Beyond Retail Market Power:
Why You Should Not Fly First Class when you Plan to Negotiate in Bentonville?

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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
  - CR₄ : 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

• 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:

  Farm → Processor → Retailer → Consumer

  Missing Information  Available Information
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

Wal-Mart | Wal-Mart | Target | Target
---|---|---|---
Sony | Panasonic | Sony | Panasonic
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
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?