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On the competition enhancing effects of exclusive dealing contracts☆

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ABSTRACT

Antitrust scholars have argued that exclusive contracts have anticompetitive, or at best neutral effects, if no efficiencies are generated. In contrast, this paper shows that exclusive contracts can have procompetitive effects, provided buyers are imperfect downstream competitors and contract breach is feasible. In that case, an efficient entrant is not necessarily foreclosed through exclusive contracts but induces buyers to breach. Because breaching buyers have to pay expectation damages to the incumbent, the downstream profits they obtain when breaching must be large enough. Therefore, the entrant needs to set a lower wholesale price than absent exclusive contracts, leading to lower final consumer prices and higher welfare.

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1. Introduction

In many recent antitrust cases incumbent upstream firms were alleged of having used exclusive contracts to foreclose potentially more efficient entrants, thereby harming consumers.[1] In these cases courts need to balance anticompetitive effects caused by increased wholesale prices against potential efficiency gains created through exclusive contracts within the vertical production chain. Several authors (e.g., Aghion and Bolton, 1987, or Segal and Whinston, 2000) have demonstrated that exclusive contracts by an incumbent firm can make entry more difficult or deter it altogether. Exclusive contracts then lead to higher prices, and therefore have anticompetitive effects. On the other hand, efficiency gains may arise due to service or effort provisions by buyers (see e.g., Mathewson and Winter, 1984). Only if these efficiency gains are large, exclusive contracts may have procompetitive effects.

In this paper we challenge this conclusion. In particular, we point out that exclusive dealing contracts can have procompetitive effects even if no efficiency gains are generated. In a nutshell, the economic mechanism for this result is as follows: If competition between buyers is relatively intense, each buyer has an incentive to sign an exclusive dealing contract with the incumbent because the upfront payment guarantees the buyer some profits. An entrant must then induce the buyers to breach the exclusive dealing contract in order to make profits. Since buyers have to pay damages to the incumbent when breaching a contract, the entrant has to offer them a low wholesale price to make breach of contract profitable. This low input price then leads to lower final consumer prices, thereby rendering exclusive dealing contracts procompetitive.

Let us explain this intuition in more detail. First, we look at the counterfactual scenario, when exclusive contracts are not allowed. In this case the upstream entrant is not foreclosed and competes against the incumbent. Given that there is Bertrand competition between upstream firms, the more efficient entrant sets its wholesale price equal to the incumbent's production cost and serves the entire market. If downstream buyers produce differentiated goods, they obtain positive profits, which we denote by π.

If exclusive contracts are allowed, the incumbent will make use of such exclusive contracts, provided it can profitably induce the downstream buyers to sign. For signing, it has to offer the downstream buyers a compensation that ensures them a profit of π. If downstream competition is relatively intense, the incumbent can indeed profitably use exclusive contracts, since π is then small. If downstream firms have signed

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[1] Recent examples are *United States* vs. *Transitions Optical*, *AMD* vs. *Intel*, and *Pernod Ricard and Campbell Distillers* vs. *Bacardi-Martini*.

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the exclusive contracts, the incumbent will set its wholesale price at the monopoly level.

Although downstream firms have signed the exclusive contracts, the entrant will enter if it can profitably induce the downstream firms to breach the exclusive contracts. When a downstream firm breaches, it must compensate the incumbent the foregone profit. Therefore, to render breach of contract profitable, the entrant has to set a sufficiently low wholesale price. If downstream competition becomes more intense, the profit the downstream firms can obtain when breaching decreases, implying that the entrant needs to set a lower wholesale price in order to render breach of contract profitable. In particular, when downstream competition is moderate, the wholesale price the entrant needs to set to induce both downstream firms to breach lies below the incumbent's production cost. It follows that for moderate degrees of downstream competition, the downstream firms will breach the exclusive contract and buy from the entrant at a lower wholesale price than absent exclusive contracts. Since the downstream firms receive the input good at a lower wholesale price, they set lower prices to final consumers which makes exclusive contracts procompetitive. We show that this mechanism occurs for a general class of demand functions.

Our analysis uses the framework developed by Simpson and Wickelgren (2007), which considers exclusive dealing contracts and allows for the possibility of contract breach. This possibility is of high practical relevance since common law provides each party to a contract the opportunity to breach that contract by paying expectation damages to the injured party. While in some situations breach of contract may indeed be prohibitively costly due to reputational reasons or high litigation costs, it seems unreasonable to assume generally that contract breach is not feasible.

In their model, Simpson and Wickelgren (2007) analyze the cases in which downstream firms are either final consumers or (almost) perfect Bertrand competitors. They find that in the first case the effect of exclusive contracts is neutral. If downstream firms do not compete, the incumbent's gain in profit through entry deterrence is lower than the downstream firms' loss in profit. Therefore, the incumbent is unable to compensate the downstream firms for signing exclusive contracts. If instead the downstream firms are (almost) perfect Bertrand competitors, the incumbent can induce the downstream firms to sign because their profits when rejecting the exclusive contract are very low. Even though downstream firms have signed the exclusive contract, entry is not deterred due to the possibility of contract breach. The entrant enters and optimally sets a wholesale price which induces only one downstream firm to breach. This is because with (almost) perfect Bertrand competition downstream firms could only make very low profits if both breached the contract. Since only the breaching downstream firm obtains the input from the entrant at a low wholesale price, it can monopolize the downstream market. As a result, final consumer prices are higher than absent exclusive dealing. Hence, Simpson and Wickelgren (2007) find that exclusive contracts have either anticompetitive or neutral effects.

In contrast to their analysis, we show that for moderate degrees of downstream competition it is optimal for the entrant to induce not just a single downstream firm to breach the contract but *both*. For moderate degrees of competition, downstream firms can make sufficiently high profits when breaching and are therefore able to afford the damage payment to the incumbent, even if the other downstream firm breaches as well. The entrant prefers both downstream firms to breach instead of only one as it then receives a higher demand. However, to render breach of contract by both downstream firms profitable, the entrant must set its wholesale price lower than it would set it absent exclusive contracts. Therefore, for moderate degrees of downstream competition both downstream firms breach the contract and buy from the entrant at a lower wholesale price than absent exclusive dealing contracts. This leads to lower final consumer prices. As a consequence, the result that exclusive contracts are anticompetitive without efficiency gains reverses. Our analysis reveals that this procompetitive effect is more likely to occur, the larger the entrant's efficiency advantage is.[2]

The main effect at work in our model is similar to the one described by Aghion and Bolton (1987). They consider the case with a single buyer and allow the incumbent to set liquidated damages. Aghion and Bolton (1987) show that under these assumptions it is possible for the incumbent to induce the buyer to sign an exclusive contract. The buyer may breach the exclusive contract later on if the entrant is so efficient that it still finds it profitable to enter and set a sufficiently low wholesale price, which enables the buyer to pay the agreed upon liquidated damages to the incumbent. Our paper differs from the one by Aghion and Bolton (1987) in that we allow for downstream competition and consider expectation damages.[3] As we point out later, our assumptions are natural but make it more difficult to obtain the result that exclusive contracts have a competition enhancing effect. Nevertheless, we show that the result is present for a general class of demand functions, thereby complementing and extending the finding by Aghion and Bolton (1987).

Our result stands in stark contrast to the previous literature, which asserts that exclusive dealing has anticompetitive, or at best neutral effects, if no efficiencies are generated. As is well-known, “Chicago School” scholars (e.g., Bork, 1978, and Posner, 1976) argue for a neutral effect. They consider situations in which downstream firms are independent monopolists (or final consumers). As mentioned above, in this case the incumbent cannot compensate for signing exclusive contracts, given no efficiencies are generated. Rasmusen et al. (1991) and Segal and Whinston (2000) challenge this argument by pointing out that the entrant may not be able to reach minimum efficient scale when selling only to a fraction of downstream firms, implying that downstream firms exert a negative externality on each other when signing. The incumbent can induce the downstream firms to sign by exploiting this externality.[4]

Fumagalli and Motta (2006) analyze the case in which downstream firms are not independent monopolists but perfect Bertrand competitors and argue for a neutral effect. With perfect downstream competition the entrant needs to sell only to a single downstream firms to reach minimum efficient scale, which removes the negative externality that signing downstream firms exert on each other. To bring out this effect, Fumagalli and Motta (2006) assume that downstream firms face a fixed fee of being active in the downstream market. This implies that downstream firms who buy from the incumbent and have a high wholesale price stay inactive, which enables a downstream firm that buys from the entrant to earn high profits.[5] Abito and Wright (2008), Wright (2008), and Kitamura (2010) point out that a different picture emerges once the assumption on the fixed fee of being active is dropped. They show that it then becomes easier for the incumbent to induce downstream firms to sign if downstream competition increases. The reason is that signed downstream firms stay active, thereby

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[2] As shown by Mathewson and Winter (1987) and Bernheim and Whinston (1998) if two *incumbent* manufacturers compete for exclusive dealing contracts, the effects of these contracts can also be procompetitive. However, the mechanisms leading to these effects—that manufacturer competition for exclusive representation is tougher than standard competition, or that exclusive dealing reduces the incentive conflict of a risk-averse retailer—are different from the one identified in this paper, in which exclusive dealing can have procompetitive effects as it forces the entrant to set a lower wholesale price in order to render breach of contract profitable for the downstream firms.

[3] In addition, we allow the incumbent to set its wholesale prices after the number of signing downstream firms is determined and entry occurred, while Aghion and Bolton (1987) assume that the incumbent can commit to a wholesale price in the exclusive contract.

[4] Doganoglu and Wright (2010) show that a similar argument obtains with network effects among downstream firms, given that the incumbent is allowed to make discriminatory offers.

[5] As shown by Wright (2009), this argument holds for the case of linear wholesale prices but extends only partly to two-part tariffs.

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