

Vertical Relations (part 2)

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Inter-brand competition and exclusion

- Vertical restraints and vertical foreclosure
- We study the impact of exclusive dealing provision on entry
- We focus on anticompetitive effect (exclusion)
- Exclusive dealing may also have procompetitive effects (stimulates investment)
- Three main ideas :
 - Exclusive contracts as a means to capture the entrant profit (Aghion and Bolton, 87)
 - Exclusive contracts as a means to deter the entry of more efficient entrants (Segal and Whinston, 2000a)
 - Exclusive contracts protect specific investments and thus stimulate investment (Segal and Whinston, 2000b)
- In all these models : *externalities* explain why the Coase theorem fails

- *"Economics of vertical restraints", Handbook of Antitrust, Rey and Vergé, 2006, (RV)
- **Competition Policy*, Motta (chapter 6), (M)
- *"Naked Exclusion : Comment", Segal and Whinston, *AER*, 2000
- Paper presentation : "Exclusive dealing and entry, when buyers compete", Fumagalli and Motta, *AER* 2006

Inter-brand competition : exclusive contracts and foreclosure

- Common framework :
 - Incumbent downstream (I) proposes a contract to a (many) downstream buyers (B)
 - Risk of exclusion of a new and more efficient entrant (E) upstream (foreclosure)
- Prevalent view (Chicago view) : no anticompetitive effect of an exclusive contract
- Chicago Argument : if the relation between E and B is more efficient, I cannot profitably impose an exclusive contract to B

Inter-brand competition : exclusive contracts and foreclosure (the Chicago view)

- Firms :
 - firm I : c_I
 - firm E : $c_E < c_I$
 - firm B : unit value of the good v
- The game
 - stage 1 : I proposes an exclusive contract with price p^e
 - stage 2 : E decides to enter
 - stage 3 : price competition if entry and no exclusive contract
- Level of t to impose the exclusive contract ?
 - The buyer B refuses. It earns $v - c_I$
 - The buyer accepts : $v - p^e$
 - To impose the contract : $p^e < c_I$
- Conclusion : it is not profitable for I to impose exclusivity
- Basic reason : the surplus shared between I and B is lower than the surplus between B and E

Inter-brand competition : exclusive contracts and foreclosure (M)

- Main argument (Aghion and Bolton in "Contracts as a barrier to entry", *AER*, 1987) :
 - an exclusive contract aims at capturing the entrant surplus
 - may lead to exclusion
- Additional ingredient : damage penalty in case of contract breach
- The penalty allows I and B to capture the E surplus
- The game
 - stage 1 : I proposes an exclusive contract with a unit price p and a penalty d
 - stage 2 : E decides to enter
 - stage 3 : price competition if entry
- Read M or RV

Inter-brand competition : exclusive contracts and foreclosure (M)

- stage 3 : E must propose to B : $p_E + d < p$
- stage 2 : entry iff $p_E = p - d > c_E$
- stage 1 : d extracts E surplus.
 - no entry : surplus shared with p : $v - c_I$
 - entry : surplus shared with d : $v - c_E$
 - Best contract : $p - d = c_E$
- Conclusion : entry, efficiency and no foreclosure

Inter-brand competition : exclusive contracts and foreclosure (M)

- Cost of E unknown : uniform priors on $[0, c_I]$
- Entry iff $p - d > p_E$
- Expected surplus for B and I :
 - if entry : $v - (p - d)$
 - if no entry : $v - c_I$
 - expected profit :
 $(p - d) \cdot (v - (p - d)) + (c_I - (p - d)) \cdot (v - c_I)$
- Trade-off :
 - higher $p - d$: more entry, lower surplus
 - lower $p - d$: less entry, higher surplus
- Optimal choice of $p - d = \frac{c_I}{2}$
- Exclusivity with damage penalty prevents efficient entry
- But...entry is crucial for I to capture surplus

Inter-brand competition : exclusive contracts and foreclosure (SW)

- The incumbent exploits externality across buyers to foreclose the entrant
- First work : "Naked Exclusion", Rasmusen, Ramseyer and Wiley, *AER* in 1991 (but see Segal and Whinston)
- Framework
 - Many buyers
 - Increasing returns impose E to deal with a critical number of buyers to enter
- Assumptions : $2(c_I - c_E) < f < 3(c_I - c_E)$
- The game in case of **no discrimination** (3 buyers) :
 - stage 1 : I proposes an exclusive contract with transfer T to each buyer
 - stage 2 : E enters or not
 - stage 3 : Bertrand competition if entry

Inter-brand competition : exclusive contracts and foreclosure (SW)

- E enters iff no buyer has not accepted an exclusive contract
- I proposes (or not) an exclusive contract with transfer T to each buyer with $c_I \leq T \leq v$
- If at least one buyer accepts the contract, the others have no other choice than to accept. E does not enter.
- If all buyers refuse the contract, E enters.
- We face here a coordination issue with 2 equilibria

Inter-brand competition : exclusive contracts and foreclosure (SW)

- **Discrimination** : I proposes different contracts.
- Contract with $T_1 = c_I - \varepsilon$ to buyer 1 and contract with $T_i = v$ to the two others ($i = 2, 3$).
- Contract T_1 always accepted. Then E cannot enter and then T_i accepted.
- We have a "divide and conquer" strategy.
- Exclusion is explained by the *externality* of one buyer on other buyers