Chapter 16, 17 & 18: Vertical relations

A **vertical merger** is a strategic merger to be as cost-saving as possible and to let the costs of the rival rise. It is a merger between two vertical related firms; they operate at different stages of the same product line.

A vertical relationship between two monopolists results in a loss in economic efficiency. This is called the problem of double marginalization. Integrating the two monopoly firms together eliminates this problem and leads to an increase in consumer surplus and total profit is also increased. More goods are now sold at a lower price.

However, the vertical merger can also lead to an upstream or downstream company that can deny rivals and competitors in the market. This leads to the possibility of **market foreclosure**. The vertical merger can also be used to price discriminate. It is very hard to detect which direction is more likely to happen.

Downstream firms that are forecloses may also have the incentive to react to integrated rivals by merging with an upstream firm itself. When vertical integration has a business advantage then all firms will have the incentive to do that.

When products are differentiated the process is more difficult. In order to understand the strategic aspects of this vertical merger, a four-stage game is developed.

- In stage 1, the downstream (D1) firm decides whether it will merge with an upstream firm (U1) or not.
- In stage 2, prices are set. When there is no merger than the firm competes in prices. When the two firms have merged to firm F1, it has two choices: foreclosure or set an upper bound on the input price.
- In the third stage (only when the firms have merged in stage 2), firms U2 and D2 decide whether to merge or not.
- In this last fourth stage, downstream prices are set given the input prices and organizational structures that have been determined in the previous cases.

A **conglomerate merger** is a merger that can allow a firm to diversify risk by evening out fluctuations in income. It is a merger of firms whose products are neither direct substitutes nor complements.

Conglomerate mergers are mergers that raise the fewest problems from an antitrust perspective. But it is very difficult for the government to identify the motivation for such a merger. They are often used to minimize risk for either stockholders or managers. Research has shown that the incentive of the CEO to merge increases when its proportion invested in the firm rises.

From the past we have seen that vertical merges have led to significant increases in monopoly power. It would lead to greater production efficiency and lower prices for consumers.

A manufacturer relies on retailers to get the good on the market. The manufactures hopes that the retailers tell them what they think is the appropriate price for consumers. However, retailers do not share their information often with the manufacturer. Double-marginalization leads to different interests between manufacturers and retailers.

But these differences can be solved by contractual agreements. However, one thing to note is that such agreements can also lead to price collusion among manufacturers or retailers.

Public policy regarding vertical restraints is complicated. One type of vertical restraint is a **RPM agreement** or resale price maintenance. These agreements specify a maximum price above which a retailer may not charge or a minimum price so that the retailer cannot discount.

An RPM agreement with a minimum price becomes more necessary when the downstream market becomes more competitive. RPM agreements may lead to an increase in consumer surplus. This is because the price under such an agreement is lower than the price without the agreement. RPM ´s suppress retail competition.

In the past, RPM agreements were seen as illegal. Nowadays these agreements are subjected to more flexible rules. It is still illegal but it may become legal when it is reasonably justified. They have changed these rules because without RPM agreements there would be large double-marginalization problems.

The contracts between manufacturers and retailers consist of a variety of non-price restrictions. Some examples of non-price restrictions are:

- **Exclusive dealing restriction.** This prevents the retailer from selling products of another manufacturer. It may only sell products of the specific manufacturer.

- **Slotting fees**. Fees that producers must pay for access to the retail distribution.

These restrictions are a restraint on trade and therefore they are seen as anticompetitive. There is a fear that the restrictions are used to eliminate competition. However, these restrictions may lead to efficiency gains. It can also be useful in creating an environment for retailers to better handle shocks of the demand.

Governments now have seen that there are some potential benefits due to empirical research. The view of public policy towards these restrictions has therefore improved.

The retailer acts as an agent for the manufacturer. The agent learns everything about the taste of consumers, makes promotion decisions and sets the final price to consumers. The agent sets the final price because he has the most knowledge about the consumers. This vertical relationship between manufacturer and retailer can be seen as a **principal-agent relationship**.