



Beyond Retail Market Power:

Why You Should Not Fly First Class when you Plan to Negotiate in
Bentonville?

Tirtha Dhar

In economics, **market power** is the ability of a firm to alter the market price of a good or service. A firm with market power can raise price without losing all customers to competitors.

- Firm faces downward sloping demand function
- Market power leads to dead weight loss

News Headlines!

- **How Wal-Mart's TV Prices Crushed Rivals (BW, April 23, 2007)**
- **Carrefour to Buy Brazil's Atacadão (WSJ, April 24, 2007)**
- ***Tesco to Expand Land Sales To Fund Growth; Profit Rises 22% (WSJ, April 18, 2007)***
- ***Wal-Mart's Midlife Crisis; Declining growth, increasing competition, and not an easy fix in site (BW, April 30, 2007)***

Stylized facts

- Retail concentration is increasing
 - CR_4 : 80% in most countries
- Average store size is increasing: 48,058 sq. ft in the US
- Supply chain is becoming global: Wal-Mart the 8th trading partner of China!
- Marketing channels are becoming more and more integrated

Agenda

- Is retailing a two sided market?
- Economic and non-economic sources of retail market power
- Should we be obsessed with market power in pricing?
- Impact of market power on quality
- What can we do?
- How should we model a market evolving from homogeneous to differentiated products

Two sided market

- Retailers job is to match right consumers and right manufacturers
- Retailers can have power on both sides of the market:
 - On the consumer side (monopoly/oligopoly power)
 - On the supplier side (monopsony/ oligopsony power)

Consumer side of the market

- Retailers are localized monopoly
 - Retailers will always have some market power
- A significant source market power is location
- City planning and zoning restrictions is making the situation worse
- Have you heard of the term 'land banking'?

Market power and how consumers shop

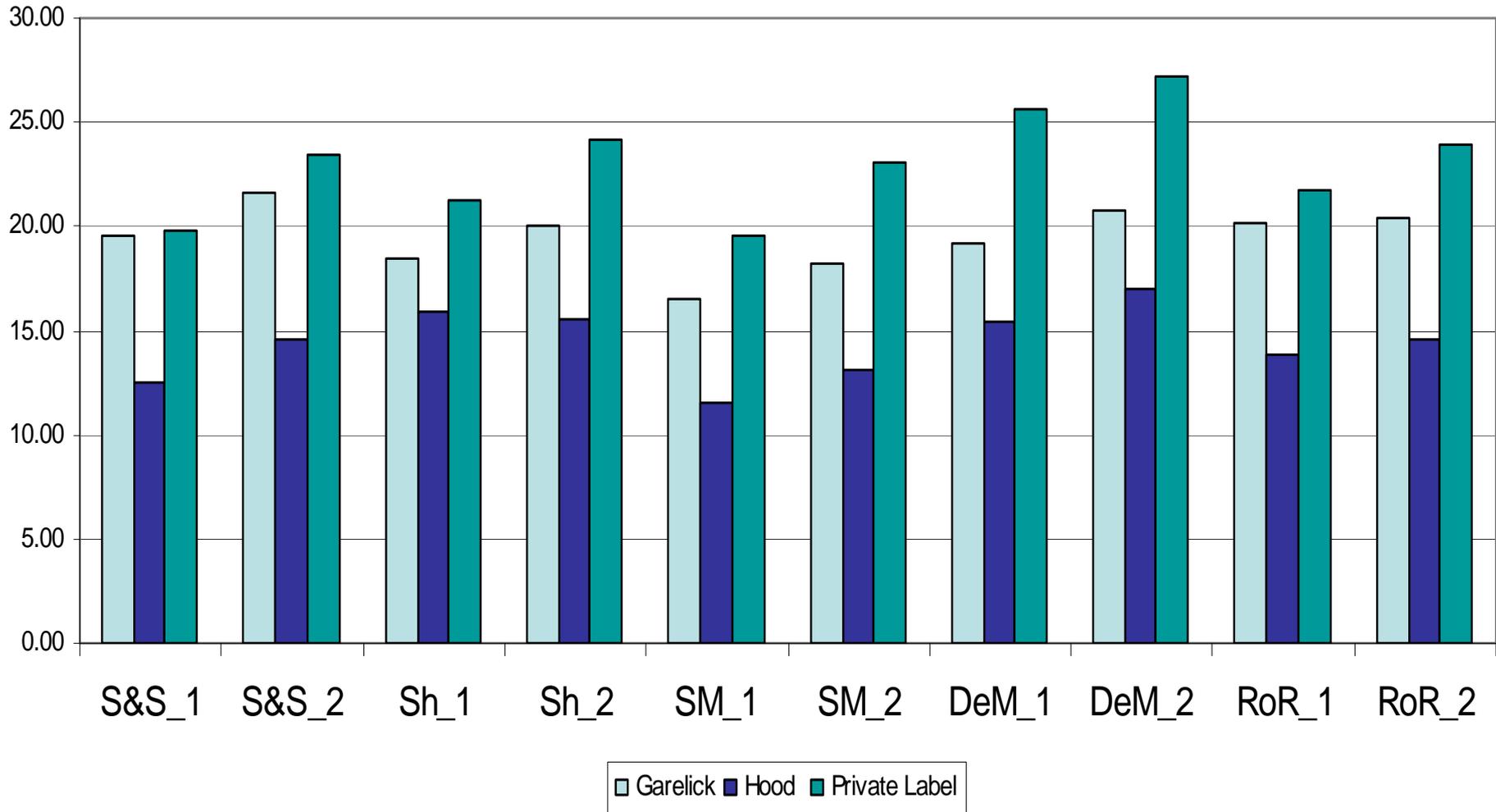
- 75% of the grocery shopping is done from only one store [UK competition commission]
- Cross price elasticities within stores are significantly higher than across stores
 - Consumers do not switch stores frequently
- Store choice decisions are significantly influenced by assortment, quality and price

Price El. across stores

Dhar et al. (2004)

- Own price elasticities within store on average (for milk) is -15.
 - This implies for 1% price change a lot consumer will switch one brand to the other
- Own price elasticities across stores on average is -0.0001
 - Very few consumers switch from one store to the other for 1% price change
- Counterfactually this implies retailers can influence the behavior of the suppliers just by manipulating the price of the products on the store shelf.

Table: Profit Margin (%) by Brand and Retail Chain

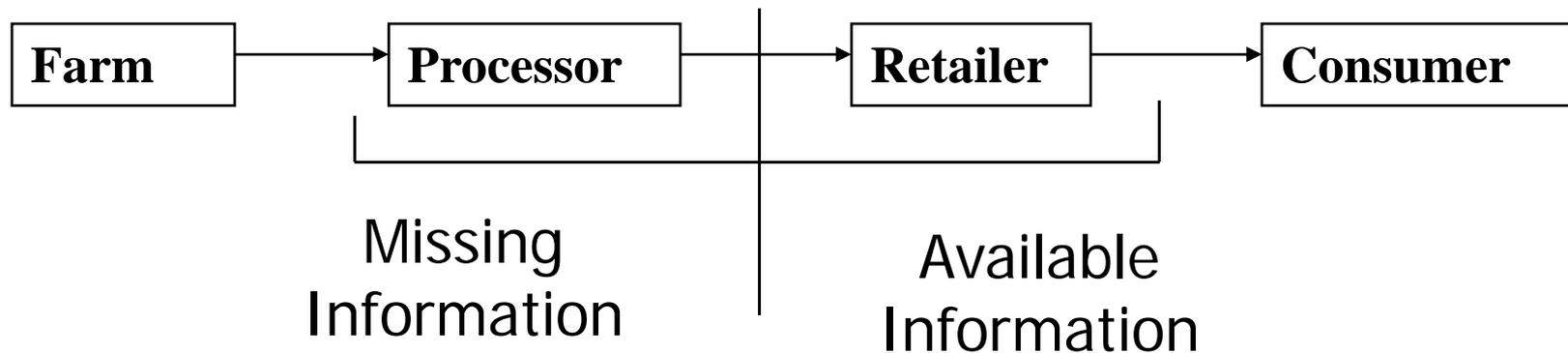


Beyond traditional market power

- Retailer will always be able to extract rent from consumers
 - National Price settings in the UK market!
- In a lot of market, market concentration is not a good measure of market power (Exp: Commercial Aircraft)
- Weakening of market power in upstream may impact the market power downstream (countervailing power)

Marketing Channel

- ◆ Challenge is to recover information from the black box:



Marketing Channel and Market Power

- Suppliers complains more than the consumers
 - Competition policy mainly takes into account consumer welfare
- Consumers are gaining because of countervailing market power

Channel and Wal-Mart



Business Week October 2003 issue cover story was, 'IS WAL-MART TOO POWERFUL?'

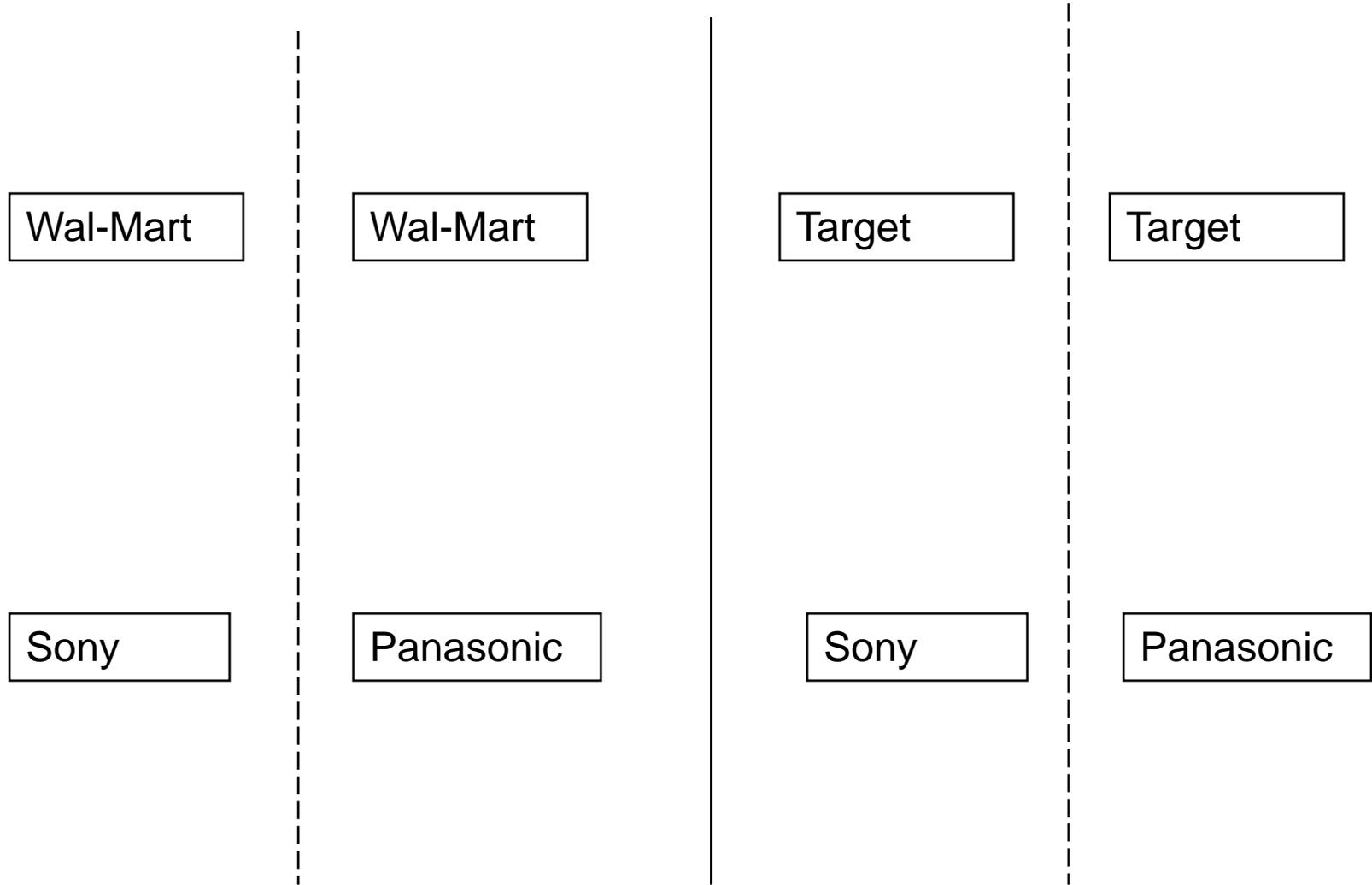
A snapshot of channel bargaining



Basic Modeling Structure

- Retail Monopolists [There can be non-price competition]
- Manufacturers bargaining to sell their product to the retailers
- Simultaneous Bargaining with no communication
- Bargaining with Full Information

Bargaining Structure



Types of Contract

- Quantity Forcing Contract: A pair of Quantity and Fixed Transfer Payment
- Two Part Tariff Contract: A Contract Over Wholesale Price and a Transfer Payment
- Two Part Tariff can generate Slotting Allowance
- Quantity Forcing Contract can be Observationally Equivalent to wholesale Pricing Contract
- Two Part Tariff is be renegotiation proof

Insights from the bargaining contract

- To max. profit **powerful retailer** extracts all the surplus from the manufacturer
 - Strong Retailer Motto: Drive Manufacturing Cost down
- To. Max profit **weak retailer** needs to share more of the channel profit with the manufacturer:
 - Weak Retailer Motto: Increase threat points
- Two part tariff tend to generate higher surplus for the retailer
- With manufacturer can still generate surplus if they have the scale

The cost Boogey



Other Implications of market power

- EU concern: Increase market power in the channel will influence the assortment and available quality in the marketing channel
- Market power in the non-price side can influence market power in the pricing side
 - Semi-Collusion example: Channel players can tacitly collude on advertising or promotion to improve market power (Shinn-Shyr Wang, Dhar and Stiegert, 2007)

Quality Choice Findings

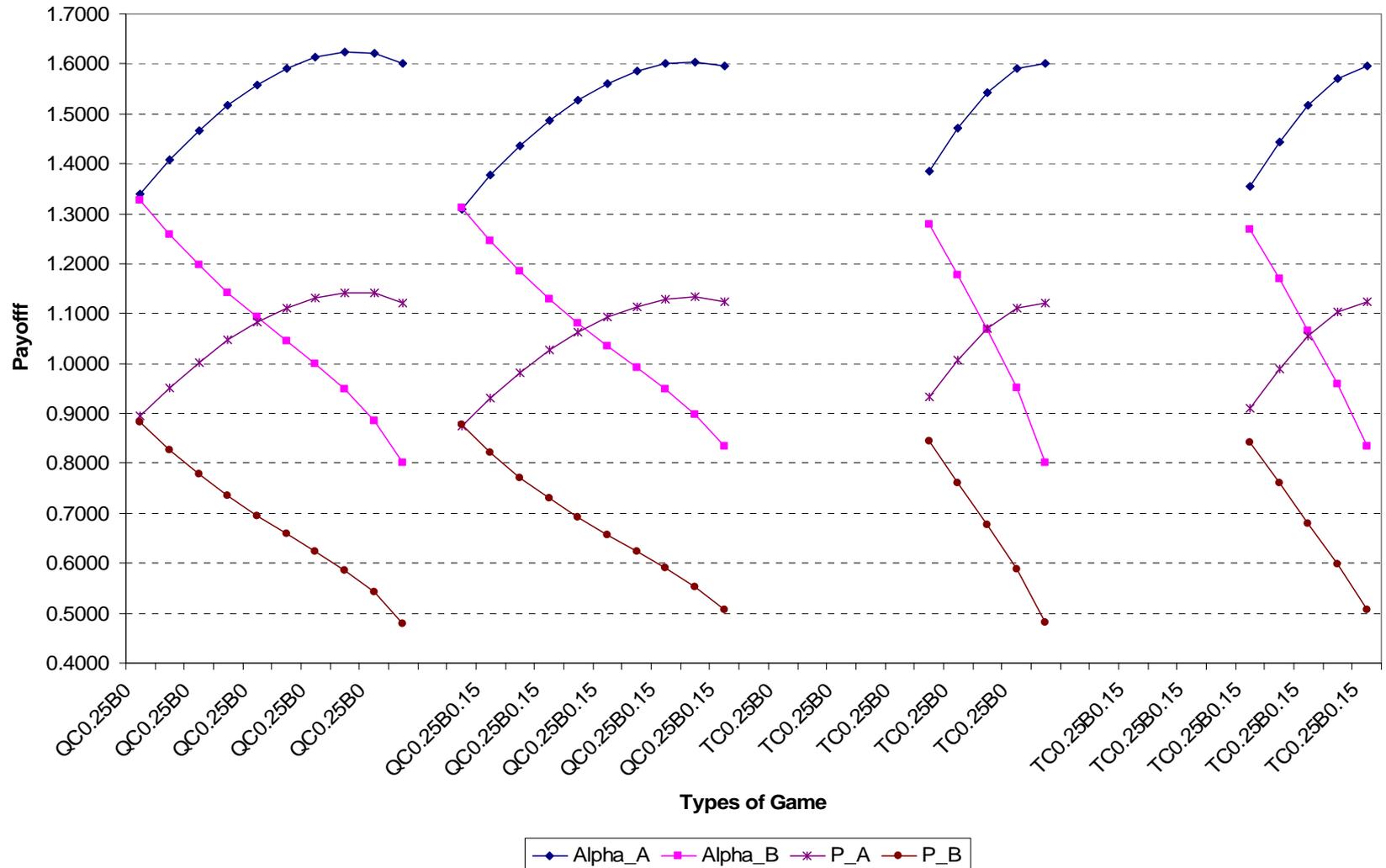
- No quality choice equilibrium exists if manufacturers make the quality choice
 - They will try to leapfrog each other due to externality
- Retailers can provide quality choice equilibrium
 - Implications: Private label can be created to meet quality requirements
 - Example: President's Choice by Loblaws

Quality Choice in a Marketing Channel

- Is Existence of Private Label a Quality Choice Issue in the Marketing Channel?
 - Vlasic Story [Internet folklore on Wal-Mart]
 - Levis Story [Specific branding and packaging for Wal-Mart]
 - Starter from Nike
 - Coke with Splenda
 - Slice One from Pepsi

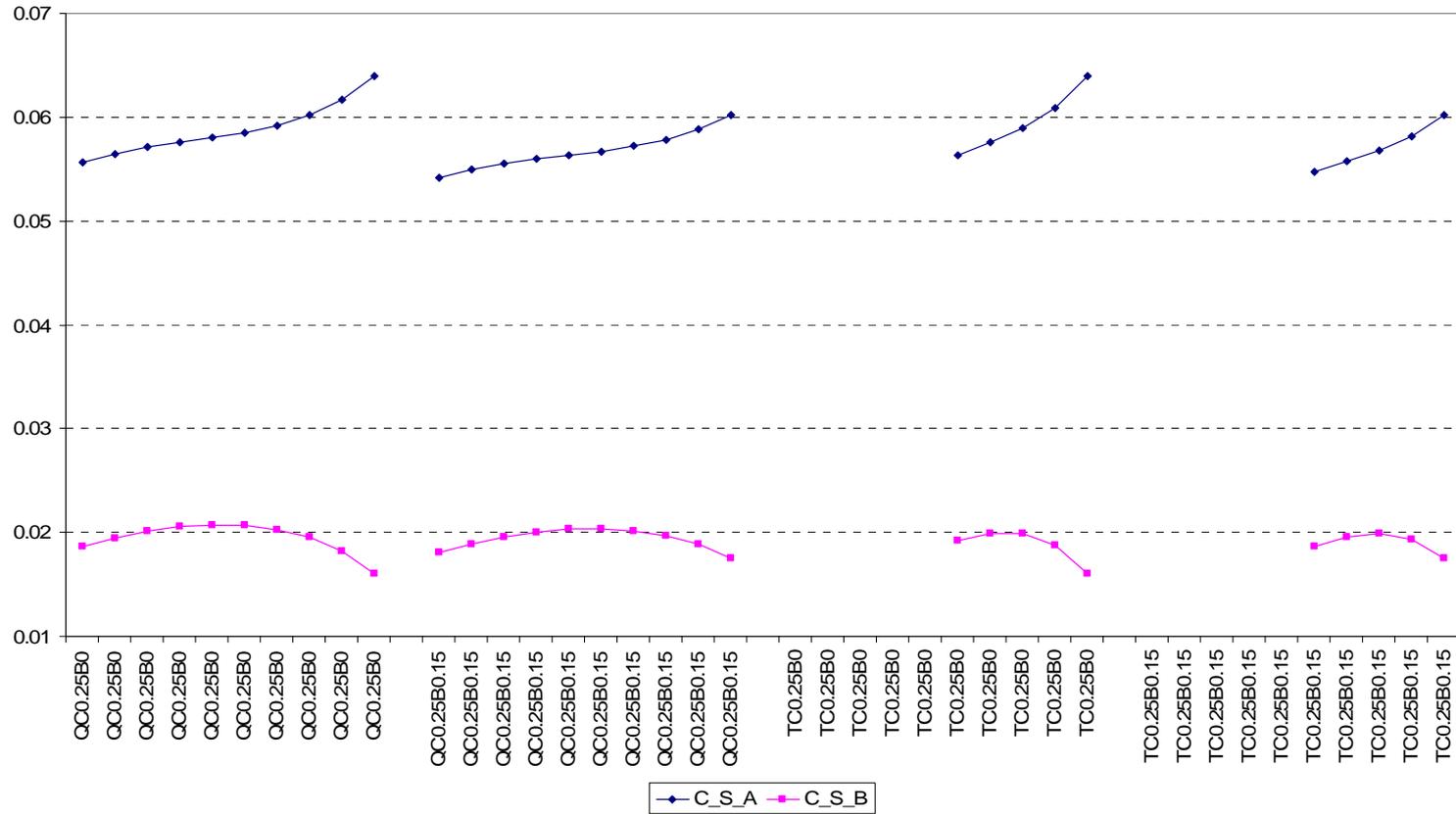
Quality Choice Simulation

Plot 1: Quality Choice and Price under Symmetric Bargaining Game



Simulation III

Plot 5: Consumer welfare under symmetric bargaining game



What can we do?

- More research on market power after taking into account strategic behavior in the marketing channel
- Need to develop better understanding non-price competition
- How do address issues related with supply side (monopsony) power of the retailers?
- Whoever differentiates (i.e. branding) capture the rent in the channel

What Happened to Wall Pocket?

