

# Collusion through Coordination of Announcements\*

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## Abstract

Motivated by some recent collusive practices that do not constrain the prices that sellers offer, a theory of collusion is developed based on interpreting firms' actions as announcements about cost. By coordinating their announcements, firms are able to produce supracompetitive prices by influencing buyers' conduct. This form of collusion can actually improve welfare. Some initial insight is provided for when sellers would prefer to coordinate on cost announcements than coordinate on prices.

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# 1 Introduction

Collusion involves firms coordinating their conduct so that, as long as all firms comply with how they agreed to behave, supracompetitive prices and profits will result. The challenge resides in ensuring that all firms comply. To achieve that end, cartels monitor for compliance and, when there is evidence of non-compliance, impose a punishment in order to provide incentives to comply.

In posted price markets (such as most retail markets), coordinated conduct typically takes the form of agreeing to charge prices above competitive levels and then monitoring prices for compliance. Examples include collusion among retail gasoline stations (Clark and Houde, 2011), retail pharmacies (Chilet, 2016), and fine arts auction houses (Mason, 2004). For many cartels in intermediate goods markets, coordination is again on price but compliance is more problematic because, given prices can be privately negotiated, monitoring of prices is difficult. For this reason, cartels also commonly coordinate on a market allocation scheme, and then monitor compliance with respect to that scheme. For example, cartels in citric acid, lysine, and vitamins agreed to sales quotas, and monitoring involved comparing actual sales with agreed-upon sales.<sup>1</sup>

While coordination on prices is most common, firms can instead coordinate on an allocation of customers to cartel members, with the understanding that a cartel member does not supply customers that it has not been assigned. An allocation could take the form of exclusive territories whereby only a single cartel member is allowed to sell to customers in a particular region. One implementation of an exclusive territories approach is the home-market principle, whereby each cartel member is allocated its home market.<sup>2</sup> In the context of auctions, it could mean allocating an item or contract to a particular member of the bidding ring, as with bidding rings in auctions for construction contracts (Kawai and Nakabayashi, 2015) and stamps (Asker, 2010). Alternatively, coordination could assign existing customers to firms. Recently, a number of high-tech companies were prosecuted for coordinating on a “no-poaching” agreement in which each agreed not to try to hire other companies’ employees.<sup>3</sup> As long as all firms complied with the no-poaching agreement,

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<sup>1</sup>Harrington (2006), Connor (2008), and Marshall and Marx (2012) provide details on these and other relevant cartels. For an analysis of this collusive practice and related ones, see Harrington and Skrzypacz (2011), Chan and Zhang (2015), Spector (2015), Awaya and Krishna (2016), and Sugaya and Wolitzky (2016).

<sup>2</sup>Harrington (2006) provides examples of the home-market principle, and Sugaya and Wolitzky (2016) offer an analysis based on the home-market principle.

<sup>3</sup>The companies are Adobe Systems, Apple, eBay, Google, Intel, Intuit, Lucasfilm and Pixar. U.S. Department of Justice, Antitrust Division, Press Release, “Justice Department Requires eBay to End Anticompetitive “No Poach” Hiring Agreements,” May 1, 2014.

each firm would pay wages below competitive levels.

These are just some of the ways in which firms can suppress competition by coordinating their conduct. The feature that we want to emphasize is that success occurs as long as all firms comply with the agreed-upon conduct because coordination directly constrains competition, whether it means the price that a firm charges or the customers that a firm supplies. The challenge is whether firms will act as agreed. As a result, the theory of collusion has focused on the characterization of effective monitoring and severe punishments.

In contrast to those canonical cases of collusion, there are some collusive practices for which coordinated conduct does not directly constrain competition, in which case it is not apparent that compliance is sufficient to produce supracompetitive outcomes. First, some cartels coordinate on list prices but not on discounts, which means firms do not coordinate on transaction prices. While it is easy to monitor and ensure that all firms set the agreed-upon list price, collusion could prove ineffective due to firms competing in discounts off of list prices. In fact, discounts were common in some of the cases involving coordination on list prices. That coordination on list prices presents a puzzle is evident from this observation by a member of the thread cartel which took the more common path of coordinating on transaction prices:

[A cartel member] explained that list prices have more of a political importance than a competitive one. Only very small clients pay the prices contained in the lists. As the official price lists issued by each competitor are based on large profit margins, customers regularly negotiate rebates, but no clear or fixed amount of rebates is granted. ... [T]he list prices are essentially “fictitious” prices.<sup>4</sup>

A second set of collusive practices has firms coordinate on a surcharge for an input, such as fuel in markets for transportation services. Cartel members were essentially agreeing on how they wrote up the invoice - there would be a line assigning a part of the transaction price to this surcharge - and not coordinating on the transaction price itself. Collusion could prove ineffective due to firms competing in the non-surcharge component of the transaction price, while complying by charging the agreed-upon surcharge. In Section 2, some of the cases involving coordination on list prices and surcharges are reviewed.

The contribution of this paper is providing an explanation for how these collusive practices could be effective. Contrary to the usual perspective of collusion - which focuses on how a collusive

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<sup>4</sup>Commission of the European Communities, 14.09.2005, Case COMP/38337/E1/PO/Thread, 112, 159-60.

practice impacts sellers' conduct - our approach takes account of how *buyers' conduct* is impacted. The theory developed here is that these collusive practices work, not because they influence what prices sellers propose to buyers, but rather because they influence *what prices buyers propose to sellers*. As reviewed in Section 2, all of these cases have occurred in intermediate goods markets for which buyer-seller negotiation is the norm. Coordination on list prices and surcharges is effective because it influences buyers' beliefs in the negotiation process, and it is the manipulation of those beliefs that results in supracompetitive prices. In fact, our theory will have sellers offering the *same* prices as under competition, in which case the impact of collusion is entirely on the prices that buyers offer and are willing to accept.<sup>5</sup>

The theory focuses on the information about a seller's cost that is conveyed by its list price or surcharge. While recognizing that list prices and surcharges can be more than information, the model parsimoniously isolates attention on the informational component by assuming that firms make cheap talk announcements about their costs. The model assumes that there are two sellers, each of which receives some information about its cost which takes the form of a distribution on cost. Sellers then make announcements - such as in the form of list prices - about whether it is a low-cost or a high-cost type. Buyers decide with whom to negotiate based on the announcements. When a buyer shows up at a seller to negotiate, a seller learns its cost which is a draw from its distribution. Buyers are heterogeneous in their values and in how many sellers they approach to negotiate. As a tractable representation of buyer-seller negotiations, a buyer is modelled as conducting a second-price auction with a reserve price in which case the sellers that are invited to a buyer's auction represent the sellers with which a buyer negotiates.

When sellers are competing, sufficient conditions are provided for a separating equilibrium to exist whereby a seller's announcement reveals its cost type to buyers. Collusion has sellers coordinate on announcements that signal they are high-cost types. These coordinated announcements induce buyers to set a high reserve price (or, in other words, negotiate less aggressively). Buyers recognize the possibility that sellers may be colluding and thus that a high-cost announcement may not signal that a seller is a high-cost type.

In viewing list prices and surcharges as cheap talk messages, the model is stylized but has the benefit of generality in that it encompasses many variables that can convey cost information.

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<sup>5</sup>That sellers' prices are exactly the same under competition is likely due to the particular modelling of the negotiation process. With other models of negotiation, sellers' prices could also be influenced, but that does not affect the main takeaway of the paper which is that buyers' conduct is impacted by sellers' collusive practices.

Though the theory does not address why firms would choose list prices or surcharges as the vehicle to manipulate buyers' beliefs about cost, they are natural candidates because they are a feature of the competitive process and are most likely perceived by buyers to be influenced by cost (indeed, surcharges are expressed to be associated with some input).<sup>6</sup> Furthermore, for the markets we have in mind, treating list prices and surcharges as cheap talk is probably a reasonable approximation. If buyers can always anticipate discounts off of list prices then list prices as an upper bound on a seller's negotiated price is not a binding constraint.<sup>7</sup> The argument for surcharges being cheap talk is perhaps even more compelling. At most, it provides a lower bound on the total price (equal to the surcharge) but that is surely a non-binding constraint. In any case, our analysis shows that the information in list prices and surcharges is sufficient for coordination on them to produce supracompetitive prices.

This paper offers the first theory of collusion based on influencing buyers' conduct, and it offers an explanation for why some recent collusive practices are effective even if they do not constrain the prices that sellers offer. Section 2 reviews some legal cases in which firms coordinated their list prices or surcharges. Section 3 describes the model and relates it to past work, and Section 4 presents the candidate strategy profile. There are two steps to developing the theoretical argument; each of which is a new contribution. The first step is establishing an endogenous connection between announcements and final transaction prices; that is performed in Section 5. The second step is showing that firms can jointly raise profits by coordinating their announcements; that is done in Sections 6-7. Section 8 offers some initial insight into when sellers prefer to coordinate on list prices (i.e., cost announcements) than on prices.

## 2 Cases

*Reserve Supply v. Owens-Corning Fiberglas* (1992) is a private litigation case involving collusion in the market for fiberglass insulation. Two of the top three suppliers were accused of coordinating their list prices over 1979-83. The plaintiffs and defendants disagreed whether the alleged coordination could have resulted in supracompetitive transaction prices:

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<sup>6</sup>Note that it is illegal for firms to explicitly coordinate their conduct in any manner that raises transaction prices. Hence, sellers are no less open to prosecution by coordinating on literal announcements about cost than they are by coordinating on list prices or surcharges. Thus, concerns about prosecution will not determine the vehicle used to influence buyers' beliefs.

<sup>7</sup>The previous quotation from the thread cartel highlights the "fictitious" nature of list prices.

Reserve points to Owens-Corning and CertainTeed’s practices of maintaining price lists for products and ... asserts that these lists have no independent value because no buyer in the industry pays list price for insulation. Instead, it claims that the price lists are an easy means for producers to communicate and monitor the price activity of rivals by providing a common starting point for the application of percentage discounts. ... Owens-Corning and CertainTeed counter by arguing that the use of list prices to monitor pricing would not be possible because the widespread use of discounts in the industry ensures that list prices do not reflect the actual price that a purchaser pays.<sup>8</sup>

The Seventh Circuit Court expressed skepticism with regards to the plaintiffs’ argument:

We agree that the industry practice of maintaining price lists and announcing price increases in advance does not necessarily lead to an inference of price fixing. ... [T]his pricing system would be, to put it mildly, an awkward facilitator of price collusion because the industry practice of providing discounts to individual customers ensured that list price did not reflect the actual transaction price.<sup>9</sup>

In a case involving the market for urethane, plaintiffs claimed:

[T]hroughout the alleged conspiracy period, the alleged conspirators announced identical price increases simultaneously or within a very short time period. ... [P]urchasers could negotiate down from the increased price. But the increase formed the baseline for negotiations. ... [T]he announced increases caused prices to rise or prevented prices from falling as fast as they otherwise would have.<sup>10</sup>

Supporting the alleged effect of list prices on transaction prices were internal memos from defendant Dow Chemical, such as:

In March 2002, Dow touted “Recent Successes,” emphasizing a class-wide price increase: “We announced 10 cts on Polyols March 1. We announced 15 cts on TDI March 1, 2002. **It’s Working!!!!!!!**”<sup>11</sup>

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<sup>8</sup> *Reserve Supply v. Owens-Corning Fiberglas* 971 F. 2d 37 (7th Cir. 1992), para 61.

<sup>9</sup> *Ibid*, para. 62.

<sup>10</sup> Class Plaintiffs’ Response Brief (February 14, 2014), *In Re: Urethane Antitrust Litigation*, No. 13-3215, 10th Cir.; pp. 8-9.

<sup>11</sup> *Ibid*, p. 15.

The Tenth Circuit Court quoted the District Court in supporting the plaintiffs:

The court reasoned that the industry’s standardized pricing structure - reflected in product price lists and parallel price-increase announcements - “presumably established an artificially inflated baseline” for negotiations. Consequently, any impact resulting from a price-fixing conspiracy would have permeated all polyurethane transactions, causing market-wide impact despite individualized negotiations.<sup>12</sup>

Turning to surcharges, over 40 air cargo companies participated in an agreement to coordinate fuel surcharges from late 1999 to early 2006. The surcharge was initially as low as four cents per kilogram and ultimately reached 72 cents per kilogram (LeClair, 2012). Guilty pleas led to fines of around \$3 billion and customer damages exceeding \$1.2 billion.<sup>13</sup> The collection of damages means there was an estimated overcharge and, therefore, coordination on fuel surcharges affected transaction prices.

In on-going private litigation, four class I railroads have been accused of coordinating their fuel surcharges starting in 2003.

The barrier to this plan [to coordinate fuel surcharges], according to plaintiffs, was that the great majority of rail freight transportation contracts already included rate escalation provisions that weighted a variety of cost factors, including fuel, based on an index called the All Inclusive Index (the “AII”). The railroad trade organization known as the Association of American Railroads (“AAR”), which is dominated by the four defendants, publishes this index. ... Plaintiffs allege that the defendants conspired to remove fuel from the AII so that they could apply a separate “fuel surcharge” as a percentage of the total cost of freight transportation.<sup>14</sup>

The plaintiffs alleged that railroads’ conduct became coordinated after the AAR moved to this All Inclusive Index Less Fuel (AII LF):

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<sup>12</sup> *In Re: Urethane Antitrust Litigation*, No. 13-3215 (10th Cir. Sep. 29, 2014); p. 7.

<sup>13</sup> “Hausfeld Announces Final Settlement in Decade-Long Air Cargo Price Fixing Litigation,” Hausfeld, May 19, 2016; downloaded from <[www.hausfeld.com/news/us/hausfeld-announces-final-settlement-in-air-cargo-price-fixing-litigation](http://www.hausfeld.com/news/us/hausfeld-announces-final-settlement-in-air-cargo-price-fixing-litigation)> on September 16, 2017.

<sup>14</sup> *In re Rail Freight Surcharge Antitrust Litig.*, 587 F.Supp.2d 27, 30 (2008), United States District Court, District of Columbia. November 7, 2008

[A]lthough the railroads' surcharges had varied in the past, from July 2003 onward the western railroads imposed identical surcharges. And from March 2004, three months after the December announcement of the AILF, the eastern railroads imposed identical fuel surcharges. Plaintiffs further assert that it is unlikely that the eastern and western defendants would independently impose identical fuel surcharges, because fuel cost as a percentage of operating cost and fuel efficiency differed widely among the defendant railroads.<sup>15</sup>

The fuel surcharge was 0.4 percent of the base rate for each dollar that the price of oil on the West Texas Intermediate index exceeded \$23 per barrel.<sup>16</sup> The Surface Transportation Board ruled that

[b]ecause railroads rely on differential pricing, under which rates are dependent on factors other than costs, a surcharge that is tied to the level of the base rate ... stands virtually no prospect of reflecting the actual increase in fuel costs.<sup>17</sup>

Over 2001-07, fuel surcharges exceeded the rise in fuel costs by 55 percent.<sup>18</sup>

Fuel is not only the only input for which there has been illegal coordination on surcharges. Six manufacturers of motive power batteries in Belgium were found guilty of coordinating on a common surcharge for lead.<sup>19</sup> The cartel lasted from 2004 to 2011, and ended with an application for leniency.

A final example of coordinated announcements is a cement cartel in the United Kingdom.<sup>20</sup> Annually, cement suppliers sent letters to their customers announcing price increases. However, prices were then individually negotiated with customers and the full price increase was rarely implemented. The Competition and Markets Authority concluded that firms coordinated their price announcement letters and noted "that firms generally fail to achieve the prices set out in the price letters, in part because of the rebates offered to large customers."<sup>21</sup> In commenting on the

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<sup>15</sup> *In re Rail Freight Surcharge Antitrust Litig.*, 587 F.Supp.2d 27, 34 (2008), United States District Court, District of Columbia. November 7, 2008

<sup>16</sup> *In re Rail Freight Surcharge Antitrust Litig.*, U.S. District Court for the District of Columbia, Opinion, June 21, 2012, p. 11.

<sup>17</sup> Surface Transportation Board Decision, STB Ex Parte No. 661 Rail Fuel Surcharges, Decided: January 25, 2007, p. 6.

<sup>18</sup> USDA: Study of Rural Transportation Issues, June 03, 2010

<sup>19</sup> Belgian Competition Authority, Press Release, N° 4/2016, 23 February 2016

<sup>20</sup> "Aggregates: Report on the market study and proposed decision to make a market investigation reference," Office of Fair Trading, OFT1358, August 2011.

<sup>21</sup> *Ibid*, p. 53.



UK cement case, the head of Compass Lexecon’s London office posed the question: “How do price announcements help firms coordinate on prices if prices are ultimately individually negotiated?”<sup>22</sup> It is to that question that we now turn.

### 3 Model

Consider a market with two sellers offering identical products. A seller may be one of two types,  $L$  or  $H$ , and type  $L$  occurs with probability  $q$ . Sellers’ types are independent. A type  $t$  seller’s unit cost is assumed to be a random draw from the cdf  $F_t : [\underline{c}_t, \bar{c}_t] \rightarrow [0, 1]$ ,  $t \in \{L, H\}$ .  $F_t$  is continuously differentiable with positive density everywhere on  $(\underline{c}_t, \bar{c}_t)$ . The inverse hazard rate function,  $h_t(c) \equiv F_t(c)/F_t'(c)$ , is assumed to be non-decreasing,  $h_t'(c) \geq 0$ , which holds for most of the common distributions such as uniform, normal, exponential, logistic, chi-squared, and Laplace. The two cost distributions are ranked in terms of their inverse hazard rates:  $h_L(c) > h_H(c)$  for all  $c \in (\underline{c}_t, \bar{c}_t]$ . Note that the latter condition implies  $F_H$  first-order stochastically dominates  $F_L$  and, consequently, we will refer to a type  $L$  seller as a low-cost type and a type  $H$  seller as a high-cost type.

There is a continuum of buyers. Each buyer is endowed with a per unit valuation  $v \in [\underline{v}, \bar{v}]$  and volume  $z \in [\underline{z}, \bar{z}]$  (that is, the number of units demanded). Buyers also differ according to whether they solicit offers from either 1 or 2 sellers.<sup>23</sup> What exactly it means to “solicit” an offer is described below. A fraction  $\gamma \in [0, 1]$  of buyers solicit an offer from a single seller and a fraction  $1 - \gamma$  from two sellers. A buyer’s per unit valuation is assumed to be independent of its volume and how many offers are solicited. Valuations are distributed according to the cdf  $G : [\underline{v}, \bar{v}] \rightarrow [0, 1]$ , where  $G$  is continuously differentiable with positive density everywhere on  $(\underline{v}, \bar{v})$ . A buyer’s volume is allowed to be correlated with how many offers are solicited, and let  $\mu^w$  be the expected volume of a buyer who solicits  $w$  offers. Normalizing total market volume to one, define

$$b \equiv \frac{\gamma\mu^1}{\gamma\mu^1 + (1 - \gamma)\mu^2}$$

as the fraction of market volume that is from buyers who solicit an offer from one seller, and  $1 - b$

<sup>22</sup> “Exchange of Information: Current Issues,” 30 April 2014, Allen & Overy, Brussels.

<sup>23</sup> The number of sellers that are solicited by a buyer is assumed to be exogenous for reasons of tractability. This specification could be rationalized by assuming buyers incur a cost to negotiating with each seller. Some buyers have very low cost and thus negotiate with both sellers, while other buyers have a high enough cost that it is optimal to only negotiate with one seller.

as the fraction of market volume that is from buyers who solicit an offer from two sellers. The ensuing analysis depends on  $\gamma$ ,  $\mu^1$ , and  $\mu^2$  only through  $b$ .

The modelling of the interaction between buyers and sellers is intended to capture many intermediate goods markets for which buyers are industrial customers. Sellers first make some announcement informative of their costs which could be a list price, surcharge, or some other variable. After observing those announcements, each buyer approaches either 1 or 2 sellers to negotiate. A buyer who approaches two sellers is presumed to engage in an iterative bargaining process whereby she uses an offer from one seller to obtain a better offer from the other seller. Rather than explicitly model that process, we will use the second-price auction with a reserve price as a metaphor for it. More specifically, a buyer “invites”  $w$  sellers to the auction, where  $w \in \{1, 2\}$ . The buyer sets a reserve price and the  $w$  sellers submit bids which, in equilibrium, will equal their cost. We have buyers choose a publicly observed reserve price so they are not passive, which better mimics negotiation. A transaction occurs if the lowest bid is below the buyer’s reserve price. In the case of having chosen just one seller, the mechanism is equivalent to the buyer making a take it or leave it offer. Announcements, such as list prices, are presumed to be chosen less frequently than negotiated prices and this has the implication that a seller knows its cost type when it makes its announcement but does not know its actual cost until the time of negotiation. In practice, this uncertainty about future cost may be due to volatility in input prices or not knowing the opportunity cost of supply because future inventories or capacity constraints are uncertain.

The extensive form is as follows. In stage 1, sellers draw types from  $\{L, H\}$  (which is private information to each seller) and choose announcements from  $\{l, h\}$ . In stage 2, buyers learn their valuations and volumes and observe sellers’ announcements. If a buyer is specified as approaching only one seller then it chooses a seller.<sup>24</sup> In stage 3, each seller realizes its cost. If a seller is type  $t$  then its cost is a draw from  $[\underline{c}_t, \bar{c}_t]$  according to  $F_t$ . In stage 4, each buyer conducts a second-price auction with a reserve price, with the outcome determined as follows. If there are two sellers in the auction and: i) both bids are below the reserve price then the buyer buys from the seller with the lowest bid at a price equal to the second lowest bid; ii) one bid is below the reserve price and the other bid is above the reserve price then the buyer buys from the seller with the lowest bid at a price equal to the reserve price; iii) both bids are above the reserve price then there is no

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<sup>24</sup>While a buyer’s valuation is private information, results are robust to assuming that a buyer’s volume is private or public information. If volume distinguishes small and large buyers then assuming it is observed by sellers is more natural.

transaction. If there is one seller in the auction and: i) the bid is below the reserve price then the buyer buys from the seller at the reserve price; ii) the bid is above the reserve price then there is no transaction.

A strategy for a seller is a pair of functions: an announcement function and a bid function. The announcement function maps from  $\{L, H\}$  to  $\{l, h\}$  and thus has a seller select an announcement based on its cost type. In the event a seller is matched with a buyer, a bid function assigns a bid depending on the seller's cost type, seller's cost, other seller's announcement, reserve price, and whether the buyer matches with one or two sellers. The weakly dominant bidding strategy for a seller is to bid its cost. From hereon, we will think of a strategy for a seller as an announcement function and a bid function that has its bid equal to its cost. For a buyer who matched with one seller, a strategy selects a seller and a reserve price conditional on the announcements and the buyer's valuation and volume (though the latter variable will not matter). If the buyer is matched with two sellers then a strategy selects a reserve price conditional on the announcements and the buyer's valuation and volume. The solution concept is perfect Bayes-Nash equilibrium.

**Related Literature** Our model is related to models of directed search in a market setting, as announcements may induce buyers to negotiate with certain sellers. The paper closest to ours is Menzio (2007), who considers cheap talk in a search model of a competitive labor market. Employers have private information about the quality of their vacancies and can costlessly communicate with unemployed workers before they engage in an alternating offer bargaining game to determine the wage. Under certain conditions, there exists an equilibrium in which cheap-talk messages about compensation are correlated with actual wages and, therefore, serve to direct the search of workers. Our theory encompasses similar forces to those present in Menzio (2007) though in the context of an imperfectly competitive product market setting.

Our paper is also related to indicative bidding, which serves as the basis for shortlisting bidders in a two-stage auction procedure. Ye (2007) shows there does not exist a symmetric separating equilibrium bid function in indicative bidding; hence, the most "qualified" bidders may not be selected for the final stage. By restricting indicative bids to a finite domain, Quint and Hendricks (2015) explicitly models indicative bidding as cheap talk with commitment, and show that a symmetric equilibrium exists in weakly-monotone strategies. But again, the highest-value bidders are not always selected, as bidder types pool over a finite number of bids. Announcements in our setting are like indicative bids in those settings. However, unlike in their analysis, in our setting the trading mechanism depends on the announcement in that it affects a buyer's reserve price as

well as the seller that the buyer selects. As a result, a separating equilibrium in the cheap-talk stage becomes possible.

Independently, Lubensky (2017) interprets a manufacturer suggested retail price (MSRP) as a cheap talk signal about cost. The model assumes a single manufacturer with private cost information that chooses an MSRP and a wholesale price for its retailers. After observing the MSRP, buyers sequentially search among retailers and a stochastic outside option, with their beliefs on retail prices influenced by any cost information conveyed by the MSRP. In contrast, our model has two competing manufacturers (each with private information on their costs), no retail sector, and buyers negotiate with sellers. After presenting our result on the informativeness of cost announcements, we will discuss how the underlying forces at play differ from those in Lubensky (2017).

## 4 Strategies Under Competition and Collusion

Suppose firms are competing. As this is a cheap talk game, there are always pooling equilibria which, in our setting, means uninformative announcements about cost. We will focus on equilibria in which a seller’s announcement is informative of its cost type as that will prove to be a necessary condition for collusion to be effective. Hence, competing sellers use the separating strategy that has a low-cost (high-cost) type choose a low-cost (high-cost) announcement:

$$\phi(t) = \begin{cases} l & \text{if } t = L \\ h & \text{if } t = H \end{cases} \quad (1)$$

If instead firms are colluding then each is presumed to make a high-cost announcement regardless of its type:

$$\psi(t) = \begin{cases} h & \text{if } t = L \\ h & \text{if } t = H \end{cases} \quad (2)$$

The value of coordinating their announcements in this manner is explained below.

An element to the ensuing theory is the descriptively realistic assumption that buyers are uncertain whether sellers are competing or colluding.<sup>25</sup> Buyers assign probability  $\kappa$  (for the German “kartell”) that firms are colluding and using (2), and probability  $1 - \kappa$  that firms are competing

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<sup>25</sup>That other agents - whether buyers, the competition authority, or potential entrants - are uncertain about whether market outcomes are the product of competition or collusion is assumed, for example, in Harrington (1984), Besanko, and Spulber (1989, 1990), LaCasse (1995), Souam (2001), and Schinkel and Tuinstra (2006).

and using (1). Buyers recognize that collusion is possible and how collusion operates. However, as colluding sellers hide their illegal activities, buyers are uncertain regarding the existence of a cartel. Buyers are assumed to live for only one period and do not observe the history.<sup>26</sup>

Given these beliefs on collusion, a buyer's beliefs as to sellers' types given their announcements can be derived. When buyers observe either or both sellers choosing a low-cost announcement, they infer that firms are competing. Letting  $m_i$  denote the message and  $t_i$  denote the type of firm  $i$ , respectively, posterior beliefs (conditional on announcements) are:

- If  $(m_1, m_2) = (l, l)$  then firms are competing and  $\Pr(t_i = L | (m_1, m_2) = (l, l)) = 1, i = 1, 2$ .
- If  $(m_i, m_j) = (l, h)$  then firms are competing and  $\Pr(t_i = L | (m_i, m_j) = (l, h)) = 1, \Pr(t_j = L | (m_i, m_j) = (l, h)) = 0, i \neq j, i, j = 1, 2$ .

However, when buyers observe both sellers choosing a high-cost announcement, they do not know whether sellers are competing (and are high-cost types) or are colluding. Bayesian updating implies:

$$\Pr(t_i = L | (m_1, m_2) = (h, h)) = \frac{\kappa q}{\kappa + (1 - \kappa)(1 - q)^2}, \quad i = 1, 2. \quad (3)$$

With these beliefs on sellers' types, the next step is to derive a buyer's reserve price. Let  $R_{m_1 m_2}^w(v)$  denote the optimal reserve price when a buyer's valuation is  $v$ , announcements are  $(m_1, m_2)$ , and the buyer approaches  $w$  sellers. (As a buyer's payoff is linear in its volume  $z$ , the optimal reserve price does not depend on  $z$ , and so that term is suppressed.) If  $(m_1, m_2) \in \{(l, l), (l, h), (h, l)\}$  then sellers are inferred to be competing in which case a seller's announcement fully reveals its type. When a buyer approaches only one seller, she will randomly choose a seller when  $(m_1, m_2) = (l, l)$  and choose the seller with the low-cost announcement when  $(m_1, m_2) \in \{(l, h), (h, l)\}$ . Hence, in all cases, a buyer's beliefs on the seller's cost (and bid) is  $F_L$ . It follows that the optimal reserve price is:

$$R_{m_1 m_2}^1(v) \equiv \arg \max z(v - R) F_L(R), \quad \forall (m_1, m_2) \in \{(l, l), (l, h), (h, l)\}. \quad (4)$$

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<sup>26</sup>Though this assumption is inconsistent with them being industrial buyers, it allows us to avoid a difficult dynamic problem. If buyers were long-lived or observed the history then they would update their beliefs over time regarding the hypothesis that there is collusion. While characterizing buyers' beliefs over time is not a problem in and of itself, colluding sellers would take into account how their current actions (both with regards to announcements and bids) impact buyers' beliefs and the future value of collusion. Thus, it now becomes a dynamic game between buyers and sellers. That is clearly a setting worth examining but is one we leave to future research.

If a buyer instead solicits bids from two sellers, she infers the sellers' types are  $(\phi^{-1}(m_1), \phi^{-1}(m_2))$  where recall  $\phi$  is a seller's strategy under competition (see (1)). It follows that

$$\begin{aligned}
& R_{m_1 m_2}^2(v) \\
\equiv & \arg \max_R z \int_{\underline{c}_{\phi^{-1}(m_1)}}^R \int_{c_1}^R (v - c_2) dF_{\phi^{-1}(m_2)}(c_2) dF_{\phi^{-1}(m_1)}(c_1) \\
& + z \int_{\underline{c}_{\phi^{-1}(m_2)}}^R \int_{c_2}^R (v - c_1) dF_{\phi^{-1}(m_1)}(c_1) dF_{\phi^{-1}(m_2)}(c_2) \\
& + z(v - R) \left[ \left(1 - F_{\phi^{-1}(m_2)}(R)\right) F_{\phi^{-1}(m_1)}(R) + \left(1 - F_{\phi^{-1}(m_1)}(R)\right) F_{\phi^{-1}(m_2)}(R) \right].
\end{aligned} \tag{5}$$

Now suppose  $(m_1, m_2) = (h, h)$  so buyers remain uncertain regarding whether firms are competing or colluding. Given posterior beliefs (3) as to a seller's type, a buyer believes a seller chooses its cost according to the mixture cdf  $F_\kappa$ :

$$F_\kappa \equiv \left( \frac{\kappa q}{\kappa + (1 - \kappa)(1 - q)^2} \right) \circ F_L + \left( \frac{\kappa(1 - q) + (1 - \kappa)(1 - q)^2}{\kappa + (1 - \kappa)(1 - q)^2} \right) \circ F_H.$$

It follows that:

$$R_{hh}^1(v) \equiv \arg \max_R z(v - R) F_\kappa(R), \tag{6}$$

and

$$\begin{aligned}
R_{hh}^2(v) & \equiv \arg \max_R z \int_{\underline{c}_L}^R \int_{c_1}^R (v - c_2) dF_\kappa(c_2) dF_\kappa(c_1) \\
& + z \int_{\underline{c}_L}^R \int_{c_2}^R (v - c_1) dF_\kappa(c_1) dF_\kappa(c_2) \\
& + z(v - R) 2(1 - F_\kappa(R)) F_\kappa(R).
\end{aligned} \tag{7}$$

where this expression uses the assumption  $\underline{c}_L \leq \underline{c}_H$ .

When a buyer approaches one seller, Lemma 1 shows that the optimal reserve price is higher when both sellers post high-cost announcements (and thus may be colluding) than when one or both sellers posts a low-cost announcement (in which case sellers are competing).<sup>27</sup>

**Lemma 1**  $R_{hh}^1(v) > R_{ll}^1(v) (= R_{lh}^1(v)), \forall v$ .

For when a buyer approaches both sellers, Lemma 2 provides sufficient conditions for the optimal reserve price to be increasing in how many sellers posted high-cost announcements.

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<sup>27</sup>Proofs are in the Appendix

**Lemma 2** *If  $\kappa$  is sufficiently small then  $R_{hh}^2(v) > R_{lh}^2(v) > R_{ll}^2(v), \forall v$ .*

As stated, the monotonicity in the optimal reserve price is proven when the probability of colluding  $\kappa$  is not too high. Otherwise, it is possible that  $R_{hh}^2(v) < R_{lh}^2(v)$ , though  $R_{hh}^2(v), R_{lh}^2(v) > R_{ll}^2(v)$  regardless of  $\kappa$ .<sup>28</sup> The main results in the paper are proven for when the optimal reserve price is monotonic and, for that reason, results will be stated assuming collusion is sufficiently unlikely.<sup>29</sup>

## 5 Competition

The objective of this section is to show that announcements can be informative under competition. Coordinating on announcements cannot be profitable unless announcements are impactful with regards to transaction prices, which requires that announcements are perceived by buyers as containing information when firms compete. In determining when a separating equilibrium (under competition) exists, the analysis will examine when  $b = 1$  (so the entire market volume is from buyers who negotiate with one seller),  $b = 0$  (all buyers negotiate with both sellers), and finally the general case of  $b \in [0, 1]$ .

### 5.1 All Buyers Negotiate with One Seller

Suppose  $b = 1$  so that all buyers approach only one seller. Let us derive the conditions for sellers' competitive strategy (1) to be part of a perfect Bayes-Nash equilibrium. We have already dealt with a buyer's beliefs and strategy and just need to derive conditions for a seller's strategy to be optimal.

A low-cost type seller prefers to choose message  $l$  (as prescribed by the competitive strategy)

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<sup>28</sup>For example, when  $\kappa = 1$ ,  $R_{hh}^2(v)$  is based on each seller having a low-cost distribution with probability  $q$ . In comparison,  $R_{lh}^2(v)$  is based on one seller having a low-cost distribution for sure and the other seller having a high-cost distribution for sure. The relationship between those reserve prices is ambiguous.

<sup>29</sup>A low value of  $\kappa$  is quite reasonable in light of cartel duration data. If buyers strongly suspected collusion (so  $\kappa$  is not low), it would be in their best interests to report those suspicions to the competition authority or pursue private litigation, which would imply cartel duration is short. To the contrary, cartels typically operate for many years before they are discovered. Average duration for discovered cartels is around six years (Harrington and Wei, 2017), with some cartels operating for decades before being discovered (Levenstein and Suslow, 2006).

and signal it is a low-cost type if and only if

$$\begin{aligned} & \left(\frac{q}{2} + 1 - q\right) \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{ll}^1(v)} (R_{ll}^1(v) - c) dF_L(c) dG(v) \\ & \geq \left(\frac{1-q}{2}\right) \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{hh}^1(v)} (R_{hh}^1(v) - c) dF_L(c) dG(v). \end{aligned} \quad (8)$$

On the LHS of the inequality is the payoff from choosing  $l$  (which uses the property,  $R_{ll}^1(v) = R_{lh}^1(v)$ ). A seller posting  $l$  is chosen for sure by the buyer when the other seller posted  $h$ , which occurs when the other seller is type  $H$  (and that occurs with probability  $1 - q$ ); and is chosen with probability  $1/2$  when the other seller posted  $l$ , which occurs when the other seller is type  $L$  (and that occurs with probability  $q$ ). Thus, a seller who chooses a low-cost announcement is approached by a buyer with probability  $\frac{q}{2} + 1 - q$ . In that case, the buyer offers a price of  $R_{ll}^1(v)$  and the seller accepts the offer if its realized cost is less than  $R_{ll}^1(v)$ . If the seller selects a high-cost announcement then it is approached by the buyer with probability  $1/2$  in the event that the other seller also posted a high-cost announcement, and is not approached when the other seller posted a low-cost announcement. Hence, a seller with announcement  $h$  assigns probability  $(1 - q)/2$  to being approached by a buyer and, in that situation, is offered  $R_{hh}^1(v)$ .

If instead a seller is a high-cost type then it prefers to choose  $h$  if and only if

$$\begin{aligned} & \left(\frac{1-q}{2}\right) \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{hh}^1(v)} (R_{hh}^1(v) - c) dF_H(c) dG(v) \\ & \geq \left(\frac{q}{2} + 1 - q\right) \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{ll}^1(v)} (R_{ll}^1(v) - c) dF_H(c) dG(v). \end{aligned} \quad (9)$$

The expressions are the same as in (8) except that the inequality is reversed and the cost distribution is  $F_H$  instead of  $F_L$ .

When a buyer selects one seller with which to negotiate, a seller's announcement plays two roles. First, it affects the likelihood that a seller is selected by a buyer. By conveying it is low cost with announcement  $l$ , a seller is selected with probability  $1 - (q/2)$ , while the probability is only  $(1 - q)/2$  if it conveys it is high cost with announcement  $h$ . This effect is referred to as the *inclusion effect* in that a low-cost announcement makes it more likely a buyer includes a seller in the negotiation process. A low-cost announcement signals a seller has a low-cost distribution in which case it is more likely to accept the buyer's offer. The inclusion effect makes a low-cost announcement attractive because it induces more buyers to approach a seller and thereby results in more sales. However, there is a countervailing effect from a seller posting conveying that message, which is that a buyer negotiates more aggressively knowing it is more likely the seller's cost is



low given it conveyed it is a low-cost type. Referred to as the *bargaining effect*, it manifests itself by a buyer making a lower offer (in the form of a lower reserve price) in response to a low-cost announcement.<sup>30</sup>

In sum, a low-cost announcement makes it more likely that a buyer negotiates with a seller but then the buyer will demand a lower price in those negotiations. Announcements can be informative because only a low-cost seller is willing to accept more aggressive buyers in exchange for attracting more buyers.<sup>31</sup>

**Theorem 3** *If  $b = 1$  then there exists  $\underline{q}$  and  $\bar{q}$  such that a separating equilibrium exists if and only if  $q \in [\underline{q}, \bar{q}]$ .*

The probability that the other seller is a low-cost type cannot be too low ( $q > \underline{q}$ ), so that a low-cost seller prefers a low-cost announcement in order to compete with a possible low-cost rival, nor too high ( $q < \bar{q}$ ), so that a high-cost seller does *not* prefer a low-cost announcement in order to compete with a possible low-cost rival. In Section 7, we offer a parametric model for which  $0 < \underline{q} < \bar{q} < 1$  and, therefore, a separating equilibrium exists.<sup>32</sup>

## 5.2 All Buyers Negotiate with Both Sellers

When all buyers approach both sellers ( $b = 0$ ), separating equilibria do not exist. The expected profit per unit to a seller of type  $t_1$  whose announcement is  $m_1$  (and thus inferred to be  $\phi^{-1}(m_1)$ ) when the other seller's type and announcement are  $t_2$  and  $m_2$ , respectively, is

$$\begin{aligned} & B(m_1, t_1; m_2, t_2) \\ \equiv & \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_{t_2}}^{\bar{c}_{t_2}} \int_{\underline{c}_{t_1}}^{\min\{R_{m_1 m_2}^2(v), c_2\}} (\min\{R_{m_1 m_2}^2(v), c_2\} - c_1) dF_{t_1}(c_1) dF_{t_2}(c_2) dG(v), \end{aligned} \tag{10}$$

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<sup>30</sup>Though not labelling them as such, the inclusion and bargaining effects are present in Menzio (2007) in the context of a competitive labor market with search.

<sup>31</sup>For reasons of economizing on the analysis, the proofs of Theorems 3 and 4 are combined.

<sup>32</sup>In Lubensky (2017), a low MSRP reveals a manufacturer has low cost and that causes buyers to expect low retail prices because retailers will face a low wholesale price. With a higher reservation utility, buyers search more. A low-cost manufacturer prefers more search (and thus has an incentive to reveal its type) because it is more likely a buyer will not buy from the outside option and instead search for a really good deal from one of the manufacturer's retailers. As a result, an MSRP can be informative of cost. That mechanism is very different from the one operating in the model of this paper. Here, a low list price serves to attract buyers to negotiate with a seller but also makes buyers negotiate more aggressively. In brief, MSRPs are informative in Lubensky (2017) because they affect the *intensity* of search, while list prices are informative here because they affect the *direction* of search and a *buyer's price* during negotiation.

and the function is referred to as  $B$  because a buyer approaches *both* sellers. Recall that a buyer's optimal reserve price is  $R_{m_1 m_2}^2(v)$  given announcements  $m_1$  and  $m_2$ . If seller 1's bid (= cost) is less than  $\min\{R_{m_1 m_2}^2(v), c_2\}$  then a buyer with valuation  $v$  buys from seller 1 and pays a price equal to  $\min\{R_{m_1 m_2}^2(v), c_2\}$ . Hence, the probability that seller 1 makes a sale is weakly increasing in the reserve price  $R_{m_1 m_2}^2(v)$ , as is the profit conditional on making a sale which equals  $\min\{R_{m_1 m_2}^2(v), c_2\} - c_1$ . For realizations of  $c_2$  and  $v$  such that  $R_{m_1 m_2}^2(v) < c_2$ , both are strictly increasing in the reserve price.  $B(m_1, t_1; m_2, t_2)$  is then increasing in the reserve price.

If seller 2 uses (1) then seller 1's expected payoff from announcement  $m_1$  is

$$qB(m_1, t_1; l, L) + (1 - q)B(m_1, t_1; h, H).$$

Given  $B(m_1, t_1; m_2, t_2)$  is increasing in the reserve price, Lemma 2 implies

$$qB(h, t_1; l, L) + (1 - q)B(h, t_1; h, H) > qB(l, t_1; l, L) + (1 - q)B(l, t_1; h, H), \quad t_1 \in \{L, H\}.$$

A seller then prefers to convey it is high cost regardless of its type. Hence, a separating equilibrium does not exist.

With buyers approaching both sellers, a seller's announcement does not affect the probability of being selected – so there is no inclusion effect – but it does affect how aggressively a buyer negotiates. A seller will always want to signal it is more likely to have a high-cost distribution because it induces a buyer to set a higher reserve price. When all buyers negotiate with both sellers, announcements are then uninformative.<sup>33</sup>

### 5.3 General Case

Thus far, it has been shown that a separating equilibrium may exist when  $b = 1$ , and only pooling equilibria exist when  $b = 0$ . The next result considers when buyers are heterogeneous regarding how many sellers are approached.<sup>34</sup>

**Theorem 4** *If  $\kappa$  is sufficiently small and a separating equilibrium exists for  $b = 1$  then there exists  $b^* \in (0, 1)$  such that a separating equilibrium exists if and only if  $b \in [b^*, 1]$ .*

Announcements about cost can be informative when they influence a buyer's decision as to which seller to approach to negotiate a deal, which we have referred to as the inclusion effect. A low-cost

<sup>33</sup>By a similar argument, one can show that semi-pooling equilibria do not exist.

<sup>34</sup>Recall that  $\kappa$  is required to be sufficiently small in Theorem 4 only to ensure that the optimal reserve price is increasing in the number of sellers who make high-cost announcements (Lemma 2).

seller can find it worthwhile to make a low-cost announcement because the resulting increase in the number of buyers it attracts offsets the enhanced aggressiveness of those buyers. For equilibrium announcements to be informative, there must then be enough volume from one-seller buyers ( $b$  is sufficiently high) so that the inclusion effect is sufficiently strong.

## 6 Collusion

Having established that announcements can impact transaction prices, the next task is to explore the profitability of coordinating cost announcements. As we'll see, the coordination of cost announcements is quite different from the coordination of prices, and this is reflected in the possibility that sellers coordinating announcements can raise profits *and* welfare.

To begin, consider a seller's expected profit under competition prior to learning its type:

$$\begin{aligned}
 E[\pi^{\text{comp}}] \equiv & b \left[ \begin{aligned} & q^2(1/2)A(l, L; l) + q(1 - q)A(l, L; h) \\ & + (1 - q)^2(1/2)A(h, H; h) \end{aligned} \right] \\
 & + (1 - b)[q^2B(l, L; l, L) + q(1 - q)B(l, L; h, H) \\
 & + q(1 - q)B(h, H; l, L) + (1 - q)^2B(h, H; h, H)]
 \end{aligned} \tag{11}$$

where

$$A(m_1, t_1; m_2) \equiv \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_t}^{R_{m_1 m_2}^1(v)} (R_{m_1 m_2}^1(v) - c) dF_{t_1}(c) dG(v) \tag{12}$$

is the expected profit per unit to a seller of type  $t_1$  whose announcement is  $m_1$  when the other seller's announcement is  $m_2$  and a buyer approaches only that seller.<sup>35</sup>  $B(m_1, t_1; m_2, t_2)$  is the corresponding expected profit per unit from a buyer who approaches both sellers (and is defined in (10)). The first bracketed expression pertains to the fraction  $b$  of market volume from buyers who negotiate with only one seller. With probability  $q$ , the seller is low cost and chooses announcement  $l$  which signals to buyers it has a low-cost distribution. From these buyers, it will attract half of them when the other seller also chooses a low-cost announcement (which occurs with probability  $q$ ) and all of them when the other seller chooses a high-cost announcement (which occurs with probability  $1 - q$ ). In that case, the expected profit earned on each unit is  $A(l, L; l)$  ( $= A(l, L; h)$ ). Now suppose this seller is a high-cost type, which occurs with probability  $1 - q$ , and thereby chooses announcement  $h$ . For the buyers who approach only one seller, the seller will not attract any of

<sup>35</sup> As expected profit does not depend on the other seller's type,  $t_2$  is absent from  $A(m_1, t_1; m_2)$ .

them when the other seller chose a low-cost announcement, and will get half of them when the other seller chooses a high-cost announcement. A high-cost announcement then attracts, in expectation,  $(1 - q)/2$  of those buyers, and the seller earns expected profit of  $A(h, H; h)$  per unit. The second bracketed expression in (11) is the expected profit coming from the fraction  $1 - b$  of market volume from buyers who negotiate with both sellers.

The expected profit of a seller from using the collusive strategy (2) and coordinating on high-cost announcements, is

$$\begin{aligned}
E[\pi^{\text{coll}}] &\equiv b[q(1/2)A(h, L; h) + (1 - q)(1/2)A(h, H; h)] \\
&\quad + (1 - b)[q^2B(h, L; h, L) + q(1 - q)B(h, L; h, H) \\
&\quad + q(1 - q)B(h, H; h, L) + (1 - q)^2B(h, H; h, H)].
\end{aligned} \tag{13}$$

For the fraction  $b$  of market volume from buyers who approach one seller, each seller will end up negotiating with half of those buyers and earn expected profit per unit of  $A(h, t; h)$  when its type is  $t$ . For the fraction  $1 - b$  of market volume from buyers who bargain with both sellers, a seller earns  $B(h, t_1; h, t_2)$  per unit when its type is  $t_1$  and the other seller's type is  $t_2$ .

Subtracting (11) from (13) and re-arranging, the incremental profit from collusion is:

$$\begin{aligned}
&E[\pi^{\text{coll}}] - E[\pi^{\text{comp}}] \\
&= b \left[ \begin{aligned} & \left(\frac{q}{2}\right) A(h, L; h) + \left(\frac{1-q}{2}\right) A(h, H; h) \\ & - \left(\frac{q^2}{2}\right) A(l, L; l) - q(1 - q)A(l, L; h) - \left(\frac{(1-q)^2}{2}\right) (1/2)A(h, H; h) \end{aligned} \right] \\
&\quad + (1 - b)\{q^2[B(h, L; h, L) - B(l, L; l, L)] + q(1 - q)[B(h, L; h, H) - B(l, L; h, H)] \\
&\quad + q(1 - q)[B(h, H; h, L) - B(h, H; l, L)] + (1 - q)^2[B(h, H; h, H) - B(h, H; h, H)]\}.
\end{aligned} \tag{14}$$

Consider the first bracketed term of  $E[\pi^{\text{coll}}] - E[\pi^{\text{comp}}]$  which is the profit differential (per unit) associated with the fraction  $b$  of market volume from buyers who approach one seller. Re-arranging that term yields

$$\begin{aligned}
&\left(\frac{q^2}{2}\right)[A(h, L; h) - A(l, L; l)] + \left(\frac{q(1 - q)}{2}\right)[A(h, L; h) - A(l, L; h)] \\
&+ \left(\frac{q(1 - q)}{2}\right)[A(h, H; h) - A(l, L; h)]
\end{aligned} \tag{15}$$

When both sellers are high-cost types then, whether colluding or not, they make high-cost announcements. Given expected profit is the same under collusion and competition, there is no term in (15) corresponding to the event when both are high-cost types. The first term in (15) pertains

to when both sellers are low-cost types which occurs with probability  $q^2$ . In that case, a seller attracts half of the volume under both collusion and competition, and makes additional expected profit per unit under collusion equal to

$$\begin{aligned} & A(h, L; h) - A(l, L; h) \\ = & \int_{\underline{v}}^{\bar{v}} \int_{c_L}^{R_{ll}^1(v)} (R_{hh}^1(v) - R_{ll}^1(v)) dF_L(c) dG(v) + \int_{\underline{v}}^{\bar{v}} \int_{R_{ll}^1(v)}^{R_{hh}^1(v)} (R_{hh}^1(v) - c) dF_L(c) dG(v). \end{aligned} \quad (16)$$

The first term in (16) is when the seller's cost is less than  $R_{ll}^1(v)$ . As collusion has both sellers choosing a high-cost announcement (rather than a low-cost announcement when competing), a seller ends up selling at  $R_{hh}^1(v)$  instead of  $R_{ll}^1(v)$ . Because buyers set a higher reserve price compared to when firms do not coordinate their announcements, the seller earns higher profit of  $R_{hh}^1(v) - R_{ll}^1(v)$  conditional on selling, which we refer to as the *price-enhancing effect*. The second term in (16) is when the seller's cost lies in  $[R_{ll}^1(v), R_{hh}^1(v)]$ . Choosing a low-cost announcement under competition would result in not making a sale because the seller's bid (which equals its cost) would exceed the buyer's reserve price of  $R_{ll}^1(v)$ . In contrast, under collusion, sellers choose high-cost announcements which induces a buyer to set the higher reserve price of  $R_{hh}^1(v)$  and, given it exceeds the seller's cost, results in a transaction at a price of  $R_{hh}^1(v)$ . Thus, collusion produces profit of  $R_{hh}^1(v) - c$ , while competition would have yielded zero profit. Also note that the consummation of this additional transaction makes the buyer better off by the amount  $v - R_{hh}^1(v)$ . This effect we refer to as the *transaction-enhancing effect*.

Next consider when the seller is a low-cost type and the other seller is a high-cost type. Under competition, the seller attracts all buyers and earns  $A(l, L; h)$  per unit, while under collusion it earns a higher profit per unit of  $A(h, L; h)$  but only attracts half of the buyers. The second term in (15) captures the half of the market that the seller attracts under both collusion and competition. On those buyers, the profit per unit is higher by  $A(h, L; h) - A(l, L; h)$ , and the associated profit gain is  $b(1/2)[A(h, L; h) - A(l, L; h)]$ . However, this gain is offset by an expected loss of  $b(1/2)A(l, L; h)$  corresponding to the half of buyers who no longer solicit a bid from the seller under collusion. That profit loss appears in the third term in (15). But the seller gets those lost buyers back when the tables are turned and it is now a high-cost type and the other seller is a low-cost type. In that event, it would not have attracted any buyers under competition but gets half of the buyers under collusion and earns expected profit of  $b(1/2)A(h, H; h)$ . That profit gain is also in the third term in (15). Hence, the net profit impact is  $b(1/2)[A(h, H; h) - A(l, L; h)]$ , which gives us the third term in (15). Referred to as the *business-shifting effect*, it is the change in profit associated with half

of the buyers no longer soliciting a bid from a firm when it is a low-cost type (under competition) and now soliciting a bid when it is a high-cost type (under collusion). This profit change could be positive or negative. While, *ceteris paribus*, it is better for a seller to attract a buyer when it is a low-cost type, the buyer's reserve price is lower. If the third term is non-negative then (15) is positive which means collusion increases expected profit earned on buyers who solicit one offer. If the third term is negative then the sign of (15) is ambiguous.

Returning to the incremental profit from collusion in (14), the second bracketed expression pertains to the fraction  $1 - b$  of market volume from buyers who solicit bids from both sellers.  $B(h, t_1; h, t_2) - B(\phi(t_1), t_1; \phi(t_2), t_2)$  is the difference in expected profit per unit for a type  $t_1$  seller under collusion and under competition. In that expression, note that  $h$  is the announcement when sellers collude, and  $\phi(t_i)$  is the type-revealing announcement when sellers compete so  $\phi(L) = l$  and  $\phi(H) = h$ . It can be shown that

$$\begin{aligned}
& B(h, t_1; h, t_2) - B(\phi(t_1), t_1; \phi(t_2), t_2) \tag{17} \\
= & \int_{\underline{v}}^{\bar{v}} \int_{R_{\phi(t_1)\phi(t_2)}^2(v)}^{R_{hh}^2(v)} \int_{\underline{c}_{t_1}}^{R_{\phi(t_1)\phi(t_2)}^2(v)} \left( c_2 - R_{\phi(t_1)\phi(t_2)}^2(v) \right) dF_{t_1}(c_1) dF_{t_2}(c_2) dG(v) \\
& + \int_{\underline{v}}^{\bar{v}} \int_{R_{\phi(t_1)\phi(t_2)}^2(v)}^{R_{hh}^2(v)} \int_{R_{\phi(t_1)\phi(t_2)}^2(v)}^{c_2} (c_2 - c_1) dF_{t_1}(c_1) dF_{t_2}(c_2) dG(v) \\
& + \int_{\underline{v}}^{\bar{v}} \int_{R_{hh}^2(v)}^{\bar{c}_{t_2}} \int_{\underline{c}_{t_1}}^{R_{\phi(t_1)\phi(t_2)}^2(v)} \left( R_{hh}^2(v) - R_{\phi(t_1)\phi(t_2)}^2(v) \right) dF_{t_1}(c_1) dF_{t_2}(c_2) dG(v) \\
& + \int_{\underline{v}}^{\bar{v}} \int_{R_{hh}^2(v)}^{\bar{c}_{t_2}} \int_{R_{\phi(t_1)\phi(t_2)}^2(v)}^{R_{hh}^2(v)} \left( R_{hh}^2(v) - c_1 \right) dF_{t_1}(c_1) dF_{t_2}(c_2) dG(v).
\end{aligned}$$

When  $(t_1, t_2) = (H, H)$ , all four terms are zero because, whether colluding or competing, they announce they are high-cost types so the outcome is the same. For any other type pairs, each of these four terms is positive.<sup>36</sup> The first and third terms are driven by the price-enhancing effect: Collusion raises the buyer's reserve price which increases the price seller 1 receives from  $R_{\phi(t_1)\phi(t_2)}^2(v)$  to  $c_2$  (in the first term) and to  $R_{hh}^2(v)$  (in the third term). The second and fourth terms capture the transaction-enhancing effect: By inducing the buyer to have a higher reserve price of  $R_{hh}^2(v)$ , seller 1 sells for a price of  $c_2$  (in the second term) and  $R_{hh}^2(v)$  (in the fourth term). There is no business-shifting effects given that these buyers solicit bids from both sellers. Coordination on list prices then always increases profits earned from buyers who solicit bids from both sellers.

<sup>36</sup> As long as  $R_{hh}^2(v) > R_{lh}^2(v)$ ; see Lemma 2.

$E[\pi^{\text{coll}}] - E[\pi^{\text{comp}}]$  is a weighted average of (17) with weight  $1 - b$ , which was just shown to be positive, and (15) with weight  $b$ , for which the sign is ambiguous. It follows that if  $E[\pi^{\text{coll}}] - E[\pi^{\text{comp}}] > 0$  for  $b = 1$  then  $E[\pi^{\text{coll}}] - E[\pi^{\text{comp}}] > 0$  for all values of  $b$ . In the next section, we offer a parametric model for which collusion is profitable.<sup>37</sup>

The welfare effects of coordination on cost announcements operate very differently from when firms coordinate on prices or bids. Generally, welfare goes down when sellers coordinate on prices or bids because some surplus-enhancing transactions no longer occur. In contrast, welfare can be *higher* when there is coordination of cost announcements because there are *more* transactions. The transaction-enhancing effect captures the increase in the volume of transactions because buyers set a higher reserve price when sellers coordinate on conveying high-cost announcements. In brief, coordination on prices or bids makes sellers less aggressive and that reduces the volume of surplus-enhancing transactions, while coordination on cost announcements makes buyers less aggressive and that expands the volume of surplus-enhancing transactions. That welfare can be higher is shown in the next section.

## 7 Collusion for a Class of Parametric Distributions

Coordination of cost announcements requires that collusion is *feasible* (i.e., announcements are informative under competition, see Theorem 3) and collusion is *profitable* (i.e., (14) is positive). In this section, we show these conditions are satisfied for a particular class of distributions on costs and values.<sup>38</sup>

Assume  $b = 1$  (so all buyers negotiate with one seller) and  $\kappa = 0$  (so the prior probability of collusion is zero). By the analysis in Section 6, the ensuing results will approximate the case when  $b$  is close to one and  $\kappa$  is close to zero.<sup>39</sup> Suppose valuations and costs have support  $[0, 1]$ . Valuations are uniformly distributed:  $G(v) = v$ . The cdf for a low-cost type is  $F_L(c) = c^\alpha$  and for

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<sup>37</sup>In the Online Appendix, a repeated game analysis is provided to derive sufficient conditions for there to be an equilibrium in which firms coordinate their cost announcements. The analysis is a straightforward modification of the usual Folk Theorem arguments. If collusion is profitable and sellers are sufficiently patient then it is an equilibrium of the infinitely repeated game to coordinate on high-cost announcements.

<sup>38</sup>Collusion also needs to be *stable* in the sense of being an equilibrium outcome in an infinitely repeated game. The only additional condition that imposes for the analysis in this section is that sellers' discount factors are sufficiently close to one.

<sup>39</sup>If  $\kappa > 0$  or  $b < 1$  then there is no longer closed-form solutions for optimal reserve prices and, therefore, no closed-form solutions for  $q$  and  $\bar{q}$ .

a high-cost type is  $F_H(c) = c^\beta$ , where  $0 < \alpha < \beta$  so the inverse hazard rate ranking is satisfied:  $h_L(c) = c/\alpha > c/\beta = h_H(c)$ . Recall that a seller is a low-cost type with probability  $q$ .<sup>40</sup>

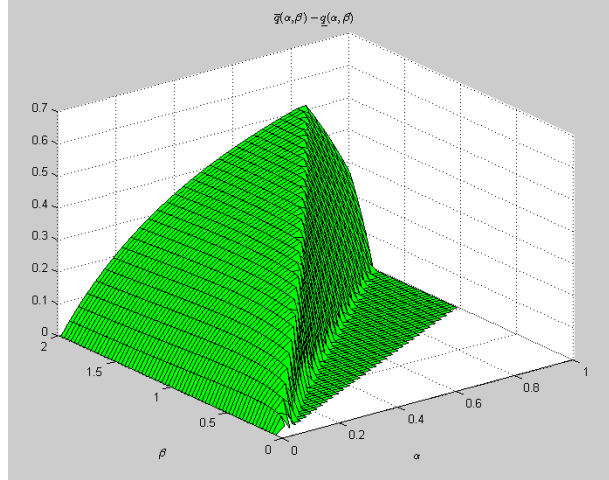
**Theorem 5** *Under the assumptions of Section 7, collusion is feasible if and only if*

$$\underline{q}(\alpha, \beta) \equiv \frac{\frac{\beta^{\alpha+1}}{(\beta+1)^{\alpha+1}} - 2\frac{\alpha^{\alpha+1}}{(\alpha+1)^{\alpha+1}}}{\frac{\beta^{\alpha+1}}{(\beta+1)^{\alpha+1}} - \frac{\alpha^{\alpha+1}}{(\alpha+1)^{\alpha+1}}} \leq q \leq \frac{\frac{\beta^{\beta+1}}{(\beta+1)^{\beta+1}} - 2\frac{\alpha^{\beta+1}}{(\alpha+1)^{\beta+1}}}{\frac{\beta^{\beta+1}}{(\beta+1)^{\beta+1}} - \frac{\alpha^{\beta+1}}{(\alpha+1)^{\beta+1}}} \equiv \bar{q}(\alpha, \beta) \quad (18)$$

and is profitable if  $\alpha < 1$ .

Given these distributions, the necessary and sufficient conditions for a separating equilibrium to exist that are provided in Theorem 3 take the form in (18). It can be shown that  $\alpha < \beta$  implies the RHS of (18) exceeds the LHS. For example,  $[\underline{q}(0.5, 2), \bar{q}(0.5, 2)] = [0.453, 0.857]$ . A sufficient condition for collusion to be profitable is that the low-cost distribution is concave,  $\alpha < 1$ .

Figure 1: Range of Values for  $q$  for which  
Collusion is Feasible and Profitable



For when  $(\alpha, \beta) \in [0, 1] \times [0, 2]$ , Figure 1 reports the range of values for  $q$ ,  $\bar{q}(\alpha, \beta) - \underline{q}(\alpha, \beta)$ , such that collusion is feasible and profitable (where the latter holds because  $\alpha < 1$ ).<sup>41</sup> Depending on the values for  $(\alpha, \beta)$ , there can be a wide range of values for  $q$  such that firms can effectively and profitably coordinate their announcements.

Let us now show that collusion can raise welfare. Let  $\Delta(q)$  denote the difference between expected total surplus under collusion and under competition, where its dependence on  $q$  is made

<sup>40</sup>The proofs of all results in this section are provided in the Online Appendix.

<sup>41</sup> $\underline{q}(\alpha, \beta)$  and  $\bar{q}(\alpha, \beta)$  are constrained to lie in  $[0, 1]$ . Hence, more exactly, Figure 1 reports  $\max\{\min\{\bar{q}(\alpha, \beta), 1\}, 0\} - \min\{\max\{q(\alpha, \beta), 0\}, 1\}$ .



explicit.<sup>42</sup> For  $(\alpha, \beta) \in [0, 1] \times [0, 2]$ , Figure 2 reports the maximum welfare difference,

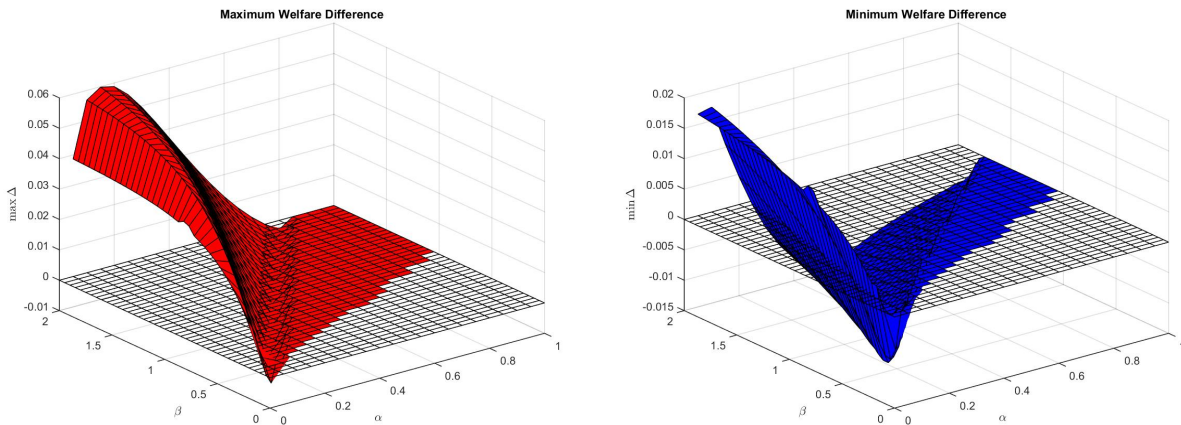
$$\overline{\Delta}(\alpha, \beta) \equiv \max \{ \Delta(q) : q \in [\underline{q}(\alpha, \beta), \bar{q}(\alpha, \beta)] \},$$

and the minimum welfare difference,

$$\underline{\Delta}(\alpha, \beta) \equiv \min \{ \Delta(q) : q \in [\underline{q}(\alpha, \beta), \bar{q}(\alpha, \beta)] \}.$$

Figure 2 shows that  $\overline{\Delta}(\alpha, \beta) > 0$  for most values of  $(\alpha, \beta)$  so collusion *improves* welfare for some values of  $q$ . In addition, for some values of  $(\alpha, \beta)$ ,  $\underline{\Delta}(\alpha, \beta) > 0$  so welfare is higher under collusion for all values of  $q$  (for which collusion is feasible and profitable). By reducing the aggressiveness of buyers, collusion enhances the total surplus in the market by resulting in more Pareto-improving transactions (which is the transaction-enhancing effect) and that can more than compensate for the higher cost under collusion (due to the business-shifting effect).

Figure 2: Welfare Difference Between Collusion and Competition



## 8 Coordination of List Prices versus Coordination of Prices

While collusion typically has firms coordinate their prices, the focus of this paper has been on when firms coordinate their list prices (or surcharges). As both schemes are well documented, we now offer some initial insight into when firms would choose one scheme over the other.<sup>43</sup>

<sup>42</sup>In the Online Appendix, the expression for  $\Delta(q)$  is provided.

<sup>43</sup>The focus here is on profitability, while assuming that monitoring is perfect with either method of collusion. In practice, an advantage to coordination on list prices and surcharges is that they are easier to monitor because those prices are public. In contrast, a seller's price to a buyer is generally private information in intermediate goods markets, though monitoring could occur using sales data (see, e.g., Harrington and Skrzypacz, 2011).

Consider these two collusive schemes: Sellers coordinate their prices (which are bids in our model) and sellers coordinate their list prices (which are cost announcements in our model). What can we say about which scheme is more profitable for sellers? If almost all buyers negotiate with only one seller ( $b$  is sufficiently high) then coordination of prices is largely irrelevant. As buyers only solicit a price from one seller, sellers do not compete in prices, in which case there is nothing gained by coordinating them. However, it is exactly in those situations - when most buyers negotiate with only one seller - that coordination of list prices has been shown to be feasible and effective in raising profits. Competition among sellers primarily involves competing in list prices in order to attract buyers to negotiate with a seller. As shown, that competition can lead to low list prices which induces buyers to believe sellers have low costs and thereby causes buyers to set low reserve prices. Sellers can enhance profits by coordinating on high list prices to induce buyers to raise their reserve prices.<sup>44</sup>

Now suppose most buyers negotiate with both sellers ( $b$  is sufficiently low). Coordination of list prices is irrelevant as list prices are uninformative as to sellers' costs. Hence, agreeing to set high list prices will not influence buyers' beliefs as to sellers' costs and thus cannot make buyers less aggressive. However, it is quite likely that coordination of prices for buyers who solicit bids from both sellers would be profitable. For example, consider the scheme described in Graham and Marshall (1987) for a second price auction with a reserve price.<sup>45</sup> In this scheme, the two sellers report their costs to a third party (who is part of the bidding ring) during a pre-auction phase. If both reported costs are above the reserve price then both sellers submit bids equal to their costs and no one sells to the buyer. If one seller's reported cost is below the reserve price and the other's is above it then again both submit bids equal to their costs and the seller with the lower cost (and bid) sells to the buyer at a price equal to the buyer's reserve price. If both sellers report costs below the reserve price then the seller that reported the lower cost submits a bid equal to its cost, while

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<sup>44</sup>That coordination of list prices can be more profitable than coordination of prices is not limited to when buyers only negotiate with one seller. That finding has also been established for a simple model involving three sellers where all buyers negotiate with two sellers (i.e., there are always two sellers at a buyer's auction). For tractability, that model assumes there are just two values for cost (with a low-cost type having a higher probability of realizing the lower cost) and sellers' types are perfectly correlated (rather than independent). The latter assumption is useful only to the extent that it ensures there is always a separating equilibrium, and thereby allows the analysis to focus on the relative profitability of coordination of list prices and of prices. This analysis is available on request.

<sup>45</sup>Though their model is for a setting in which a seller conducts an auction to sell a single unit, the analysis applies as well to when a buyer conducts a procurement auction to buy a single unit. Other relevant papers are Mailath and Zemsky (1991) and McAfee and McMillan (1992).

the other seller submits a bid exceeding the reserve price. The former sells to the buyer at a price equal to the reserve price and makes a payment to the other seller equal to the difference between the reserve price and that seller's reported cost. The additional profit generated by collusion is the expected difference between the reserve price and the highest cost of the two sellers, (when both sellers have costs below the reserve price). This scheme is shown to be profitable, incentive compatible (in particular, it induces sellers to truthfully report their costs), and satisfy ex ante budget balancing. In sum, when enough buyers negotiate with both sellers, sellers do better by coordinating their prices as opposed to coordinating their list prices.

While the preceding analysis focused on extreme cases of the model, we believe the forces at play are quite general. In intermediate goods markets, there are two sources of pricing pressure for sellers. First, buyers bargain to receive lower prices. Second, rival sellers offer lower prices in order to compete for the business of a buyer. Whether sellers prefer to coordinate their list prices or their prices depends on the relative importance of these forces. If buyers tend to negotiate with a very limited number of sellers then the primary source of pricing pressure is coming from the buyer rather than other sellers. That pricing pressure is magnified when sellers compete in their list prices so as to attract buyers to negotiate. Such competition can result in low list prices which leads buyers to believe that sellers have low costs, and that induces them to negotiate more aggressively. A way in which to soften buyers' aggressiveness is to coordinate on high list prices so that buyers think sellers are likely to have high costs, which will make buyers less inclined to demand a low price during negotiations. If instead buyers tend to negotiate with many sellers then the greater concern is competition from rival sellers, which makes it more important for sellers to coordinate on the prices that sellers offer to buyers. In sum, if a seller's price is largely constrained by the aggressiveness of buyers then sellers prefer to coordinate on list prices, while if a seller's price is largely constrained by competition from other sellers then sellers prefer to coordinate on prices. Depending on market conditions, either collusive scheme could be more profitable.<sup>46</sup>

## 9 Concluding Remarks

This paper offers the first theory of collusion based on influencing buyers' conduct. It was shown that coordination of cost announcements - such as through list prices and surcharges - can be

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<sup>46</sup>Of course, there is also the possibility of coordinating on both list prices and transaction prices. That is a topic for future research.

an effective form of collusion even though sellers are left unconstrained in the prices they offer buyers. By coordinating on announcements that convey they have high cost, sellers can induce buyers to bargain less aggressively and that will deliver supracompetitive prices. Notably, sellers continue to set prices in a competitive manner. As opposed to coordination of prices, coordination of cost announcements can raise welfare because buyers are made less aggressive and that results in more transactions. Finally, the paper suggests that coordination of list prices (in the form of cost announcements) can be preferred to coordination of prices when the primary source of pressure on a seller's transaction price is due to buyer bargaining, while coordination of prices is preferred when the pressure is largely coming from rival sellers' prices. There is clearly room for more research to explore how influencing buyers' conduct in intermediate goods markets can be a profitable form of collusion for sellers.

## 10 Appendix

**Proof of Lemmas 1 and 2:** First, it can be verified that given  $h_L(c) > h_H(c)$ , we have  $h_L(c) > h_\kappa(c) > h_H(c)$  if  $\kappa \in (0, 1)$ .

To show Lemma 1, the first-order conditions of (4) and (6) are given by

$$\begin{aligned} v - R_{m_1 m_2}^1(v) &= h_L(R_{m_1 m_2}^1(v)), \quad \forall (m_1, m_2) \in \{(l, l), (l, h), (h, l)\} \\ v - R_{hh}^1(v) &= h_\kappa(R_{hh}^1(v)) \end{aligned}$$

It is easily verified that

$$R_{m_1 m_2}^{1'}(v) = \frac{1}{1 + h'_L(R_{m_1 m_2}^1(v))} > 0, \quad \forall (m_1, m_2) \in \{(l, l), (l, h), (h, l)\}$$

So  $R_{m_1 m_2}^1(v)$  is increasing in  $v$ ,  $\forall (m_1, m_2) \in \{(l, l), (l, h), (h, l)\}$ .

To show that  $R_{hh}^1(v) > R_{ll}^1(v) (= R_{lh}^1(v) = R_{hl}^1(v)) \forall v$ , suppose the negation so that  $R_{hh}^1(v) \leq R_{ll}^1(v)$  for some  $v$ . It follows that

$$0 \leq -(R_{hh}^1(v) - R_{ll}^1(v)) = h_\kappa(R_{hh}^1(v)) - h_L(R_{ll}^1(v)) \leq h_\kappa(R_{hh}^1(v)) - h_L(R_{hh}^1(v)) < 0$$

which is a contradiction.

Next to show Lemma 2, when  $(m_1, m_2) \in \{(l, l), (h, h)\}$ , the first-order condition from (5) and (7) are given by

$$v - R_{ll}^2(v) = h_L(R_{ll}^2(v)) \tag{19}$$

$$v - R_{hh}^2(v) = h_\kappa(R_{hh}^2(v)) \quad (20)$$

So we have  $R_{ll}^2(v) = R_{ll}^1(v)$  and  $R_{hh}^2(v) = R_{hh}^1(v)$ . When  $(m_1, m_2) \in \{(l, h), (h, l)\}$ , say, when  $(m_1, m_2) = (l, h)$ , the first-order condition from (5) becomes

$$\begin{aligned} 0 &= (1 - F_H(R_{lh}^2)) f_L(R_{lh}^2) [(v - R_{lh}^2) - h_L(R_{lh}^2)] \\ &\quad + (1 - F_L(R_{lh}^2)) f_H(R_{lh}^2) [(v - R_{lh}^2) - h_H(R_{lh}^2)]. \end{aligned}$$

Given the assumption that  $h_L(R_{lh}^2) > h_H(R_{lh}^2)$ , we have

$$(v - R_{lh}^2) - h_L(R_{lh}^2) < 0 < (v - R_{lh}^2) - h_H(R_{lh}^2), \quad (21)$$

As  $(v - R_{ll}^2) - h_L(R_{ll}^2) = 0$  (from (19)) then (21) implies  $(v - R_{lh}^2) - h_L(R_{lh}^2) < (v - R_{ll}^2) - h_L(R_{ll}^2)$ . As  $(v - R_{hh}^2) - h_\kappa(R_{hh}^2) = 0$  (from (20)) then (21) implies  $(v - R_{hh}^2) - h_\kappa(R_{hh}^2) < (v - R_{lh}^2) - h_H(R_{lh}^2)$ . Those two conditions imply  $R_{lh}^2 + h_L(R_{lh}^2) > R_{ll}^2 + h_L(R_{ll}^2)$  and  $R_{hh}^2 + h_\kappa(R_{hh}^2) > R_{lh}^2 + h_H(R_{lh}^2)$ . When  $\kappa$  is sufficiently small, we have  $R_{hh}^2 + h_\kappa(R_{hh}^2) > R_{hh}^2 + h_H(R_{hh}^2) > R_{lh}^2 + h_H(R_{lh}^2)$  by continuity of  $h_\kappa(R_{hh}^2)$  in  $\kappa$ .

Given that  $h'_t(z) \geq 0$ , we have the strict monotonicity of  $z + h_t(z)$ ,  $t \in \{L, H\}$ . Thus  $\exists \bar{\kappa} > 0$  such that if  $\kappa \in [0, \bar{\kappa}]$  then  $R_{hh}^2(v) > R_{lh}^2(v) > R_{ll}^2(v)$ ,  $\forall v$ .

**Proof of Theorem 3 and 4:** Let us first prove Theorem 4. Recall that  $A(m_1, t_1; m_2)$  is the expected profit per unit to a seller of type  $t_1$  whose announcement is  $m_1$  when the other seller's announcement is  $m_2$  and a buyer approaches only that seller. When the seller chooses a low-cost announcement, its expected payoff is independent of the other seller's announcement as buyers believe firms are competing:  $A(l, t_1; l) = A(l, t_1; h)$ . However, when the seller's announcement conveys it is high cost then the payoff does depend on the other seller's announcement, for if it is a low-cost message then buyers believe sellers are competing and when it is a high-costs message then buyers are uncertain about whether they face competition or collusion:  $A(h, t_1; l) \neq A(h, t_1; h)$ .

When it chooses its announcement, a seller knows that a fraction  $b$  of market volume is from buyers who approach only one seller (and that those buyers will choose the seller with the low-cost announcement) and a fraction  $1 - b$  of market volume is from buyers who approach both sellers. In that case, a type  $L$  seller optimally chooses announcement  $l$  if and only if

$$\begin{aligned} W(l, L, b) &\equiv b \left[ \left( \frac{q}{2} \right) A(l, L; l) + (1 - q) A(l, L; h) \right] \\ &\quad + (1 - b) [qB(l, L; l, L) + (1 - q)B(l, L; h, H)] \\ &\geq b \left( \frac{1 - q}{2} \right) A(h, L; h) + (1 - b) [qB(h, L; l, L) + (1 - q)B(h, L; h, H)] \equiv W(h, L, b). \end{aligned} \quad (22)$$

A type  $H$  seller optimally chooses announcement  $h$  if and only if

$$\begin{aligned}
W(h, H, b) &\equiv b \left( \frac{1-q}{2} \right) A(h, H; h) + (1-b) [qB(h, H; l, L) + (1-q)B(h, H; h, H)] \\
&\geq b \left[ \left( \frac{q}{2} \right) A(l, H; l) + (1-q)A(l, H; h) \right] + (1-b) [qB(l, H; l, L) + (1-q)B(l, H; h, H)] \\
&\equiv W(l, H, b)
\end{aligned} \tag{23}$$

From Section 4.2, if  $b = 0$  then (22) does not hold (as a type  $L$  seller prefers to choose announcement  $h$ ) though (23) does hold. Suppose that (22)-(23) are satisfied when  $b = 1$ . Combining these conditions for  $b = 0$  and  $b = 1$  delivers:

$$\begin{aligned}
W(l, L, 1) - W(h, L, 1) &> 0 > W(l, L, 0) - W(h, L, 0) \\
W(h, H, 1) - W(l, H, 1) &> 0 > W(l, H, 0) - W(h, H, 0)
\end{aligned} \tag{24}$$

By the linearity of the conditions in (24) with respect to  $b$ , it follows that there exists  $b^* \in (0, 1)$  such that (22)-(23) hold if and only if  $b \in [b^*, 1]$ .

Turning to the proof of Theorem 3, set  $b = 1$ . Using (12) in (22)-(23), those conditions can be re-arranged to conclude that a separating equilibrium exists if and only if  $q \in [\underline{q}, \bar{q}]$  where

$$\begin{aligned}
&\frac{\int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{hh}(v)} (R_{hh}(v) - c) dF_L(c) dG(v) - 2 \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{ll}(v)} (R_{ll}(v) - c) dF_L(c) dG(v)}{\int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{hh}(v)} (R_{hh}(v) - c) dF_L(c) dG(v) - \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_L}^{R_{ll}(v)} (R_{ll}(v) - c) dF_L(c) dG(v)} \equiv \\
&\quad \underline{q} \leq q \leq \bar{q} \\
&\equiv \frac{\int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{hh}(v)} (R_{hh}(v) - c) dF_H(c) dG(v) - 2 \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{ll}(v)} (R_{ll}(v) - c) dF_H(c) dG(v)}{\int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{hh}(v)} (R_{hh}(v) - c) dF_H(c) dG(v) - \int_{\underline{v}}^{\bar{v}} \int_{\underline{c}_H}^{R_{ll}(v)} (R_{ll}(v) - c) dF_H(c) dG(v)} \tag{25}
\end{aligned}$$

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