# Chapter 19: Nonprice Vertical Restraints

## Learning Objectives

Students should learn to:

1. Differentiate between exclusive selling and exclusive territories and will be able to explain motivations for each.
2. Explain why exclusive dealing may lead to reduced wholesale competition.
3. Explain the advantages and disadvantages of franchising versus ownership for an upstream firm.
4. Understand that there are efficient, pro-competitive reasons for vertical restraints as well as anti-competitive ones and that we can test empirically for which effects dominate

## Suggested Lecture Outline:

Spend one fifty-minute long lecture on this chapter

## Lecture 1:

1. Exclusive territories and exclusive selling
2. Exclusive dealing
3. Franchising and divisionalization
4. Public policies towards nonprice vertical restraints
5. Review the Sass (2005) study of the U.S. beer industry

## Suggestions for the Instructor:

1. It is useful to point out that exclusive territories usually come with three things: implicit bilateral monopoly, the potential for free-riding, and two-part tariffs with the resulting franchise fees.
2. Be sure to point out that exclusive dealers leave the “non-favored” competitive retailer out in the cold.
3. A discussion of the potential conflicts for a car dealer who carries both Nissan and Mercury is a good way to motivate why manufacturers like exclusive dealing. Another example would be the shoe store that carries both a high priced brand and a lower priced knockoff with a higher margin for the store.
4. In discussing franchising the McDonald’s example is an excellent introduction since one can use it to cover retail service, double marginalization (if too much monopoly power is given to the franchisee), spatial variety and/or location, asymmetric information about the cost of operating a franchise, etc

## Solutions to End of the Chapter Problems:

### Problem 1

Exclusive dealing may result in efficient market outcomes while it may result in limited competition among both retailers and manufacturers. If the supermarkets offer products from all beer companies, there may be fierce price competition between the beer companies to compete for sales. While this would be good for consumers, it would lessen the profits of both the beer companies and the supermarket retailers. Exclusive dealing with the supermarkets could soften the effects of interbrand competition.

**Problem 2**

The practice puts the automakers in a "prisoners' dilemma' situation, each matching each others model in a product line, and thus helping the consumers more than the automakers.

**Problem 3**

This practice offers some benefits, such as optimal level of advertising at the dealer level. The practice, however, reduces both *intrabrand* and *interbrand* competitions, which results in a significant loss in consumer surplus. Under most situations, this practice should be illegal.

**Problem 4**

Exclusive dealing prevents the entrant from taking advantage of its scale economies, and thus, it may prevent entry.

**Problem 5**

The franchisees are paying for the right to use the McDonald's name and reputation. Some customers will choose to buy the product from the franchisee based on the national reputation of McDonald's as compared to the same basic product offered under a local name.

**Problem 6**

The outlet on the turnpike will pay more since many of its customers will be one-time visitors who cannot independently verify the quality of the product. They will visit a McDonald's based on previous experience. A local resident may choose to visit the restaurant in the center of town and check it out, knowing that they can return if it is good and inexpensive and that they can avoid it if it is bad. The locals can also ask neighbors about the local restaurant while the interstate traveler has only a Travel Guide (if they are lucky) to consult.

**Problem 7**

They want to insure quality and consistency in the product so that consumer demand will remain strong and the quality reputation of a McDonald's hamburger will remain high. This will encourage potential franchisees in other towns to consider opening a McDonald's. The point is to ensure uniform quality and gain from the positive externality of knowing that other McDonald's will have same quality. This may also be a way to increase profits through tie-in sales.