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The Choice of Exclusive Dealing: Economic Rationales and Evidence from French Retail Chains☆

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Abstract

As one of the most common business practices in retailing, exclusive dealing (ED) restrictions are of great importance for business participants, academics and policy makers. Despite the rich theoretical analysis of this type of vertical restraint, evidence on the rationales of ED remains scarce. This paper uses a simple model to survey the vast theoretical literature on ED, and identifies two opposing motivations for ED contracts: anti-competitive versus efficiency-enhancing motivations. The theoretical predictions are subject to empirical investigation using unique French cross-sectional data encompassing diverse retail sectors. Our estimations provide evidence for both types of motivations for ED contracts, manifesting in different contexts. In particular, we find that the efficiency-enhancing motivation is more likely to explain the choice of ED when suppliers are less concentrated, whereas the anti-competitive motivation is present in highly standardized product markets. Moreover, our results reveal a positive linkage of ED and different types of investments, as part of branding strategy, with important retailing and marketing-related implications. In particular, we show that retailers have to be meticulous regarding the conditions of the retail contract before accepting the ED restriction, which may dampen their business efficiency in the long run.

Keywords: Exclusive dealing; Retail contract; Vertical restraints; Brand strategy

Introduction

Exclusive dealing (ED) clauses, which restrict a signed retailer to purchase only from a particular supplier (hereafter called the “focal firm”), are one of the most common business practices in retailing. Owing to it being an important type of contract, ED is receiving great attention from business participants, academics and policy makers. Regarding anti-trust regulation on ED clauses, a long-standing view according to the courts is that ED can serve anti-competitive purposes. However, under some circumstances, ED has been proved to be efficiency enhancing and is therefore exempt from regulation. This is the case in the European legal environment, which allows manufacturers a large amount of flexibility to impose ED on retailers (Lafontaine and Slade 2012).

The resulting policy controversy has sparked a large volume of theoretical analysis regarding the rationales for ED. Indeed, there has been a lot of theoretical work leading to two dominant and opposing explanations for ED contracts: ED may be used for anti-competitive purpose (e.g., Aghion and Bolton 1987; Jing and Winter 2014; Rasmusen, Ramseyer, and Wiley 1991, etc.) or for efficiency enhancing motivation (e.g., Besanko and Perry 1993; Marvel 1982; Masten and Snyder 1993, etc.). However, there is still little empirical work that comprehensively tests these explanations and establishes which has greater empirical support. Several recent empirical investigations (e.g., Asker 2016; Ater 2015, etc.) address the welfare effects of ED to pro-

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vide insights for the purposes of implementation of competition policies. However, the evidence remains limited to a specific sector.

This paper is one of the first empirical studies of motivations for ED encompassing diverse distribution channels. Our primary goal is to empirically test extant theoretical explanations, and to show which holds in French retailing in order to better understand the nature of such contracts and the retailing or marketing-related implications. In particular, our rich data contain detailed information about industry features and contract specifications. They allow us to identify different competition and investment natures in the relationship between suppliers and retailers. Estimating two-stage probit least squares models we control for the potential endogeneity bias, and for the influence of other vertical restraints in the contract, namely exclusive territories. Finally, we take into account the potential impact of the focal firm's location, which is also new in the empirical literature on ED.

While most of the existing work focuses on the welfare impact of ED, our paper has specific implications for retail management and scholarship. Indeed, our estimations provide evidence for both types of motivations for ED contracts, manifesting in different contexts. In particular, we find a positive linkage of ED with different types of investments, as part of the branding strategy of the focal firm. Some types of investment practices, for example, initial training provided by the focal firm, may benefit the entire distribution channel, and hence, be efficiency-enhancing. However, practices such as the definition of the assortment of stores by the focal firm may create additional costs for the retailers when dealing with the competing suppliers. This is especially the case in markets where the product is highly standardized, which involves a high level of inter-brand competition for the retailers, favorable to the anti-competitive motive of ED. For this reason, our study implies that retailers have to be meticulous regarding the conditions of the retail contract before accepting an ED restriction.

The remainder of this paper is organized as follows. Section "Theoretical Motivations and Hypotheses" surveys the theoretical literature, using a simple model to organize the prior arguments. We also provide a review of the extant evidence on the theories of ED. Section "Empirical Specifications" presents empirical specifications regarding the French retail system, the sample and the study variables. Section "Empirical Determinants of Exclusive Dealing" contains the estimations. The implications and concluding comments are presented in Section "Conclusion".

Theoretical Motivations and Hypotheses

The rationales for ED have been extensively discussed in the theoretical literature. The center of the economic arguments is whether ED is strategically used to deter efficient entry (anti-competitive motives) or to foster the investment of the vertical related parties (efficiency-enhancing motive). The literature shows that these diverse motives depend on the industrial structure as well as the nature of the investments. In this section, we use a simple framework to summarize the main arguments within the existing literature of ED.

The Basic Setting

We start with a simple vertical structure employed in the standard ED literature, where, at the supplier level, a focal firm (denoted firm A) and a representative competitor (denoted B) compete in supplying their products to a representative retailer (denoted R). The market structure is depicted in Appendix A.

The focal firm A can propose an ED contract to R, which prevents R from dealing with suppliers B. We denote by Π_A^{NoED} and Π_R^{NoED}, the respective profits of the A and R in the case where there is no ED contract and by Π_A^{ED} and Π_R^{ED}, their profits under the ED contract. The two parties A and R will find it profitable to conclude an ED contract only if they can realize a joint profit higher than the case without the ED contract. That is, $\Pi_A^{ED} + \Pi_R^{ED} \geq \Pi_A^{NoED} + \Pi_R^{NoED}$. Or equivalently,

$$\Pi_A^{ED} - \Pi_A^{NoED} \geq \Pi_R^{NoED} - \Pi_R^{ED} \tag{1}$$

The motivation for using ED, thus stems from condition (1): ED is likely to be signed either because it increases the focal firm gain or because it reduces the retailer's loss from not dealing with other suppliers.

The Chicago School critique, led by Bork (1978) and Posner (1976), highlights that if competitor B is more efficient than the focal firm A, it is not possible for the focal firm to preclude the competitor with ED. However, this argument has been challenged over the last three decades. A large volume of literature has argued that ED can be used strategically to deter efficient entry (Aghion and Bolton 1987; Jing and Winter 2014; Rasmusen, Ramseyer, and Wiley 1991, etc.). As we shall see in the following subsection, the likelihood of ED occurring depends on how the competition at the supplier level and the retailing level affects the profits of the contracting parties (Π_A^{NoED}, Π_R^{NoED}, Π_A^{ED} and Π_R^{ED}).

Likelihood of Exclusive Dealing and Market Structure

In this section, to understand the motives of ED relating to the market structure, we focus on the case where competitor B is more efficient than the focal firm A. To be consistent with the literature (Fumagalli and Motta 2006; Rasmusen, Ramseyer, and Wiley 1991; Segal and Whinston 2000a, etc.), we assume that A and B provide a homogeneous product. Thus, without ED, the competition drives A out of the market ($\Pi_A^{NoED} = 0$). The ED constraint thus becomes:

$$\Pi_A^{ED} + \Pi_R^{ED} \geq \Pi_R^{NoED} \tag{2}$$

Consider first the supplier competition, that is, the inter-brand competition. In a framework where the incumbent supplier A can merge with the competing supplier B, Fumagalli, Motta, and Persson (2009) suggest that the retailer R, expecting weak competition between A and B, is more likely to accept the ED offer proposed by A. Moreover, the bigger the focal firm A, the more profit it can create with the retailer under the ED contract.