Exclusivity Contracts, Insurance and Financial Market Foreclosure

C. Argenton & B. Willems

Discussion for the IDEI conference on Energy Markets

General Background

- This paper revisits the exclusive dealing debate with risk-averse buyers.
- Hot topic in energy on LT contract. Is it possible to justify those contracts by an insurance motive?
- The authors show that exclusivity clauses, although they induce efficient risk sharing, can foreclose entry on both the product market and the financial market.
- They show that with an insurance contract, the buyer may sign an exclusive contract at no cost for him so extract the incumbent rents. The insurers will then given up and the incumbent can seize a large share of the surplus.
- The "optimal solution" is to allow ex ante financial contract and prohibit exclusive dealing interim.

Framework

- Model à la Aghion-Bolton with
  1. the incumbent firm with known marginal cost c_I;
  2. A **risk-averse** buyer with known value for the good (1)
  3. A potential entrant with a marginal cost c_E unknown ex-ante.
- On top of adding risk-aversion for the buyer, the authors adds fringe consumers (to make the price in some situation) and financiers able to propose ex-ante financial forward contract.
- The timing is such that
  (1) pure insurance contracts are first available on financial markets,
  (2) the incumbent can sign specific contracts with the buyer
  (3) the entrant learn his cost and decide to compete or not.

Results

- Comparison of 3 situations:

1. **No contract:** the equilibrium price is only driven by a Bertrand Competition. The presence of financiers induces perfect insurance for the buyers + efficient entry.
2. **Exclusivity Contract:** this contract destroys any possibility of ex ante financial contract. Both the financial and the product market are foreclose but there is full insurance for the buyer.
3. **Financial Contract:** since the incumbent plays after the financial markets (competitive), he cannot propose any contract that will generated more utility for the buyer. We have here efficient entry and perfect insurance.

Rmk: If the financial markets do not exist, this financial contract (forward) is proposed by the incumbent but there is still efficient entry

Comments/Questions

- Very interesting paper dealing with an important and current debate : what is the value of LT contract? What is the cost/benefit analysis?
- It is quite intuitive that, when possible, insurance and production should be separated to avoid foreclusion. But,

1. the paper only deals with price risk whereas quantity risk is crucial.
   - The forward contract are only financial and not physical.
   - Many LT contract are signed to guarantee security of supply.
   - Extension with potential capacity constraints (cf Bolton-Whinston (RES 1993))
2. Not much is said on the investment issue.
   - To induce investment (upstream and downstream), we need long term views not only on price but also on quantity
   - Pure financial contract, either by the market or by the incumbent, would hardly give any real visibility

Comments/Questions

- When access to a scarce resource or facility is limited, the LT contract have a important role which goes beyond the pure assurance of price fluctuation.
- In the energy markets, it seems difficult to treat the exclusive dealing issue without keeping this aspect in mind.
- If one wants to avoid any need for exclusive dealing arrangement, it is necessary to increase the potential number of suppliers or the sensibility of final consumers to real prices.