ECO 650: Firms' Strategies and Markets

Vertical Relationships and Bargaining(II)

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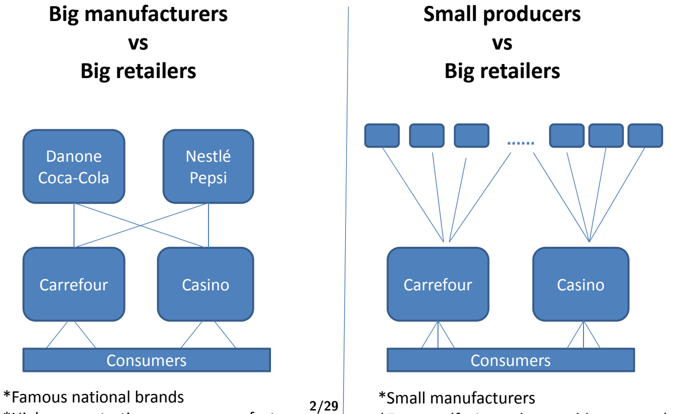
Buying power of retailers

A retailer is an intermediary: he buys products to suppliers and resells them to consumers.

The high concentration on the retail market ⇒ buying power towards suppliers: heterogenous balance of power!!



Sources of buyer power

- Buyer size (larger discount?...)
- Gatekeeper positions (local monopoly on a market)
- Constrained capacity shelves space
- Outside options
  - Number of alternative suppliers vs alternative retailers. OECD (1998): "*Retailer A has buyer power over supplier B if a decision to delist B's product could cause A's profit to decline by 0.1% and B's to decline by 10%.*"
  - How differentiated ? Loyalty to the brand vs loyalty to the store; A survey by INSEE, 1997: When the favorite brand is not in its favorite store's shelves: 56% of consumers choose another brand, 24% will buy it later and 20% buy it in another store.
  - Private labels (since 70s): products sold under retailer's own brand

Consequences of Buyer Power: Potential Harms and Benefits

- Potential harms: Hold-up effect (reduction of inevtsements), Exit of small suppliers in situation of economic dependence (reduction of variety,...).
- Benefit: A monopolist may prefer dealing with several retailers, and thus favor competition, to obtain higher profits.

Methodological tool:Bargaining

- Bargaining: situation in which at least two players have a common interest to cooperate, but have conflicting interests over exactly how to co-operate.
- How to share a pie? Depends on:
  - The number of negotiators;
  - Each negotiator's "ability to negotiate", or "bargaining power";
  - Each negotiator's "outside option".
- "Bargaining theory with Applications", Muthoo (2004).

The Nash program (1950,1953)

- A bargaining problem with two players
- A vector $x = (x_1, x_2) \in \mathbb{R}^2$; x_i is the allocation of player i.
- A threat point $\underline{x} = (\underline{x}_1, \underline{x}_2) \in \mathbb{R}^2$;
- Players utility function $U_i(x)$.
- F is the set of feasible allocations;
  $F \bigcap \{(x_1, x_2) \in \mathbb{R}^2 : x_1 \geq \underline{x}_1, x_2 \geq \underline{x}_2\}$ is nonempty and bounded.

Theorem

The Nash Bargaining Solution x^* satisfies:

$$x^* \in \underset{x \in F}{argmax} (U_1(x_1) - U_1(\underline{x}_1))(U_2(x_2) - U_2(\underline{x}_2))$$

Five axioms

- Strong Pareto Optimality: the solution has to be realizable and Pareto optimal.
- Individual rationality: No player can have less than his outside option, otherwise he will not accept the “agreement”.
- Invariance by an affine transformation: The result does not depend on the representation of (Von Neumann Morgenstern) utility functions.
- Independence of Irrelevant Alternatives: Eliminating alternatives that would not have been chosen, without changing the outside option, will not change the solution.
- Symmetry: Symmetric players receive symmetric payoffs.

Extension: The Nash bargaining solution with asymmetry

Assume that the players have different bargaining powers, say α and $1-\alpha$.

The Nash bargaining solution can be extended to that situation. It is the unique Pareto-optimal vector that satisfies:

$$x^* \in \underset{x \in F}{argmax} (U_1(x_1) - U_1(\underline{x}_1))^{\alpha} (U_2(x_2) - U_2(\underline{x}_2))^{1-\alpha}$$

Split-The-Difference-Rule

- Let V denote the cake to be shared such that $x_1 = V - x_2$,
- $U_i(x_i) = x_i$ (Risk neutral); $(\alpha, 1-\alpha)$ the bargaining powers.

The Nash bargaining solution (x_1^N, x_2^N) is:

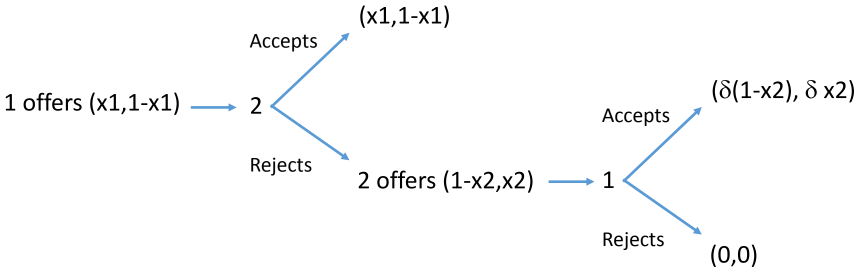
$$x_1^N = \underline{x}_1 + \alpha(V - \underline{x}_1 - \underline{x}_2)$$

$$x_2^N = \underline{x}_2 + (1-\alpha)(V - \underline{x}_1 - \underline{x}_2)$$

The Rubinstein (1982) bargaining model

- Two players, 1 and 2, have to reach an agreement on the partition of a pie of size 1.
- Each of them has to make in turn a proposal as to how it should be divided:
  - At each period, one offer is made;
  - They alternate making offers.
  - Player 1 makes the first offer.
- Finite number T of periods.
- There is a discount factor δ by period.

The Rubinstein (1982) game for $T = 2$



Resolution of the Rubinstein game

- Assume $T = 2$; in the second period, there is an equilibrium where 1 accepts any nonnegative offer by 2; 2 thus offers $(0, 1)$ (or $(\varepsilon, 1 - \varepsilon)$ to select equilibria); in period 1, 1 offers $(1 - \delta, \delta)$ and 2 accepts.
- Assume $T = 3$; in the third period, 1 makes the last offer and 2 accepts any nonnegative offer; 1 thus offers $(1, 0)$; in period 2, 2 offers $(\delta, 1 - \delta)$ and 1 accepts; in period 1, 1 offers $(1 - \delta(1 - \delta), \delta(1 - \delta))$ and 2 accepts.
- By iteration, there is an equilibrium where 1 offers in the first period $(x_1 = 1 - \delta + ... + (-1)^{T-1}\delta^{T-1}, 1 - x_1)$.

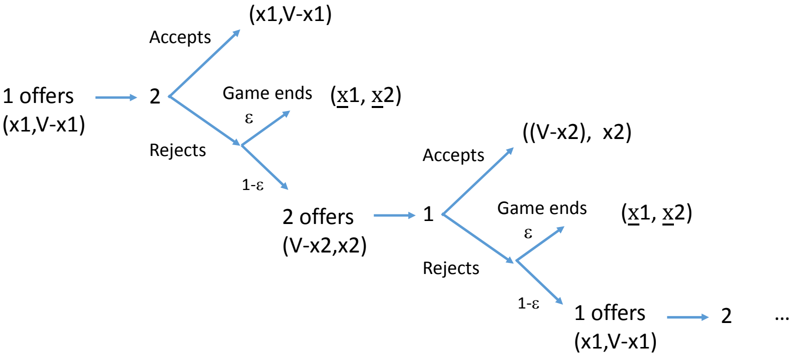
Solution of the Rubinstein game

- At the limit, when $T \to +\infty$, the sharing of the pie is $(x_1 = \frac{1}{1+\delta}, 1 - x_1)$;
- Impatience is the driving force that leads to an agreement, and it increases the power of the first player:
  - When the two players are infinitely patient, their situations become symmetric: when $T \to +\infty$ and $\delta = 1$, the sharing of the pie is $(\frac{1}{2}, \frac{1}{2})$;
  - When the two players are infinitely impatient, player 1 gets the whole pie: when $T \to +\infty$ and $\delta = 0$, the sharing of the pie is $(1, 0)$.

The Binmore-Rubinstein-Wolinsky (1986) bargaining model

- Two players 1 and 2 want to share a “pie" of value V
- Outside option: player i has a utility $\underline{x}_i$ if negotiation breaks, where $\underline{x}_1 + \underline{x}_2 < V$;
- Players alternate making the same offers 1 offers $(x_1, V - x_1)$ and 2 offers $(V - x_2, x_2)$;
- Infinite horizon; each time an offer is rejected, there is an exogenous risk of breakdown (end of the game) with a probability ε (no discounting).

Binmore-Rubinstein-Wolinsky (1986) game



Binmore-Rubinstein-Wolinsky (1986): results

- Any subgame perfect equilibrium involves player i indifferent between accepting or rejecting the offer of player j.

$$V - x_1^* = \epsilon \underline{x}_1 + (1-\epsilon) x_2^*$$

$$V - x_2^* = \epsilon \underline{x}_2 + (1-\epsilon) x_1^*$$

- The solution satisfies:

$$x_i^* = \underline{x}_i + \frac{1}{2-\epsilon}(V - \underline{x}_1 - \underline{x}_2)$$

- If both firms have the same bargaining power ($\epsilon \to 0, \alpha = 1/2$), in equilibrium, equal sharing of the surplus: $(\underline{x}_1 + \frac{V - \underline{x}_1 - \underline{x}_2}{2}; \underline{x}_2 + \frac{V - \underline{x}_1 - \underline{x}_2}{2})$. This is the symmetric Nash bargaining solution.
- If $\epsilon \to 1$, the player that plays first has all the power and the other player gets its disagreement payoff.

The hold-up Problem

Assumptions

Asset specificity: An investment brings more value when used by a particular buyer (matching, compatibility,...)

- An upstream seller S can produce a unit of good at cost $C(I)$.
- By investing I the unit cost decreases $C'(I) < 0$ but at a decreasing rate $C''(I) > 0$.
- We assume that the investment I is "specific":
  - The cost is $C(I)$ if S makes a deal with a "specific" buyer B.
  - The cost is $C(\lambda I)$ if S makes a deal with any other buyers with $\lambda \in [0, 1]$.
  - λ is the degree of specificity of the investment for B with a complete specificity when $\lambda = 0$ and no specificity when $\lambda = 1$.

The hold-up Problem

Assumptions

Incomplete contracts: Contracts cannot be written ex ante, i.e. before the investment decision is taken

- Irrespective of the buyer, an agreement between S and a buyer brings a value V.
- Formally we have a sequential stage game :
  1. An upstream seller S chooses its investment level I. Once the investment is realized, it is sunk.
  2. S bargains with B, following a Nash bargaining, over a contract T.

Bargaining stage

Following a Nash bargaining :

$$\underset{T}{Max}[V - T][T - C(I) - (V - C(\lambda I))]$$

is equivalent to the split-the-difference-rule:

$$V - T = T - C(I) - (V - C(\lambda I)) \Rightarrow T = V + \frac{C(I) - C(\lambda I)}{2}$$

In stage 2, the profit of the buyer is

$$\Pi_B = \frac{C(\lambda I) - C(I)}{2}.$$

Π_B increases if λ decreases, i.e. as the specificity of the investment increases.

The profit of the seller is

$$\Pi_S = V - (\frac{C(I) + C(\lambda I)}{2}) - I$$

decreases with the specificity of the investment.

Investment stage

The seller maximizes its profit with respect to I

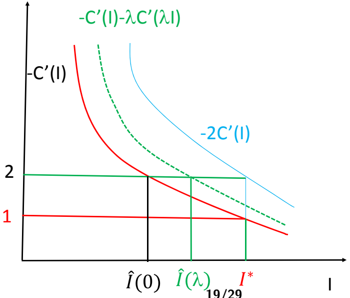
$$\underset{I}{Max}\, V - (\frac{C(I) + C(\lambda I)}{2}) - I$$

The FOC is:

$$-C'(I) - \lambda C'(\lambda I) = 2$$

The FOC of an integrated firm is:

$$-C'(I) = 1$$



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Remember

- Investments in specific assets and incomplete contracts may generate hold-up, i.e. under-investment!
- The hold-up effect is stronger as the specificity of investment increases.
- Vertical integration is a solution to hold-up.

Bargaining power within a vertical Chain

- One of the main source of power is the number of alternative suppliers vs retailers.
- Bargaining power in a chain of monopolies: Exercise 1.
- Bargaining power in a vertical chain with downstream competition

Exercise 1

Assumptions:

- A manufacturer produces a good at a unit cost c.
- A retailer faces a demand $D(p) = 1 - p$.
- The game:
  1. The manufacturer and the retailer bargain over a two-part tariff contract (w, F);
  2. The retailer sets a final price p to consumers.

Questions:

1. Given the contract (w, F), determine the optimal price set by the retailer in stage 2. Determine the stage-2 equilibrium profits of firms $\pi_U(w) + F$ and $\pi_D(w) - F$.
2. Write down the Nash program and determine the optimal contract (w, F). Is it efficient?
3. Assume now that the retailer can access another supply source at marginal cost $\bar{c} > c$ (competitive fringe). What is the outside option profit of the retailer $\bar{\Pi}$? How does it affect the bargaining?

Bargaining with downstream competitors

Assumptions:

- U offers a good at a unit cost c.
- D_1 and D_2 are two downstream firms that compete à la Cournot.
- Demand is $P = 1 - q_1 - q_2$.
- The game is a follows:
  1. U and each D_i bargain over a two-part tariff contract (w_i, T_i).
  2. Each D_i chooses its quantity q_i.
- The Nash bargaining takes place simultaneously and secretly. In case of a breakdown in one bargaining, the link is broken forever and the remaining pair renegotiates. (Stole and Zwiebel, 1996)
- We consider an asymmetric Nash bargaining framework with a parameter $(\alpha, 1-\alpha)$.

Second stage game

- If the two firms have accepted their contract. Firm i chooses q_i to maximize $\underset{q_i}{max}(1 - q_i - q_j - w_i)q_i - F_i$ anticipating $\hat{q}_j$. Best reaction functions are:

$$q_i(\hat{q}_j) = \frac{1 - \hat{q}_j - w_i}{2}$$

for $i = 1, 2$. $\pi_i = \frac{(1-w_i)^2 - \hat{q}_j^2}{4} - F_i$;
$\pi_U = \frac{(w_i - c)(1 - w_i - \hat{q}_j)}{2} + F_i + \frac{(w_j - c)(1 - w_j - \hat{q}_i)}{2} + F_j$

- If only one firm i has accepted the contract (w_i, F_i), firm i chooses q_i to maximize $\underset{q_i}{max}(1 - q_i - w_i)q_i - F_i$ with respect to q_i and therefore $q_i^s = \frac{1-w_i}{2}$. $\pi_i^s = \frac{(1-w_i)^2}{4} - F_i$ and $\pi_U^s = \frac{(w_i - c)(1 - w_i)}{2} + F_i$

Bargaining stage

- In case of a breakdown with one pair, the remaining pair maximizes:

$$\max_{(w_i,F_i)} (\pi_i^s)^{(1-\alpha)}(\pi_U^s)^{\alpha}$$

$$\max_{(w_i,F_i)} (1-\alpha)ln(\pi_i^s) + \alpha ln(\pi_U^s)$$

Deriving and rearranging, we obtain

$$(1-\alpha)\pi_U^s = \alpha\pi_i^s \quad (1)$$

$$(1-\alpha)\frac{\frac{\partial\pi_i^s}{\partial w_i}}{\pi_i^s} + \alpha\frac{\frac{\partial\pi_U^s}{\partial w_i}}{\pi_U^s} = 0 \quad (2)$$

Plugging (5) into (6), we obtain $\frac{\partial\pi_i^s + \partial\pi_U^s}{\partial w_i} = 0$ which gives $w^s = c$, $\pi_i^s = \frac{(1-c)^2}{4} - F_i = \pi^M - F_i$. and then:

$$\alpha(\pi^M - F_i) = (1-\alpha)F_i \Rightarrow F^s = \alpha\pi^M$$

The profit of the upstream firm is: $\pi_U^s = F^s = \alpha\pi^M$

- Absent any breakdown, a pair maximizes:

$$\max_{(w_i,F_i)} \pi_i^{(1-\alpha)}(\pi_U - \pi_U^s)^\alpha$$

$$\max_{(w_i,F_i)} (1-\alpha)ln(\pi_i) + \alpha ln(\pi_U - \pi_U^s)$$

Deriving and rearranging, we obtain:

$$\begin{aligned} (1-\alpha)(\pi_U - \alpha\pi^M) &= \alpha\pi_i & (3) \\ (1-\alpha)\frac{\frac{\partial\pi_i}{\partial w_i}}{\pi_i} + \alpha\frac{\frac{\partial\pi_U}{\partial w_i}}{\pi_U - \pi_U^s} &= 0 & (4) \end{aligned}$$

Plugging (7) into (8), we obtain $\frac{\partial\pi_i + \partial\pi_U}{\partial w_i} = 0$ which gives $w_i = w_j = c$ (Opportunism). Therefore, equilibrium quantities are $q_i = q_j = q^C = \frac{1-c}{3}$. Therefore, the equilibrium profit $\pi_i = \frac{(1-c)^2}{9} - F_i = \pi_i^C - F_i$ and plugging into (7), we obtain: $(1-\alpha)(2F_i - \alpha\pi^M) = (-F_i + \pi_i^C)\alpha \Rightarrow F_i = \frac{\alpha}{2-\alpha}(\pi_i^C + (1-\alpha)\pi^M)$

When does the bargaining succeeds?

The bargaining succeeds as soon as U gets more profit negotiating with the two firms than with only one.

- If U negotiated with only one firm, U gets a share α of the monopoly profit, i.e. $\pi_U^s = \alpha\pi^M$.
- If U negotiates with two firms, the industry profit to share is the Cournot profit (lower than the monopoly profit) but U may obtain higher profit by using each D_i as an outside option in its bargaining with the rival.
- Formally, we compare profits in the two cases

$$\frac{2\alpha}{2-\alpha}(\pi_i^C + (1-\alpha)\pi^M) > \alpha\pi^M$$

$$\Rightarrow 2\pi_i^C > \alpha\pi^M \Rightarrow \alpha < \frac{2\pi_i^C}{\pi^M} = \frac{8}{9}$$

Remember

- The relative outside options are key to determine the sharing of profits within the channel.
- Despite, the opportunism problem, a firm might prefer bargaining with two retailers to obtain a higher share of a lower cake (Cournot instead of monopoly profit)
- The above result holds as long as downstream competition is not too strong. It would not hold in a Bertrand competition framework.

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