

University of Wisconsin-Madison
Department of Agricultural & Applied Economics

Staff Paper No. 535

Revised October 2010

**On Pricing and Vertical Organization of
Differentiated Products**

By

Guanming Shi and Jean-Paul Chavas

**AGRICULTURAL &
APPLIED ECONOMICS**

STAFF PAPER SERIES

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The Effects of Vertical Organization on the Pricing of Differentiated Products

by
Guanming Shi
and
Jean-Paul Chavas¹

October 2010

Abstract: This paper investigates differentiated product pricing and the effects of vertical organization under imperfect competition. We use a Cournot model to examine the relationship between price margins and market concentrations in a vertical sector involving multi-product firms producing differentiated products. The analysis relies on vertical measures of concentration (termed VHHI) to study how the exercise of market power varies with substitution/complementarity relationships among products and vertical structures. This approach is used to analyze the US soybean seed pricing under two vertical structures: vertical integration and licensing. We find evidence that vertical organization has significant effects on soybean seed prices. These effects vary depending on the institutional setup. The empirical evidence indicates how complementarity can mitigate price enhancements associated with market concentration.

Key Words: Vertical structures, pricing, imperfect competition, seed, biotechnology

JEL Code: L13, L4, L65

¹ Respectively, Assistant Professor and Professor, Taylor Hall, University of Wisconsin, Madison, WI 53706. Email: gshi@wisc.edu and jchavas@wisc.edu. This research was funded in part by NRI grant #144-QS50 and a USDA Hatch grant.

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1. INTRODUCTION

A great deal of research has examined the role of market power exercised by firms in vertical structures (e.g., Spengler 1950; Hart and Tirole 1990; Ordoover, Saloner and Salop 1990; O'Brien and Shaffer 1992; McAfee and Schwartz 1994; De Fontenay and Gans 2005; Lafontaine and Slade 2007; Gans 2007). Yet, the implications of vertical control remain a subject of debate (e.g., Tirole 1992; Whinston 2006). On the one hand, one school of thought—often associated with the University of Chicago—stresses the notion that greater vertical control leads to efficiency gains. On the other hand, concerns linger about potential adverse welfare effects of vertical control, including the impact on foreclosures and possible efficiency losses associated with reduced competition (e.g., Whinston 2006; Rey and Tirole 2008).

Adding differentiated products to the analysis of vertical organization further complicates matters. Previous work has often avoided this issue by focusing on monopolies or on perfect substitutes in upstream and/or downstream markets (e.g. Hart and Tirole 1990; Ordoover, Saloner and Salop 1990; O'Brien and Shaffer 1992). Yet, product differentiation is commonly found in vertical channels.² This raises the question: how to analyze the effects of vertical organization on pricing of differentiated products? The objective of this paper is to study the linkages between vertical structures and pricing under product differentiation. This is done using a Cournot model of multi-product firms to examine the relationship between price margins, vertical organization and market concentrations.

² For example, Hastings (2004) found that gasoline consumption in southern California exhibits significant vertical product differentiation: consumers view branded gasoline supplied under vertical integration as different from generic gasoline sold by independent gas stations.

A key aspect of the analysis involves the characterization of vertical market concentrations under product differentiation. Economists have come to rely on the Herfindahl-Hirschman Index (HHI) to assess horizontal market concentration (e.g., Whinston 2006). Our analysis extends it by developing a vertical HHI (termed VHHI) that captures the ways in which market concentration and vertical organization interact to influence the exercise of market power, and consequently, the prices of differentiated products. Note that adapting HHI measures to the analysis of vertical organization is not new. For example, McAfee et al. (2001) and Gans (2007) have studied how HHI-type measures can be used to examine the effects of vertical mergers. Yet, their analysis focused on the case of a single consumer good. The VHHI concentration measures used in our analysis apply to vertical organization under differentiated products.³ The usefulness of the approach is illustrated in an econometric application to pricing in the soybean seed industry. It shows how our VHHI measures provide valuable insights into the effects of vertical integration under product differentiation.

The soybean seed market makes an excellent case study. The recent biotechnology revolution has led agricultural biotech firms to differentiate their seed products through patented genetic materials.⁴ In addition, in the last two decades, mergers and acquisitions in the US soybean seed industry has changed the industry's horizontal and vertical structures. The markets for soybean seeds have become increasingly concentrated. In the late 1980s, the top four largest firms accounted for 40% of the soybean seed market, a substantial rise from 5.2% in 1980 (Fernandez-Cornejo 2004). Our data show that this percentage further increased to 55% in 2007. These changes are associated with the growing importance of biotech firms producing patented

³ See Chavas and Shi (2010) for a detailed discussion about how our VHHI measures compare and differ from that of Gans (2007).

⁴ For biotech seeds, one aspect of product differentiation involves the inclusion of patented genes/traits in seeds, either individually (often referred as "single-trait") or in bundled form (often referred as "stacked traits").

genes in the upstream trait market. This upstream market is highly concentrated: Over the last ten years, only two biotech companies have been involved in the soybean seed market. Finally, the vertical organization of the industry has also changed. While biotech firms (producing patented genes) have relied extensively on licensing their technologies to seed companies (who produce the seeds sold to farmers), they have recently increased their use of vertical control through integration. For example, our data show that vertical integration in the US single-traited soybean seed market has increased from 13% in 2000 to 26% in 2007.

As Graff, Rausser and Small (2003) have noted, these structural changes have been motivated in part by complementarities of assets within and between the agricultural biotechnology and seed industries. Thus, it seems likely that seed markets have become highly concentrated because vertical and horizontal integration have created efficiency gains (particularly due to economies of scope in the production of genetic traits). However, biotech firms can also use their market power to increase seed prices, which can adversely affect economic efficiency and farmers' profits (e.g., Fulton and Giannakas 2001; Fernandez-Cornejo 2004). Are the structural changes in the US soybean seed market motivated by efficiency gains, or do they reflect attempts to increase market power? We attempt to answer these questions by empirically investigating how differentiated seed products are priced under two alternative vertical structures: vertical integration versus licensing.

Our analysis also examines how the institutional setup can affect soybean seed pricing. Beginning in the 1970s, the US soybean seed industry experienced a rapid shift from public sector to private sector breeding. Publicly developed varieties' acreage shares decreased from over 70% in 1980 to 10% in the mid-1990s (Fernandez-Cornejo 2004) and to 0.5% in 2007,

according to our data.⁵ Such changes were initiated largely by advances in breeding technology (including biotechnology) and changes in the intellectual property protection of life forms. Presently, how these institutional changes impact pricing is not well understood. Our study provides new and useful information about these effects.

Our econometric analysis examines the interactions between product differentiation, vertical organization, market concentrations and pricing in the soybean seed industry. We document that publicly sourced seeds are priced significantly lower than are privately sourced seeds. We find that seeds sold through vertically integrated structures are priced higher than those that are licensed. Our investigation also shows how complementarity can mitigate market power-related price enhancements within the privately sourced seed market. It indicates that market concentration studies that ignore vertical structures (e.g., those that utilize a traditional HHI) fail to capture the linkages between market structure and pricing.

Our analysis is organized as follows. In Section 2 we present a conceptual framework for multiproduct pricing under imperfect competition. We develop a Cournot model that motivates the VHHIs and captures the role of imperfect competition in both vertical and horizontal markets. In Sections 3 and 4 we present an econometric specification of pricing and its application to the US soybean seed market. The model provides a basis to investigate the joint role of vertical organization and market power (using our VHHIs measures). In Section 5 we discuss our estimation method and econometric results, and in Sections 6 and 7 we report our empirical findings and evaluate their implications. In Section 8 we offer some concluding thoughts.

⁵ Focusing only on the market for conventional seeds (i.e., seeds not including patented genes), publicly sourced soybean seed varieties accounted for approximately 10% of the acreage in 2007.

2. MODEL

Consider a market involving N firms that produce K outputs. Output production and marketing involves upstream markets under V alternative vertical structures (e.g., vertical contracts or ownership). We use $\mathbf{y}^n = (y_{11}^n, \dots, y_{k\tau}^n, \dots, y_{kV}^n) \in \mathfrak{R}_+^{KV}$ to denote the vector of output quantities that are produced by the n -th firm, where $y_{k\tau}^n$ represents the k -th output quantity produced by the n -th firm under the τ -th vertical structure. We assume that the vertical structures can support product differentiation and price discrimination schemes. This means that products and prices can vary across vertical structures (e.g., from differences in consumer perception, quality, label and/or packaging). Within this context, the price-dependent demand for the k -th output under the τ -th vertical structure is $p_{k\tau}(\sum \mathbf{y}^n)$.

For simplicity, we assume that efficient contracts exist among all firms. This means that upstream production and marketing decisions are efficient and made in ways consistent with the minimization of aggregate cost across all marketing channels.⁶ Given these conditions, the n -th firm's profit is $\pi^n = \sum_{k \in \mathbf{K}} \sum_{\tau \in \mathbf{V}} [p_{k\tau}(\sum \mathbf{y}^j) \cdot y_{k\tau}^n] - C^n(\mathbf{y}^n)$, where $C^n(\mathbf{y}^n)$ denotes the n -th firm's cost of producing \mathbf{y}^n , $\mathbf{K} \equiv \{1, \dots, K\}$ denotes the output set, and $\mathbf{V} \equiv \{1, \dots, V\}$ denote the set of alternative vertical structures. We assume a Cournot game. Under differentiability, the decisions of the n -th firm satisfies $\pi^n \geq 0$, along with the profit maximizing condition with respect to the k -th output quantity in the τ -th vertical structure, $y_{k\tau}^n$,

$$p_{k\tau} + \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} (\partial p_{mu} / \partial y_{k\tau}^n) \cdot y_{mu}^n - (\partial C^n / \partial y_{k\tau}^n) \leq 0, \quad (1a)$$

⁶ Note that the presence of efficient vertical contracts rules out vertical externalities. Previous research has discussed possible inefficiencies in vertical contracts (Spengler 1950; Tirole 1992). These include “double marginalization” situations, wherein a failure to deal with vertical externalities can contribute to cost increases. While these inefficiencies would affect cost in equations (1a) and (1c), such effects are neglected in our analysis. While studying these effects remains of interest, they are not examined in this paper for a simple empirical reason: without data on upstream prices in the soybean seed industry, it does not seem possible for us to identify the effects of double marginalization. Examining the issue of double marginalization under product differentiation appears to be a good topic for future research.

$$y_{k\tau}^n \geq 0, \quad (1b)$$

$$[p_{k\tau} + \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} (\partial p_{mu} / \partial y_{k\tau}^n) \cdot y_{mu}^n - (\partial C^n / \partial y_{k\tau}^n)] \cdot y_{k\tau}^n = 0. \quad (1c)$$

Equation (1c) is the complementary slackness condition. It applies irrespective of whether the k -th output is produced by the n -th firm in the τ -th vertical structure ($y_{k\tau}^n > 0$), or not ($y_{k\tau}^n = 0$). And it remains valid regardless of how many of the K products the firm chooses to carry. As such, this equation is consistent with foreclosure strategies (where some of the outputs are zero), as analyzed in previous research (e.g., Ordober, Saloner, and Salop 1990; Whinston 2006; Rey and Tirole 2008). Additionally, equation (1c)'s validity is unaffected by the vertical structure that the n -th firm chooses to market its products. This means that, under imperfect competition, equation (1c) is broad enough to allow for interactions among firms both horizontally and vertically.

We assume that the cost function of the n -th firm takes the form $C^n(\mathbf{y}^n) = F^n(\mathbf{R}^n) + \sum_{k \in \mathbf{K}} \sum_{\tau \in \mathbf{V}} c_{k\tau} y_{k\tau}^n + 0.5 \sum_{k, m \in \mathbf{K}} \sum_{\tau, u \in \mathbf{V}} c_{mk, u\tau} y_{mu}^n y_{k\tau}^n$, where $\mathbf{R}^n = \{(j, \tau): y_{j\tau}^n > 0, j \in \mathbf{K}, \tau \in \mathbf{V}\}$ is the set of products produced at positive levels by the n -th firm. Here, we use $F^n(\mathbf{R}^n) \geq 0$ to denote fixed cost that satisfies $F^n(\emptyset) = 0$, while $\sum_{k \in \mathbf{K}} \sum_{\tau \in \mathbf{V}} c_{k\tau} y_{k\tau}^n + 0.5 \sum_{k, m \in \mathbf{K}} \sum_{\tau, u \in \mathbf{V}} c_{mk, u\tau} y_{mu}^n y_{k\tau}^n$ denotes variable cost. Note that the presence of fixed costs (where $F^n(\mathbf{R}^n) > 0$ for $\mathbf{R}^n \neq \emptyset$) can imply increasing returns to scale. Then, marginal cost pricing would imply negative profit, and any sustainable equilibrium would necessarily be associated with departures from marginal cost pricing. The fixed cost $F^n(\mathbf{R}^n)$ can come from upstream markets (e.g., R&D cost that an upstream firm incurs when developing a new technology) or downstream markets (such as the expense of establishing a vertical structure).

Total cost $C^n(\mathbf{y}^n)$ can also reflect economies of scope. Scope economies can arise when outputs exhibit complementarity. Complementarity occurs when $\partial^2 C^n / \partial y_{mu}^n \partial y_{k\tau}^n < 0$, i.e. when the

production of output y_{mu}^n reduces the marginal cost of $y_{k\tau}^n$ for $m \neq k$ and $u \neq \tau$ (Baumol et al. 1982, p. 75). In situations of economies of scope, a firm can reduce aggregate cost and generate efficiency gains by selling multiple products across multiple vertical structures.⁷

The above arguments show how our approach can capture efficiency gains. However, our model is also able to represent the exercise of market power. Let $\partial p_{mu} / \partial y_{k\tau} = \alpha_{mk,u\tau}$, where $\alpha_{mm,uu} < 0$ corresponding to a downward sloping demand. The marginal cost of $y_{k\tau}^n$ is $\partial C^n / \partial y_{k\tau}^n = c_{k\tau} + \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} c_{mk,u\tau} y_{mu}^n$, with $c_{mm,uu} \geq 0$ by non-increasing marginal productivity, and $c_{mk,u\tau} = c_{km,\tau u}$ by symmetry. We use $Y_{k\tau} = \sum_{i=1}^N y_{k\tau}^i$ to denote the aggregate output quantity of the k -th product in the τ -th vertical structure. Assuming that $Y_{k\tau} > 0$, define $S_{k\tau}^n = y_{k\tau}^n / Y_{k\tau} \in [0, 1]$ as n -th firm's market share for the k -th product in the τ -th vertical structure. We divide equation (1c) by $Y_{k\tau}$ and sum across all firms to yield:

$$p_{k\tau} = c_{k\tau} + \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} (c_{mk,u\tau} - \alpha_{mk,u\tau}) \sum_{i=1}^N S_{mu}^i S_{k\tau}^i Y_{mu}, \quad (2)$$

which may also be written as

$$p_{k\tau} = c_{k\tau} + \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} (c_{mk,u\tau} - \alpha_{mk,u\tau}) H_{mk,u\tau} Y_{mu}, \quad (3)$$

where $H_{mk,u\tau} = \sum_{i=1}^N S_{mu}^i S_{k\tau}^i$.

Equation (3) is a price-dependent supply function for the k -th product in the τ -th vertical structure. It includes the term

$$M_{k\tau} = \sum_{m \in \mathbf{K}} \sum_{u \in \mathbf{V}} (c_{mk,u\tau} - \alpha_{mk,u\tau}) H_{mk,u\tau} Y_{mu}. \quad (4)$$

In (4), $M_{k\tau}$ is associated with the exercise of market power. Note that $H_{mk,u\tau} \in [0, 1]$, and that $H_{mk,u\tau} \rightarrow 0$ under perfect competition, when there are many active firms. It follows that

⁷ In addition, economies of scope can arise when the joint provision of outputs reduces fixed cost $F^n(\mathbf{R}^n)$ (see Baumol et al., 1982, p. 75).

$M_{k\tau} \rightarrow 0$ under perfect competition. At the opposite extreme, $H_{mk,u\tau} = 1$ under a monopoly, when there is a single active firm. In general, $H_{mk,u\tau}$ increases with market concentration. As such, the term $M_{k\tau}$ in (4) is the price margin that captures the market power effects of imperfect competition. In our analysis below, we make extensive use of equations (3) and (4). In addition, note that M/p is related to the Lerner index L , defined as a relative measure of departure from marginal cost pricing: $L = (p - \partial C/\partial y)/p$. Indeed, when marginal cost is constant, equations (3)-(4) imply that the Lerner index reduces to $L_{k\tau} = (M_{k\tau} / p_{k\tau})$.

Equation (4) provides useful information on the structural determinants of $M_{k\tau}$. When there is a single product ($K = 1$) and a single vertical structure ($V = 1$), $H_{11,11}$ is the traditional Herfindahl-Hirschman Index (HHI), which measures market concentration.⁸ The HHI is commonly used to analyze the exercise of market power (e.g., Whinston 2006). Given a positive marginal cost ($c_{11,11} \geq 0$) and a negative demand slope ($\alpha_{11,11} < 0$), equations (3) – (4) indicate that an increase in the HHI, $H_{11,11}$, which simulates an increase in market power, is associated with an increase in M_{11} , and thus an increase in price, p_{11} . As a rule of thumb, regulatory agencies have regarded $H_{11,11} > 0.1$ as an indication of a concentrated market, in which the exercise of market power may raise competitive concerns (e.g., Whinston 2006).

In equations (2) – (4), we extend the HHI to explore various vertical structures (when $V > 1$) and a multi-product scenario (when $K > 1$). We define the $H_{mk,u\tau}$'s as vertical Herfindahl-Hirschman indexes or VHHI measuring vertical market concentrations. From equations (3) – (4), the VHHI's will provide a basis to evaluate the effects of vertical organization and market power

⁸ When all products are perfect substitutes (including across vertical channels), then market concentration can be analyzed *as if* there was a single market. In this context, it can be shown that the classical HHI becomes a simple weighted average of our VHHI measures (see Chavas and Shi (2010) for details).

on pricing. To illustrate, consider the special case where $u \neq \tau$, $m = k$, where products are differentiated across vertical channels due to consumer perception and/or quality differences. From equation (3), a rise in the VHHI $H_{kk,u\tau}$ would be associated with an increase (a decrease) in price $p_{k\tau}$ if $[c_{kk,u\tau} - \alpha_{kk,u\tau}] > 0 (< 0)$. Given that $\alpha_{kk,u\tau} = \partial p_{ku} / \partial y_{k\tau}$, we follow Hicks (1939) and note that $\alpha_{kk,u\tau} < 0 (> 0)$, when product k exhibits substitution (complementarity) on the demand side across vertical structures u and τ . This occurs in situations where an increase in quantity of product k under vertical structure τ tends to decrease (increase) the perceived marginal value of product k under vertical structure u . Similarly, $c_{kk,u\tau} = \partial^2 C / \partial y_{ku} \partial y_{k\tau} > 0 (< 0)$, when product k are substitutes (complements) on the supply side across vertical structures u and τ . This corresponds to situations where an increase in output quantity $y_{k\tau}$ tends to increase (decrease) the marginal cost of producing y_{ku} . We note that the complementary case (where $c_{kk,u\tau} < 0$) can generate economies of scope (Baumol et al. 1982, p. 75), where multi-output production reduces costs. In general, the term $[c_{kk,u\tau} - \alpha_{kk,u\tau}]$ is positive when y_{ku} and $y_{k\tau}$ behave as substitutes on both the supply and demand sides, and it is negative when y_{ku} and $y_{k\tau}$ behave as complements on both the supply and demand sides. Thus, a rise in $H_{kk,u\tau}$ would contribute to an increase (decrease) in $M_{k\tau}$ and in price $p_{k\tau}$ when the k -th products across two vertical channels (y_{ku} and $y_{k\tau}$) are substitutes (complements).⁹

This leads us to ask whether there are conditions under which vertical structures would have no effect on prices. As discussed in Chavas and Shi (2010), such situations can occur if products k and m are perfect substitutes (on both the demand and supply sides) across vertical

⁹ Identifying the role of substitution/complementarity in the exercise of market power is not new (e.g., Tirole 1992; Venkatesh and Kamakura 2003; Whinston 2006; Rey and Tirole 2008). However, our VHHI measures provide simple and explicit linkages between substitution/complementarity and prices.

structures. Perfect substitution on the supply side corresponds to situations wherein the cost function takes the form $C^n(\mathbf{y}^n) = C^n(\sum_{\tau \in \mathbf{V}} y_{1\tau}^n, \dots, \sum_{\tau \in \mathbf{V}} y_{K\tau}^n)$, which implies that $c_{k\tau} = c_k$ and $c_{mk,u\tau} = c_{mk}$ for $m, k \in \mathbf{K}$ and $\tau, u \in \mathbf{V}$. Similarly, perfect substitution on the demand side occurs where $\partial p_{mu} / \partial y_{k\tau} \equiv \alpha_{mk,u\tau} = \alpha_{mk}$. These restrictions generate the following testable hypotheses H_0 :

$c_{mk,u\tau} - \alpha_{mk,u\tau} = c_{mk,\tau u} - \alpha_{mk,\tau u} = c_{mk,uu} - \alpha_{mk,uu} = c_{mk,\tau\tau} - \alpha_{mk,\tau\tau}$, under which vertical organization has no effect on prices. These hypotheses will be investigated empirically in Sections 4 and 5.

Below, we illustrate the usefulness of our VHHI measures and equation (3) by presenting an econometric analysis of the role of vertical structures in pricing of differentiated products, with an application to the US soybean seed industry.

3. DATA

Our analysis relies on an extensive data set that provides detailed information about the US soybean seed market. The data were collected by **dmrkynetec** [hereafter **dmrk**]¹⁰ from a stratified sample of farmers who were surveyed annually between 2000 and 2007.¹¹ The survey provides farm-level information about seed purchases, acreages, seed types and prices. Farmers typically buy their seeds locally, and seeds suitable for planting at local market differ from region to region; thus, we define the “local market” at the Crop Reporting District (CRD)¹² level, and consider only those transactions that occurred in CRDs where more than ten farms are sampled in every year. Our data set contains a total of 75,560 farm-level purchase observations,

¹⁰ **dmrkynetec** changed its name to GfK Kynetec in May 2009. Its web address is www.gfk.com, and the seed data set is a product called TraitTrak.

¹¹ The survey was stratified to over-sample producers with large acreages, and was collected using computer assisted telephone interviews.

¹² The U.S. Department of Agriculture delineates crop-reporting districts (CRD) in order to reflect local agro-climatic conditions. CRDs are generally larger than counties, but are smaller than states.

from 18 states over a span of eight years (2000 – 2007). These are not panel data, given that the farm sample changes from year to year.

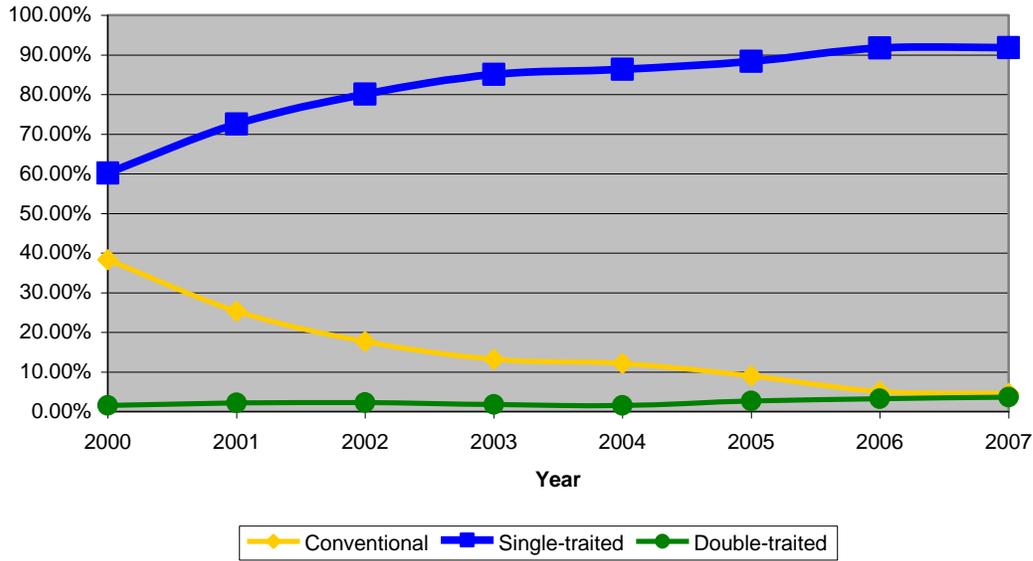
The biotech soybean seed industry currently markets herbicide tolerance (*HT*) traits. These patented genetic traits are inserted into seeds by biotech firms and designed to make it easier for farmers to control weeds, thus contributing to improved agricultural productivity. Below, we use the labels *HT1* and *HT2* to delineate the two major *HT* traits. Different biotech companies own these traits, and they also own subsidiary seed companies. Some biotech seeds contain only one of these traits, while others include a bundle of both *HT1* and *HT2* traits, a scenario called “double stacking”.

Figure 1 illustrates how soybean acreage shares have evolved over time, and reflects adoption rates for different types of soybean seeds in the US between 2000 and 2007. The acreage share of conventionally bred seeds has decreased rapidly, from 38.3% of the market in 2000 to 4.6% in 2007. Single-traited biotech seeds dominate the market, and have accounted for over 90% of acreage share since 2006. “Double stacked” seeds have carved out a small market share, and have exhibited a rising trend since 2005.

Biotech seeds are distributed by seed companies affiliated with the biotech companies that own a particular trait, and by seed companies that are unaffiliated. US patent law states that if a non-affiliated seed company wants to produce a seed that contains a patented trait, it is required to obtain a license from the patent owner, the related biotech company. Affiliated seed companies are exempt from this requirement.¹³ Therefore, we consider two vertical structures, $\mathbf{V} = \{v, \ell\}$, where v corresponds to *vertical integration* (wherein a seed company is affiliated with a related biotech firm) and ℓ corresponds to *licensing* (wherein an unaffiliated seed company

¹³ The affiliated subsidiary seed company may still operate under a license from the biotech company, but the licensing terms are understandably different from those for unaffiliated firms.

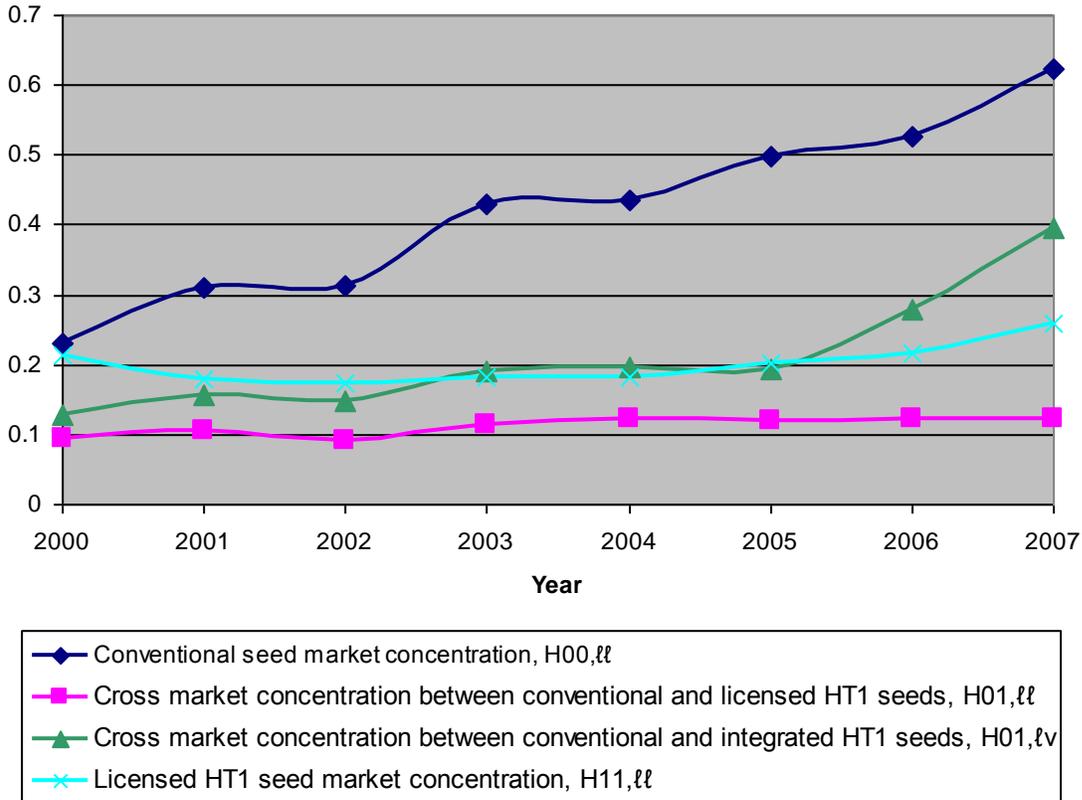
Figure 1. US Soybean Seed Adoption Rates by Acreage Share, 2000 – 2007.



licenses a trait from a biotech firm). As noted earlier, the proportion of vertically integrated seed increased from 13% of the single-traited market in 2000 to 26% in 2007. Among those farmers who adopted some biotech seeds in 2007, 57% purchased them only through the licensed channel, 16% bought seeds only through the integrated channel and 27% bought their seeds from both channels.

Figure 2 shows the trend in our constructed VHHIs. We use subscript 0 to denote the conventional seed market and subscript 1 to indicate the single-traited *HT1* market. Market concentration in the conventional seed market ($H_{00,\ell\ell}$) increased substantially over the years: It was 0.231 in 2000 and grew to 0.623 in 2007. Cross-market concentration between the integrated *HT1* and conventional seed markets ($H_{01,\ell v}$) also rose especially after 2005: Cross-concentration was 0.128 in 2000, 0.192 in 2005 and climbed to 0.395 in 2007. Market concentration in the licensed *HT1* market ($H_{11,\ell\ell}$) and cross-market concentration between the licensed *HT1* and conventional seed markets ($H_{01,\ell\ell}$) exhibit no dramatic changes over the study period.

Figure 2. VHHIs Over Time, 2000 – 2007



4. ECONOMETRIC SPECIFICATION

We use equation (3) (see Section 2) as the basis for our analysis of US soybean seed prices. As derived, equation (3) expresses the determinants of pricing for differentiated products under alternative vertical structures in situations of imperfect competition. Our attention is focused on two vertical structures: vertical integration, v , and licensing, ℓ ; and on four seed types, each containing genetic traits that are available individually or stacked. Let $T_k \in \{0, 1\}$ be dummy variables for seed types, satisfying $T_k = 1$ for seed type k and $T_k = 0$ otherwise, with $\sum_{k=0}^3 T_k = 1$: conventional ($T_0 = 1$), single-traited *HT1* ($T_1 = 1$), single-traited *HT2* ($T_2 = 1$), and *HT1* and *HT2* stacked ($T_3 = 1$). Additionally, let $D_\tau \in \{0, 1\}$ be dummy variables for vertical structures, satisfying $D_\tau = 1$ for the τ -th vertical structure and $D_\tau = 0$ otherwise, $\tau \in \mathbf{V} = \{\ell, v\}$.

Our analysis allows for fixed and variable costs to vary across vertical structures. Under vertical integration, an integrated firm can recover R&D fixed costs directly through seed sales; however, biotech firms may face higher integration costs. Under a licensing scenario, a seed company pays a licensing fee to a biotech firm to help it recover its R&D investment. In general, the two vertical structures can vary in terms of efficiency and in the exercise of market power. The multi-product nature of the market also affects the assessment of both efficiency and exercise of market power. For example, as noted above, complementarity across vertically differentiated products can contribute to economies of scope, while also reducing the firms' ability to exercise market power. Alternatively, substitutability across vertical structures could help enhance the exercise of market power.

We begin with a standard hedonic pricing model wherein the price of a good varies with its characteristics (following Rosen 1974). Consider a hedonic equation that represents the determinants of price p for seed type k sold in the τ -th vertical structure:

$$p_{k\tau} = \beta_{k\tau} + \sum_{m=0}^3 \sum_{u \in \mathbf{V}} \delta_{mu} T_m D_u + \phi \mathbf{X} + \varepsilon_{k\tau}, \quad (5a)$$

where \mathbf{X} is a vector of other relevant covariates and $\varepsilon_{k\tau}$ is an error term with mean zero and finite variance. Specification (5a) allows prices to vary across seed types and vertical structures. In equation (5a), price p represents the net seed price that farmers pay (in \$ per 50lb bag).¹⁴ It is measured for each seed purchase taking place at the farm-level.

As we did with equations (3) – (4), we introduce market power effects in (5a) by specifying

$$\beta_{k\tau} = \beta_0 + \sum_{m=0}^3 \sum_{u \in \mathbf{V}} \beta_{mk,u\tau} H_{mk,u\tau} Y_{mu} T_k D_\tau, \quad (5b)$$

¹⁴ Seeds are usually sold at a list price less a discount that is available at the point of sale. Our study utilizes the after-discount “net price”.

where $\beta_{mk,u\tau} \equiv [c_{mk,u\tau} - \alpha_{mk,u\tau}]$ and $H_{mk,u\tau} \equiv \sum_{i=1}^N S_{mu}^i S_{k\tau}^i$ is the VHHI, S_{mu}^i being the i -th firm's share in the market for the m -th seed type under the u -th vertical structure. We calculate all VHHI terms at the crop reporting district (CRD) level, assuming that it is the relevant local market for farmers. In a way similar to equations (3)-(4), since $H_{mk,u\tau} \rightarrow 0$ under competitive conditions, we can capture the exercise of market power in (5a) – (5b) through the term:

$$M_{k\tau} = \sum_{m=0}^3 \sum_{u \in \mathbf{V}} \beta_{mk,u\tau} H_{mk,u\tau} Y_{mu} T_k D_\tau, \quad (6)$$

where $M_{k\tau} = 0$ under perfect competition. Equation (6) measures the effects of imperfect competition under various vertical structures.

Since conventional seeds contain no added biotech traits, we assume that the vertical structure for conventional seed is “un-integrated” (ℓ). Thus, building on (5a) – (5b), we estimate the equation for conventional seeds ($T_0 = 1$) as:

$$p_{0\ell} = \beta_0 + \sum_{m=0}^3 (\beta_{m0,\ell\ell} H_{m0,\ell\ell} Y_{m\ell} + \beta_{m0,v\ell} H_{m0,v\ell} Y_{mv}) T_0 D_\ell + \delta_{0\ell} + \boldsymbol{\phi} \mathbf{X} + \varepsilon_{0\ell},$$

For HT1 seed ($T_1 = 1$), the price equations for licensed and integrated seeds are:¹⁵

$$p_{1\ell} = \beta_0 + \sum_{m=0}^3 (\beta_{m1,\ell\ell} H_{m1,\ell\ell} Y_{m\ell} + \beta_{m1,v\ell} H_{m1,v\ell} Y_{mv}) T_1 D_\ell + \delta_{1\ell} + \boldsymbol{\phi} \mathbf{X} + \varepsilon_{1\ell},$$

$$p_{1v} = \beta_0 + \sum_{m=0}^3 (\beta_{m1,\ell v} H_{m1,\ell v} Y_{m\ell} + \beta_{m1,vv} H_{m1,vv} Y_{mv}) T_1 D_v + \delta_{1v} + \boldsymbol{\phi} \mathbf{X} + \varepsilon_{1v}.$$

The \mathbf{X} covariates in equation (5a) include location, year dummies, individual farms' total corn acreages, and binary terms that capture alternative purchase sources. Farmers can obtain various types of seeds from multiple sources. We use purchase source to describe possible price discrimination schemes that affect the prices that farmers pay for their seeds. We define the location variables as state dummy variables, which reflect spatial heterogeneity in cropping

¹⁵ Similar equations can be written for HT2 ($T_2 = 1$) and stacked seeds ($T_3 = 1$). However, our sample includes an insufficient number of observations for these seed types, and this prevents us from obtaining reliable measures of the VHHIs. Therefore, for these two seed types, we explore merely how prices vary across characteristics and vertical structures.

systems, weather patterns and yield potentials. We also include year dummies in order to capture structural changes over time and advances in genetic technologies. We use the farm acreage variable to catch possible price discrimination that may be related to bulk purchases. Finally, to capture possible life cycle effects of each product, we include entry and exit dummies for a specific type of seed: $Entry = 1$ if it is in its first year on the market, and $Exit = 1$ if it is in its last year on the market.

As mentioned in Section 3, since the 1980s the soybean industry has transitioned away from using publicly-bred seed, in favor of privately-bred varieties. Our model is based on profit maximizing behavior that may not apply to public breeders. We expect pricing in the public sector to differ from that of the private sector. On this basis, we have introduced a dummy variable that captures institutional structure: $Pub = 1$ represents the public sector and $Pub = 0$ signifies the private sector. In equation (5b) we include the dummy variable Pub as both an intercept shifter and a slope shifter.

5. ECONOMETRIC ESTIMATION

In table 1 we report summary statistics for key variables used in the analysis. The mean value of conventional seed HHI, $H_{00,\ell\ell}$, is 0.412, which is more than twice the Department of Justice's threshold of 0.18 for identifying "significant market power". Biotech $HT1$ seeds in the licensed channel exhibit greater competition than do conventional seeds, and have a mean value of $H_{11,\ell\ell}$ at 0.201. We observe significant changes in the VHHIs across regions and over time (see figure 2), and this reflects the fact that the soybean seed market has undergone dramatic structural changes over the last decade. Our analysis of the determinants of seed prices both over time and across space provides useful information about the effects of these changes.

Table 1. Summary Statistics

Variable ^b	Number of Observations ^a	Mean	Standard Deviation	Min.	Max.
Net Price (\$/Bag)	75560	23.05	5.04	2.46	43
Farm Size (Acre)	75560	619.0	656.5	4	24000
Conventional Seed Market Concentration, $H_{00,\ell\ell}$	564	0.412	0.280	0.063	1
Cross-Market Concentration (Conventional and Licensed $HT1$), $H_{01,\ell\ell}$	520	0.110	0.093	0.00006	0.606
Cross-Market Concentration (Conventional and Integrated $HT1$), $H_{01,\ell v}$	308	0.180	0.180	0.001	1
Licensed $HT1$ seed market concentration, $H_{11,\ell\ell}$	608	0.201	0.094	0.065	0.805
Integrated $HT1$ seed market concentration, $H_{11,vv}$	601	1	0	1	1

^a/ For the market concentration measurements H_s , we report only the summary statistics for those non zeros at the CRD level. Therefore the number of observations is, at most, $76 \times 8 = 608$.

^b/ Two VHHIs are not reported in the table: $H_{11,\ell v} = H_{11,v\ell} = 0$, because in the soybean industry, we do not observe companies that are both vertically integrated and licensed in the same market. This is not a general case: For example, these measures are nonzero in the cotton seed market. Moreover, $H_{01,\ell\ell} = H_{10,\ell\ell}$ and $H_{01,\ell v} = H_{10,v\ell}$ by symmetry in construction.

One econometric issue in the specification (5a)-(5b) is the endogeneity of the VHHIs.

We expect that market concentration (as measured by H), quantity sold (Y) and seed price will be jointly determined, given that each is dependent upon a firm's market strategies. Due to the fact that the econometrician does not observe some of the determinants of these strategies, this implies that terms $H \cdot Y$ are likely correlated with the error term in equation (5a). In such situations, least-squares estimation of (5a) – (5b) would yield biased and inconsistent parameter estimates. One can deal with this issue by using an instrumental variable (IV) method to estimate equations (5a) – (5b).

We first test for possible endogeneity of the H 's and Y 's using a C statistic calculated as the difference of two Sargan statistics (Hayashi 2000, p. 232). Under the null hypothesis of

exogeneity for H and Y , the C statistic is distributed as Chi-square with degrees of freedom equal to the number of variables tested. The test is robust to violations of the assumption of conditional homoscedasticity (Hayashi 2000, p. 232).¹⁶ In our case, the C statistic is 33.93, with a p -value of less than 0.0001. This offers strong statistical evidence against the null hypothesis of exogeneity.

The presence of endogeneity motivates the use of an IV estimator, and this raises the issue of selecting appropriate instruments. The instruments need to satisfy two conditions: First, they should be orthogonal to the error term in (5a). Second, they should be relevant variables that can identify the appropriate parameters, (i.e., they should not be “weak instruments”).

Seed companies make production decisions at least a year ahead of marketing decisions due to lags in the seed production process. Therefore, lag values are part of the information set that seed companies have available to them at the time they make their production decisions. Although our data set is not a panel at the farm-level (due to the fact that the farm sample changes from year to year), we do have panel data on CRD-level concentration measure H s and on each seed type’s market size Y s. This means that the H and Y lagged values appear to be good candidates for instruments. On that basis, equation (5a)-(5c) was estimated by two-stage-least-squares (2SLS), using the one-year lagged Y and the interaction between the one-year lagged value of each H and the one-year lagged value of Y as instruments.

Besides *a priori* reasoning, this choice of instruments is supported by a series of statistical tests. The Hansen over-identification test was not statistically significant, with a p -value of 0.23. This indicates that our instruments satisfy the required orthogonality conditions. To test for “weak instruments”, we use the Bound *et al.* (1995) measures and the Shea (1997) partial R^2 statistic. Following Staiger and Stock (1997), the test results do not provide evidence

¹⁶ Under conditional homoskedasticity, the C statistic is numerically equivalent to a Hausman test statistic.

that our instruments are weak. The Kleibergen-Paap weak instrument test (Kleibergen and Paap, 2006)¹⁷ yields a test statistic of 21.89. Using the critical values presented in Stock and Yogo (2005), this indicates again that our instruments are not weak.

Finally, we evaluated the properties of the error term in (5a). Typically, each farm purchases several different seed varieties (the sample mean is three varieties per farm per year). Some of the unobserved factors affecting seed prices may be farm-specific and vary across farms. This suggests that the error term in (5a) may exhibit heteroscedasticity. Using a Pagan-Hall test,¹⁸ we find strong evidence against homoscedasticity, with a Chi-square statistic of 203.9 and a p -value of less than 0.0001. On that basis, we use heteroscedastic-robust standard errors in the estimation of equations (5a) – (5b). We also cluster the standard errors at the farm level.¹⁹ Indeed, in the presence of farm-specific unobserved factors, the error terms in (5a) is expected to be correlated across observations associated with a given farm.

6. RESULTS

Table 2 reports the econometric results of our 2SLS IV estimation of equations (5a) – (5b) with heteroscedastic-robust standard errors under clustering. For comparison purposes, we also report the ordinary least square (OLS) estimation results. The OLS estimates of the market concentration parameters differ substantially from those of the 2SLS results (reflecting the presence of endogeneity). Given that IV estimation corrects for endogeneity bias, our discussion below focuses on the 2SLS estimates.

¹⁷ Note that unlike the Cragg-Donald test for weak instruments, the Kleibergen-Paap remains valid under heteroscedasticity.

¹⁸ The Pagan-Hall test is a more general test for heteroscedasticity in an IV regression than is the Breusch-Pagan test. Pagan-Hall remains valid in the presence of heteroscedasticity (Pagan and Hall 1983).

¹⁹ We also tried clustering the standard errors at CRD×Year level. The results were qualitatively similar.

We begin by discussing our estimates of how prices vary across seed types and vertical structures, and then shift our attention to the estimated effects of market power.

The Effects of Various Seed Types

Table 2 indicates that publicly-bred conventional seeds are priced significantly lower than those that are privately-bred, at a discount of \$5.05 per bag.²⁰ This is consistent with our expectation that private and publicly-sourced seed companies rely on different pricing rules. The results show that all biotech seeds receive a price premium over private conventional seeds; however, this premium varies by vertical structure. The coefficients of the δ_{kvS} (seed k under an integrated vertical structure) and $\delta_{k\ell S}$ (except for $\delta_{2\ell}$) (seed k under a licensing scenario), $k = 1, 2, 3$, corresponding to the *HT1* single-trait, the *HT2* single-trait and the double stacking seeds, are each positive and statistically significant. These coefficients range from \$2.18 to \$7.76, and they show evidence of significant premiums for these biotech traits. The coefficient, $\delta_{2\ell}$, which represents *HT2* biotech seed under licensing agreements, is not statistically different from zero. Finally, for all three types of biotech seeds, those sold under the vertical integration scenario are priced higher than are those that are produced and marketed under licensing agreements. The effects of vertical structure are further discussed below.

Market Concentration and Vertical Structures

Our model utilizes the VHHI to capture market share information about each seed type in different vertical structures. In Section 2, we argued that the impacts of VHHI $H_{mk,u\tau}$ depend on substitutability/complementarity relationships between type- m seed in u -th market structure and

²⁰ Almost all of the observations in our data indicate that publicly-sourced seeds are conventional seeds.

type- k seed in τ -th market structure. If the two types of seed are substitutes (complements), we expect that an increase in the VHHI will be associated with a rise (decrease) in prices.

For the three VHHIs that relate to conventional seed prices ($H_{00,\ell\ell}$, $H_{10,\ell\ell}$, $H_{10,v\ell}$), the interaction between the public dummy and the VHHIs separates out the public sector and private sector effects. Table 2 offers strong statistical evidence that supports the notion that the public and private sectors follow different pricing rules. For the private sector, the coefficient of the traditional HHI ($H_{00,\ell\ell}$) is positive and statistically significant at the 5 percent level; however, for the public sector this positive effect disappears. The cross-market VHHI coefficient between licensed *HT1* and conventional seeds ($H_{10,\ell\ell}$) is negative for the private sector and positive for the public sector. This suggests that in the private sector the two products are complements (in supply and/or in demand). If complementarity exists on the demand side, it should similarly affect seed pricing in the public sector. However, the coefficient, $H_{10,\ell\ell}$, is positive for publicly-sourced conventional seed, and this offsets the complementarity effects between licensed *HT1* and conventional seeds. We thus infer that the complementarity between these two seed types likely comes from the supply side, wherein the private and public sectors appreciably differ. The VHHI coefficients for the private and public sectors that cross the integrated *HT1* and conventional seeds ($H_{10,v\ell}$) are not statistically significant.

For the two cross-market VHHI coefficients that affects *HT1* biotech seed, the coefficient of $H_{01,\ell\ell}$ (associated with the pricing of licensed *HT1* seed) is negative and statistically significant. This is consistent with the way it affects the conventional seed market through the VHHI $H_{10,\ell\ell}$. It suggests that conventional and licensed *HT1* seeds exhibit strong and symmetric complementarity. We think that such complementarity likely comes from the supply side. Given that complementarity contributes to economies of scope (see Section 2), this result offers indirect

Table 2. OLS and IV (2SLS) Regression with Robust Standard Errors.^a

Dependent Variable: Net Price (\$/Bag)	OLS		2SLS	
	Coefficient	t-statistics	Coefficient	Robust Z Statistics
<i>Effects of Seed Characteristics: Benchmark Is Private Conventional Seed</i>				
δ_0 public (Publicly-Sourced Conventional Seed)	-4.35***	-19.03	-5.05***	-10.71
$\delta_{1\ell}$ (HT1 Under Licensing)	7.51***	101.65	7.38***	29.70
δ_{1v} (HT1 Under Vertical Integration)	7.89***	96.60	7.76***	30.33
$\delta_{2\ell}$ (HT2 Under Licensing)	0.44***	3.94	0.00	0.00
δ_{2v} (HT2 Under Vertical Integration)	2.02***	9.48	2.18***	5.23
$\delta_{3\ell}$ (Stacked Under Licensing)	7.69***	50.78	7.45***	25.77
δ_{3v} (Stacked Under Vertical Integration)	8.01***	87.50	7.75***	30.56
<i>Market Concentration and Vertical Structures</i>				
$H_{00,\ell\ell}T_0D_\ell Y_{0\ell}$ (Conventional Seed)	0.025***	3.26	0.163**	2.58
$H_{00,\ell\ell}T_0D_\ell Y_{0\ell_pub}$ (Publicly-Sourced Conventional Seed)	-0.071	-0.25	-0.156*	-1.89
$H_{10,\ell\ell}T_0D_\ell Y_{1\ell}$ (Conventional Seed)	-0.047***	-3.59	-0.261***	-3.85
$H_{10,\ell\ell}T_0D_\ell Y_{1\ell_pub}$ (Publicly-Sourced Conventional Seed)	0.102*	1.84	0.330***	3.22
$H_{10,v\ell}T_0D_\ell Y_{1v}$ (Conventional Seed)	-0.055**	-2.15	0.009	0.10
$H_{10,v\ell}T_0D_\ell Y_{1v_pub}$ (Publicly-Sourced Conventional Seed)	-0.020	-0.25	-0.029	-0.21
$H_{01,\ell\ell}T_1D_\ell Y_{0\ell}$ (HT1 Under Licensing)	-0.060***	-6.02	-0.145***	-3.01
$H_{11,\ell\ell}T_1D_\ell Y_{1\ell}$ (HT1 Under Licensing)	0.012***	2.99	0.00006	0.017
$H_{01,\ell v}T_1D_v Y_{0\ell}$ (HT1 Under Vertical Integration)	0.041***	4.43	0.075	1.58
$H_{11,vv}T_1D_v Y_{1v}$ (HT1 Under Vertical Integration)	-0.004	-1.40	-0.021***	-2.62
<i>Other Variables</i>				
Exit	-0.35***	-12.36	-0.33***	-8.43
Entry	0.21***	9.92	0.03	0.99
Year 2002	0.14***	4.70	0.33**	6.03
Year 2003	-0.32***	-8.37	-0.09	-1.18
Year 2004	2.28***	60.29	2.48***	34.54
Year 2005	5.17***	138.94	5.39***	60.56
Year 2006	6.06***	131.62	6.29***	56.92
Year 2007	6.27***	165.80	6.49***	65.21
Total Soybean Acreage by Individual Farm (1000 Acre)	-0.286***	-13.57	-0.273***	-4.99
Constant	16.65***	175.92	16.98***	64.84
<i>Number of observations</i>	64550			

^a Statistical significance is noted by * at the 10 percent level, ** at the 5 percent level, *** at the 1 percent level. The R^2 is 0.77 for the OLS estimation. For the 2SLS estimation, the centered R^2 is 0.74, and un-centered R^2 is 0.99. In order to save space, we do not report results for the location and purchase source effects; however, we discuss these in the text.

evidence to support our assertion that seed companies experience economies of scope in their production and marketing of conventional and licensed *HT1* seeds. We also note that the cross-market VHHI coefficient of integrated *HT1* and conventional seeds ($H_{0l,\ell v}$) is also negative, but not statistically significant. This result may reflect transaction costs present in vertical integration (such as those costs associated with negotiation and re-organization), and these may offset some of the efficiency gains that firms garner from economies of scope.

The own-market VHHIs, $H_{1l,\ell\ell}$ and $H_{1l,vv}$, are standard Herfindahl indices that measure market concentration in the licensed and integrated (respectively) *HT1* seed markets. Although the associated coefficient is positive for the licensed *HT1* seed market (in a way consistent with our *a priori* expectation), its effect is not statistically significant. The coefficient of term $H_{1l,vv}$ is negative and statistically significant, contrary to *a priori* expectation. However, we note that throughout our study period this market maintains a concentration measure, $H_{1l,vv}$, of 1, which means that the market is monopolistic. Thus, our estimation of coefficient $H_{1l,vv}$ relies entirely on observed variations in market size of integrated *HT1* seed, Y_{lv} , which has been expanding over the years. The negative coefficient estimate may reflect the fact that this market expansion contributes to lower prices.

We then ask whether vertical organization affects prices. We investigate this issue by examining whether market concentrations relate to seed prices in similar ways under alternative vertical structures. In section 2, we develop testable hypotheses $H_0: c_{mk,u\tau} - \alpha_{mk,u\tau} = c_{mk,\tau u} - \alpha_{mk,\tau u} = c_{mk,uu} - \alpha_{mk,uu} = c_{mk,\tau\tau} - \alpha_{mk,\tau\tau}$, under which vertical organization has no effect on prices. This generates the following hypotheses: For a given seed type,

$$(I) H_0: \beta_{10,\ell\ell} = \beta_{10,v\ell},$$

$$(II) H_0: \beta_{01,\ell\ell} = \beta_{01,\ell v} \text{ and}$$

$$(III) H_0: \beta_{11,\ell\ell} = \beta_{11,vv},$$

where the β 's are the corresponding VHHI coefficients.²¹

The test results reject the null hypothesis for (I) and (II) at the 5% level of significance, but fail to reject the null hypothesis for (III) at the 10% level of significance. This result suggests that different vertical structures in the *HT1* seed market generate different cross-market concentration effects on the pricing of conventional seeds (Hypothesis I). Moreover, this cross-market concentration in turn implies differing effects on the pricing of licensed *HT1* and vertically integrated *HT1* seeds (Hypothesis II). These results provide statistical evidence that it is essential to include vertical organization in the analysis. Our findings document how vertical structures significantly influence how firms exercise market power and price goods.

Other Factors

Table 2 illustrates variations in prices over time. The year dummies show a strong rising trend beginning in and continuing after 2004. In 2007, the price per bag of seed was \$6.49 higher than it was in 2001. Given that the mean price is approximately \$23.05 per bag, this demonstrates an annual growth rate higher than that of rate of inflation during the same time period.²² Our estimates also indicate that soybean seeds sold in Corn Belt states are discounted more than those sold in other states. They also indicate how the source of purchase affects prices.

²¹ The demand for seed reflects farmers' desire to maximize their profits; thus, we can express the willingness to pay for a specific type of seed as marginal profit. The demand slope is therefore the second derivative of farmers' profit. Using Young's theorem, this implies the following symmetry restrictions: $\partial p_{mu} / \partial y_{k\tau} = \partial p_{k\tau} / \partial y_{mu}$. Given that $\partial p_{mu} / \partial y_{k\tau} = \alpha_{mk,u\tau}$, $c_{mk,u\tau} = c_{km,\tau u}$, and $\beta_{mk,u\tau} = [c_{mk,u\tau} - \alpha_{mk,u\tau}]$, we generate the following hypotheses for the relevant cross markets:

$$(IV) H_0: \beta_{10,\ell\ell} = \beta_{01,\ell\ell},$$

$$(V) H_0: \beta_{01,\ell v} = \beta_{10,v\ell}.$$

We use a Wald test, and fail to reject these null hypotheses (whose p -values are 0.22 and 0.47, respectively). While the results we present below do not impose these null hypotheses, we note our main findings were not affected by imposing the above symmetry restrictions.

²² The Department of Labor Statistics reported the average inflation rate from 2000 to 2007 at 2.78%.

Farmers who buy their seeds from a “farmer who is a dealer or agent” save \$0.12 per bag by purchasing them directly from “a seed company or its representatives” and spend \$0.27 more per bag if they buy seeds from cooperatives. Additionally, table 2 shows that the farm size effect is statistically significant: In each state, large farms pay less for seeds, which may be due to bulk discount.²³

7. IMPLICATIONS

In this section, we further evaluate the pricing of seeds for different seed types and different vertical organizations. We also study the effects of imperfect competition by examining the market power component of price, M , for different seed types. This analysis provides useful information about the effects of vertical integration and the extent of departure from competitive pricing. For illustration purposes, our analysis focuses on Illinois in 2004. Illinois is one of the largest soybean-producing states in the US, and it has the largest number of farms in our sample. We choose the year 2004 as it is in the middle of the sample period, and set the relevant variables at sample means.²⁴

Table 3 reports estimated prices for different seed types and different vertical structures. The mean conventional seed price is \$16.25 per bag. As expected, biotech traits add price premiums over conventional varieties. And, in both vertical structures, stacked seeds exhibit a premium over single-traited seed. Table 3 also reports price differences across vertical structures. It shows that seed prices under vertical integration are higher than those under licensing arrangements. Per bag, the price difference amounts to \$0.50 and \$2.17 for *HT1* and *HT2* seeds, respectively. Being statistically significant at the 1 percent level, this difference provides

²³ In addition, the exit dummy is negative and statistically significant. Prior to the year of exit, seed price tends to be discounted by \$0.22 per bag. Finally, the entry dummy has a positive but insignificant coefficient, suggesting that firms do not price new seeds differently than they do other seeds.

²⁴ We set the purchase source as “Farmer who is a dealer or agent”. All simulated prices are bootstrapped.

evidence that vertical organization affects pricing. It indicates that the trend toward vertical integration pushes farmers to pay higher seed prices.

Table 3. Estimated Prices for Different Seed Types and Vertical Structures, \$/Bag.^a

Seed Type	Licensed (<i>l</i>)		Vertically integrated (<i>v</i>)		Difference Between Vertical Structures ($p_v - p_l$)
	Expected Seed Price	Difference in Price vs. Conventional	Expected Seed Price	Difference in Price vs. Conventional	
Conventional	16.25	N/A	N/A	N/A	N/A
<i>HT1</i> Biotech	23.88	7.63*** (0.12)	24.38	8.13*** (0.12)	0.50*** (0.07)
<i>HT2</i> Biotech	16.75	0.50** (0.21)	18.94	2.69*** (0.36)	2.17*** (0.38)
<i>HT1&HT2</i> Stacked	24.21	7.96*** (0.20)	24.50	8.25*** (0.14)	0.31* (0.16)

^a Standard errors are listed in parentheses. Statistical significance is noted by * at the 10 percent level, ** at the 5 percent level, and *** at the 1 percent level.

Next, we evaluate the term M in equations (4) and (6), a measure of market power.²⁵ The estimated value of M in equation (6) allows us to characterize the strength of imperfect competition.

To illustrate, we evaluate three scenarios: S1, S2 and S3. Scenario S1 considers a case wherein concentration changes only in the conventional market: In Illinois, $H_{00,\ell\ell}$ shifts from zero to its sample mean, holding other H 's constant. In Scenario S2, we consider market concentration changes in the licensed *HT1* seed market: In Illinois, we adjust $H_{11,\ell\ell}$ from zero to the sample mean (again holding other H 's constant). Finally, Scenario S3 considers the joint effects of Scenarios S1 and S2: We alter market concentrations in the conventional and licensed

²⁵ As discussed in section 2, M would be zero under perfect competition, but non-zero under concentrated markets. As such M can be interpreted as a measure of the price enhancements associated with imperfect competition.

HT1 markets, and imply that all corresponding HHIs and VHHIs will also change. Table 4 reports the estimated changes in M under each scenario, and presents M/p as the corresponding relative measures of market power effects.

For the conventional seed market under scenario S1, the estimated market power component is positive and statistically significant: $M = \$0.60$ per bag. The corresponding relative measure M/p is 0.036. It means that the portion of the conventional seed price attributable to market power amounts to 3.6% of the price. Under Scenario S2, the market power component for licensed *HT1* seed is not statistically different from zero.

The Scenario S3 results are of particular interest. Recall that S3 evaluates the joint effects simulated in S1 and S2. Under Scenario S3, the market power components M are negative and significant for both the conventional and licensed *HT1* markets. In contrast with the S1 and S2 results, it means that concentrated markets contribute to significant reductions in prices. The difference is due to cross-markets concentration effects. This provides empirical evidence that cross-market effects are important factors associated with seed prices. In particular, S3 does not show the price enhancing-effects of market power observed in S1 for conventional seeds. This illustrates that the cross-market power effects dominate the own-market power effect.

The results reported in scenario 3 reflect that our estimated complementarity effects reduce the price enhancements associated with market power. These complementarity effects are important for two reasons. First, when associated with the supply side, they contribute to economies of scope and can generate efficiency gains from firm consolidations/mergers. Second, they contribute to reducing the price enhancement effects of increased concentrations. Given that complementarity reflects cross-markets effects, this underscores the need to address market power issues in a multi-market framework both horizontally and vertically.

Table 4. Estimated Market Power Component.^a

Seed Type	Mean Seed Price (\$/bag)	Market Power Component					
		Scenario S1		Scenario S2		Scenario S3	
		<i>M</i> (\$/bag)	<i>M/p</i>	<i>M</i> (\$/bag)	<i>M/p</i>	<i>M</i> (\$/bag)	<i>M/p</i>
Conventional	16.47	0.60**	0.036	N/A	N/A	-0.52*	-0.032
Licensed <i>HT1</i> Biotech	23.53	N/A	N/A	-1.50E-03	-6.37E-05	-0.25***	-0.011

^a Statistical significance is noted by * at the 10 percent level, ** at the 5 percent level, and *** at the 1 percent level.

8. CONCLUSION

The paper has developed a Cournot model of pricing of differentiated products under imperfect competition and alternative forms of vertical control. It proposes a general approach to evaluate the exercise of market power in vertical structures. This involves a vertical HHI (termed VHHI) that captures how the interactions of market concentration and vertical organization relate to the pricing of differentiated products.

The usefulness of the analysis is illustrated in an econometric application involving the estimation of a pricing model where our VHHIs capture the effects of imperfect competition across both horizontal and vertical markets. Applied to the US soybean seeds, the econometric analysis finds evidence that vertical organization has significant effects on seed prices. It means that market concentration analyses that neglect vertical structures (e.g., using a traditional HHI) would fail to capture the linkages between market structure and pricing. However these effects are found to vary with the institutional setup. We uncover evidence that complementarity and economies of scope can reduce the price-enhancement associated with market concentration. Since complementarity reflects cross-markets effects, this stresses the need to address market power issues in a multi-market framework.

Our analysis can be extended in several directions. First, by assuming efficient contracting among firms, we neglected issues related to possible double marginalization in a vertical sector. Additional research is needed to explore these issues. Second, our econometric analysis focused on the soybean seed industry. There is a need to explore empirically how market power affects horizontal and vertical markets in other industries.

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