excess of its marginal cost (MC) of production. The competition among retailers drives the final market price paid by consumers to an equality with retailer marginal cost (which is WP). This scheme allows the manufacturer to appropriate all of the profits from the sale of the good and economic efficiency is achieved. This outcome obtains, provided the input bought from the manufacturer is not substitutable.

In contrast, when input substitution is possible, setting WP any higher than MC will not only erode the dealer margin in the first instance, but also motivate the dealer to search for alternatives. The input substitution possibilities introduce increased intrabrand competition in the final market that may reduce overall upstream industry profits.

Let us consider the role of vertical restraints in a few stylized situations.

Stylized Scenario: Surplus Extraction

Consider a business circumstance where either the retailer does not capture the consumer surplus fully or the retailer does not pass on a desired share of its profit to the manufacturer. The manufacturer can use vertical restraints as described below and target either the consumer or retailer surplus.

(1) The manufacturer can impose *a resale price floor*, whereby WP is set at his MC level and then a franchise fee is set to appropriate any dealer surplus.

(2) Another way for the manufacturer to get at consumer surplus in different geographical markets is to eliminate intrabrand competition through the assignment of *exclusive territories*. By placing territorial customer resale restraints on his dealers, the manufacturer can facilitate geographic price discrimination. If territorial restrictions can be enforced, then hauling goods from higher priced locations to lower priced areas can be checked and profitable price discrimination can be practised. The manufacturer can induce optimal price discrimination by setting all the wholesale prices equal to marginal cost.

(3) Alternatively, the use of a system of *resale price maintenance* under which the maintained price varies across regions would also achieve the desired downstream geographic discrimination.

Stylized Scenario: Retail Margins and Raising Promotional Effort

It is commonplace that product promotion results in increased consumer demand and higher sales. The retailer is often recognized to be the better agent to deliver the promotional