FORMULA PRICING AND PROFIT SHARING
IN TRADITIONAL FRANCHISING

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I. INTRODUCTION

In traditional franchising, manufacturers of differentiated goods distribute their products through networks of geographically dispersed franchised dealers. Suppose that within each local market, there is room for only one distributor and, therefore, each franchisee is awarded exclusive rights. This means that each franchisee has a monopoly in the resale of the manufacturer’s product locally. This gives rise to a market structure known as a successive monopoly, where we expect to find repeated marginalization at successive stages of production and distribution. It is well known that if such repeated marginalization occurs, the sum of the profits of the manufacturer and retailer is below the joint profit-maximizing level. This creates an incentive to vertically integrate. Vertical integration solves the successive monopoly problem by removing the second monopoly, and thus the second margin.

In some situations, discussed further below, ownership integration may not be an attractive or even a feasible option. But there is still a powerful profit incentive to achieve the economic results of vertical integration. In analyses of the bilateral monopoly problem, where the downstream firm is not only a local monopolist, but also a monopsonist for the upstream firm’s product, it has been typical to assume that the bilateral monopolists understand that cooperation is in their best interest, and that they will find a way to achieve the joint-profit maximizing level of output. Similarly, there is no reason to suppose that the firms in a successive monopoly will fail to recognize that cooperation is in their mutual interest. To this end, in this

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1 This paper relies on earlier work with a great friend, David Kaserman, who left us far too soon. Another great friend, Francine Lafontaine, made major improvements on an earlier draft. I am grateful to both of them for their contributions, but retain full responsibility for what follows.

2 See Spengler (1950) and Machlup and Taber (1960) for early treatments of successive monopoly.
paper, we characterize a contractual agreement that provides results that are very close to those obtained under ownership integration in the successive monopoly situation. This agreement specifies a profit sharing rule, or, equivalently, a formula that determines the franchisor’s wholesale price as a function of the final output price and the average costs of production at both the upstream and the downstream stages.\footnote{See Blair and Kaserman (1987) for an examination of price contracts as a means of dealing with the bilateral monopoly problem.}