Discussion: Multilateral Vertical Contraction with an Alternative Supplier

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Setting of the Model

- A dominant input supplier sells an input to a downstream duopoly market
  - e.g., a wholesaler sells a product to two competing retailers.
- Retailers have an outside option:
  - a perfectly substitutable input is available from a high cost rival wholesaler (an upstream fringe);
  - Retailers accept a contract with the dominant wholesaler only if the contract offers higher rents than can be earned by purchasing on the spot market from the fringe.

Contribution

- The model innovates from those in the contracts literature by considering an outside option for downstream firms:
  - This improves the bargaining position of downstream firms (rent distribution issue);
  - This can change the equilibrium outcome in a second-best contract setting.

The Main Result

- The presence of the outside option implies that nondiscrimination law can reduce the wholesale price below marginal cost
  - This restores the intended welfare implication
  - Potential competition from the fringe reverses the finding of Rey and Tirole (2003)

First-Best Contract Setting

- Optimal contract: monopoly wholesaler, no fringe, and duopoly retailers
  - exists a contract price, $w^* > c$, that induces retailers to set monopoly retail prices (p^*);
    - Lump-sum fee can be used to redistribute rents
- Optimal contract: dominant wholesaler, high-cost fringe, and duopoly retailers
  - precisely the same whenever $c' > w^* > c$
  - Additional provisions necessary when $c' \leq w^*$

Commitment problem

- Commitment problem with the (w,F) contract:
  - if a retailer refuses to sign the contract, the wholesaler has an incentive to later undercut the contract price, w*
- Contract forms that obtain the first-best:
  - RPM (per se illegal);
  - Quantity-forcing;
  - (w,F) contract combined with nondiscrimination law;
  - (w,F) contract combined with exclusive territories;
  - (w,F) contract combined with best-price provision.

Some things to consider…

- The dominant wholesaler-fringe context is interesting and relevant in a first-best contract framework
  - Application 1. Slotting allowances as a naked exclusionary device
    - If $c' \leq w^*$, then the retailer has an incentive to cut and run on the first-best optimal contract;
    - One way to resolve this problem is for the retailers to charge slotting fees to fringe suppliers (this raises c' to re-establish the fringe zero profit condition).

Other applications

- Applications to settings with differentiated upstream products (and multi-product retailing):
  - Private label vs. National brand
    - What is the effect of private label ownership structure on the optimal wholesale-retail contract?

Summary

- The model makes a nice contribution by considering 2x2 contracts
  - To sell the paper in the context of nondiscrimination law involves comparing Pareto-dominated contracts;
  - One approach is to examine first-best contracts that implicitly control the fringe;
    - Are there implementation constraints? If so, then we may observe below-cost pricing, even absent nondiscrimination law.
- There is a rich set of issues in the 2x2 context –many of which are highly relevant to agricultural markets;
  - The return to pressing forward with the analysis seems very high.