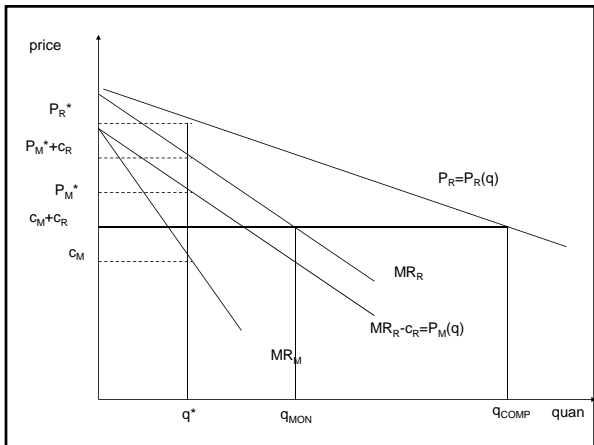
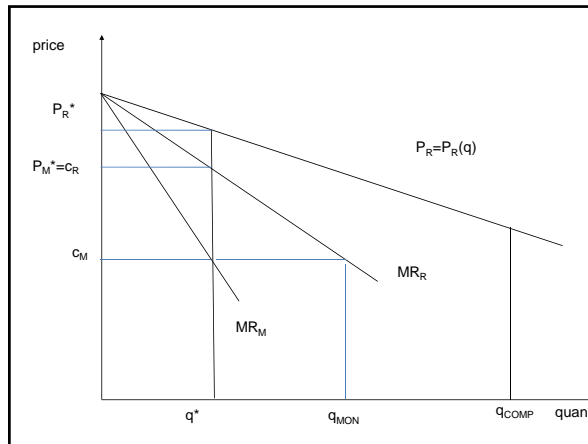


Vertical Relationships II

Industrial Organization
K. Graddy



Double Marginalization

- Outcome: Output of successive monopoly is lower than vertically integrated monopoly and lower than the competitive level of output. Profits are lower and social welfare is lower than the monopoly case.

Intra-Brand Competition

- One manufacturer sells through one or more retailers
 - Double Marginalization Problem
 - Horizontal Externality: Free-Riding in the Provision of Services

Horizontal Service Externalities: Free Riding Example

- Several shops sell a certain brand of dishwasher.
- There are many activities these shops might carry out to increase consumers' appeal – answering questions, etc.
- These may make the consumer more willing to buy the particular brand, but not necessarily at that shop

- Competing dealers are located nearby – or at the click of a mouse – and it is not costly for a consumer to search.
- Shops will not want to invest a lot of effort into selling the brand.
 - Investment can include investing in advertising, sales training, store displays, etc.

Horizontal Service Externality: Under-provision of Service

- Suppose that downstream retailers are competing vigorously on price
- From a double marginalization view, good for upstream firm
- However, they may not be providing the correct profit-maximizing level of service
- Price Competition can lead to under-provision of services

Vertical Service Externalities

- Even without the presence of competing firms, does a downstream firm have the correct incentives regarding service provision?

Solutions

- Vertical integration– internalises all externalities
- Vertical restraints
 - Franchise fee – charge marginal price equal to c_M and extract all profit using fixed part (A) of fee
 - RPM-set $p=p_M+c_R$
 - Quantity fixing-set Q at the appropriate level
 - Exclusive Territories
 - Exclusive Dealing
- Competition: Bertrand competition downstream will set $p_R=p_M+c_R$
- All these measures raise monopoly profits and social welfare

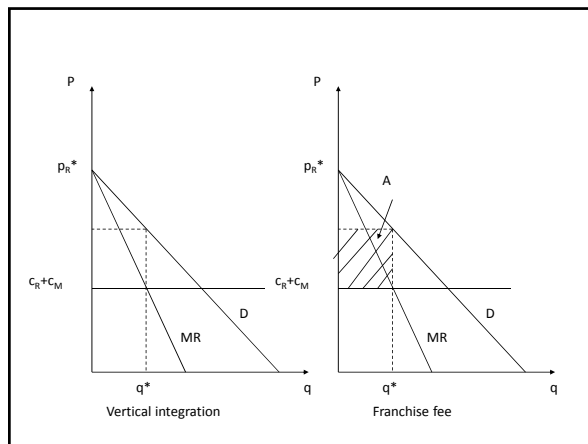
Solutions: 1. Vertical Integration

- Antitrust Laws:
 - The Court's early view was negative
 - Concern was foreclosure
 - Button example
- Antitrust Cases
 - Yellow Cab (1947) Vertical integration is per se illegal
 - Columbia Steel (1948)
 - "It is clear to us that vertical integration, as such without more, cannot be held violative of the Sherman Act"

- Du Pont (1957):
 - Since 1920, duPont had supplied GM with automotive finishes and fabrics.
 - DuPont owned a 23% stock interest in General Motors
 - U.S. government brought suit, claiming a violation of the antitrust laws.
- Since duPont, the DOJ has generally emphasized the vertical integration alone is not objectionable
 - Focus is on whether or not it increases market power

Solutions 2. Franchising

- Franchisor sells
 - A total system of doing business (a business-format) franchisor, or
 - The right to carry franchisor's brand
- One format is to charge a franchise fee in addition to marginal cost of the product



Franchises

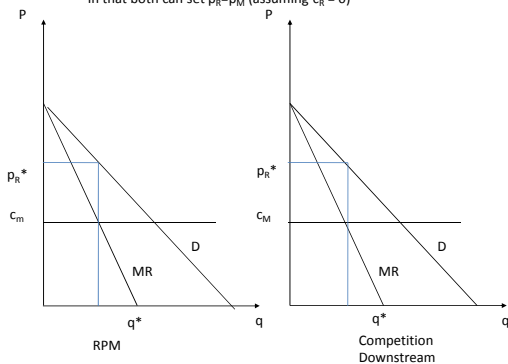
- Franchises are hugely popular
 - From 1975 to 2003, the number has increased from 220,000 to more than 580,000 units
 - 40% of U.S. retail sales may take place at franchise outlets
 - Subway has 28,468 locations (as of 11/15/07)
 - And 31,974 restaurants in 90 countries (as of 11/10/09!)
 - As of 2003, Car dealerships are 100% franchised, gasoline stations are 85% franchised, fast-food restaurants are 79% franchised, convenience stores are 82% franchised

Solutions

3. Vertical Restraints

- Retail Price Maintenance (RPM)
 - A manufacturer may set a minimum (or maximum) price that retailers may charge in order to control the price at which an item is sold to end consumers
 - A maximum retail price can solve the double mark-up problem
 - A minimum retail price may solve horizontal service externalities

Note: RPM and competition downstream are equivalent in that both can set $p_R = p_M$ (assuming $c_R = 0$)



RPM and Antitrust Issues

- Dr. Miles (1911) John D. Park, a distributor, refused to enter into a contract that established a minimum price at which Dr. mile's drug products could be sold
 - Court ruled RPM was illegal
- In 1937, the Miller-Tydings Resale Price Maintenance Act was passed and in 1951, the McGuire Act was passed

RPM and Antitrust Issues

- These acts allowed the manufacturer to set the retail price as long as states had a fair-trade status
- The laws allowing resale price maintenance were repealed in 1975, and all resale price maintenance again became per se illegal....
-until 2007!

Solutions

3. Vertical Restraints

- Quantity Forcing
 - Imposing a sales quota on a distributor
 - Sales quotas induce distributors to expand their output by lowering their price
 - Many automobile dealerships and computer retailers have sales quotas

Solutions

3. Vertical Restraints

- Exclusive Territories
 - Provide dealers with incentives to promote product
 - Prevent free riding
- Legal History
 - White Motor (1963)
 - A truck manufacturer limited the territory in which its distributors could sell the product
 - Ruling: exclusive territories do not necessarily violate antitrust laws

- General motors (1966)
 - General motors wanted to prevent dealers from reselling cars to discount dealers
 - Court ruled that this behavior violated antitrust laws
- Schwinn (1967)
 - Court ruled that exclusive territories “are so obviously destructive of competition that their mere existence is enough
 - Exclusive territories became per se illegal

- GTE Sylvania (1977) Court overruled Schwin’s per se prohibition
 - Court acknowledged that exclusive territories can promote competition

Solutions

3. Vertical Restraints

- Exclusive Dealing
 - A manufacturer prevents its distributors from selling competing brands
 - Note:
 - Exclusive territories address free riding of one dealer on the efforts of another
 - Exclusive dealing addresses free riding of one manufacturer on the efforts of another
 - Exclusive dealing can raise entry barriers by raising distribution costs

Exclusive Dealing

- Antitrust History
- Standard Fashion Company (1922)
 - Supreme court refused to enforce a manufacturer's contract with a retailer that forbade the sale of brands of other manufacturers.
- Standard Stations (1949)
 - Standard Oil of California required dealers to purchase petroleum products and automobile accessories only from them



- Supreme Court did not apply a rule of reason
- Essentially said too great a burden to show that competition had diminished, so the court will simply rule that competition had been foreclosed and not allow exclusive dealing
- GTE Sylvania (1977) should apply to exclusive dealing, however, so no longer per se illegal

Summary

- Franchise fee: $T(q)=A+pq$, where $p=c$. This removes vertical externalities in pricing a quality by the retailer. Does not solve horizontal externalities
- Quantity forcing: requirements in q .
- RPM -avoids competition in prices so increases sales effort
- Exclusive territories: prevents dealer free-riding
- Exclusive Dealing – prevents manufacturer free-riding

Blockbuster and Double Marginalization

- Prior to 1998, distributors sold tapes to video rental stores at about \$65 to \$70.
- Retailers decided which tapes to stock and the price of the tapes.
- In 1998, Blockbuster introduced a revenue sharing contract in which they share between 40 and 60% of the revenue along with a tape charge of only \$8.00

- Mortimer (2002) estimates that the sum of retailer's and distributor's profits increased from 3 to 6 percent.
- The rental price declined from \$4.64 to \$4.08.
- The average number of tapes in a store's inventory rose from 20.1 to 24.2.

The Beer Orders

- In 1989, the MMC in the UK ordered the divestiture by brewers of about 14,000 pubs
- Claimed recommendation would lower retail prices and increase consumer choice
- Why might integration be efficient?

- Double Marginalization Problem
- Quality Assurance and Effort by Retailers
 - Quantity of beer sold determined by retail price and “quality,” where quality includes
 - Cleanliness of pub, proper maintenance of cask beer, quality of food
- If vertical control is efficient, divestiture will lead to lower quality and higher prices
- This is widely perceived to have happend

Conclusion

- Problems with Vertically separated firms
- Solutions to these problem
- Antitrust issues
- Empirical studies