

# Vertical Integration and Vertical Restraints

---

- Manufacturers rarely supply final consumers directly
- Btw, why?
  - Increasing returns to distribution due to shopping needs or travel costs for consumers,
  - Choice of variety,
  - Demand for service,
  - Integration of complementary products,
  - Different geographical markets, etc.
- So there are upstream and downstream firms

# Vertical Integration and Vertical Restraints

---

Downstream firms do not simply consume the good, but typically make further decisions regarding the product and those decisions affect the profits of upstream firms.

Examples of activities of downstream firms:

- determination of final price
- promotional effort
- placement of product on store shelves
- promotion and placement of competing products
- Additional services

# Vertical Integration and Vertical Restraints

---

- Since those activities of the downstream firms may affect the profits of the upstream firms, upstream firms care about the activities of the downstream firms. That is why we study vertical integration/control/restraints between firms in these settings. We'll study, in particular, the incentives for vertical control when the market for the intermediate good is imperfectly competitive.
- Last lecture we saw that without control (that is, in the double marginalization model) the sum of profits for upstream and downstream firms was smaller than if they integrate.

# Vertical Integration and Vertical Restraints

---

- There are externalities between the downstream firms and the upstream firms
- There are externalities among downstream firms. We saw that if downstream market is competitive the double marginalization problem did not occur.
- One of the main issues this lecture is that if firms use vertical restraints efficiently, they should be able to attain/replicate the vertically integrated profits.
- So Vertical Integration is not the only solution to solve this coordination problem.

# Comparing three benchmark situations

	VI Monopoly	Monop W, Comp R	Monop W, Monop R
Retail price	6.5	6.5	8.25
Wholesale price	NA	5.5	5.5
Q	3.5	3.5	1.75
Retail profit	NA	0	3.1
Wholesale profit	NA	12.25	6.12
Total profit	12.25	12.25	9.22

# Vertical Restraints

---

- Exclusive Territories: an upstream firm (retailer) is assigned a (usually geographic) territory by the manufacturer/ upstream firm and given monopoly rights to sell in that area.
- Exclusive Dealing: the downstream firm/retailer is not allowed to carry the brands of a competing upstream firm.
- Full-line forcing: a dealer is committed to sell all the varieties of the manufacturer's products rather than a limited selection (i.e., the upstream firm ties all its products when selling to the downstream firm).
- Resale Price Maintenance: a retailer commits to a retail price or a range of retail prices for the product.
- More complicated vertical contracts, such as franchising, revenue sharing, ...

# Again: Double marginalization.

---

- Basic problem: each seller in the vertical chain ignores the effect of its markups on the profits of the other firms in the chain.
- Graph:

# Again: Double marginalization.

---

- Basic problem: each seller in the vertical chain ignores the effect of its markups on the profits of the other firms in the chain.
- Solution 1

# Again: Double marginalization.

---

- Basic problem: each seller in the vertical chain ignores the effect of its markups on the profits of the other firms in the chain.
- Solution 2

# Again: Double marginalization.

---

- Basic problem: each seller in the vertical chain ignores the effect of its markups on the profits of the other firms in the chain.
- Solution 3 : Fixed franchise fee and then per-unit price

# Application: Franchising

---

- Franchisor (e.g McDonald's)
- Franchisee (owner of the McDonald outlet)
- Most are business-format franchises:
  - The franchisor provides the total system of doing business
- Examples – are they business-format franchises?
  - Fast food outlets
  - Auto dealers
  - Gas stations

# Application: Franchising

---

- .

# Application: Franchising

---

- .

# Law and Vertical Integration

---

- – Courts are concerned with foreclosure
  - And if vertical integration can be used to increase market power
  - Price discrimination – but not clear welfare effects...

# Law and Vertical restraints

---

- There are a lot of ambiguities in legal treatment of vertical contracts.
- For example, until the 1970s, Resale Price Maintenance (RPM) and Exclusive Territories were per se illegal under the Sherman Act.
- But many states passed fair trade laws (e.g. McGuire in RPM). Thus, although price fixing remains per se illegal, it's not always applied in vertical settings because it conflicts with free-trade notions between firms in the vertical structure.
- Non-price issues have been generally accepted to be ok by the courts
- Vertical restraints to raise rivals costs, deter entry
- But banning vertical restrictions is only effective if integration is not an option for firms (this occurs when integration is more expensive than the restrictions)

# Law and Vertical restraints

---

- Resale price maintenance: McGuire Act (1951) allowed for states with fair trade, then in 1975 prohibited again. Nowadays not overruled per se illegality but ... Note that allowing RPM leads to less free-riding on promotional efforts of downstream firms because it gives incentives to downstream firms to compete for customers with non-price strategies (since price is fixed) hence promoting more.
- Exclusive Territories: also leads to incentives to promote more and less free-riding among downstream firms (that sell the same product) but restricts competition in the market!
- Exclusive Dealing: ambiguous effects...

# Empirical Evidence on Vertical Restraints

---

- .
- .
- .
- .
- .
- .

# Long Term Contracts & Relation Specific Investments

---

- Example 1: Carwash at Gasoline stations (last lecture)
- Example 2: Irrigation method and farmer's crop choice
- Example 3: Movie and Actors industry