Exclusive Dealing and Large Distributors

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Abstract

This paper explores the effect of exclusive dealing with large distributors. We show that exclusive dealing contracts between incumbents deter the efficient entrants in the downstream. Moreover, we extend our model with an inefficient entrant in upstream. We show that it may decrease the possibility of exclusion. However, in this case, the efficient entrant manufacturer would be active in the market. This is the other source of inefficiency caused by the inefficient entry.

Key words: Exclusive Dealing, Entry Threat, Antitrust Policy

JEL Classification: D86, K21, L11, L13, L14, L42

Whether exclusive dealing contracts prevent efficient entries is one of the main issues in the economic literature on vertical restraints. Recently, Fumagalli and Motta (2006) and Simpson and Wickelgren (2007) extend this issue to the case when downstream buyers are competing, i.e. they are distributors.

This line of literature examines the case where one large incumbent producer is facing a potential efficient entrant. They implicitly assume that there are many small identical distributors in the downstream. Fumagalli and Motta (2006) show that when distributors are competing fiercely, exclusive dealing contracts between the incumbent and distributors may not deter the efficient entrant. This is the opposite result from Rasumsen et al. (1991) and Segal and Whinston (2000) both assuming downstream buyers are final consumers. In contrast, this paper explores the effect of exclusive dealing when distributors are large and have bargaining power over upstream firms. We show that when distributors are large, exclusive dealing contracts between incumbents deters the efficient entrant, even if they compete fiercely.

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In this paper, we propose a "large distributor model"; a model with a large incumbent in the downstream and a number of identical upstream firms. We examine the case where the dominant incumbent is facing an efficient entrant and it can employ exclusive dealing contracts to deter the rival. We also extend our model with an inefficient entrant in the upstream. We explore the role of the inefficient entry in the upstream and show that it may decrease the possibility of agreement of exclusive dealing contract. However, with fully signed exclusive contracts, the efficient entrant distributor has no other choice of buying from the inefficient producer to enter the market. And sometimes they can enter the market with relatively lower integrated cost than incumbents. This is the other source of inefficiency caused by the inefficient entry.

In this paper, we show that when large distributors have strong bargaining power over their suppliers, exclusive dealing contracts can be effective for entry deterrence. This result has implications for competition policy. When concentration among distributors is strengthened in an industry, the incumbent may prevent a price cutting new distributor's entry by contracting with all upstream firms exclusively. This would happen certainly than entry prevention of efficient producers. In addition, the entry in the upstream can make the exclusion unfeasible. Thus, by promotion of entry in the upstream, even if entrants are less efficient than incumbents, the efficient entry in the downstream would be promoted.