Stylized Scenario: Providing Dealer Insurance and Incentives

Consider an environment of business uncertainty. Retail markets are constantly buffeted by fluctuations in demand and costs. Consequently, retail profits become uncertain. The manufacturer has to come up with schemes, such as RPM or competition among retailers or exclusive territories (ET), that provide some insurance to retailers without distorting their incentives to engage in promotional efforts. Consider these three schemes in turn (competition, RPM and ET) under cost and demand uncertainty.[20]

(1) Under the manufacturer-induced *competition among dealers* scheme, each dealer faces the residual demand curve (i.e., the market demand shared with other dealers). Under the scheme of competition among retailers, the dealers are fully insured against both cost and demand fluctuations. Why? Any demand or cost change that hits one dealer, indirectly affects his rivals in a similar way. In this view, all the retailers respond in tandem (such as raising the price when the cost rises). Retailers are insured against demand and cost fluctuations. Moreover, competition has desirable properties, as it can also be seen as a device that is compatible with dealers' incentives to engage in promotional efforts.

(2) Under *RPM*, in the form of a fixed price, the price does not adjust to either changes in costs or demand. RPM and dealer competition schemes are equally profitable for the manufacturer when dealers face demand uncertainty. However, in the face of cost shocks, RPM does poorly because it introduces price rigidity. In this regard, RPM fares worse than dealer competition and *exclusive territory* schemes.

(3) Let us compare RPM and ET. From the point of view of the manufacturer, ET is superior to RPM under cost uncertainty because ET does not inhibit price adjustment to changes in cost. However, when retailers are risk averse and care about the level of retail profits, RPM is better than ET under demand uncertainty. As demand fluctuates, the manufacturer can adjust the wholesale price and the retailer can maintain the posted retail price and its profit. Thus, RPM preserves incentives for a retailer to engage in product promotion and service. In this situation, RPM can provide some income stability in the face of market fluctuations.[21]

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[20] P. Rey and J. Tirole, "The Logic of Vertical Restraints", *American Economic Review*, (76) December 1986: 921-39.

[21] *Ibid.*