LECTURE 12.5

CONTRACTING WITH

DISTRIBUTORS

CONTRACTING WITH DISTRIBUTORS

What is the optimal length of a contract?

- long term contracts provide incentives for relationship-specific investments

- but it is difficult to write and enforce long term contracts when there is substantial uncertainty

- use long term contracts when firm-specific investments are needed and the investment climate is stable

- vertical integration might be preferred if firm-specific investments are needed and the outlook is uncertain

CONTRACTING WITH DISTRIBUTORS

Similar issues apply in the firm's relationships with distributors.

- free rider problems

- double marginalisation

A distributor has an incentive to free ride on the efforts of the manufacturer

- advertising, service, sales effort

Potential solutions

- vertical integration

- partial vertical integration: e.g. the manufacturer takes over advertising

- exclusive territories: grant the distributor market power in a region to improve incentives – but this exacerbates double marginalisation.

DOUBLE MARGINALISATION

Suppose both manufacturer and distributor are monopolists

• each will charge a price above marginal costs

• industry profits are not maximised

• this is an example of an externality between distributor and manufacturer

• there is an incentive for firms to vertically integrate or use vertical restrictions

Example: AutoCorp is a monopolist with demand for cars:

$$P \ = \ 55000 \ - \ 100Q$$

AutoCorp has costs:

$$C(q) \ = \ 5000q$$

Suppose AutoCorp is both manufacturer and distributor.

• The profit maximising output and price are Q = 250, P = 30,000, and π = 6.25m.

DOUBLE MARGINALISATION

Suppose instead that AutoCorp sells vehicles through SUVMart:

- AutoCorp sets the wholesale price P_w

- SUVMart sets the retail price P

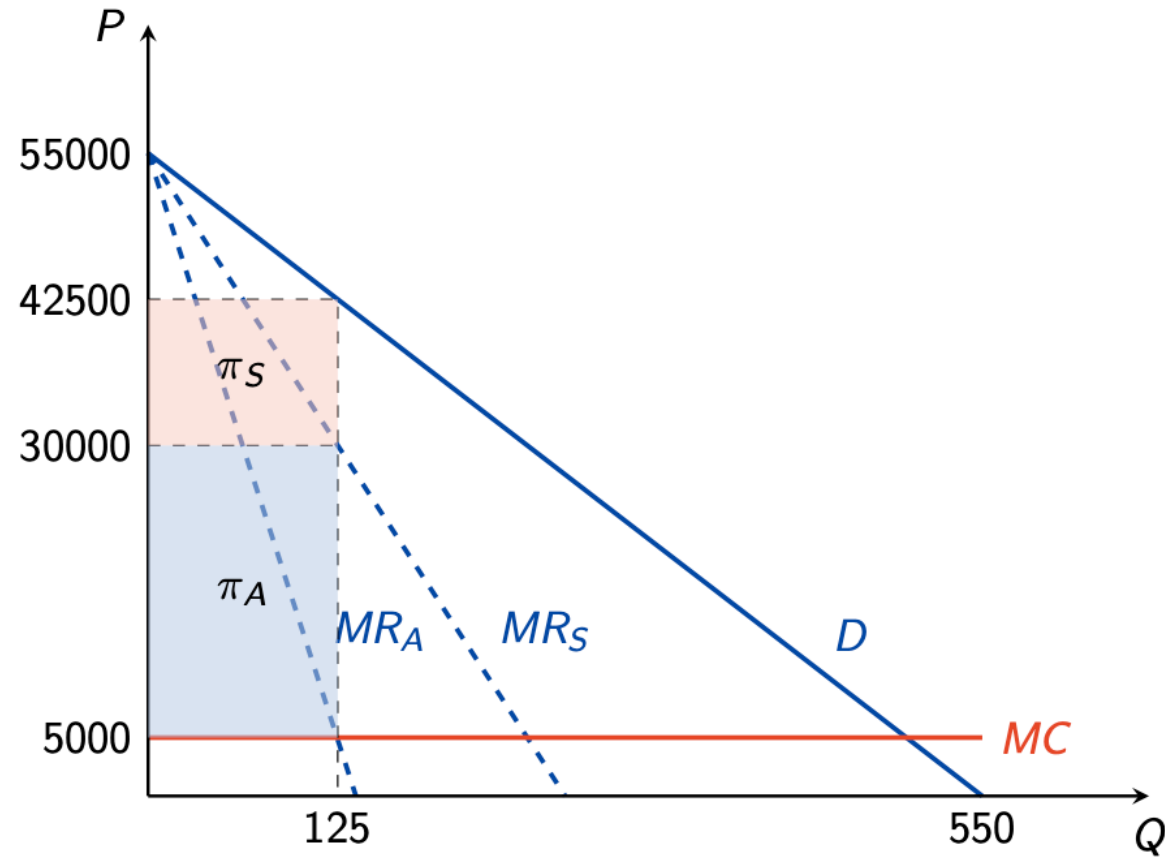SUVMart is a monopolist with marginal cost equal to P_w. They set MR = MC:

$$55000 - 200Q = P_W$$

This is the demand curve for AutoCorp. AutoCorp also sets MR = MC:

$$55000 - 400Q = 5000$$

This leads to prices and output of Q = 125, P_w = 30,000, P = 42,500, and profits for each firm of π_A = 3.125m, π_S = 1.5625m.

DOUBLE MARGINALISATION

DOUBLE MARGINALISATION

When AutoCorp sells directly to public they look at the demand curve for vehicles and choose price/ quantity to maximise profit.

When they sell via SUVMart, if they set the wholesale price equal to MC then SUVMart captures all the profits. To capture some of the profits AutoCorp increase the price at which they sell to SUVMart and in turn reduce the amount that SUVMart sells as the local monopolist.

- Total profits will be lower in the latter case

How to solve this problem?

It would be possible, for example, for AutoCorp to set a two part tariff

- For example, an upfront 'franchise fee' of $3.125m what would AutoCorp do?