Star attraction
Could exclusive deals and vertical mergers in two-sided markets be good for consumers?

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Competition authorities tend to view exclusive contracts as being inherently anti-competitive if they involve suppliers with market power. However, when markets are two-sided – benefitting by matching suppliers with consumers – things can be different. 'Superstar' content providers, who can bring consumers to a platform, can make that platform more attractive to small providers and also benefit consumers. Competition authorities need to take account of these effects, both when assessing exclusive dealing and also when considering a vertical merger between a superstar and a platform.

Superstars in two-sided markets

Online platforms create new possibilities to match consumers and content suppliers, thereby benefiting both groups. Platforms, such as music-on-demand apps, facilitate interactions between content providers (artists) and consumers (listeners) who both value the number and quality of the interactions with the other side of the market. Some of these content suppliers are more influential than others and can have a significant impact on the market. These are 'superstar' content providers who have loyal followers or are considered high-quality. As a result, these superstars are in a strong bargaining position when it comes to negotiating their exclusive or non-exclusive presence on platforms that are in turn competing to create an ecosystem of consumers and content providers.

For instance, in the music industry there are a few top-rated artists who have a large number of loyal fans. These superstars' content can either be made available exclusively on one platform or non-exclusively on all platforms. Platforms will always prefer exclusivity, but the superstars themselves face a difficult decision.

Moreover, whether they choose to have an exclusive or non-exclusive contract can have competition implications, as exclusive contracts have sometimes been considered harmful. For example, the Chinese competition authority is investigating Tencent Music on its exclusive deals with labels, and is strongly considering banning exclusive deals in this market.[4] However, these concerns do not pay enough attention to the differences between traditional one-sided markets and two-sided platforms.

Determining the winners and losers (if any)

To demonstrate this we examined first, under what conditions superstars would sign such exclusive deals, and then what the effects would be, on competition and consumers.

We use a model of competition between two horizontally differentiated platforms creating valuable interactions between firms and consumers. We distinguish between two types of content providers: the superstar who has market power and offers content either exclusively or non-exclusively in the market, and a fringe of small content providers who decide whether to join the platforms and do not have market power.

Why do superstars sign exclusive contracts?

When deciding between offering its content exclusively or non-exclusively, a superstar faces a trade-off. A superstar makes profits from two elements: it receives a payment when selling its unique content to a platform; but it also benefits from the presence of consumers on a platform (for example, through fame or ancillary revenues such as merchandising, visits to concerts and so on). For the first element an exclusive contract will be better, as the platform hosting the superstar exclusively is more attractive to consumers and this can be monetized by the superstar.

However, the superstar would also benefit from interactions with more consumers, creating an incentive to distribute its content more widely. When the superstar offers an exclusive contract to a platform, that platform becomes more attractive to consumers and hence also to small content providers. As more consumers follow the superstar, more small content providers become active in the market and agglomerate on this platform. Exclusivity, therefore, renders this platform *favoured* in the competition with the rival *unfavoured* platform.

When the superstar offers a non-exclusive contract, in contrast, the two platforms are very similar in the eyes of the consumers and the products of all active small providers are available on both platforms. As a result, consumers join the platform they prefer, because there are no other differences between them. Thus, the effect of exclusivity on the second element depends on how willing consumers are to switch between platforms if the superstar signs an exclusive contract with one platform - the strength of the network effects.

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Fiercer platform competition drives more exclusivity

With highly mobile consumers, consumers are more responsive to the presence of the superstar and there is intense platform competition. More consumers join the *favoured* platform than the *unfavoured* platform without the superstar. This stimulates more exclusivity in the market. First, some of the content providers that were inactive (in the case of non-exclusive contracts) become active on the *favoured* platform. Second, some of the small providers that were multihoming under a non-exclusive contract, affiliate exclusively with the *favoured* platform. If this additional surplus due to the exclusive presence of the superstar is large, the superstar finds it profitable to offer exclusive contracts.

In contrast, when the consumers are less mobile and so competition between the platforms is softer, the exclusive contract of the superstar does not affect as much the competition between the platforms. In this situation reaching the largest possible audience becomes more profitable for the superstar, who is hence more likely to offer non-exclusive contracts.

Figures 1 and 2 provide a graphical representation of the industry dynamics when the superstar makes non-exclusive and exclusive contract offers to platforms, respectively.

Figure 1: Non-exclusive contracts

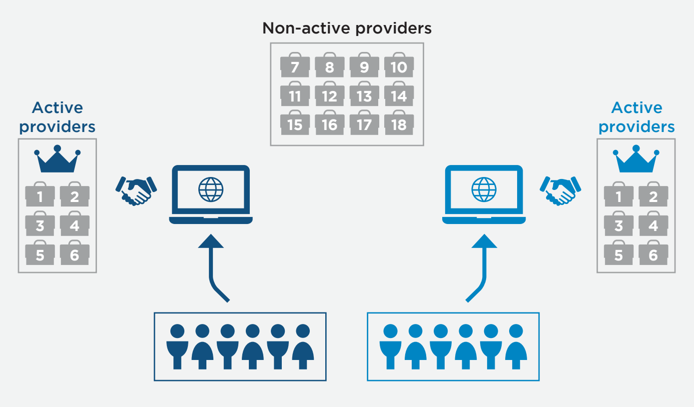
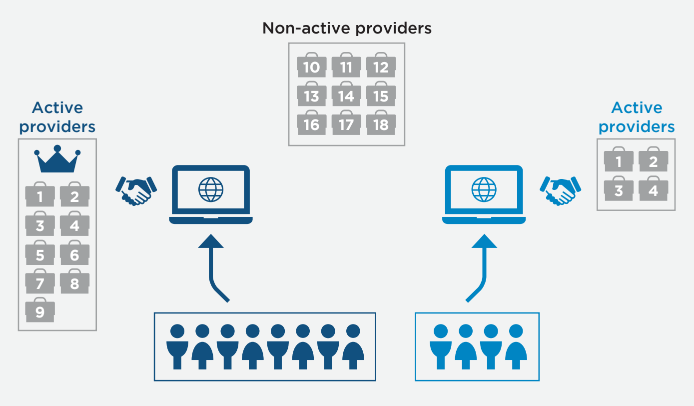


Figure 2: Exclusive contract



What is the effect of exclusive contracts?

In one-sided markets, exclusive contracts involving a supplier with market power have ambiguous effects: there may be efficiency benefits but such exclusivity can sometimes lead to foreclosure. However, in two-sided markets with network effects, exclusivity is more likely to be pro-competitive.

Our research has shown that exclusive contracts of the sort we describe here are always beneficial to small content providers. This is because small content providers benefit from the content-discovery and demand-discovery effects generated by the Superstar. More content providers join the market and there is a surplus creation on this side of the market.

Furthermore, exclusive contracts might also be beneficial to consumers when those consumers highly value the presence of smaller content providers on the other side. If consumers care about variety when joining Spotify, Apple Music, and Tidal, then the presence of a superstar exclusively on a platform can be welfare-enhancing as more consumers and small firms are present on that platform. The presence of these strong network benefits may make exclusive contracts beneficial to consumers.

Vertical mergers lead to lower prices under exclusivity

Many two-sided platforms are characterized by a significant degree of vertical integration, due to in-house content production or vertical mergers. For instance, in the music industry, Spotify recently acquired Gimlet and Parcast, two top-rated podcast producers.

Our research also shows that indirect network effects in two-sided markets also increase the benefits from vertical integration. Post-merger, the merged entity is more likely to offer non-exclusive contracts than would an independent superstar. This is because the merged entity internalizes the network benefits the superstar obtains from the interactions with consumers and hence lowers its prices under exclusive deals relative to the pre-merger case. This is an additional downward pressure on prices apart from the usual vertical merger efficiencies such as avoidance of double marginalization and other merger specific efficiencies. This implies that non-exclusive contracts are more appealing in the post-merger case than in the pre-merger case. In contrast, when superstars' content is available non-exclusively, we found no change in prices as a result of the merger.

Policy Implications

Competition authorities need to consider the effects of superstars on both sides of the market

Indirect network externalities do matter. Our results suggest that exclusive dealing between a premium agent and a platform(s) is not necessarily bad for welfare. Because of network effects, an exclusive contract might benefit small providers and final consumers.

Banning exclusive dealing may lead to unintended effects

Policy measures leading to a ban on exclusive dealing are undoubtedly detrimental to small content providers who benefit from positive spill-over of exclusive deals by large content providers, in such markets. Consumers might also be harmed by such a ban.

Competition drives exclusivity

Our results identify an important efficiency motive for exclusive dealing in two-sided markets: attracting consumers to the superstar's exclusive presence, enabling a surplus to be extracted by the superstar with an exclusive contract. Thus, policies limiting exclusive dealing might harm competition. For instance, facilitating switching behaviour through data portability may increase competitive pressure by lowering consumer attachment to their preferred platform and, in turn, lead to more exclusivity.

Due diligence when assessing vertical mergers with network effects

Finally, our research shows that, when network effects are at stake, vertical mergers can often reduce prices, rather than leading to higher prices through foreclosure. First, the likelihood of input foreclosure (through exclusive supply) is lower under vertical integration of the superstar and a platform than when they are separate. Second, if input foreclosure (exclusive contracts) occurs, consumer prices are lower than under vertical separation as the merged entity internalizes the network effect of the superstar.

These results suggest that policymakers must take account of the pro-competitive effects of exclusive dealing when reviewing mergers involving two-sided markets with indirect network effects. Failing to do so could lead to overestimation of the potential harm and thus efficient mergers being rejected without good reason.

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