Vertical Restrictions

Vertical restrictions: contractual restraints on nonprice terms (e.g. territories, inventory, minimum retail price);

- Approximates VI where costly / not feasible (e.g. Japanese and French firm)
- Local market conditions important

Incentives FOR vertical restrictions:

1) **Double monopoly markup** (successive monopolies)

* Graph *

- Manufacturers want to distribute product at lowest cost (think input)

  → Promote efficiency and/or raise profits

  VRs:

  - Maximum retail P (induce competition at distribution level)
  - Quantity forcing (sales quota: car dealers, computer retailers)
  - Franchise rights (2-part pricing)

2) **Free Riding** (firm benefits from action of another without paying for it)

Likely with hi expenditures by distributor on…

Showroom trained sales staff displays quality maintenance

advertising durable gds

Retailers: low effort if not compensated (e.g. Berkley electronics)

(Sell @ lower price w/o sales effort) (Klor's vs. Broadway-Hale)

VRs:

- Exclusive territories (create property right in sales effort: e.g. beer)
- RPM (50's-70's banned)
- Manufacturer advertises or pays for it (charges higher wholesale P)

Distributors: (using same retailer) (e.g. Sony and Panasonic)

Advertise, train, customer lists

VRs:

- Exclusive dealing (e.g.s Beauty Rest, beer)

Aside: Franchising (special vertical relationship)

Franchisor	→	Franchisee

(sells business format or right to brand name)

- Franchisor provides training and other assistance…
  Advice on purchasing Accounting Procedures
  Pricing Location Advertising
- Franchisor gets rapid growth, expansion and brand name reputation.

Mutually Beneficial Relationship

If not difficult to monitor, will own franchise outlet

However, if difficult to monitor → free riding on brand name…

Principal-agent problem: principal contracts w/agent to perform action in manner that principal can't fully control

Provide (franchise) w/incentives (residual claimancy)
Franchisee pays: fee + % sales (royalty) (sales vs. profits)

e.g.s McDonald's = \$45K + 12.5%
Taco Bell = \$45K + 5.5%
"7-11" = varies…
Subway = \$10K + 8%

- % sales also a check on franchisor (continues to monitor or fee falls)

Q: VR's desirable? Trade off

<u>Cons</u>: - Exclusive territories (limit competition, cartelize industry)
- Exclusive distribution (prevent entry)

<u>Pros</u>: - Lowers P's, encourage sales effort (raises services)

Perspective: e.g. camera, test drive car

Q: Ban them? VI, unless more expensive

Conclusion: consumers gain/lose (welfare effect, ambiguous)