Bertrand-Edgeworth competition with capacity uncertainty - Feasting on leftovers *

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There is ample empirical evidence documenting that large firms set significantly lower prices than smaller, capacity-constrained, firms in procurement auctions. This is paradoxical in light of the standard theoretical result that large firms charge higher prices than small firms in models of price competition with capacity constraints. We argue that private information about the capacity constraints can account for this puzzle. We do so by studying duopoly pricing in which firms are privately informed whether they are capacity-constrained or not. We find that a capacity-constrained firm will price less aggressively than an unconstrained firm as it prefers to focus on any leftover demand in case her rival is also capacity-constrained and would rather not undercut the low prices charged by an unconstrained firm. Privately known capacity constraints thus provide a potential explanation for the empirically observed negative correlation between capacity constraints and prices charged by competitive firms.

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