Referee report on "Incentives in Supply Function equilibrium" by Henrik Vetter (MS-1288)

This paper analyzes how strategic delegation by owners of a firm to managers affects the profitability, assuming that managers compete in supply functions. In particular, in a first stage owners choose incentive contracts that specify the relative weight on profits and sales that managers will then try to maximize in the second stage in a noisy linear demand function environment . The author shows that strategies in the second stage are strategic complements and that owners manipulate incentives such that profits are higher than when no delegation occurs. This is in contrast to the case where managers compete in quantities. In fact, the owners' profits in the delegation game with supply function equilibrium are even higher than those under standard Cournot competition.

I believe the analysis is correct and find the result interesting. In fact, this finding may revive the interest in supply function equilibrium in general. The paper is well-written and the intuition for the result is made quite clear.

I have two comments on the limited environment considered in the paper. First, the paper limits the possible types of incentive contracts to be used. Only own profits and sales can be used, and only in a linear fashion. In reality incentive payment schedules may be more general, for example by incorporating profits, revenues or markets shares of the rival. A second restriction is that demand is assumed linear. Given the general framework in the seminal Klemperer and Meyer (Econometrica 1989) model of supply function equilibria, I conjecture that it may be possible to extend the results to more general demand specifications.

I have only one comment on the analysis. At several points in the paper it is assumed that the system defined by equations (2) and (3) is stable. But this can in fact be straightforwardly shown to be true (because slopes are less than 1).