Long Term Contracts as Barriers to Entry

Comments made by David S. Sibley, University of Texas at Austin, at the DOJ/FTC Hearings on Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy, May 14, 2002.

The argument that long term contracts can be anti-competitive has been around ever since the United Shoe case and, until fairly recently, has been viewed skeptically by economists and lawyers. To the notion that long term contracts exclude competitors, Posner, Bork and others have replied that a customer would hardly be willing to sign a long term contract with a monopolist unless he got at least as good a deal as he would by not signing, and waiting around for whatever new entry might bring. In economic terms, the long- term contract must be individually rational for the buyer to sign. Since the seminal 1987 paper by Aghion and Bolton, however, economists have considered another element in the story. By locking himself into a long- term contract with the seller, a buyer reduces the size of a potential entrant's market, thereby reducing the probability of entry. As a result, other buyers will have to accept a higher price. The seller can exploit this negative externality between buyers to extract consumer surplus from the others. In other words, there is more to the story than individual rationality, stressed by Bork and Posner. One must also take into account the externality effect of one buyer's signing on the likelihood that other buyers will face a competitive alternative.

Aghion and Bolton were the first to point this out and analyzed the implications of externalities between buyers under the assumption that the long- term contract was of a

liquidated damages type. This type of contract is only partly exclusionary, since a sufficiently efficient entrant can always set a price low enough to allow the buyer to pay the liquidated damages if he or she switches to the new supplier. A more recent paper, by Segal and Whinston, extends the analysis in other directions assuming that the seller can monitor and enforce a completely exclusionary contract. A simple example based on their paper might runs as follows. Suppose that there are 15 total buyers and that an incumbent monopolist can earn a profit of $3 if there is no entry. The monopolist is currently protected by a patent, but that patent will expire in one period. If there is entry after the patent expires, each buyer can gain $5. However, due to fixed costs of post-patent entry, if the incumbent signs 5 or more customers to a long- term contract, post-patent entry will be unprofitable; if fewer than 5 are signed up, entry will occur with certainty after one period. Will exclusion be profitable for the incumbent monopolist? If the incumbent signs up 5 buyers, it excludes entry, but from Bork and Posner's individual rationality requirement we know that the seller will have to discount the monopoly price by $5 in order to get anyone to sign a long- term contract. Having signed up these five buyers and excluded entry, the incumbent can charge the monopoly price to the ten remaining buyers and earn a profit of $3 on each. Net profit to the seller is $20 (15x$3 – 5x$5), so exclusion is profitable. To see that it is not always profitable, note that if it takes 11 customers to exclude entry, then the profits to exclusion are minus $10. Simple as it is, this example illustrates the impact of the buyer-to-buyer externality: the five buyers that sign the long term contract with the incumbent are individually rational to do so, satisfying the Bork and Posner requirement. However, buy signing, they help the

incumbent to exclude post patent entry and cost the other 10 buyers $5 each. Overall, consumer welfare goes down by $25 due to the long term contract.

References

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