Thanks for the attention. As I read the report you have raised three issues: the form of incentive payments, possible generalisations and stability. You find my suggestions below.

Point 1. Incentive payment schedules.

Page 5 old manuscript. At the bottom there is a new note by the end of first paragraph of section 2.

"Incentive contracts can also include measures of market share, firm-profits vis-à-vis average industry profits and similar relative performance measures. Notice that Reitman (1987) argues that the use of stock options makes managers behave more accommodating and sometimes fully eliminate aggressive behaviour."

Point 2. Generalisations.

Page 13 old manuscript. There is a new note 11 at the end of first paragraph. New note 11 reads:

The result in Theorem 1 presupposes the linear demand function also used by Fershtman and Judd (1987) and Sklivas (1987). A referee suggests that the result applies to more general demand specifications. Indeed, Klemperer and Meyer (1989) uses (in our notation) $q_1 + q_2 = f(p) + \omega$, where $f(p)$ is twice differentiable, strictly decreasing and concave in the relevant price range. In this case our equations (2), (3) and (4) will be $\mu_i = (1 - b\mu_i\alpha_i)\left(\mu_j - f'(p)\right)$ and $(\mu_i + \mu_j)p = f(p) + \omega$, respectively. Based on this, it emerges that managers' strategies are strategic complements, i.e., $d\mu_i/d\alpha_i$ and $d\mu_j/d\alpha_i$ are both negative, depending on conditions on the relationship between $f'(p)$ and $f''(p)$. Tedious but straightforward calculations shows that $d\mu_i/d\alpha_i$ and $d\mu_j/d\alpha_i$ are negative around $\alpha_i = \alpha_j = 1$ when $-(1 - b\mu_i)z < f'' < \left(1 + b(\mu_i - f')\right)z$, where $z = \left(p(1 - b\mu_i)\right)^{-1}(2\mu_i - f')$ and $\mu_i = \mu_j$ under symmetry. Evidently, the specification with linear demand meets this condition. Next, proceeding along the lines of the proofs of Lemmas 1 and 2, when $d\mu_i/d\alpha_i < 0$ and $d\mu_j/d\alpha_i < 0$, we can show when the optimal contracts punish sales. To calculate exact conditions in more general circumstances, and spell out when delegation improves profit, is left for future work.

Point 3. Stability.

Page 8 old manuscript. The text following equations (2) and (3) is changed. The new text is:

"Equations (2) and (3) define managers' response functions that are $\mu_1 = \mu_1(\alpha_1, \mu_2)$ and $\mu_2 = \mu_2(\alpha_2, \mu_1)$. It is easy to see that the slopes of these response function are less than 1 which ensures that the system is stable. Owners' decisions enter into the best response function showing how owners, by their choice of incentives, manipulate the supply functions."

The text page 10 (old manuscript) has been changed since stability is no longer an assumption.