International
Competition
Network

Analyzing Competitive Effects

Pro-competitive efficiencies from ED

Martin Mandorff*
Swedish Competition Authority

* The views expressed are those of the author and not of the Swedish Competition Authority

Stockholm, Tuesday 17/9/2013

International Competition Network

Exclusive dealing
… common also in the absence of market power

International Competition Network

… one color in the palette of vertical controls

Unit price

Promotional agreements

Exclusivity

Vertical integration

Firms need to worry about efficient distribution

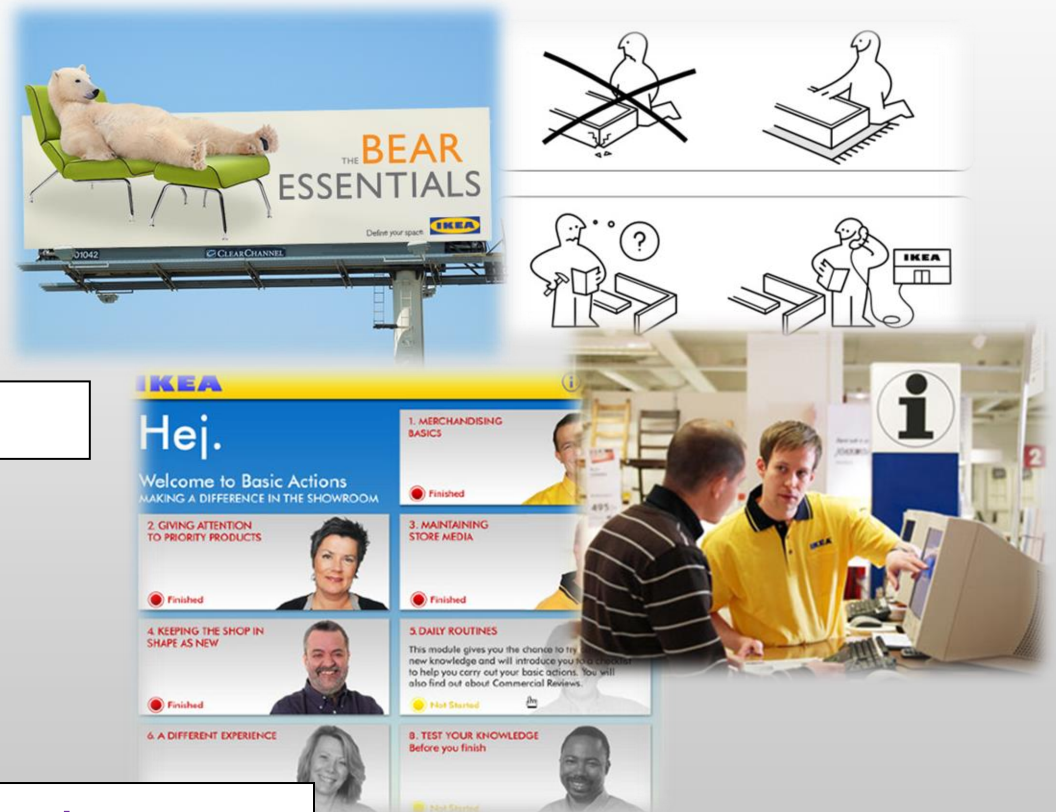
Supplier

High end-value at low cost….

Retailer

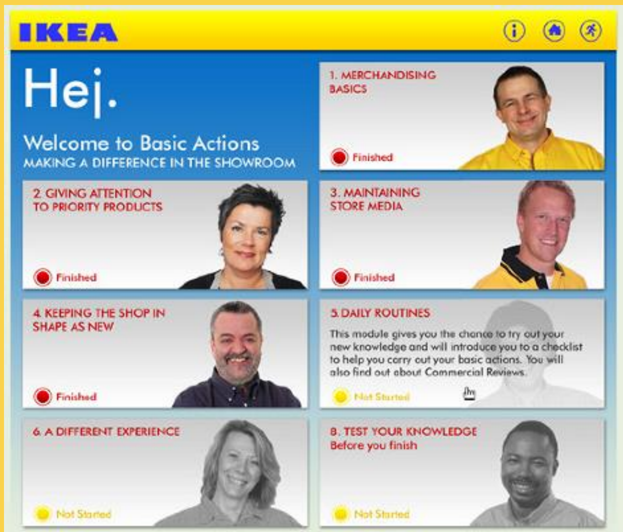
… often requires efforts and investments both at the supplier and retail level

End customer



Example: Relationship-specific investment

- Supplier needs to invest in training of retailer’s staff



- **Problem**: Supplier and retailer cannot write contract that prevents training from being used to sell competitor’s products
- Result: Insufficient investment in training

Far-reaching solution...
Vertical integration

- "Theory of the firm"
  - Why do some firms vertically integrate while others use the market mechanism?
  - Studied by economists such as Coase, Alchian, Williamson, Grossman-Hart-Moore

- Incomplete contracts and property rights
  - Relationship-specific investments, ownership assigned to optimize investment incentives (by minimizing risk of hold-up)

- There are costs to vertical integration: sometimes better to handle problems contractually (e.g. ED)

Example (cont.): Relationship-specific investment

- Supplier needs to invest in training of retailer's staff

- **Solution:** Retailer commits not to sell competitor's products (exclusivity)
- Result: Optimal investment in training

International Competition Network

Efficiencies obtained through exclusive dealing

Encourage suppliers to provide services or marketing that benefits retailers	ED protects supplier investments	• Preventing retailer inter-brand free-riding
Encourage retailers to service and promote a supplier's products more vigorously	ED protects retailer investments	• Preventing customer intra-brand free-riding • Incentivizing retailer promotional activity
Avoid incentive conflicts due to common agency	ED aligns retailer incentives	• Allows retailer and supplier to e.g. share risk

- Note: not all problems are solved by exclusive dealing
  E.g. investments that are purely internal to the relationship
  (Segal & Whinston 2000)
- Also: are efficiencies obtainable through less restrictive means?

Exclusivity to control externalitites and free-riding

Investing supplier

Rival supplier

Retailer

End customer

If *supplier* makes investment that benefits retailer, often ED to prevent retailer from free-riding and using benefit to promote other suppliers' products

International Competition Network

Exclusivity to control externalitites and free-riding

Supplier

If *retailer* makes investment that benefits supplier’s product, often ED to prevent customers from free-riding and buying product at other retailer

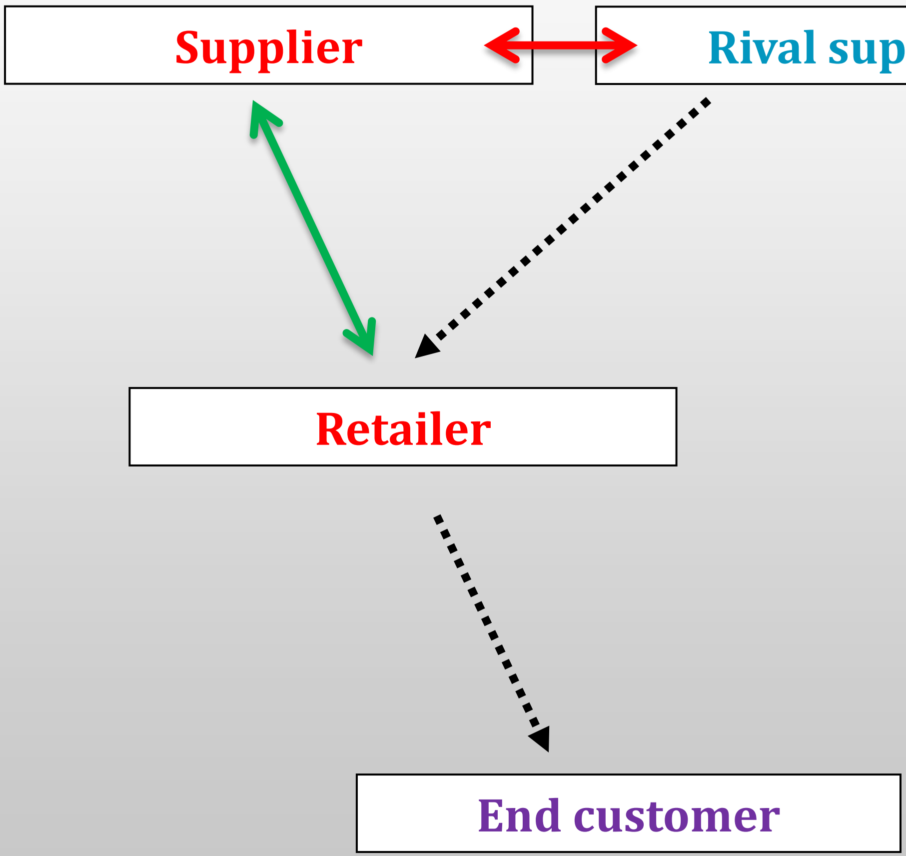
Investing retailer

Rival retailer

End customer

International Competition Network

More general conclusion: Fundamental difference between horizontal & vertical agreements



- **Horizontal** agreement = combination of substitutes; want the other party to *worsen* product-offering (e.g. to raise price)
- **Vertical** agreement = combination of complements; want the other party to *improve* product-offering (e.g. to lower price)