

# Two-Part Tariffs versus Linear Pricing Between Manufacturers and Retailers : Empirical Tests on Differentiated Products Markets

Céline Bonnet\*, Pierre Dubois† Michel Simioni‡

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*Comments Welcome.*

## Résumé

We present a methodology allowing to introduce manufacturers and retailers vertical contracting in their pricing strategies on a differentiated product market. We consider in particular two types of non linear pricing relationships, one where resale price maintenance is used with two part tariffs contracts and one where no resale price maintenance is allowed in two part tariffs contracts. Our contribution allows to recover price-cost margins at the manufacturer and retailer levels from estimates of demand parameters. The methodology allows then to test between different hypothesis on the contracting and pricing relationships between manufacturers and retailers in the supermarket industry using exogenous variables supposed to shift the marginal costs of production and distribution. We apply empirically this method to study the market for retailing bottled water in France. Our empirical evidence shows that manufacturers and retailers use non linear pricing contracts and in particular two part tariffs contracts with resale price maintenance.

**Key words :** vertical contracts, two part tariffs, double marginalization, collusion, competition, manufacturers, retailers, differentiated products, water, non nested tests.

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\*University of Toulouse (INRA, GREMAQ)

†University of Toulouse (INRA, IDEI) and CEPR

‡University of Toulouse (INRA, IDEI)

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# 1 Introduction

Vertical relationships between manufacturers and retailers seem to be more and more important in the competition analysis of the supermarket industry and in particular in food retailing. Issues related to market power on some consumption goods markets necessarily involve the analysis of competition between producers but also between retailers and the whole structure of the industry. Consumer welfare depends crucially on these strategic vertical relationships and the competition or collusion degree of manufacturers and retailers. The aim of this paper is thus to develop a methodology allowing to estimate alternative structural models where the role of manufacturers and retailers is explicit. Previous work on these issues generally does not account for the behavior of retailers in the manufacturers pricing strategies. One of the reasons is that the data used for these studies are generally demand side data where only retail prices are observed. Information on wholesale prices and marginal costs of production or distributions are generally difficult to obtain. Following Rosse (1970), researchers have thus tried to develop methodologies allowing to estimate price-cost margins that are necessary for market power analysis and policy simulations, using only data on the demand side, i.e. sales quantities, market shares and retail prices. The new literature on empirical industrial organization brought new methods to address this question with the estimation of structural models of competition on differentiated products markets such as cars, computers, and breakfast cereals (see, for example, Berry, 1994, Berry, Levinsohn and Pakes, 1995, and Nevo, 1998, 2000, 2001, Ivaldi and Verboven, 2001). Until recently, most papers in this literature assume that manufacturers set prices and that retailers act as neutral pass-through intermediaries or that they were charging exogenous constant margins. The strategic role of retailers has been emphasized only recently in the empirical economics and marketing literatures. Actually, Goldberg and Verboven (2001), Mortimer (2004), Sudhir (2001), Berto Villas Boas (2004) or Villas-Boas and Zhao (2004) introduce retailers' strategic behavior. For instance, Sudhir (2001) considers the strategic interactions between manufacturers and a single retailer on a local market but focuses exclusively on a linear pricing model leading to double margi-

nalization. These recent developments that introduce retailers' strategic behavior consider mostly cases where competition between producers and/or retailers remains under linear pricing. Berto Villas-Boas (2004) extends the Sudhir's framework to multiple retailers and considers the possibility that vertical contracts between manufacturers and retailers make pricing strategies depart from double marginalization by setting alternatively wholesale margins or retail margins to zero. Using recent theoretical developments due to Rey and Vergé (2004) characterizing pricing equilibria in the case of competition under non linear pricing between manufacturers and retailers (namely two part tariffs with or without resale price maintenance), we extend the analysis taking into account vertical contracts between manufacturers and retailers.

We present how to test across different hypothesis on the strategic relationships between manufacturers and retailers in the supermarket industry and in particular how one can test whether manufacturers use two part tariffs contracts with retailers. We consider several alternative models of competition and exchange between manufacturers and retailers on a differentiated product market and test between these alternatives. In particular, we consider two types of non linear pricing relationships, one where resale price maintenance is used with two part tariffs contracts and one where no resale price maintenance is allowed in two part tariffs (Rey and Vergé, 2004). Modelling explicitly optimal two part tariffs contracts (with or without resale price maintenance) allows to recover the pricing strategy of manufacturers and retailers and thus the different price-cost margins. The price-cost margins are expressed as functions of demand parameters. The estimated values of these demand parameters allow to recover price-cost margins at the manufacturer and retailer level using only data on the demand side, i.e. without observing wholesale prices. Using non nested test procedures, we then show how to test between the different models using exogenous variables that are supposed to shift the marginal costs of production and distribution.

We apply this methodology to study the market for retailing bottled water in France. The paper thus presents the first formal empirical tests of whether or not manufacturers

use non linear contracts, and, in particular, two-part tariffs contracts with retailers. Our empirical evidence shows that, in the French bottled water market, manufacturers and retailers use non linear pricing contracts and in particular two part tariffs contracts with resale price maintenance.

In section 2, we first present some stylized facts on the market for bottled water in France, an industry where the questions of vertical relationships and competition of manufacturers and retailers seem worth studying. Section 3 presents the main methodological contribution on the supply side. We show how price-cost margins can be recovered with demand parameters, in particular when taking explicitly into account two part tariffs contracts. Section 4 presents the demand model, its identification and the estimation method proposed as well as the testing method between the different models. Section 5 presents the empirical results. A conclusion with future research directions is proposed in section 6, and some appendices follow.

## **2 Stylized Facts on the Market for Bottled Water in France**

The French market for bottled water is one of the more dynamic sector of the French food processing industry : the total production of bottled water has increased by 4% in 2000, and its turnover by 8%. Some 85% of French consumers drink bottled water, and over two thirds of French bottled water drinkers drink it more than once a day, a proportion exceeded only in Germany. The French bottled water sector is a highly concentrated sector, the first three main manufacturers (Nestlé Waters, Danone, and Castel) sharing 90% of the total production of the sector. Moreover, given the rarity of natural springs, entry both for mineral or spring water is rather difficult in this market where there exist some natural capacity constraints. Compte, Jenny and Rey (2002) comment on the Nestlé/Perrier Merger case that took place in the beginning of 90's in Europe and point out that these capacity constraint are a factor of collusion by themselves in addition to the high concentration of the sector. This sector can be divided in two major segments : mineral water and spring water. Natural mineral water benefits some properties favorable to health, which are officially recognized. Composition must be guaranteed as well as the

consistency of a set of qualitative criteria : mineral content, visual aspects, and taste. The mineral water can be marketed if it receives an agreement from the French Ministry of Health. The exploitation of a spring water source requires only a license provided by local authorities (*Prefectures*) and a favorable opinion of the local health committee. Moreover, the water composition is not required to be constant. The differences between the quality requirements involved in the certification of the two kinds of bottled water may explain part of the large difference that exists between the shelf prices of the national mineral water brands and the local spring water brands. Moreover, national mineral water brands are highly advertised. The bottled water products use mainly two kinds of differentiation. The first kind of differentiation stems from the mineral composition, that is the mineral salts content, and the second from the brand image conveyed through advertising. Actually, thanks to data at the aggregate level (Agreste, 1999, 2000, 2002) on food industries and the bottled water industry, one can remark (see the following Table) that this industry uses much more advertising than other food industries. Friberg and Ganslandt (2003) also report a high advertising to revenue ratio for the same industry in Sweden, i.e., 6.8% over the 1998-2001 period. For comparison, the highest advertising to revenue ratio in the US food processing industry corresponds to the ready-to-eat breakfast cereal industry and is of 10.8%. These figures may be interpreted as showing the importance of horizontal differentiation of products for bottled water.

Year	Bottled Water		All Food Industries	
	<i>PCM</i>	Advertising/Revenue	<i>PCM</i>	Advertising/Revenue
1998	17.38%	12.09%	6.32%	5.57%
1999	16.70%	14.91%	6.29%	6.81%
2000	13.61%	15.89%	3.40%	8.76%

Table : Aggregate Estimates of Margins and Advertising to Sales Ratios.

These aggregate data also allow to compute some accounting price-cost margin<sup>1</sup> defined as value added<sup>2</sup> (*VA*) minus payroll (*PR*) and advertising expenses (*AD*) divided by the value of shipments (*TR*). As emphasized by Nevo (2001), these accounting estimates can

<sup>1</sup>The underlying assumptions in the definition of these price-cost margins are that the marginal cost is constant and is equal to the average variable cost (see Liebowitz, 1982).

<sup>2</sup>Value added is defined as the value of shipments plus services rendered minus cost of materials, supplies and containers, fuel, and purchased electrical energy.

be considered as an upper bound to the true price-cost margins.

Recently, the degradation of the distribution network of tap water has led to an increase of bottled water consumption. This increase benefited to the cheapest bottled water, that is to the local spring water. For instance, the total volume of local spring water sold in 2000 reached closely the total volume of mineral water sold the same year. Households buy bottled water mostly in supermarkets : some 80% of the total sales of bottled water comes from supermarkets. Moreover, on average, these sales represent 1.7% of the total turnover of supermarkets, the bottled water shelf being one of the most productive. French bottled water manufacturers thus deal mainly their brands through retailing chains. These chains are also highly concentrated, the market share of the first five accounting for 80.7% of total food product sales. Moreover, these late years, like other processed food products, these chains have developed private labels to attract consumers. The increase in the number of private labels tends to be accompanied by a reduction of the market shares of the main national brands.

We thus face a relatively concentrated market for which the questions of whether or not producers may exert bargaining power in their strategic relationships with retailers is important. The study of competition issues and evaluation of markups, which is crucial for consumer welfare, has then to take into account the possibility that non linear pricing may be used between manufacturers and retailers. Two part tariffs are typically relatively simple contracts that may allow manufacturers to benefit from their bargaining position in selling national brands. Therefore, we study in the next section different alternative models of strategic relationships between multiple manufacturers and multiple retailers that are worth considering.

### **3 Competition and Vertical Relationships Between Manufacturers and Retailers**

Before presenting our demand model, we present now the modelling of the competition and vertical relationships between manufacturers and retailers. Given the structure of the bottled water industry and the retail industry in France, we consider several oligopoly

models with different vertical relationships that seem to deserve particular attention. More precisely, we show how each supply model can be solved to obtain an expression for both the retailer's and manufacturer's price-cost margins just as a function of demand side parameters. Then using estimates of a differentiated products demand model, we will be able to estimate empirically these price-cost margins and we will show how we can test between these competing scenarios. A similar methodology has been used already for double marginalization scenarios considered below by Sudhir (2001) or Brenkers and Verboven (2004) or Berto Villas-Boas (2004) but none of the papers in this literature already considered the particular case of competition in two part tariffs as in Rey and Vergé (2004).

Let's first introduce the notations. There are  $J$  differentiated products defined by the couple product-retailer corresponding to  $J'$  national brands and  $J - J'$  private labels. There are  $F$  manufacturers and  $R$  retailers. We denote by  $S_r$  the set of products sold by retailer  $r$  and by  $F_f$  the set of products produced by firm  $f$ . In the following we present successively the different oligopoly models that we want to study.

### 3.1 Linear Pricing and Double Marginalization

In this model, except for private labels, the manufacturers set their prices first, and retailers follow, setting the retail prices given the wholesale prices. For private label products, prices are chosen by the retailer himself who acts as doing both manufacturing and retailing. Thus, suppose there are  $R$  retailers competing in the retail market and that there are  $F$  manufacturers competing in the wholesale market. We consider that competition is *à la* Nash-Bertrand. We solve this vertical model by backward induction considering the retailer's problem. The profit  $\Pi^r$  of retailer  $r$  in a given period (we drop the time subscript  $t$  for ease of presentation) is given by

$$\Pi^r = \sum_{j \in S_r} (p_j - w_j - c_j) s_j(p) M$$

where  $p_j$  is the retail price of product  $j$  sold by retailer  $r$ ,  $w_j$  is the wholesale price paid by retailer  $r$  for product  $j$ ,  $c_j$  is the retailer's (constant) marginal cost of product  $j$ ,  $s_j(p)$  is the market share of product  $j$ ,  $p$  is the vector of all products retail prices and  $M$  is the

size of the market. Assuming that a pure-strategy Bertrand-Nash equilibrium in prices exists and that equilibrium prices are strictly positive, the price of any brand  $j$  sold by retailer  $r$  must satisfy the first-order condition

$$s_j + \sum_{k \in S_r} (p_k - w_k - c_k) \frac{\partial s_k}{\partial p_j} = 0, \quad \text{for all } j \in S_r. \quad (1)$$

Now, we define  $I_r$  (of size  $(J \times J)$ ) as the ownership matrix of the retailer  $r$  that is diagonal and whose elements  $I_r(j, j)$  are equal to 1 if the retailer  $r$  sells products  $j$  and zero otherwise. Let  $S_p$  be the market shares response matrix to retailer prices, containing the first derivatives of all market shares with respect to all retail prices, i.e.

$$S_p \equiv \begin{pmatrix} \frac{\partial s_1}{\partial p_1} & \cdots & \frac{\partial s_J}{\partial p_1} \\ \vdots & & \vdots \\ \frac{\partial s_1}{\partial p_J} & \cdots & \frac{\partial s_J}{\partial p_J} \end{pmatrix}$$

In vector notation, the first order condition (1) implies that the vector  $\gamma$  of retailer  $r$ 's margins, i.e. the retail price  $p$  minus the wholesale price  $w$  minus the marginal cost of production  $c$ , is<sup>3</sup>

$$\gamma \equiv p - w - c = -(I_r \times S_p \times I_r)^{-1} \times I_r \times s(p) \quad (2)$$

Remark that for private label products, this price-cost margin is in fact the total price cost margin  $p - \mu - c$  which amounts to replace the wholesale price  $w$  by the marginal cost of production  $\mu$  in this formula.

Concerning the manufacturers' behavior, we also assume that each manufacturer maximizes his profit choosing the wholesale prices  $w_j$  of the product  $j$  he sells and given the retailers' response (1). The profit of manufacturer  $f$  is given by

$$\Pi^f = \sum_{j \in F_f} (w_j - \mu_j) s_j(p(w)) M$$

where  $\mu_j$  is the manufacturer's (constant) marginal cost of production of product  $j$ . Assuming the existence of a pure strategy Bertrand-Nash equilibrium in wholesale prices between manufacturers, the first order conditions are

$$s_j + \sum_{k \in F_f} \sum_{l=1, \dots, J} (w_k - \mu_k) \frac{\partial s_k}{\partial p_l} \frac{\partial p_l}{\partial w_j} = 0, \quad \text{for all } j \in F_f. \quad (3)$$

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<sup>3</sup>Remark that in all the following, when we use the inverse of non invertible matrices, it means that we consider the matrix of generalized inverse which means that for example  $\begin{bmatrix} 2 & 0 \\ 0 & 0 \end{bmatrix}^{-1} = \begin{bmatrix} 1/2 & 0 \\ 0 & 0 \end{bmatrix}$ .

Consider  $I_f$  the ownership matrix of manufacturer  $f$  that is diagonal and whose element  $I_f(j, j)$  is equal to one if  $j$  is produced by the manufacturer  $f$  and zero otherwise. We introduce  $P_w$  the  $(J \times J)$  matrix of retail prices responses to wholesale prices, containing the first derivatives of the  $J$  retail prices  $p$  with respect to the  $J'$  wholesale prices  $w$ .

$$P_w \equiv \begin{pmatrix} \frac{\partial p_1}{\partial w_1} & \dots & \frac{\partial p_{J'}}{\partial w_{J'}} & \dots & \frac{\partial p_J}{\partial w_1} \\ \vdots & & \vdots & & \vdots \\ \frac{\partial p_1}{\partial w_{J'}} & \dots & \frac{\partial p_{J'}}{\partial w_{J'}} & \dots & \frac{\partial p_J}{\partial w_{J'}} \\ 0 & \dots & 0 & \dots & 0 \\ 0 & \dots & 0 & \dots & 0 \end{pmatrix}$$

Remark that the last  $J - J'$  lines of this matrix are zero because they correspond to private labels products for which wholesale prices have no meaning.

Then, we can write the first order conditions (3) in matrix form and the vector of manufacturer's margins is<sup>4</sup>

$$\Gamma \equiv w - \mu = -(I_f \times P_w \times S_p \times I_f)^{-1} \times I_f \times s(p) \quad (4)$$

The first derivatives of retail prices with respect to wholesale prices depend on the strategic interactions between manufacturers and retailers. Let's assume that the manufacturers set the wholesale prices and retailers follow, setting the retail prices given the wholesale prices. Therefore,  $P_w$  can be deduced from the differentiation of the retailer's first order conditions (1) with respect to wholesale price, i.e. for  $j \in S_r$  and  $k = 1, \dots, J'$

$$\sum_{l=1, \dots, J} \frac{\partial s_j(p)}{\partial p_l} \frac{\partial p_l}{\partial w_j} - \frac{\partial s_k(p)}{\partial p_j} + \sum_{l \in S_r} \frac{\partial s_l(p)}{\partial p_j} \frac{\partial p_l}{\partial w_k} + \sum_{l \in S_r} (p_l - w_l - c_l) \sum_{s=1, \dots, J} \frac{\partial^2 s_l(p)}{\partial p_j \partial p_s} \frac{\partial p_s}{\partial w_k} = 0 \quad (5)$$

Defining  $S_p^{pj}$  the  $(J \times J)$  matrix of the second derivatives of the market shares with respect to retail prices whose element  $(l, k)$  is  $\frac{\partial^2 s_k}{\partial p_j \partial p_l}$ , i.e.

$$S_p^{pj} \equiv \begin{pmatrix} \frac{\partial^2 s_1}{\partial p_1 \partial p_j} & \dots & \frac{\partial^2 s_{J'}}{\partial p_1 \partial p_j} \\ \vdots & & \vdots \\ \frac{\partial^2 s_1}{\partial p_{J'} \partial p_j} & \dots & \frac{\partial^2 s_{J'}}{\partial p_{J'} \partial p_j} \end{pmatrix}$$

We can write equation (5) in matrix form<sup>5</sup> :

$$P_w = I_r \times S_p \times [S_p \times I_r + I_r \times S_p' \times I_r + (S_p^{p1} \times I_r \times \gamma | \dots | S_p^{pJ} \times I_r \times \gamma) \times I_r]^{-1} \quad (6)$$

<sup>4</sup>Rows of this vector that correspond to private labels are zero.

<sup>5</sup>We use the notation  $(a|b)$  for horizontal concatenation for vectors (or matrices)  $a$  and  $b$ .

where  $\gamma = p - w - c$ . Equation (6) shows that one can express the manufacturer's price cost margins vector  $\Gamma = w - \mu$  as depending on the function  $s(p)$  by replacing the expression (6) for  $P_w$  in (4).

The expression (6) comes from the assumption that manufacturers act as Stackelberg leaders in the vertical relationships with retailers. In the case where we would assume that retailers and manufacturers set simultaneously their prices, we assume like Sudhir (2001) that only the direct effect of wholesale price on retail price matter through. Thus, the retailer input cost is accounted for in the retailer's choice of margin. In this case, the matrix  $P_w$  has to be equal to the following diagonal matrix

$$\begin{pmatrix} 1 & 0 & .. & .. & 0 \\ 0 & \ddots & \ddots & \ddots & \vdots \\ \vdots & \ddots & 1 & \ddots & \vdots \\ \vdots & .. & .. & 0 & 0 \\ 0 & .. & .. & 0 & 0 \end{pmatrix}$$

Then, again one can compute the price-cost margins of the retailer and the manufacturer under this assumption.

We can also consider the model where retailers and/or manufacturers collude perfectly just by modifying the ownership matrices. In the case of perfect price collusion between retailers, instead of using the ownership matrices  $I_r$  for each retailers in (2) one can get the price cost margins of the retail industry by replacing  $I_r$  in (2) by the identity matrix (the situation being equivalent to a retailer in monopoly situation). Similarly, one can get the price-cost margins vector of manufacturers in the case of perfect collusion by replacing the ownership matrix  $I_f$  in (4) by a diagonal matrix where diagonal elements are equal to one except for private labels goods.

Finally, one can also consider the case of a monopoly and we simply need to consider the joint maximization of profits of all retailers and manufacturers which amounts to maximize

$$\sum_{j=1, \dots, J} (p_j - \mu_j - c_j) s_j(p) M$$

Therefore, the price-cost margins of the full vertically and horizontally integrated structure

can be expressed as (retail price minus both marginal costs denoted  $\gamma + \Gamma$ )

$$\gamma + \Gamma = p - \mu - c = -S_p^{-1} \times s(p) \quad (7)$$

### 3.2 Two-Part Tariffs

We now consider the case where manufacturers and retailers can sign two-part tariffs contracts. We assume that manufacturers have all the bargaining power. To prove the existence and characterize equilibria in this multiple common agency game is difficult. We could assume the existence of symmetric subgame perfect Nash equilibria but Rey and Vergé (2004) prove that some equilibrium exists under some assumptions on the game played. Actually, assume that manufacturers and retailers play the following game. First, manufacturers simultaneously propose two-part tariffs contracts to each retailer. These contracts consist in the specification of franchise fees and wholesale prices but also on retail prices in the case where manufacturers can use resale price maintenance. Thus we assume that, for each product, manufacturers propose the contractual terms to retailers and then, retailers simultaneously accept or reject the offers that are public information. If one offer is rejected, then all contracts are refused<sup>6</sup>. If all offers have been accepted, the retailers simultaneously set their retail prices, demands and contracts are satisfied. Rey and Vergé (2004) showed (in the two manufacturers - two retailers case) that there exist some equilibria to this (double) common agency game provided some conditions on elasticities of demand and on the shape of profit functions are satisfied<sup>7</sup>. Rey and Vergé (2004) show that it is always a dominant strategy for manufacturers to set retail prices in their contracting relationship with retailers. Moreover, with resale price maintenance, the manufacturer can always replicate the retail price that would emerge and the profit it would earn without resale price maintenance. We also consider the case where resale price maintenance would not be used by manufacturers because in some contexts, like in

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<sup>6</sup>This assumption is strong but it happens that the characterization of equilibria in the opposite case is very difficult (see Rey and Vergé, 2004). However, this assumption means that we should observe all manufacturers trading with all retailers, which is the case for bottled water in France.

<sup>7</sup>These technical assumptions require that direct price effects dominate in demand elasticities such that if all prices increase, demand decreases. The empirical estimation of demand will confirm that this is the case for bottled water in France. Also it has to be that the monopoly profit function of the industry has to be single peaked as well as manufacturers revenue functions of the wholesale price vector.

France, resale price maintenance may be forbidden and manufacturers thus prefer not to use it.

In the case of these two part tariffs contracts, the profit function of retailer  $r$  is :

$$\Pi^r = \sum_{s \in S_r} [M(p_s - w_s - c_s)s_s(p) - F_s] \quad (8)$$

where  $F_s$  is the franchise paid by the retailer for selling product  $s$ .

Manufacturers set their wholesale prices to  $w_k$  and the franchise fees  $F_k$  and choose the retail's prices in order to maximize profits which is for firm  $f$  equal to

$$\Pi^f = \sum_{k \in F_f} [M(w_k - \mu_k)s_k(p) + F_k] \quad (9)$$

subject to the retailers' participation constraints  $\Pi^r \geq 0$ , for all  $r = 1, \dots, R$ .

Since the participation constraints are clearly binding (Rey and Vergé, 2004) and manufacturers choose the fixed fees  $F_k$  given the ones of the other manufacturers, one can replace the expressions of the franchise fee  $F_k$  of the binding participation constraint (8) into the manufacturer's profit (9) and obtain the following profit for firm  $f$  (see details in appendix 7.1)

$$\sum_{k \in F_f} (p_k - \mu_k - c_k)s_k(p) + \sum_{k \notin F_f} (p_k - w_k - c_k)s_k(p)$$

Then, the maximization of this objective function depends on whether resale price maintenance is used or not by manufacturers.

*Two part tariffs with resale price maintenance :*

Since manufacturers can capture retail profits through the franchise fees and moreover set retail prices, the wholesale prices have no direct effect on profit. Rey and Vergé (2004) showed however that the wholesale prices influence the strategic behavior of competitors. They show that there exists a continuum of equilibria, one for each wholesale price vector. For each wholesale price vector  $w^*$ , there exists a unique symmetric subgame perfect equilibrium in which retailers earn zero profit and manufacturers set retail prices to  $p^*(w^*)$ , where  $p^*(w^*)$  is a decreasing function of  $w^*$  equal to the monopoly price when the wholesale prices are equal to the marginal cost of production. For our purpose, we choose some possible equilibria among this multiplicity of equilibria. For a given equilibrium  $p^*(w^*)$ ,

the program of manufacturer  $f$  is now

$$\max_{\{p_k\} \in F_f} \sum_{k \in F_f} (p_k - \mu_k - c_k) s_k(p) + \sum_{k \notin F_f} (p_k^* - w_k^* - c_k) s_k(p)$$

Thus, we can write the first order conditions for this program as

$$\sum_{k \in F_f} (p_k - \mu_k - c_k) \frac{\partial s_k(p)}{\partial p_j} + s_j(p) + \sum_{k \notin F_f} (p_k^* - w_k^* - c_k) \frac{\partial s_k(p)}{\partial p_j} = 0 \quad \text{for all } j \in F_f \quad (10)$$

Then, depending on the wholesale prices, several cases can be considered. We will consider two cases of interest : first when wholesale prices are equal to the marginal cost of production ( $w_k^* = \mu_k$ ), second, when wholesale prices are such that the retailer's price cost margins are zero ( $p_k^*(w_k^*) - w_k^* - c_k = 0$ ).

First, when  $w_k^* = \mu_k$ , the first order condition (10) writes

$$\sum_{k \in F_f} (p_k - \mu_k - c_k) \frac{\partial s_k(p)}{\partial p_j} + s_j(p) + \sum_{k \notin F_f} (p_k^* - \mu_k - c_k) \frac{\partial s_k(p)}{\partial p_j} = 0 \quad \text{for all } j \in F_f$$

i.e.

$$\sum_k (p_k - \mu_k - c_k) \frac{\partial s_k(p)}{\partial p_j} + s_j(p) = 0 \quad \text{for all } j \in F_f$$

which gives in matrix notation for manufacturer  $f$

$$\gamma_f + \Gamma_f = (p - \mu - c) = -(I_f \times S_p)^{-1} I_f \times s(p) \quad (11)$$

Second, when wholesale prices  $w_k^*$  are such that  $p_k^*(w_k^*) - w_k^* - c_k = 0$ , then (10) becomes

$$\sum_{k \in F_f} (p_k - \mu_k - c_k) \frac{\partial s_k(p)}{\partial p_j} + s_j(p) = 0 \quad \text{for all } j \in F_f$$

In matrix notations, we get for all  $f = 1, \dots, F$

$$\gamma_f + \Gamma_f = (p - w - c) = (p - \mu - c) = -(I_f \times S_p \times I_f)^{-1} \times I_f \times s(p)$$

However, among the continuum of possible equilibria, Rey and Vergé (2004) showed that the case where wholesale prices are equal to the marginal costs of production is the equilibrium that would be selected if retailers can provide a retailing effort that increases demand. Actually, in this case it is worth for the manufacturer to make the retailer residual claimant of his retailing effort which leads to select this equilibrium wholesale price.

In the case of two part tariffs contracts with *RPM* between manufacturers and retailers, we assume that the profit maximizing strategic pricing of private label products by retailers is taken into account by manufacturers when they choose fixed fees and retail prices of their own products in the contract. This implies that the prices of private label products chosen by retailers is such that they maximize their profit on these private labels and the total price cost margin  $\tilde{\gamma}_r + \tilde{\Gamma}_r$  for these private labels will be such that

$$\tilde{\gamma}_r + \tilde{\Gamma}_r \equiv p - \mu - c = - \left( \tilde{I}_r \times S_p \times \tilde{I}_r \right)^{-1} \times \tilde{I}_r \times s(p) \quad (12)$$

where  $\tilde{I}_r$  is the ownership matrices of private label products of retailer  $r$ .

*Two part tariffs without resale price maintenance :*

Let's consider now that resale price maintenance cannot be used by manufacturers. Since they cannot choose retail prices, they only set wholesale prices in the following maximization program

$$\max_{\{w_k\} \in F_f} \sum_{k \in F_f} (p_k - \mu_k - c_k) s_k(p) + \sum_{k \notin F_f} (p_k - w_k - c_k) s_k(p)$$

Then the first order conditions are for all  $i \in F_f$

$$\sum_k \frac{\partial p_k}{\partial w_i} s_k(p) + \sum_{k \in F_f} \left[ (p_k - \mu_k - c_k) \sum_j \frac{\partial s_k}{\partial p_j} \frac{\partial p_j}{\partial w_i} \right] + \sum_{k \notin F_f} \left[ (p_k - w_k - c_k) \sum_j \frac{\partial s_k}{\partial p_j} \frac{\partial p_j}{\partial w_i} \right] = 0$$

which gives in matrix notation

$$I_f \times P_w \times s(p) + I_f \times P_w \times S_p \times I_f \times (p - \mu - c) + I_f \times P_w \times S_p \times I_{-f} \times (p - w - c) = 0$$

This implies that the total price cost margin  $\gamma + \Gamma = p - \mu - c$  is such that for all  $j = 1, \dots, J$  :

$$\gamma + \Gamma = (I_f \times P_w \times S_p \times I_f)^{-1} \times [-I_f \times P_w \times s(p) - I_f \times P_w \times S_p \times I_{-f} \times (p - w - c)] \quad (13)$$

that allows us to estimate the price-cost margins with demand parameters using (2) to replace  $(p - w - c)$  and (6) for  $P_w$ . Remark again that the formula (2) provides directly the total price-cost margin obtained by each retailer on its private label product.

We are thus able to obtain the several expressions for price-cost margins at the manufacturing or retail levels under the different models considered and function of the demand parameters.

## 4 Differentiated Products Demand

### 4.1 The Random Utility Demand Model

We now describe our model of differentiated product demand. We use a standard random utility model. Actually, denoting  $V_{ijt}$  the utility for consumer  $i$  of buying good  $j$  at period  $t$ , we assume that it can be represented by

$$\begin{aligned} V_{ijt} &= \theta_{jt} + \varepsilon_{ijt} \\ &= \delta_j + \gamma_t - \alpha p_{jt} + \varepsilon_{ijt} \text{ for } j = 1, \dots, J \end{aligned}$$

where  $\theta_{jt}$  is the mean utility of good  $j$  at period  $t$  and  $\varepsilon_{ijt}$  a (mean zero) individual-product-specific utility term representing the deviation of individual's preferences from the mean  $\theta_{jt}$ .

Moreover, we assume that  $\theta_{jt}$  is the sum of a mean utility  $\delta_j$  of product  $j$  common to all consumers, a mean utility  $\gamma_t$  common to all consumers and products at period  $t$  (due to unobserved preference shocks to period  $t$ ), and an income disutility  $\alpha p_{jt}$  where  $p_{jt}$  is the price of product  $j$  at period  $t$ .

Consumers may decide not to purchase any of the products. In this case they choose an outside good for which the mean part of the indirect utility is normalized to 0, so that  $V_{i0t} = \varepsilon_{i0t}$ . Remark that the specification used for  $\theta_{jt}$  is such that one could also consider that the mean utility of the outside good depends also on its time varying price  $p_{0t}$  without changing the identification of the other demand parameters. Actually, adding  $-\alpha p_{0t}$  to the outside good mean utility is equivalent to adding  $\alpha p_{0t}$  to all other goods mean utility, which would amount to replace  $\gamma_t$  by  $\gamma_t + \alpha p_{0t}$ .

Then, we model the distribution of the individual-specific utility term  $\varepsilon_{ijt}$  according to the assumptions of a nested logit model (Ben-Akiva, 1973). Actually, we assume that the bottled water market can be partitioned into  $G$  different groups, each sub-group  $g$  containing  $J_g$  products ( $\sum_{g=1}^G J_g = J$ ). With an abuse of notation, we will also denote  $J_g$  the set of products belonging to the sub-group  $g$ . Since products belonging to the same subgroup share a common set of unobserved features, consumers may have correlated preferences over these features. The distributional assumptions of the nested logit model imply that

consumers may have correlated preferences across all products of a given subgroup. In the bottled water market in France, it seems that customers make a clear difference between two groups of bottled water ( $G = 2$ ), mineral and spring water, such that it makes sense to allow customers to have correlated preferences over such groups (Friberg and Ganslandt (2003) use a similar demand model).

Assuming that consumers choose one unit of the good that maximizes utility, the distributional assumptions of the nested logit model yield the following choice probabilities or market share for each product  $j$ , as a function of the price vector  $p_t = (p_{1t}, p_{2t}, \dots, p_{Jt})$  :

$$s_{jt}(p_t) = P\left(V_{ijt} = \max_{l=0,1,\dots,J} (V_{ilt})\right) = s_{jt/g}(p_t) \times s_{gt}(p_t)$$

where  $s_{gt}(p_t)$  and  $s_{jt/g}(p_t)$  denote respectively the probability choice of group  $g$  and the conditional probability of choosing good  $j$  conditionally on purchasing a good in group  $g$ .

The expressions of these probabilities are given by

$$s_{jt/g}(p_t) = \frac{\exp \frac{\theta_{jt}}{1-\sigma_g}}{\sum_{j \in J_g} \exp \frac{\theta_{jt}}{1-\sigma_g}} = \frac{\exp \frac{\theta_{jt}}{1-\sigma_g}}{\exp \frac{I_{gt}}{1-\sigma_g}}$$

$$s_{gt}(p_t) = \frac{\left(\sum_{j \in J_g} \exp \frac{\theta_{jt}}{1-\sigma_g}\right)^{1-\sigma_g}}{\sum_{g=0}^G \left(\sum_{j \in J_g} \exp \frac{\theta_{jt}}{1-\sigma_g}\right)^{1-\sigma_g}} = \frac{\exp I_{gt}}{\exp I_t}$$

where  $I_{gt}$ , and  $I_t$ , are “inclusive values”, defined by :

$$I_{gt} = (1 - \sigma_g) \ln \sum_{j \in J_g} \exp \frac{\theta_{jt}}{1 - \sigma_g}$$

$$I_t = \ln \sum_{g=1,\dots,G} \exp I_{gt}$$

The parameter  $\sigma_g$  associated to the subgroup  $g$  measures the degree of correlation of consumer preferences for bottled water belonging to the same subgroup. The conditions on McFadden’s (1978) Generalized Extreme Value model required for the model to be consistent with random utility maximization are that  $\sigma_g \in [0, 1]$ . When  $\sigma_g$  goes to 1, preferences for products of the same subgroup become perfectly correlated meaning that these products are perceived as perfect substitutes. When  $\sigma_g$  goes to 0, preferences for all products become uncorrelated, and the model reduces to a simple multinomial logit model. At the aggregate demand level, the parameter  $\sigma_g$  allows to assess to which extent

competition is localized between products from the same subgroup. This specification is more flexible than a simple multinomial logit specification (since it includes it as a special case). Actually, in the special case where  $\sigma_g = 0$  for  $g = 1, \dots, G$ , we obtain a simple multinomial logit model which amounts to assume that  $\varepsilon_{ijt}$  is i.i.d. with a type I extreme value distribution. Then we have

$$s_{jt}(p_t) = \frac{\exp[\theta_{jt}]}{1 + \sum_{j=1, \dots, J} \exp[\theta_{jt}]}$$

Removing the time subscript for notational simplicity, the nested logit specification assumption implies that the price-elasticity of demand of good  $j$  belonging to group  $g$  with respect to good  $k$  is given by

$$\eta_{jk} \equiv \frac{\partial s_j}{\partial p_k} \frac{p_k}{s_j} = \begin{cases} \frac{\alpha}{1-\sigma_g} p_k [\sigma_g s_{j/g} + (1-\sigma_g) s_j - 1] & \text{if } j = k \text{ and } \{j, k\} \in g \\ \frac{\alpha}{1-\sigma_g} p_k [\sigma_g s_{k/g} + (1-\sigma_g) s_k] & \text{if } j \neq k \text{ and } \{j, k\} \in g \\ \alpha p_k s_k & \text{if } j \in g \text{ and } k \in g' \text{ and } g \neq g' \end{cases}$$

The nested logit model can be interpreted as a special case of the random coefficients logit models estimated by Berry, Levinsohn and Pakes (1995), Nevo (2001), Petrin (2002) and others. McFadden and Train (2000) show that any random utility model can be arbitrarily approximated by a random coefficient logit model. The nested logit model introduces restrictions on the underlying model but it has the advantage to be econometrically tractable even if potentially restrictive (Berry, 1994, and Berry and Pakes, 2001). However, one can then test whether the structural restrictions imposed by the nested logit model are empirically accepted or not.

## 4.2 Identification and Estimation of the Econometric Model

Following Berry (1994) and Verboven (1996), the random utility model introduced in the previous section leads to the following equations on the aggregate market shares of goods  $j$  at time  $t$

$$\begin{aligned} \ln s_{jt} - \ln s_{0t} &= \theta_{jt} + \sigma_g \ln s_{jt|g} + u_{jt} \\ &= \delta_j + \gamma_t - \alpha p_{jt} + \sigma_g \ln s_{jt|g} + u_{jt} \end{aligned} \quad (14)$$

where  $s_{jt|g}$  is the relative market share of product  $j$  at period  $t$  in its group  $g$  and  $s_{0t}$  is the market share of the outside good at time  $t$ . In the particular case of the simple logit

model, this equation becomes

$$\ln s_{jt} - \ln s_{0t} = \delta_j + \gamma_t - \alpha p_{jt} + u_{jt} \quad (15)$$

Remark that the full set of time fixed effects  $\gamma_t$  captures preferences for bottled water relative to the outside good, and can thus be thought of as accounting for macro-economic fluctuations (like the weather) that affect the decision to buy bottled water<sup>8</sup> but also as accounting for the outside good price variation across periods.

The error term  $u_{jt}$  captures the remaining unobserved product valuations varying across products and time, e.g. due to unobserved variations in advertising. Of course, the usual problem of endogeneity of price  $p_{jt}$  and relative market shares  $s_{jt|g}$  has to be handled correctly in order to identify and estimate the parameters of these models.

Our identification strategy then relies on the use of instrumental variables. Actually, thanks to the collection of data on wages, oil, diesel, packaging material and plastic prices over the period of interest, we construct instruments for prices  $p_{jt}$  that are interactions between characteristics of bottled water and these prices (in particular we use the mineral versus spring water dummy crossed with these prices). The identification then relies on the fact that these input prices affect the product prices because they are correlated with input costs but are not correlated with the idiosyncratic unobserved shocks to preferences  $u_{jt}$ . For the simple logit model, this set of instrumental variables is sufficient, but for the nested logit model, one has also to take into account the endogeneity of the relative (within group) market shares. For these relative market shares, our strategy relies on the fact that the contemporaneous correlation between  $\ln s_{jt|g}$  and unobserved shocks  $u_{jt}$ , which is the source of the endogeneity problem, can be removed with some suitable projection of the relative market shares on the hyperplane generated by some observed variables.

Actually, the endogeneity of price makes the relative market share endogenous since it is correlated with price and thus with idiosyncratic preference shock  $u_{jt}$ . One can decompose the relative market share between a predicted part and an unpredicted part using some

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<sup>8</sup>Similarly, in all the regressions they perform, Friberg and Ganslandt (2003) include also a dummy for the high demand season, i.e. summer.

observed covariates. We estimate the following regression

$$\ln s_{jt|g} = \pi_j + \beta \ln s_{jt-1|g} + \xi_{jt}^g \quad (16)$$

and we assume that

$$\text{corr}(\xi_{jt}^g, \ln s_{jt|g}) \neq 0 \text{ and } \text{corr}(\xi_{jt}^g, u_{jt}) = 0$$

Then, we use  $\xi_{jt}^g$  crossed with the dummy variables for mineral or spring water as additional instrument for  $\ln s_{jt|g}$  in our main equation (14). This strategy relies on a structural assumption about the endogeneity problem raised by the relative market shares  $\ln s_{jt|g}$  in our main equation (14). Actually, constructing valid instrumental variables for  $\ln s_{jt|g}$  using  $\xi_{jt}^g$  means that the endogeneity problem of  $\ln s_{jt|g}$  comes through the unobserved non time-varying effects  $\pi_j$  and eventually through the lagged value of the relative market share that are correlated with shocks  $u_{jt}$ . As we will see later, this interpretation is consistent with empirical tests of the validity of these instruments. A detailed description of (16) is given in appendix 7.2. The instruments  $\xi_{jt}^g$  prove empirically to be well correlated with the endogenous variables (as shown by first stage regressions) and satisfy the overidentifying restrictions.

The identification and estimation of these demand models then permits to evaluate own and cross price elasticities in this differentiated product demand model.

### 4.3 Testing Between Alternative Models

We now present how to test between the alternative models once we have estimated the demand model and obtained the different price-cost margins estimates according to their expressions obtained in the previous section.

Denoting by  $h$  the different models considered, for product  $j$  at time  $t$  under model  $h$ , we denote  $\gamma_{jt}^h$  the retailer price cost margin and  $\Gamma_{jt}^h$  the manufacturer price cost margin. Using  $C_{jt}^h$  for the sum of the marginal cost of production and distribution ( $C_{jt}^h = \mu_{jt}^h + c_{jt}^h$ ) we can estimate this marginal cost using prices and price cost margins with

$$C_{jt}^h = p_{jt} - \Gamma_{jt}^h - \gamma_{jt}^h \quad (17)$$

Let's now assume that these marginal costs are affected by some exogenous shocks  $W_{jt}$ , we use the following specification

$$C_{jt}^h = p_{jt} - \Gamma_{jt}^h - \gamma_{jt}^h = \left[ \exp(\omega_j^h + W_{jt}'\gamma_h) \right] \eta_{jt}^h$$

where  $\omega_j^h$  is an unknown product specific parameter,  $W_{jt}$  are observable random shock to the marginal cost of product  $j$  at time  $t$  and  $\eta_{jt}^h$  is an unobservable random shock to the cost. Taking logarithms, we get

$$\ln C_{jt}^h = \omega_j^h + W_{jt}'\gamma_h + \ln \eta_{jt}^h \quad (18)$$

Assuming that  $\text{corr}(\ln \eta_{jt}^h, W_{jt}) = \text{corr}(\ln \eta_{jt}^h, \omega_j^h) = 0$ , one can identify and estimate consistently  $\omega_j^h$ ,  $\gamma_h$ , and  $\eta_{jt}^h$ .

Now, for any two models  $h$  and  $h'$ , one would like to test one model against the other, that is test between

$$p_{jt} = \Gamma_{jt}^h + \gamma_{jt}^h + \left[ \exp(\omega_j^h + W_{jt}'\gamma_h) \right] \eta_{jt}^h$$

and

$$p_{jt} = \Gamma_{jt}^{h'} + \gamma_{jt}^{h'} + \left[ \exp(\omega_j^{h'} + W_{jt}'\gamma_{h'}) \right] \eta_{jt}^{h'}$$

Using non linear least squares

$$\min_{\gamma_h, \omega_j^h} Q_n^h(\gamma_h, \omega_j^h) = \min_{\gamma_h, \omega_j^h} \frac{1}{n} \sum_{j,t} \left( \ln \eta_{jt}^h \right)^2 = \min_{\gamma_h, \omega_j^h} \frac{1}{n} \sum_{j,t} \left[ \ln \left( p_{jt} - \Gamma_{jt}^h - \gamma_{jt}^h \right) - \omega_j^h - W_{jt}'\gamma_h \right]^2$$

Then, we use non nested tests (Vuong, 1989, and Rivers and Vuong, 2002) to infer which model  $h$  is statistically the best. The tests we use consist in testing models one against another. The test of Vuong (1989) applies in the context of maximum likelihood estimation and thus would apply in our case if one assumes log-normality of  $\eta_{jt}^h$ . Rivers and Vuong (2002) generalized this kind of test to a broad class of estimation methods including non linear least squares. Moreover, the Vuong (1989) or the Rivers and Vuong (2002) approaches do not require that either competing model be correctly specified under the tested null hypothesis. Indeed, other approaches such as Cox's tests (see, among others, Smith, 1992) require such an assumption, i.e. that one of the competing model accurately

describes the data. This assumption cannot be sustained when dealing with a real data set like ours.

Taking any two competing models  $h$  and  $h'$ , the null hypothesis is that the two non nested models are *asymptotically equivalent* when

$$H_0 : \lim_{n \rightarrow \infty} \left\{ \bar{Q}_n^h(\bar{\gamma}_h, \bar{\omega}_j^h) - \bar{Q}_n^{h'}(\bar{\gamma}_{h'}, \bar{\omega}_j^{h'}) \right\} = 0$$

where  $\bar{Q}_n^h(\bar{\gamma}_h, \bar{\omega}_j^h)$  (resp.  $\bar{Q}_n^{h'}(\bar{\gamma}_{h'}, \bar{\omega}_j^{h'})$ ) is the expectation of a lack-of-fit criterion  $Q_n^h(\gamma_h, \omega_j^h)$  (i.e. the opposite of a goodness-of-fit criterion) evaluated for model  $h$  (resp.  $h'$ ) at the pseudo true values of the parameters of this model, denoted by  $\bar{\gamma}_h, \bar{\omega}_j^h$  (resp.  $\bar{\gamma}_{h'}, \bar{\omega}_j^{h'}$ ). The first alternative hypothesis is that  $h$  is *asymptotically better* than  $h'$  when

$$H_1 : \lim_{n \rightarrow \infty} \left\{ \bar{Q}_n^h(\bar{\gamma}_h, \bar{\omega}_j^h) - \bar{Q}_n^{h'}(\bar{\gamma}_{h'}, \bar{\omega}_j^{h'}) \right\} < 0$$

Similarly, the second alternative hypothesis is that  $h'$  is *asymptotically better* than  $h$  when

$$H_2 : \lim_{n \rightarrow \infty} \left\{ \bar{Q}_n^h(\bar{\gamma}_h, \bar{\omega}_j^h) - \bar{Q}_n^{h'}(\bar{\gamma}_{h'}, \bar{\omega}_j^{h'}) \right\} > 0$$

The test statistic  $T_n$  captures the statistical variation that characterizes the sample values of the lack-of-fit criterion and is then defined as a suitably normalized difference of the sample lack-of-fit criteria, i.e.

$$T_n = \frac{\sqrt{n}}{\hat{\sigma}_n^{hh'}} \left\{ Q_n^h(\hat{\gamma}_h, \hat{\omega}_j^h) - Q_n^{h'}(\hat{\gamma}_{h'}, \hat{\omega}_j^{h'}) \right\}$$

where  $Q_n^h(\hat{\gamma}_h, \hat{\omega}_j^h)$  (resp.  $Q_n^{h'}(\hat{\gamma}_{h'}, \hat{\omega}_j^{h'})$ ) is the sample lack-of-fit criterion evaluated for model  $h$  (resp.  $h'$ ) at the estimated values of the parameters of this model, denoted by  $\hat{\gamma}_h, \hat{\omega}_j^h$  (resp.  $\hat{\gamma}_{h'}, \hat{\omega}_j^{h'}$ ).  $\hat{\sigma}_n^{hh'}$  denotes the estimated value of the variance of the difference in lack-of-fit. Since our models are strictly non nested, Rivers and Vuong showed that the asymptotic distribution of the  $T_n$  statistic is standard normal. The selection procedure involves comparing the sample value of  $T_n$  with critical values of the standard normal distribution<sup>9</sup>. In the empirical section, we will present evidence based on these different statistical tests.

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<sup>9</sup>If  $\alpha$  denotes the desired size of the test and  $t_{\alpha/2}$  the value of the inverse standard normal distribution evaluated at  $1 - \alpha/2$ . If  $T_n < t_{\alpha/2}$  we reject  $H_0$  in favor of  $H_1$ ; if  $T_n > t_{\alpha/2}$  we reject  $H_0$  in favor of  $H_2$ . Otherwise, we do not reject  $H_0$ .

## 5 Econometric Estimation and Test Results

### 5.1 Data and Variables

Our data were collected by the company SECODIP (*Société d'Étude de la Consommation, Distribution et Publicité*) that conducts surveys about households' consumption in France. We have access to a representative survey for the years 1998, 1999, and 2000. These data contain information on a panel of nearly 11000 French households and on their purchases of mostly food products. This survey provides a description of the main characteristics of the goods and records over the whole year the quantity bought, the price, the date of purchase and the store where it is purchased. In particular, this survey contains information on all bottled water purchased by these French households during the three years of study. We consider purchases of the seven most important retailers which represent 70.7% of the total purchases of the sample. We take into account the most important brands, that is five national brands of mineral water, one national brand of spring water, one retailer private label brand of mineral water and one retailer private label spring water. The purchases of these eight brands represent 71.3% of the purchases of the seven retailers. The national brands are produced by three different manufacturers : *Danone*, *Nestlé* and *Castel*. This survey presents the advantage of allowing to compute market shares that are representative of the national French market thanks to a weighting procedure of the available household panel. Then, the market shares are defined by a weighted sum of the purchases of each brand during each month of the three years considered divided by the total market size of the respective month. The market share of the outside good is defined as the difference between the total size of the market and the shares of the inside goods. We consider all other non-alcoholic refreshing drinks as the outside good. Therefore, the market size consists in all non-alcoholic refreshing drinks such as bottled water (sparkling and flavored water), tea drinks, colas, tonics, fruit drinks, sodas lime. Our data thus allow to compute this market size across all months of the study. It is clearly varying across periods and shows that the market for non-alcoholic drinks is affected by seasons or for example the weather.

We consider eight brands sold in seven distributors, which gives more than 50 differentiated products in this national market. The number of products in our study thus varies between 51 and 54 during the 3 years considered. Considering the monthly market shares of all of these differentiated products, we get a total of 2041 observations in our sample. For each of these products, we compute an average price for each month. These prices are in euros per liter (even if until 2000, the money used was the French Franc). Table 1 presents some first descriptive statistics on some of the main variables used.

<b>Variable</b>	Mean	Median	Std. dev.	Min.	Max
Market share (all inside goods)	0.005	0.003	0.006	$4.10^{-6}$	0.048
Market share : Mineral Water	0.004	0.003	0.003	$10^{-6}$	0.048
Market share : Spring Water	0.010	0.007	0.010	$10^{-5}$	0.024
Price in €/liter (all inside goods)	0.298	0.323	0.099	0.096	0.823
Price in €/liter : Mineral Water	0.346	0.343	0.060	0.128	0.678
Price in €/liter : Spring Water	0.169	0.157	0.059	0.096	0.276
Mineral water dummy (0/1)	0.73	1	0.44	0	1
Market Share of the Outside Good	0.71	0.71	0.04	0.59	0.78

**Table 1** : Summary Statistics

We also use data from the French National Institute for Statistics and Economic Studies (INSEE) on the plastic price, on a wage salary index for France, on oil and diesel prices and on an index for packaging material cost. Over the time period considered (1998-2000), the wage salary index always raised while the plastic price index first declined during 1998 and the beginning of 1999 before raising again and reaching the 1998 level at the end of 2000. Concerning the diesel price index, it shows quite an important volatility with a first general decline during 1998 before a sharp increase until a new decline at the end of 2000. Also, the packaging material cost index shows important variations with a sharp growth in 1998, a decline at the beginning of 1999 and again an important growth until the end of 2000. Interactions of these prices with the dummies for the type of water (spring versus mineral) will serve as instrumental variables as they are supposed to affect the marginal cost of production and distribution of bottled water. Actually, it is likely that labor cost is not the same for the production of mineral or spring water but it is also known in this industry that the plastic quality used for mineral or spring water is usually not the same which is also likely to affect their bottling and packaging costs. Also, the

relatively important variations of all these price indices during the period of study suggests a potentially good identification of our cost equations.

## 5.2 Demand Results

We estimate the demand model (14) which is the following

$$\ln s_{jt} - \ln s_{0t} = \delta_j + \gamma_t - \alpha p_{jt} + \sigma_g \ln s_{jt|g} + u_{jt}$$

as well as the simple logit demand model (15) using two stage least squares in order to instrument the endogenous variables  $p_{jt}$  and  $\ln s_{jt|g}$ . Results are in Table 2.  $F$  tests of the first stage regressions show that our instrumental variables are well correlated with the endogenous variables. Moreover, the Sargan test of overidentification validates the exclusion of excluded instruments from the main equation. The price coefficient has the expected sign in both specifications and in the case of the nested logit model, the coefficients  $\sigma_g$  actually belongs to the  $[0, 1]$  interval as required by the theory. Moreover, since one can reject that parameters  $\sigma_g$  are zero, it is clear that the nested logit specification is preferred to the simple logit one for this market of bottled water.

Variable	Simple Multinomial Logit	Nested Logit
Price ( $\alpha$ ) (Std. error)	5.04 (1.35)	4.74 (1.56)
Mineral water $\sigma_g$ (Std. error)		0.52 (0.18)
Spring water $\sigma_g$ (Std. error)		0.68 (0.17)
Coefficients $\delta_j, \gamma_t$ not shown		
$F$ test that all $\delta_j = 0$ ( $p$ value)	39.79 (0.000)	0.18 (1.000)
Wald test that all $\gamma_t = 0$ ( $p$ value)	89.89 (0.0000)	64.50 (0.0034)
First stage $F$ test for full model :	Stat. ( $p$ value)	Stat. ( $p$ value)
Price $p_{jt}$	5.42 (0.000)	5.43 (0.000)
Mineral water $\ln s_{jt g}$		161.87 (0.000)
Spring water $\ln s_{jt g}$		171.96 (0.000)
First stage $F$ test for excluded instruments :		
Price $p_{jt}$	7.99 (0.000)	7.26 (0.000)
Mineral water $\ln s_{jt g}$		584.99 (0.000)
Spring water $\ln s_{jt g}$		620.63 (0.000)
Sargan test for overidentification	6.302 (0.1777)	6.766 (0.1488)

**Table 2** : Estimation Results of Demand Models

In appendix 7.2, we present the first stage regressions of the main demand equation. Given the demand estimates, it is interesting to note that we find estimates of unobserved

product specific mean utilities  $\delta_j$ . Using these parameters estimates, one can look at their correlation with observed product characteristics using ordinary least squares. This is done in Table 3 below.

Fixed Effects $\delta_j$	Multinomial Logit	Nested Logit
Mineral Water (0/1) (Std. error)	-2.78 (0.11)	-1.20 (0.09)
Minerality (Std. error)	0.81 (0.05)	0.75 (0.04)
Manufacturer 1 (Std. error)	6.30 (0.11)	4.21 (0.09)
Manufacturer 2 (Std. error)	5.65 (0.11)	3.75 (0.09)
Manufacturer 3 (Std. error)	-3.66 (0.09)	-3.51 (0.07)
Constant (Std. error)	-2.18 (0.06)	-2.23 (0.05)
<i>F</i> test ( <i>p</i> value)	3145.94 (0.000)	3926.94 (0.000)

**Table 3** : Regression of fixed effects on the product characteristics

Table 3 shows that the product specific constant mean utility  $\delta_j$  is increasing with the minerality of water and that the identity of the manufacturer of the bottled water affects this mean utility. This is probably due to image, reputation and advertising of the manufacturing brands. Remark that if one does not control for the manufacturer identity this mean utility is larger for mineral water rather than spring water but it is not the case anymore when one introduces these manufacturer dummy variables.

Finally, once we obtained our structural demand estimates, we can compute price elasticities of demand for our differentiated products. Table 4 presents the different average elasticities obtained for the simple multinomial logit or the nested logit demand model. All of them have the expected sign and the magnitude of own-price elasticities are much larger than that of cross-price elasticities. It is interesting to see that in the unrestricted specification (nested logit), the average own price elasticities are larger than in the restricted (multinomial logit) model. Also average own price elasticities for mineral water and spring water are almost proportional to average prices of these segments (nearly twice for mineral water than for spring water) in the case of the multinomial logit model while it is not the case anymore in the more flexible nested logit model. Average own-price elasticity for mineral water is actually larger than for spring water but the ratio is not as large as the one of their average prices. As expected, the cross-price elasticities are larger within each segment of product than across segments.

<b>Average elasticities</b>	<b>Multinomial Logit</b>	<b>Nested Logit</b>
<b>All bottle water</b>		
Own-price elasticity	-9.84 (3.29)	-20.72 (4.99)
Cross-price elasticity within group	0.05 (0.05)	0.51 (0.55)
Cross-price elasticity across group		0.05 (0.05)
<b>Mineral water</b>		
Own-price elasticity	-11.40 (2.04)	-22.20 (3.67)
Cross-price elasticity within group	0.05 (0.05)	0.36 (0.31)
Cross-price elasticity across group		0.05 (0.05)
<b>Spring water</b>		
Own-price elasticity	-5.54 (1.97)	-16.08 (5.68)
Cross-price elasticity within group	0.05 (0.05)	0.99 (0.81)
Cross-price elasticity across group		0.05 (0.04)

**Table 4** : Summary of Elasticities Estimates

### 5.3 Price-Cost Margins and Non Nested Tests

Once one has estimated the demand parameters, we can use the formulas obtained in section 3 to compute the price cost margins at the retailer and manufacturer levels, or the total price cost margins, for all products, under the various scenarios considered. We presented several models that seem worth of consideration with some variants on manufacturers or retailers behavior. Among the different models with double marginalization or two part tariffs, we consider the models described in the following table. Each scenario can be described according to the assumptions made on the manufacturers behavior (collusive or Nash), the retailers behavior (collusive or Nash) and the vertical interaction which can be Stackelberg or Nash under double marginalization or with *RPM* or not under two part tariffs contracts :

<b>Models</b>	<b>Retailers Behavior</b>	<b>Manufacturers Behavior</b>	<b>Vertical Interaction</b>
<b>Double marginalization</b>			
Model 1	Collusion	Nash	Nash
Model 2	Collusion	Nash	Stackelberg
Model 3	Collusion	Collusion	Nash
Model 4	Collusion	Collusion	Stackelberg
Model 5	Nash	Nash	Nash
Model 6	Nash	Nash	Stackelberg
Model 7	Nash	Collusion	Nash
Model 8	Nash	Collusion	Stackelberg
<b>Two Part Tariffs</b>			
Model 9	Nash	Nash	RPM <sup>10</sup> ( $w = \mu$ )
Model 10	Collusion	Collusion	RPM ( $w = \mu$ )
Model 11	Nash	Nash	RPM ( $p = w + c$ )
Model 12	Collusion	Collusion	RPM ( $p = w + c$ )
Model 13	Nash	Nash	no RPM
Model 14 : joint profit maximization	Collusion	Collusion	Collusion

Note that in the case of private labels products, we assume that the retailer is also the producer which amounts in our models to assume that the behavior for pricing private labels is equivalent to the one of a manufacturer perfectly colluding with the retailer for this good. Of course, only one price cost margin is then computed for these private label goods because it has then no meaning to compute wholesale price and retail price margins separately. Note also that models where perfectly colluding manufacturers would use two part tariffs contracts with perfectly colluding retailers (models 10 and 12) are not equivalent to the joint profit maximization of the industry (model 14) because of the presence of private label products.

Tables 5 and 6 then present the averages<sup>11</sup> of product level price cost margins estimates under the different models with either the logit demand (Table 5) or the more general nested logit demand (Table 6). It is worth noting that price cost margins are generally lower for mineral water than for spring water. As done by Nevo (2001), one could then compare price cost margins with accounting data to evaluate their empirical validity and also even-

<sup>10</sup>RPM means resale price maintenance. Vertical contracts are such that the producer is always a Stackelberg leader.

<sup>11</sup>Note that the average price-cost margin at the retailer level plus the average price-cost margin at the manufacturer level do not sum to the total price cost margin because of the private labels products for which no price cost margin at the manufacturer level is computed, the retailer price cost margin being then equal to the total price cost margin.

tually test which model provides the most realistic result. However, the lack of data both on retailers or manufacturers margins prevents such analysis. Moreover accounting data only provide an upper bound for price-cost margins.

<b>Price-Cost Margins</b> (% of retail price $p$ )		Mineral Water	Spring Water		
		Mean	Std.	Mean	Std.
<b>Double Marginalization</b>					
Model 1	Retailers	13.47	3.64	30.24	11.49
	Manufacturers	9.38	1.18	29.79	2.59
	Total	<b>22.04</b>	<b>3.35</b>	<b>45.11</b>	<b>26.01</b>
Model 2	Retailers	13.47	3.64	30.24	11.49
	Manufacturers	10.11	1.36	32.02	3.31
	Total	<b>22.70</b>	<b>3.48</b>	<b>46.22</b>	<b>27.22</b>
Model 3	Retailers	13.47	3.64	30.24	11.49
	Manufacturers	11.56	1.62	36.80	4.49
	Total	<b>24.01</b>	<b>3.97</b>	<b>48.62</b>	<b>29.77</b>
Model 4	Retailers	13.47	3.64	30.24	11.49
	Manufacturers	15.70	3.22	50.18	10.46
	Total	<b>27.80</b>	<b>5.66</b>	<b>55.29</b>	<b>37.39</b>
Model 5	Retailers	9.50	2.21	21.34	7.42
	Manufacturers	9.38	1.18	29.79	2.59
	Total	<b>18.07</b>	<b>2.58</b>	<b>36.21</b>	<b>22.35</b>
Model 6	Retailers	9.50	2.21	21.34	7.42
	Manufacturers	9.61	1.61	31.02	3.19
	Total	<b>18.27</b>	<b>2.74</b>	<b>36.82</b>	<b>22.95</b>
Model 7	Retailers	9.50	2.21	21.34	7.42
	Manufacturers	11.56	1.62	36.80	4.49
	Total	<b>20.05</b>	<b>3.14</b>	<b>39.71</b>	<b>26.00</b>
Model 8	Retailers	9.50	2.21	21.34	7.42
	Manufacturers	12.67	2.52	38.94	4.29
	Total	<b>21.32</b>	<b>5.05</b>	<b>41.57</b>	<b>27.62</b>
<b>Two part Tariffs with RPM</b>					
Model 9	Nash and $w = \mu$	<b>9.21</b>	<b>2.17</b>	<b>21.40</b>	<b>8.00</b>
Model 10	Collusion and $w = \mu$	<b>11.14</b>	<b>2.11</b>	<b>24.28</b>	<b>10.22</b>
Model 11	Nash and $p = w + c$	<b>9.82</b>	<b>2.00</b>	<b>25.60</b>	<b>11.70</b>
Model 12	Collusion and $p = w + c$	<b>11.80</b>	<b>2.09</b>	<b>25.60</b>	<b>11.69</b>
<b>Two-part Tariffs without RPM</b>					
Model 13	Retailers	<b>9.50</b>	<b>2.21</b>	<b>21.34</b>	<b>7.42</b>
	Manufacturers	<b>2.42</b>	<b>0.66</b>	<b>8.08</b>	<b>2.56</b>
	Total	<b>11.73</b>	<b>2.05</b>	<b>25.36</b>	<b>11.62</b>
<b>Joint Profit Maximization</b>					
Model 14		<b>13.47</b>	<b>3.63</b>	<b>30.24</b>	<b>11.49</b>

**Table 5** : Price-Cost Margins by groups for the Multinomial Logit Model

<b>Price-Cost Margins</b> (% of retail price $p$ )		Mineral Water		Spring Water	
		Mean	Std.	Mean	Std.
<b>Double Marginalization</b>					
Model 1	Retailers	13.27	2.73	29.36	11.25
	Manufacturers	6.36	1.07	14.90	2.02
	Total	<b>18.93</b>	<b>3.23</b>	<b>34.66</b>	<b>17.67</b>
Model 2	Retailers	13.27	2.73	29.36	11.25
	Manufacturers	6.71	1.33	15.85	2.41
	Total	<b>19.23</b>	<b>3.40</b>	<b>34.96</b>	<b>18.11</b>
Model 3	Retailers	13.27	2.73	29.36	11.25
	Manufacturers	11.05	1.46	18.26	2.81
	Total	<b>23.09</b>	<b>4.38</b>	<b>36.99</b>	<b>20.08</b>
Model 4	Retailers	13.27	2.73	29.36	11.25
	Manufacturers	14.56	3.61	28.14	6.63
	Total	<b>26.21</b>	<b>6.27</b>	<b>41.12</b>	<b>25.47</b>
Model 5	Retailers	5.04	0.94	7.65	2.82
	Manufacturers	6.36	1.07	14.90	2.02
	Total	<b>10.69</b>	<b>2.23</b>	<b>12.96</b>	<b>9.67</b>
Model 6	Retailers	5.04	0.94	7.65	2.82
	Manufacturers	7.32	4.31	17.06	3.94
	Total	<b>12.20</b>	<b>4.31</b>	<b>27.77</b>	<b>4.27</b>
Model 7	Retailers	5.04	0.94	7.65	2.82
	Manufacturers	11.05	1.46	18.26	2.81
	Total	<b>14.86</b>	<b>3.63</b>	<b>15.28</b>	<b>11.84</b>
Model 8	Retailers	5.04	0.94	7.65	2.82
	Manufacturers	14.44	4.88	20.98	5.33
	Total	<b>17.87</b>	<b>6.24</b>	<b>16.42</b>	<b>13.49</b>
<b>Two part Tariffs with RPM</b>					
Model 9	Nash and $w = \mu$	<b>5.03</b>	<b>1.25</b>	<b>7.51</b>	<b>3.23</b>
Model 10	Collusion and $w = \mu$	<b>9.54</b>	<b>1.57</b>	<b>6.69</b>	<b>2.17</b>
Model 11	Nash and $p = w + c$	<b>6.42</b>	<b>1.10</b>	<b>8.82</b>	<b>5.03</b>
Model 12	Collusion and $p = w + c$	<b>10.79</b>	<b>1.72</b>	<b>12.00</b>	<b>5.78</b>
<b>Two-part Tariffs without RPM</b>					
Model 13	Retailers	<b>5.04</b>	<b>0.94</b>	<b>7.65</b>	<b>2.82</b>
	Manufacturers	<b>3.19</b>	<b>1.10</b>	<b>3.58</b>	<b>2.84</b>
	Total	<b>7.91</b>	<b>1.58</b>	<b>11.07</b>	<b>7.35</b>
<b>Joint Profit Maximization</b>					
Model 14		<b>12.91</b>	<b>3.58</b>	<b>27.33</b>	<b>13.42</b>

**Table 6** : Price-Cost Margins by groups for the Nested Logit Model

After estimating the different price cost margins for the models considered, one can recover the marginal cost  $C_{jt}^h$  using equation (17) and then estimate (18). The empirical results of the estimation of these cost equations are in appendix 7.3. They are useful mostly in order to test which model fits best the data. We thus performed the non nested tests presented in 4.3. Tables 7 and 8 present the Rivers and Vuong tests for the logit

or nested logit demand models. In both cases, the statistics of test<sup>12</sup> show that the best model appears to be the model 9, that is the case where two part tariffs contracts with resale price maintenance are used by manufacturers with retailers. The Vuong (1989) tests based on the maximum likelihood estimation of the cost equations under normality draw the same inference about the best model (see Tables of results of these tests in appendix 7.4).

Rivers and Vuong Test Statistic $T_n = \frac{\sqrt{n}}{\hat{\sigma}_n} \left( Q_n^2(\hat{\Theta}_n^2) - Q_n^1(\hat{\Theta}_n^1) \right) \rightarrow N(0, 1)$													
$\backslash$	$H_2$												
$H_1$	2	3	4	5	6	7	8	<b>9</b>	10	11	12	13	14
1	2.51	2.60	4.59	-2.64	-2.63	-2.40	-1.94	<b>-2.86</b>	-2.82	-2.86	-2.78	-2.78	-2.71
2		2.07	4.19	-3.20	-3.20	-3.05	-2.72	<b>-3.35</b>	-3.32	-3.35	-3.30	-3.30	-3.26
3			4.29	-3.35	-3.35	-3.18	-3.11	<b>-3.53</b>	-3.50	-3.53	-3.47	-3.47	-3.42
4				-5.16	-5.16	-5.04	-4.98	<b>-5.29</b>	-5.27	-5.28	-5.24	-5.24	-5.20
5					0.57	9.27	3.36	<b>-8.42</b>	-7.41	-8.27	-6.45	-6.96	-1.94
6						6.11	3.52	<b>-9.80</b>	-8.30	-9.64	-7.30	-6.48	-2.58
7							2.14	<b>-9.63</b>	-9.17	-9.59	-9.23	-9.31	-8.12
8								<b>-4.40</b>	-4.21	-4.36	-4.06	-3.99	-3.65
<b>9</b>									<b>10.02</b>	<b>6.25</b>	<b>10.35</b>	<b>9.96</b>	<b>9.53</b>
10										-8.11	6.00	5.26	7.58
11											10.61	8.82	9.45
12												0.74	7.42
13													6.79

**Table 7** : Results of the Rivers and Vuong Test for the Multinomial Logit Model

Rivers and Vuong Test Statistic : $T_n = \frac{\sqrt{n}}{\hat{\sigma}_n} \left( Q_n^2(\hat{\Theta}_n^2) - Q_n^1(\hat{\Theta}_n^1) \right) \rightarrow N(0, 1)$													
$\backslash$	$H_2$												
$H_1$	2	3	4	5	6	7	8	<b>9</b>	10	11	12	13	14
1	5.90	6.22	5.99	-9.85	-9.51	-9.78	-9.14	<b>-10.25</b>	-9.94	-10.10	-10.02	-9.71	-9.98
2		5.59	5.77	-9.82	-9.50	-9.75	-9.23	<b>-10.24</b>	-9.98	-10.09	-10.01	-9.74	-9.83
3			5.32	-8.82	-8.58	-8.75	-8.36	<b>-9.22</b>	-9.04	-9.09	-9.02	-8.81	-8.55
4				-7.62	-7.49	-7.55	-7.36	<b>-7.87</b>	-7.79	-7.80	-7.74	-7.64	-7.23
5					5.73	6.91	6.62	<b>-11.41</b>	-8.26	-10.65	-9.01	-4.70	8.85
6						-0.22	4.36	<b>-10.58</b>	-8.59	-9.70	-8.79	-6.61	7.63
7							5.10	<b>-10.51</b>	-8.59	-9.48	-9.76	-6.51	8.62
8								<b>-9.39</b>	-8.32	-8.65	-8.39	-6.84	5.71
<b>9</b>									<b>3.50</b>	<b>9.54</b>	<b>10.69</b>	<b>13.16</b>	<b>10.03</b>
10										2.58	6.26	8.33	9.25
11											6.83	11.16	9.60
12												3.43	9.53
13													8.62

<sup>12</sup>Recall that for a 5% size of the test, we reject  $H_0$  in favor of  $H_2$  if  $T_n$  is lower than the critical value -1.64 and that we reject  $H_0$  in favor of  $H_1$  if  $T_n$  is higher than the critical value 1.64.

**Table 8** : Results of the Rivers and Vuong Test for the Nested Logit Model

Finally, the non rejected model tells that manufacturers use two part tariffs with retailers and moreover (as predicted by the theory) that they use resale price maintenance in their contracting relationships although it is in principle not legal in France. For this model, the estimated total price cost margin (price minus marginal cost of production and distribution), are relatively low with an average of 5.03% for the mineral water and 7.51% for spring water. These figures are lower than the rough accounting estimates that one can get from aggregate data (see section 2). Also, for our best model, we can look at the average price-cost margins for national brands products versus private labels products. In the case of mineral water, the average price-cost margins for national brands and private labels are not statistically different and about the same with an average of 4.91% for national brands and of 6.77% for private labels. However, in the case of natural spring water, it appears that price-cost margins for national brands are larger than for private labels with an average of 10.87% instead of 4.89%. As Nevo (2001) remarks these accounting margins only provide an upper bound of the true values. Moreover, these accounting estimates do not take into account the marginal cost of distribution while our structural estimates do. These empirical results seem then quite realistic and consistent with the bounds provided by accounting data.

## 6 Conclusion

We presented how to test across different hypothesis on the strategic relationships between manufacturers and retailers in the supermarket industry and in particular how one can test whether manufacturers use two part tariffs contracts with retailers. We consider several alternative models of competition between manufacturers and retailers on a differentiated product market and test between these alternatives. We consider in particular two types of non linear pricing relationships, one where resale price maintenance is used with two part tariffs and one where no resale price maintenance is allowed in two part tariffs. The method is based on estimates of demand parameters that allow to recover

price-cost margins at the manufacturer and retailer levels. We then test between the different models using exogenous variables that are supposed to shift the marginal cost of production and distribution. We apply this methodology to study the market for retailing bottled water in France. Our empirical evidence allows to conclude that manufacturers and retailers use non linear pricing contracts and in particular two part tariffs contracts with resale price maintenance.

Although, we present the first empirical estimation of a structural model taking into account explicitly two part tariffs contracts between manufacturers and retailers, this work calls for further developments and studies about competition under non linear pricing in the supermarket industry. In particular, further studies where assumptions of constant marginal cost of production and distribution or more general contractual forms would be allowed are needed. Also, it is clear that more empirical work on other markets will be useful for a better understanding of vertical relationships in the retailing industry. Finally taking into account the endogenous market structure (Rey and Vergé, 2004, started investigating some theoretical aspects of it) is also an objective that theoretical and empirical research will have to tackle.

## 7 Appendix

### 7.1 Detailed Proof of the Manufacturers Profit Expression under Two Part Tariffs

We use the theoretical results due to Rey and Vergé (2004) applied to our context with  $F$  firms and  $R$  retailers. The participation constraint being binding, we have for all

$r \sum_{s \in S_r} [M(p_s - w_s - c_s)s_s(p) - F_s] = 0$  which implies that

$$\sum_{s \in S_r} F_s = \sum_{s \in S_r} M(p_s - w_s - c_s)s_s(p)$$

and thus

$$\begin{aligned} \sum_{j \in F_f} F_j + \sum_{j \notin F_f} F_j &= \sum_{j=1, \dots, J} F_j = \sum_{r=1, \dots, R} \sum_{s \in S_r} F_s \\ &= \sum_{r=1, \dots, R} \sum_{s \in S_r} M(p_s - w_s - c_s)s_s(p) = \sum_{j=1, \dots, J} M(p_j - w_j - c_j)s_j(p) \end{aligned}$$

so that

$$\sum_{j \in F_f} F_j = \sum_{j=1, \dots, J} M(p_j - w_j - c_j) s_j(p) - \sum_{j \notin F_f} F_j$$

Then, the firm  $f$  profits are

$$\begin{aligned} \Pi^f &= \sum_{k \in F_f} M(w_k - \mu_k) s_k(p) + \sum_{k \in F_f} F_k \\ &= \sum_{k \in F_f} M(w_k - \mu_k) s_k(p) + \sum_{j=1, \dots, J} M(p_j - w_j - c_j) s_j(p) - \sum_{j \notin F_f} F_j \end{aligned}$$

Since, producers fix the fixed fees given the ones of other producers, we have that under resale price maintenance :

$$\begin{aligned} \max_{\{F_i, p_i\}_{i \in F_f}} \Pi^f &\Leftrightarrow \max_{\{p_i\}_{i \in F_f}} \sum_{k \in F_f} (w_k - \mu_k) s_k(p) + \sum_{j=1, \dots, J} (p_j - w_j - c_j) s_j(p) \\ &\Leftrightarrow \max_{\{p_i\}_{i \in F_f}} \sum_{k \in F_f} (p_k - \mu_k) s_k(p) + \sum_{k \notin F_f} (p_k - w_k - c_k) s_k(p) \end{aligned}$$

and with no resale price maintenance

$$\begin{aligned} \max_{\{F_i, w_i\}_{i \in F_f}} \Pi^f &\Leftrightarrow \max_{\{w_i\}_{i \in F_f}} \sum_{k \in F_f} (w_k - \mu_k) s_k(p) + \sum_{j=1, \dots, J} (p_j - w_j - c_j) s_j(p) \\ &\Leftrightarrow \max_{\{w_i\}_{i \in F_f}} \sum_{k \in F_f} (p_k - \mu_k) s_k(p) + \sum_{k \notin F_f} (p_k - w_k - c_k) s_k(p) \end{aligned}$$

Then the first order conditions of the different two part tariffs models can be derived very simply.

## 7.2 Details on regressions for demand estimates

First Stage Results	Dependent Variable			
	Multinomial Logit	Nested Logit		
Instrumental Variables	Price $p_{jt}$	Price $p_{jt}$	$\ln s_{jt g}$ (Spring)	$\ln s_{jt g}$ (Mineral)
$w_t^1 \times 1_{(j \in \text{Mineral water})}$	0.051 (0.028)	0.053 (0.031)	0.019 (0.016)	0.000 (0.024)
$w_t^1 \times 1_{(j \in \text{Spring water})}$	0.045 (0.027)	0.049 (0.030)	-0.019 (0.016)	0.008 (0.023)
$w_t^2 \times 1_{(j \in \text{Mineral water})}$	0.020 (0.014)	0.028 (0.015)	0.013 (0.008)	-0.007 (0.012)
$w_t^2 \times 1_{(j \in \text{Spring water})}$	-0.001 (0.009)	0.004 (0.012)	-0.008 (0.006)	0.004 (0.009)
$w_t^3 \times 1_{(j \in \text{Mineral water})}$	-0.002 (0.009)	-0.003 (0.010)	-0.008 (0.005)	0.002 (0.008)
$w_t^3 \times 1_{(j \in \text{Spring water})}$	-0.007 (0.008)	0.008 (0.009)	0.008 (0.005)	-0.005 (0.007)
$w_t^4 \times 1_{(j \in \text{Mineral water})}$	-0.009 (0.006)	-0.010 (0.007)	-0.002 (0.004)	0.005 (0.005)
$w_t^4 \times 1_{(j \in \text{Spring water})}$	0.002 (0.005)	0.002 (0.006)	0.001 (0.003)	-0.000 (0.004)
$w_t^5 \times 1_{(j \in \text{Mineral water})}$	0.006 (0.009)	0.008 (0.010)	0.002 (0.005)	-0.007 (0.007)
$w_t^5 \times 1_{(j \in \text{Spring water})}$	-0.005 (0.007)	-0.006 (0.007)	0.000 (0.004)	-0.001 (0.006)
$\xi_{jt}^g \times 1_{(j \in \text{Mineral water})}$		-0.068 (0.032)	1.057 (0.017)	0.002 (0.025)
$\xi_{jt}^g \times 1_{(j \in \text{Spring water})}$		-0.019 (0.037)	-1.058 (0.020)	0.877 (0.028)
Estimates of $\delta'_j, \gamma'_t$ not shown				
$F$ test that all $\delta'_j = 0$	163.18	153.65	31.89	92.00
( $p$ value)	(0.000)	(0.000)	(0.000)	(0.000)
$F$ test that all $\gamma'_t = 0$	2.81	2.88	0.62	0.82
( $p$ value)	(0.000)	(0.000)	(0.954)	(0.756)

Table : First Stage Results for the Demand Estimates

The first stage regressions of the two stage least squares estimation of the demand models also include some period specific effects (denoted  $\gamma'_t$ ) and some product specific effects (denoted  $\delta'_j$ ). Moreover, excluded instrumental variables are variables crossing the mineral water and spring water dummy variables with the wage salary, an oil price index, a diesel price index, a packaging material cost index and the plastic price. In the case of the nested logit model estimation, one needs more instrumental variables and we thus use the variable denoted  $\xi_{jt}^g$  obtained from (16) that is reported in the following table (all the estimated  $\pi_j$  are not reported).

$\ln s_{jt g}$	Coefficient	Std.
$\ln s_{jt-1 g}$	0.469	(0.020)
Constant	-1.992	(0.760)
$F$ test that all $\pi_j = 0$	10.97	(0.000)
$F$ test ( $p$ value)	549.10	(0.000)

Table : Auxiliary regression to define  $\xi_{jt}^g$

### 7.3 Estimates of Cost Equations

Here, we present the empirical results of the estimation of the cost equation (18) for  $h = 1, \dots, 14$  that is

$$\ln C_{jt}^h = \omega_j^h + W_{jt}\gamma_g + \ln \eta_{jt}^h$$

where variables  $W_{jt}$  include time dummies  $\delta_t$ , wages, oil, diesel, packaging material and plastic price variables interacted with the dummy variable for spring water ( $SW$ ) and mineral water ( $MW$ ).

$\ln C_{jt}^h$	Coefficients (Std. err.)					
	salary $\times SW$	salary $\times MW$	plastic $\times SW$	plastic $\times MW$	packaging $\times SW$	packaging $\times MW$
Model 1	-0.316 (0.032)	-0.109 (0.025)	-0.074 (0.014)	-0.039 (0.012)	0.071 (0.011)	0.020 (0.009)
Model 2	-0.504 (0.042)	-0.147 (0.032)	-0.127 (0.018)	-0.054 (0.015)	0.098 (0.014)	0.030 (0.012)
Model 3	-0.318 (0.041)	-0.110 (0.030)	-0.062 (0.018)	-0.037 (0.014)	0.063 (0.013)	0.026 (0.011)
Model 4	0.040 (0.058)	-0.175 (0.040)	0.090 (0.024)	-0.055 (0.019)	0.000 (0.017)	0.039 (0.014)
Model 5	-0.021 (0.015)	-0.008 (0.012)	0.001 (0.007)	-0.009 (0.006)	0.002 (0.005)	0.006 (0.004)
Model 6	-0.036 (0.015)	-0.009 (0.012)	-0.001 (0.007)	-0.010 (0.006)	0.005 (0.005)	0.006 (0.004)
Model 7	-0.107 (0.018)	-0.042 (0.014)	-0.020 (0.008)	-0.020 (0.007)	0.020 (0.006)	0.013 (0.005)
Model 8	-0.165 (0.021)	-0.057 (0.017)	-0.035 (0.009)	-0.024 (0.008)	0.034 (0.007)	0.014 (0.006)
Model 9	0.002 (0.013)	0.008 (0.010)	0.005 (0.006)	-0.004 (0.005)	-0.002 (0.004)	0.003 (0.004)
Model 10	-0.019 (0.014)	-0.008 (0.011)	0.001 (0.006)	-0.008 (0.005)	0.003 (0.005)	0.006 (0.004)
Model 11	-0.007 (0.013)	-0.002 (0.011)	0.003 (0.006)	-0.006 (0.005)	-0.000 (0.005)	0.004 (0.004)
Model 12	-0.076 (0.014)	-0.040 (0.011)	-0.014 (0.006)	-0.017 (0.005)	0.014 (0.005)	0.012 (0.004)
Model 13	-0.027 (0.014)	-0.011 (0.011)	-0.000 (0.006)	-0.007 (0.005)	0.004 (0.005)	0.006 (0.004)
Model 14	-0.133 (0.015)	-0.066 (0.012)	-0.027 (0.007)	-0.024 (0.006)	0.025 (0.005)	0.016 (0.004)

Table : Cost Equations for the Multinomial Logit Model

$\ln C_{jt}^h$	Coefficients (Std. err.)				All $\delta_t = 0$	All $\omega_j^g = 0$
	diesel $\times SW$	diesel $\times MW$	oil $\times SW$	oil $\times MW$	$F$ test ( $p$ val.)	$F$ test ( $p$ val.)
Model 1	-0.013 (0.007)	0.006 (0.006)	0.040 (0.009)	0.007 (0.008)	8.01 (0.000)	274.39 (0.000)
Model 2	-0.003 (0.009)	0.007 (0.007)	0.043 (0.012)	0.008 (0.010)	5.80 (0.000)	189.82 (0.000)
Model 3	-0.027 (0.008)	0.004 (0.006)	0.058 (0.011)	0.008 (0.009)	3.35 (0.000)	250.34 (0.000)
Model 4	-0.061 (0.012)	-0.004 (0.009)	0.058 (0.015)	0.024 (0.013)	2.08 (0.001)	218.02 (0.000)
Model 5	-0.005 (0.003)	-0.000 (0.003)	0.011 (0.005)	0.003 (0.004)	1.67 (0.011)	783.26 (0.000)
Model 6	-0.005 (0.003)	-0.000 (0.003)	0.012 (0.005)	0.003 (0.004)	1.72 (0.008)	796.10 (0.000)
Model 7	-0.006 (0.004)	0.001 (0.003)	0.018 (0.005)	0.004 (0.005)	2.64 (0.000)	729.80 (0.000)
Model 8	-0.009 (0.004)	0.003 (0.004)	0.024 (0.006)	0.004 (0.005)	3.47 (0.000)	599.76 (0.000)
Model 9	-0.004 (0.003)	-0.001 (0.003)	0.007 (0.004)	0.002 (0.003)	1.29 (0.133)	560.97 (0.000)
Model 10	-0.005 (0.003)	-0.000(0.002)	0.010 (0.004)	0.002 (0.004)	1.16 (0.251)	535.56 (0.000)
Model 11	-0.004 (0.003)	-0.001 (0.002)	0.008 (0.004)	0.002 (0.003)	1.47 (0.045)	557.61 (0.000)
Model 12	-0.005 (0.003)	0.001 (0.002)	0.014 (0.004)	0.004 (0.004)	3.43 (0.000)	550.13 (0.000)
Model 13	-0.005 (0.003)	-0.001 (0.002)	0.012 (0.004)	0.004 (0.003)	1.89 (0.002)	562.73 (0.000)
Model 14	-0.005 (0.003)	0.001 (0.003)	0.020 (0.004)	0.007 (0.004)	7.25 (0.000)	519.31 (0.000)

Table (continued) : Cost Equations for the Multinomial Logit Model

$\ln C_{jt}^h$	Coefficients (Std. err.)					
	salary $\times$ SW	salary $\times$ MW	plastic $\times$ SW	plastic $\times$ MW	packaging $\times$ SW	packaging $\times$ MW
Model 1	-0.172 (0.023)	-0.006 (0.018)	-0.010 (0.010)	0.000 (0.008)	-0.004 (0.010)	-0.025 (0.009)
Model 2	-0.206 (0.025)	-0.005 (0.020)	-0.017 (0.011)	-0.000 (0.008)	-0.003 (0.011)	-0.028 (0.010)
Model 3	-0.257 (0.028)	-0.010 (0.022)	-0.029 (0.012)	-0.000 (0.009)	-0.003 (0.012)	-0.035 (0.010)
Model 4	0.027 (0.036)	-0.046 (0.025)	0.062 (0.014)	-0.003 (0.011)	-0.037 (0.014)	-0.024 (0.012)
Model 5	-0.007 (0.013)	0.004 (0.010)	0.011 (0.006)	0.000 (0.004)	-0.003 (0.006)	0.000 (0.005)
Model 6	-0.006 (0.019)	0.004 (0.015)	0.017 (0.008)	-0.003 (0.006)	-0.010 (0.0081)	0.002 (0.007)
Model 7	-0.015 (0.014)	-0.002 (0.011)	0.010 (0.006)	0.001 (0.005)	-0.005 (0.006)	-0.002 (0.005)
Model 8	-0.018 (0.016)	0.012 (0.013)	0.011 (0.007)	0.006 (0.005)	-0.005 (0.007)	-0.005 (0.006)
Model 9	0.000 (0.012)	0.005 (0.010)	0.008 (0.005)	-0.001 (0.004)	-0.001 (0.005)	0.002 (0.005)
Model 10	-0.004 (0.014)	-0.006 (0.011)	0.005 (0.006)	-0.004 (0.005)	0.001 (0.006)	0.006 (0.005)
Model 11	-0.003 (0.012)	0.004 (0.010)	0.009 (0.005)	0.000 (0.004)	-0.003 (0.005)	0.001 (0.005)
Model 12	-0.031 (0.015)	-0.007 (0.011)	0.006 (0.006)	-0.001 (0.005)	-0.005 (0.006)	-0.004 (0.006)
Model 13	-0.008 (0.013)	0.002 (0.011)	0.010 (0.006)	0.000 (0.004)	-0.000 (0.006)	0.001 (0.005)
Model 14	-0.097(0.018)	-0.008 (0.014)	0.001 (0.007)	0.003 (0.006)	-0.006 (0.007)	-0.019 (0.007)

Table : Cost Equations for the Nested Logit Model

$\ln C_{jt}^h$	Coefficients (Std. err.)				All $\delta_t = 0$	All $\omega_j^g = 0$
	diesel $\times$ SW	diesel $\times$ MW	oil $\times$ SW	oil $\times$ MW	$F$ test ( $p$ val.)	$F$ test ( $p$ val.)
Model 1	0.013 (0.005)	0.014 (0.004)	0.000 (0.007)	-0.010 (0.006)	5.38 (0.000)	300.63 (0.000)
Model 2	0.017 (0.005)	0.016 (0.005)	-0.001 (0.008)	-0.013 (0.006)	5.48 (0.000)	274.99 (0.000)
Model 3	0.024 (0.006)	0.020 (0.005)	-0.005 (0.008)	-0.016 (0.007)	6.01 (0.000)	244.69 (0.000)
Model 4	-0.010 (0.008)	0.015 (0.006)	0.007 (0.010)	-0.006 (0.008)	3.13 (0.000)	233.37 (0.000)
Model 5	-0.002 (0.003)	-0.001 (0.002)	0.005 (0.004)	0.003 (0.003)	1.09 (0.345)	495.72 (0.000)
Model 6	-0.001 (0.004)	-0.001 (0.003)	0.006 (0.006)	0.002 (0.005)	1.02 (0.435)	276.84(0.000)
Model 7	-0.000 (0.003)	0.001 (0.003)	0.004 (0.004)	0.002 (0.004)	1.21 (0.200)	473.69 (0.000)
Model 8	0.001 (0.004)	-0.000 (0.003)	0.002 (0.005)	0.002 (0.004)	1.23 (0.190)	383.82 (0.000)
Model 9	-0.003 (0.003)	0.002 (0.002)	0.006 (0.004)	0.003 (0.003)	1.08 (0.356)	473.31 (0.000)
Model 10	-0.005 (0.003)	-0.002 (0.003)	0.008 (0.004)	0.003 (0.004)	0.84 (0.707)	236.63 (0.000)
Model 11	-0.002 (0.003)	-0.001 (0.002)	0.005 (0.004)	0.003 (0.003)	1.13 (0.287)	490.63 (0.000)
Model 12	-0.000 (0.003)	0.002 (0.003)	0.002 (0.003)	0.006 (0.004)	1.97 (0.002)	298.09 (0.000)
Model 13	-0.004 (0.003)	-0.001 (0.003)	0.007 (0.004)	0.003 (0.003)	1.18 (0.238)	452.71 (0.000)
Model 14	0.006 (0.004)	0.009 (0.003)	0.006 (0.005)	-0.006 (0.005)	6.33 (0.000)	350.49 (0.000)

Table (continued) : Cost Equations for the Nested Logit Model

## 7.4 Additional Non Nested Tests

Vuong (1989) Test Statistic													
$H_1 \backslash H_2$	2	3	4	5	6	7	8	<b>9</b>	10	11	12	13	14
1	3.74	3.34	8.01	-4.96	-4.93	-4.10	-2.78	<b>-6.06</b>	-5.68	-6.02	-5.62	-5.64	-5.396
2		1.70	5.77	-7.10	-7.16	-6.32	-4.93	<b>-8.27</b>	-7.87	-8.23	-7.82	-7.84	-7.67
3			6.46	-7.01	-7.08	-6.17	-5.74	<b>-8.25</b>	-7.83	-8.21	-7.77	-7.78	-7.52
4				-12.93	-13.16	-11.84	-11.38	<b>-14.57</b>	-14.02	-14.51	-13.89	-13.90	-13.54
5					0.56	13.18	4.39	<b>-12.63</b>	-7.32	-12.23	-7.81	-9.29	-2.03
6						7.77	4.92	<b>-11.63</b>	-7.06	-11.29	-7.07	-6.67	-2.58
7							2.51	<b>-15.63</b>	-12.10	-15.53	-13.27	-14.69	-11.99
8								<b>-6.65</b>	-5.85	-6.58	-5.77	-5.67	-5.06
<b>9</b>									<b>8.80</b>	<b>6.87</b>	<b>16.42</b>	<b>12.47</b>	<b>12.19</b>
10										-7.07	2.36	1.60	6.41
11											14.26	12.21	12.00
12												0.46	7.30
13													7.23

Table : Results of the Vuong Test for the Multinomial Logit Model

Vuong (1989) Test Statistic													
$H_1 \backslash H_2$	2	3	4	5	6	7	8	<b>9</b>	10	11	12	13	14
1	9.17	7.68	7.98	-15.49	-1.06	-14.98	-3.95	<b>-15.34</b>	-10.75	-15.65	-11.21	-13.57	-15.35
2		6.64	6.88	-15.46	-1.39	-14.96	-4.62	<b>-15.56</b>	-11.40	-15.78	-11.70	-13.98	-14.65
3			5.46	-14.46	-1.79	-13.96	-5.32	<b>-14.90</b>	-11.47	-14.98	-11.56	-13.47	-12.57
4				-14.94	-2.44	-14.55	-6.55	<b>-15.23</b>	-12.15	-15.30	-12.35	-14.54	-12.10
5					1.58	12.88	2.09	<b>-10.29</b>	3.61	-11.47	5.49	0.47	12.51
6						-1.35	-0.64	<b>-2.00</b>	1.22	-1.91	-1.13	-1.54	-0.27
7							1.56	<b>-11.68</b>	1.22	-12.97	2.49	-2.15	11.04
8								<b>-3.06</b>	-1.21	-2.85	-1.02	-1.96	0.98
<b>9</b>									<b>9.65</b>	<b>6.67</b>	<b>12.09</b>	<b>5.49</b>	<b>13.25</b>
10										-8.13	2.40	-2.64	6.90
11											10.86	4.56	13.55
12												-3.63	7.40
13													9.59

Table : Results of the Vuong Test for the Nested Logit Model

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