

Stylized Scenario: Preserving Brand Reputation

Frequently the dealer can affect consumers' valuation of the overall quality or brand image of the good. Products and brand names sold in well laid out and customer friendly stores at premium locations often carry an image of superior quality. An individual dealer can contribute to a brand's reputation which is likely to bring repeat business. Higher demand may also spill over to other dealers selling the same well recognized brand name. However, dealers tend to undersupply quality efforts by using fewer inputs than optimal.

(1) To coax dealers to bring forth the optimal level of reputation enhancing effort, in addition to *RPM*, the manufacturer can *impose quality standards on dealer performance*. For instance, many franchise arrangements have minimum quality standards built in their contracts.

Stylized Scenario: Picking Dealers

The manufacturer's profits typically vary with the number of dealers. A large number of dealers may have negative effects, as the competition among dealers could result in discount pricing and reduced dealer services. On the other hand, a manufacturer may benefit from having multiple retailers.

First, multiple dealers increase intrabrand competition, which serves to limit the markup of the final price over marginal cost and hence confers some vertical control to the manufacturer. Second, when dealers differ by the quality of services they provide, an increase in their number tends to stimulate demand for the manufacturer's output. Third, consumers may be heterogeneous. Having retailers located at different points in the geographical or quality spectrum enables a manufacturer to better appropriate their surplus. Fourth, having multiple dealers allows the manufacturer to develop a benchmark against which to measure any one dealer's performance.

To get the desired number of retailers, the manufacturer can consider a range of vertical restraints.

(1) The manufacturer can choose the number of dealers by simply *refusing to deal* with more than a set number of downstream firms.

(2) The manufacturer can choose the number of retailers either directly, or indirectly by setting the *franchise fee* (the number of retailers is determined by the last franchisee who merely breaks even). The higher the fixed franchise fee, the lower the number of retailers who can afford to enter the market.