Naked Exclusion by a Dominant Supplier: Exclusive Contracting and Loyalty Discounts

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Important Paper

• Shows that exclusion can be used to limit the expansion of a rival supplier, not just to prevent their entry.

• The argument does not depend on keeping a rival out by making it impossible for him to cover his entry costs since there are no entry costs.

• In practice this is (often) the relevant case.

• (Note, the argument doesn’t depend on coordination failure either.)
The Numerical Example

• Suppose R’s input more efficient than D’s for all users.
• But exogenously, R cannot offer exclusive dealing contracts.
• If R sells, the maximum profit earned is r-d (since B will price its product at 0). If D sells and offers exclusivity, the maximum price the product can sell at is d which may be greater than r-d.
• If so there are more rents if R sells and offers exclusive deals. These rents can be used to bribe the m downstream firms that can sell R’s input to accept exclusivity. They need only be paid (r-d)q each, so if (r-d)qm<bq, then exclusion is profitable.
The Main Model

• This example relies on R not being able to offer exclusive dealing contracts. The contribution of the paper is to show that this assumption can be dispensed with.

• The intuition is that D has another source of rents for bribes, and another reason to prevent R from entering, which is his “core” market. This core market is more valuable than R’s core market.
A more Symmetric Model

• The key is to introduce two market segments, one that prefers the D input and one that prefers the R input. Assume that downstream firms can, once they obtain input, sell to either type of customer (customer type can’t be verified by D or R).

• This means that if R’s input is sold at all, it could be used to compete on price on D’s “turf”, reducing D’s monopoly profits there.

• D therefore has a strong reason to prevent R from entering at all.
The exclusivity “battle”

- Equally, however, the model is symmetric in that R also has a strong reason to prevent D from entering his “turf”.

- Both D and R can offer exclusivity to try to prevent competition arising. But the size of the bribes that D is able to offer are smaller because:
  a) the rent that can be earned when D competes in R’s segment is smaller than the rent which can be earned when R competes in D’s segment (e.g., because the quantity demanded in D’s segment is greater).
  b) the number of downstream firms able to sell R’s product m may be smaller than the number f able to sell D’s product.
Anti-competitive exclusive payments need not push net prices below cost

• Each downstream firm must receive \((r-d)q\) - the maximum that it could make by selling into R’s core market in the case of competition - to get it to agree to exclusivity.

• Because with exclusion D’s prices will be at monopoly levels \(=d\), there is no particular reason why the provision of the above bribe should push D’s prices below marginal cost. Thus net prices need not be below cost for the exclusive contract to be anti-competitive.
Another nice feature of the model

Remark: No explicit penalty for breaching exclusivity once it is “agreed” is necessary. Instead, all that happens is that after a downstream firm reneges on the agreement is that the upstream firm reneged upon gets the chance to revise its prices.
Extending the model to deliver as promised (1)

Remark: In the main model, exclusion prevents \( R \) from selling at all. (Is it in fact true that there is no set of parameters for which competition emerges? Would \( D \) and \( R \) both benefit by agreeing exclusive territories for downstream firms instead of fighting for exclusivity?)

It's easy to fix this by introducing a third segment served by a distinct set of downstream firms serving strong customers with preferences for the rival's good. There is no need to exclude \( R \) from this segment because these downstream firms won't spoil \( D \)'s core market. Then \( D \) excludes only on the segment where downstream firms preferences are weaker.
Extending the model to deliver as promised (2)

- Alternatively, suppose the extra segment is served by the same set of downstream firms. If preferences for R are very strong, it is unprofitable to exclude R from this segment, so pure exclusive dealing contracts with the downstream firms are useless.

- But instead, partial exclusion via loyalty discounts (instead of exclusive deals) will be the most profitable choice for the incumbent. Downstream firms can make limited sales into the market which is most profitable for the R product, they won’t selling into D’s core market as they will lose their loyalty discount.
Extending the model to deliver as promised (3)

• So, so far either: exclusive dealing and positive sales arise only when the positive sales are to downstream firms that cannot sell into “core” markets (i.e., no substitutability in supply).

• Or, exclusive dealing does not arise but rather loyalty discounts.
Extending the Model - Suggestions

Q: Can you build a model of what is probably the most realistic case, where D signs exclusivity deals with some producers and not others in the same market?

• For example, D signs with “the most important” downstream firms. If downstream firms differ by capacity, then instead of offering loyalty discounts, it might work equally well to capture the largest downstream firms, because then a few R consumers can still be supplied through the smaller downstream firms, which is efficient.

• Which downstream firms will be offered exclusivity payments? Large, low cost ones?
Summary

• This paper makes an important step forward in understanding how exclusive dealing can be profitably used against an already present but smaller rival.

• But there is still more to understand:

• (Why) do we see exclusive dealing and positive sales for the non-excluding firm when markets are not segmented (downstream asymmetries)?

• If exclusive dealing were banned could any other instruments be used to the same effect?