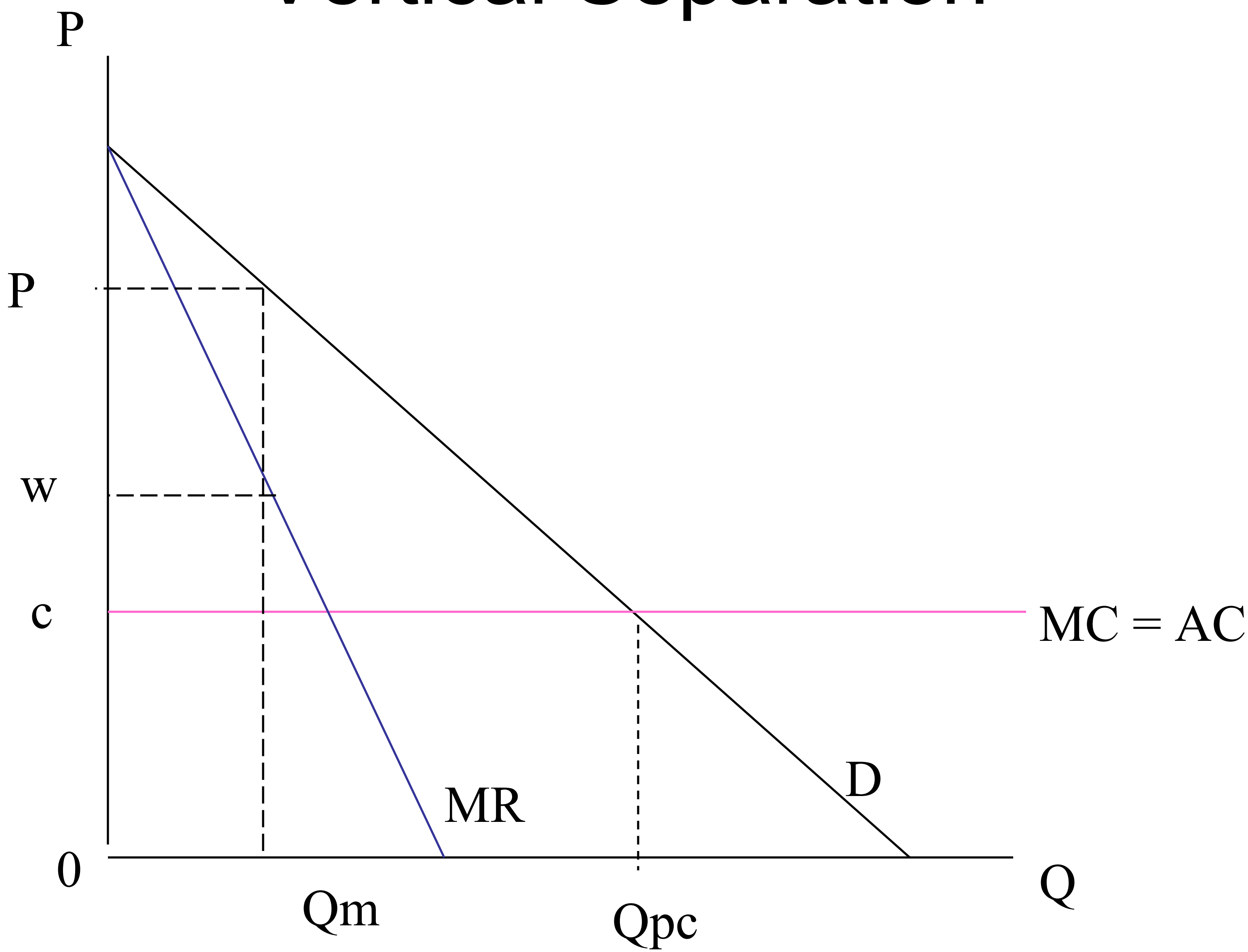
Intra-brand Competition (1)

- Abstract from the effect on other brands
- If both manufacturer and retailer have market power…
  - Double marginalization
  - Vertical integration would increase consumer, producer and social welfare
  - Similarly vertical restraints are welfare enhancing:
    - Resale price maintenance
    - Non-linear pricing

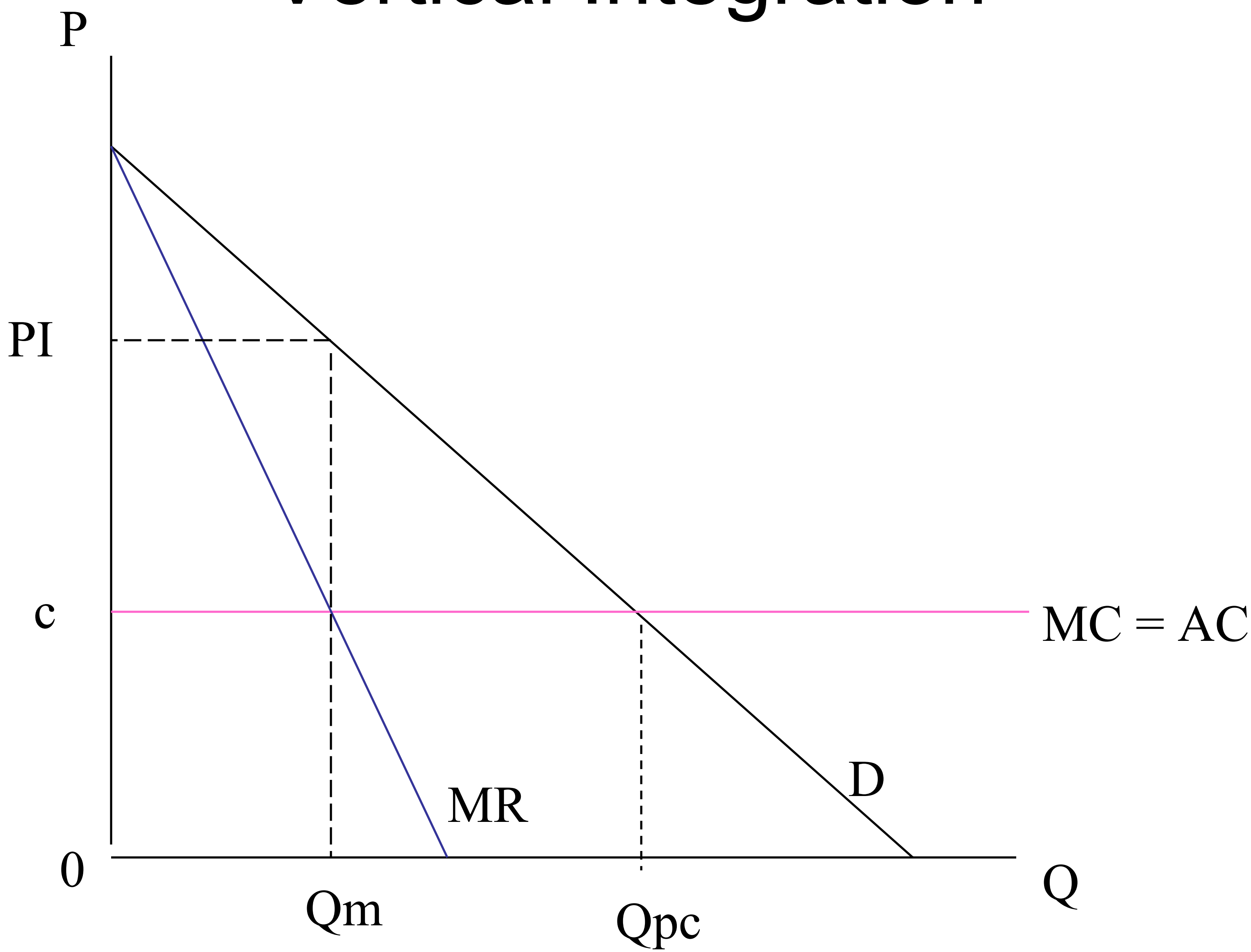
Vertical chain



Vertical Separation



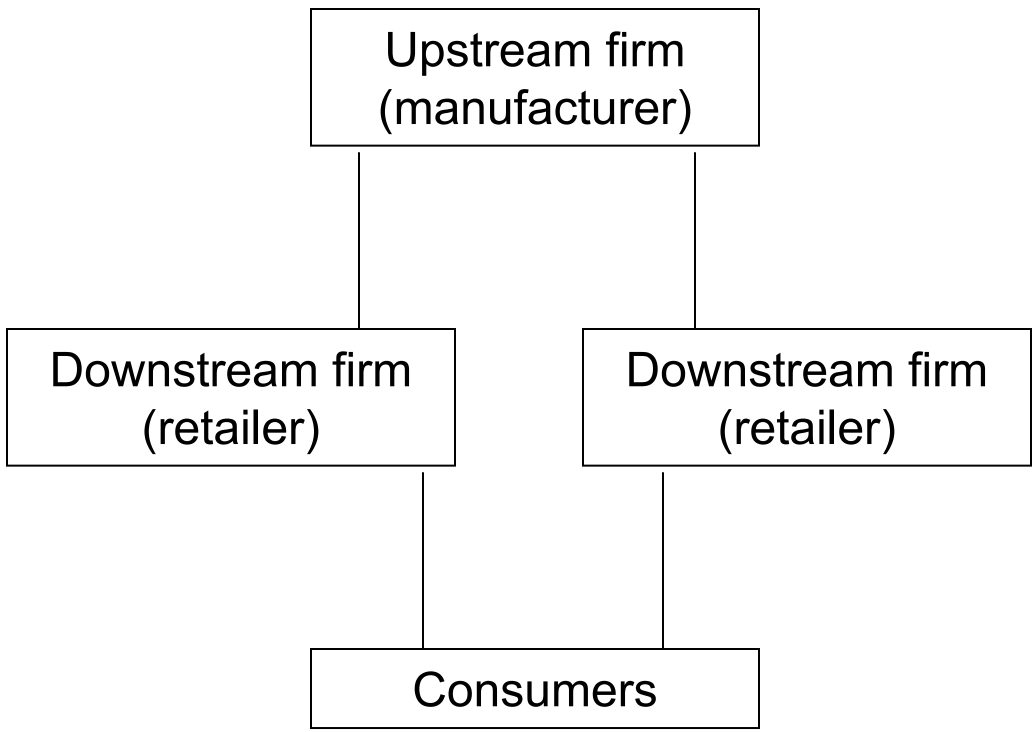
Vertical Integration



Intra-brand Competition (2)

- If there are several retailers…
  - They cannot fully appropriate benefits from advertising effort, for example
  - Vertical restraints can restore efforts:
    - Exclusive territories
    - Fix price floor
  - Consumer and producer welfare increases

Vertical chain



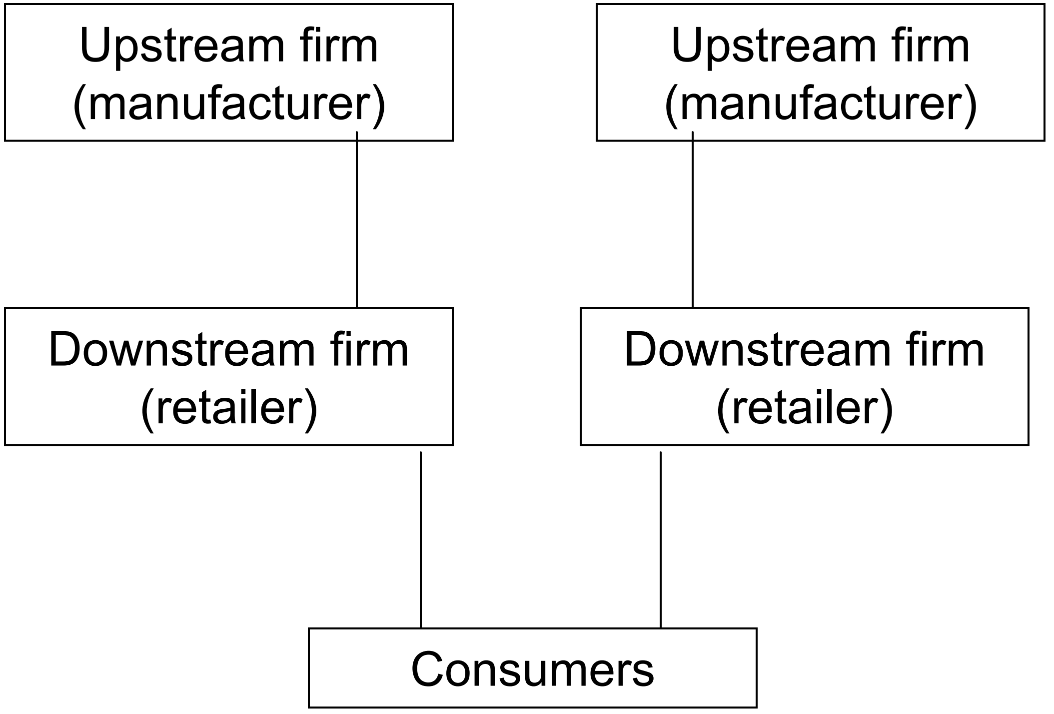
Other efficiencies from Vertical mergers and vertical restraints

- Quality certification:
  - Selective distribution
- Free-riding among producers:
  - Exclusive dealing
- Removal of opportunistic behavior and promotion of specific investments:
  - Exclusive territories
  - Exclusive dealing

Inter-brand Competition

- Vertical restraints have an impact on other vertical chains
- Strategic rationale behind vertical restraints
- Manufacturer wants retailer to become a “softer” competitor (set higher prices)
- Examples:
  - two parts tariff
  - exclusive territories

Vertical chain



Summarizing…

- If vertical restraints affect only intra-brand competition…
  - Likely to improve consumer and social welfare

- If they affect intra-brand competition…
  - They may have welfare reducing effects
  - Mainly if firms have market power

Leverage and Foreclosure

- Can we extend market power from one market to the other?
  - Exclusive dealing can deter entry
  - Similarly vertical mergers
- Industrial Organization literature has provide some (few) examples of this

In conclusion…

- Vertical restraints and vertical mergers may increase or decrease welfare
- Vertical agreements are anticompetitive only if firms have market power
- Rule of reason should be adopted in this case balancing the efficiencies with the possible anti-competitive effects