The Consumer in Vertical Restraints

THOMAS K. CHENG
UNIVERSITY OF HONG KONG

PROS & CONS 2019
STOCKHOLM NOV 8, 2019

Classification of Retailers

- Single brand retailers vs. multibrand retailers

Classification of Retail Services

- General retail services:
  - General in-store amenities, which include store location, parking facilities, opening hours, general store environment and ambience, number of shop assistants, number of cashiers, number of fitting rooms, general training of shop assistants, return and refund policies, credit terms, and repair facilities
  - Inter-retailer substitution effect
  - Interbrand spillover effect

Classification of Retail Services

- Product-specific retail services:
  - Product demonstration, product display and promotion, care of product (e.g., proper temperature control or product rotation), inventory, and post-sales service such as product repair
  - Interbrand substitution effect
  - No interbrand spillover effect

Different Models of Consumption Behavior

- Different models of consumption behavior:
  - Interbrand primacy model
  - Inter-retailer primacy model
  - Impulse purchase model
- Robert Steiner:
  - The relevant question is whether consumers will "switch brands within store" or "switch stores within brand".
- William Comanor:
  - "This distinction has strong implications for the design and implementation of antitrust policy toward manufacturer-distributor relationships. A failure of antitrust policy to take into account these relationships in the past followed in part from an effort to create a "one size fits all" policy."

Interbrand Primacy Model

- Consumers are assumed first to choose the brand of product to purchase in a differentiated product market, and then to shop among the different retailers carrying the product for the best deal.
- At the interbrand stage, consumers will focus on a variety of product attributes, such as price, product quality, brand reputation, availability of sales and after-sales services, etc.
- At the intrabrand stage, the primary consideration of the consumers at this stage will be price.

Interbrand Primacy Model

- This type of consumer behavior is most often observed with products "where brands enjoy strong consumer franchises and tend to be heavily advertised." It is unlikely to be observed when brands have relatively low visibility and consumers do not have strong preference between brands.
- Brand reputation is more likely to be important to consumers where product quality is not immediately apparent or readily verifiable, or where, as in the case of luxury goods, the appeal of the product partly comes from the appeal of the brand and not solely the product itself.

Inter-retailer Primacy Model

- Instead of choosing the brand before picking the retailer, consumers decide on the retailer first, browse around, and choose from the product selection available in the store.
- This model only applies to multibrand retailers.
- Two scenarios:
  - Single-purchase consumers: where consumers are looking for a product in general, such as a piece of clothing or an accessory, and do not exhibit a strong preference for a brand.
  - Basket-purchase consumers: where consumers are looking to purchase a large variety of products on one shopping trip. The archetypal example is grocery shopping.

Inter-retailer Primacy Model

- Marketing scholars:
  - Intertype/intratype competition
  - Interformat/intraformat competition
  - Intercategory/intracategory competition
  - Stronger competition within type, format, or category
- Miller et al. (1999): three key dimensions of competition among retailers:
  - Store scale
  - Retail saturation: the density of retailers in relation to population
  - Personal service level
  - All these pertain to general retail services. Retailers compete much less on individual product prices.

Inter-retailer Primacy Model

- Hansen (2003):
  - Price was only the twentieth and seventeenth most important factor out of a list of twenty-five respectively for supermarkets and specialty food stores.
- Bell & Lattin (1998):
  - Even in cases in which consumers are found to exhibit considerable price sensitivity, they seem to respond to overall price levels or price expectations of a retailer rather than the price of specific brands.

Inter-retailer Primacy Model

- Basket-purchase consumer's price and service elasticity:
  - Elastic to general retail services and less so to product-specific services
  - Elastic to general price expectations but less so to individual product prices
- Single-purchase consumer's price and service elasticity:
  - Elastic to both general and product-specific retail services
  - Elastic on an individual product level and less so at the retailer level.
- Horizontal pecuniary and promotional externalities have limited relevance under the inter-retailer primacy model.

Impulse Purchase Model

- Mihic & Kursan (2010): impulse purchase can be defined as "unplanned, sudden, and spontaneous impulse to buy, which lacks careful evaluation of product and purchase consequences."
- Cobb and Hoyer (1986): impulse buyers do not make any product category or brand decision in advance and only decide in the store.
- Consumers enter a store they happen to pass by on a whim and make a purchase if they see something suitable, and abstain from purchasing if they do not. If they find the price-quality-service combinations offered by the various brands in the store to be unattractive, they do not search further and simply walk away.

Impulse Purchase Model

- Prevalence of impulse purchase:
  - The frequency of impulsive purchase has been estimated to be as high as 90%.
  - Impulse purchases account for between 27% and 62% of all department store purchases, 50.5% of all grocery purchases, and almost 40% of online sales.
  - Impulse purchases also account for 70% of Coca-Cola’s sales.
- Impulse purchase tends to be product-specific.
- Impulse purchasers respond to situational factors or external stimuli: “store design, sales staff, music, aroma, store location, displays, product packaging, larger quantity of displayed merchandise, and shelf arrangement … promotional aspects, advertising, and point of sale events”.

Impulse Purchase Model

- Schulz (2007):
- "A consumer strolling through a city may suddenly decide to visit a store and to find out what is on offer, although he had no intent to do so, when he decided to go downtown. Customers of this type typically do not actively search. Once a store is entered he only decides whether or not a good that he finds promising is worth its price. But he will not visit another store in order to search for a better price (in a world without RPM). If all consumers were of this type there would be no essential role for competition among retailers but for showy appearances in order to attract the consumer's attention. A bookstore could more or less act like a local monopolist."
- Under this model, there is no intrabrand, inter-retailer substitution effect or horizontal promotional externality.

Implications for Free Riding Defense

- Assumptions of the defense:
  - Manufacturers cannot obtain the desired retail services through other means.
  - The retail service and the product itself can be consumed separately.
  - Retailers cannot separately charge for the retail services.
  - It is worth the consumers’ while to go to a different retailer to purchase the desired product.
  - Retailers would be spurred by the increased retail margin to provide the desired retail services:
    - The retailers will choose competition, price or non-price, over a live-and-let-live situation.
    - If retailers do engage in non-price competition, they will only do so by providing the kind of retail services desired by the manufacturers.

Implications for Free Riding Defense

- Under inter-retailer primacy model:
  - Retailers will focus on providing retail services that will attract consumers into the store as opposed to services that will draw consumers to a particular brand.
  - Given that general retail services will mainly produce inter-retailer substitution effect while product-specific retail services will mostly create intra-retailer interbrand substitution effect, the retailers will focus on general retail services as opposed to product-specific retail services.
  - A manufacturer wants the retailers to provide product-specific retail service, which drives sales of its own brand, and not general retail service.
  - Therefore, in a market populated by multibrand retailers where the inter-retailer primacy model applies, incentive incompatibility between the manufacturer and the retailers is highly likely. RPM will fail to generate the kind of product-specific retail services required by the manufacturers.

Implications for Free Riding Defense

- Under the inter-retailer primacy model, free riding is simply not an issue because product-specific retail services of the kind invoked in the free riding defense do not produce spillover effects on other retailers. There is no horizontal promotional externality. When other retailers do not benefit from the retail services provided by a retailer, there is no issue of free riding.
- Under the impulse purchase model, there is even less inter-retailer competition as consumers do not fully evaluate their shopping alternatives. The lack of inter-retailer competition means that retail services have little inter-retailer spillover effect, which in turn means that there is little room for free riding.

Implications for Free Riding Defense

- In sum, free riding defense is largely irrelevant under the inter-retailer primacy model and the impulse purchase model, and is at most only applicable to a small class of products with respect to product demonstration under the interbrand primacy model.
- Even this requires the assumption that the retailers will somehow have the incentives to invest the enhanced retail margins to provide the product-specific retail services desired by the manufacturer, a situation deemed highly unlikely with multibrand retailers.
- With all these qualifications, it is not at all clear what is left of the free riding defense.

Free Riding is Relatively Uncommon

- To raise antitrust concerns and justify RPM, free riding must occur with enough frequency to deter retailers from investing in the promotional efforts desired of them by the manufacturer
- Market research suggests that occurrence of free-riding is limited: (Gundlach 2010)
  - (1) the costs of visiting multiple stores lead consumers to rely on one channel of distribution (Li & Kannan 2014)
  - (2) distribution channels are generally designed and built to reach discrete segments of consumers

Free Riding Leads to Cannibalization

- RPM that results in uniform prices yields similar nonprice strategies across channels, which may increase rather than decrease the adverse effects of free-riding in the form of cannibalization
  - Cannibalization generally refers to a reduction in sales volume, sales revenue, or market share of one product as a result of the introduction of a new product by the same producer. In this instance, we are referring to cannibalization of one retailer by another retailer.
  - Avery (2009): "Cannibalization is more likely to occur when channels closely duplicate each other and do not provide adequate product and/or service differentiation. Second, it is more likely to occur when channels target same consumers"
- The unintended effect of cannibalization:
  - Cannibalization brought about by RPM distorts the dynamics of market processes making them less efficient overall.
  - It also undermines retail innovation.
  - It can also adversely affect the choice and variety that would otherwise benefit consumers.

Free Riding Could Lead to Beneficial Crowding

- The assumption that free-riding leads to higher costs for retailers may not be so straightforward:
  - Taking into account personal factors, e.g. personal tolerance, time spent in shopping, shopping intention, Eroglu (2005) found that human crowding positively affects shopping satisfaction.
  - Therefore, modest crowds in a retail store may increase buyer’s hedonic shopping values before extremely crowded stores began to deter buying.

Emergence of E-Commerce

- The emergence of e-commerce has changed the pattern of consumer behavior, which raises further questions:
  - What is the relationship between brick-and-mortar retailers and online retailers as far as free riding is concerned?
  - What kind of services do consumers want from each type of retailer?
  - Do brick-and-mortar retailers provide valuable retail services from which online retailers benefit?
  - Even if online retailers do free-ride on brick-and-mortar retailers, would RPM solve the problem?
  - Do brick-and-mortar retailers free ride on online retailers? If so, how should the latter be compensated?

Free Riding Goes in Both Directions

- The popular perception is that consumers typically visit brick-and-mortar retailers to view a product, gather information, and consume a salesperson's time, only to subsequently purchase the item from an online retailer at a lower price. It is therefore argued that the prevalence of internet sales strengthens the free-rider defense.
- However, empirical data suggests that free riding occurs in both directions and brick-and-mortar stores do not necessarily lose out.

Free Riding Goes in Both Directions

- Evidence indicates that research shoppers routinely search on the Internet and subsequently purchase from brick-and-mortar stores:
  - "Browsing on the Internet and purchasing merchandise at a store is the most common use (75%) of multiple channels during a shopping episode." (IBM 2008)
  - For 97% of shoppers, the most essential piece of information on the path to purchase is a customer's review. Without customer reviews, 92% of consumers will hesitate to make a purchase. (Fan & Fuel Digital Marketing Group 2017)
- Meanwhile, online shoppers do not seem to rely heavily on product display by brick-and-mortar stores:
  - 26.4% of online purchasers visited brick-and-mortar stores before completing their online purchase. (Baal & Dach 2005)
  - 44% of the consumers said they have never seen, touched or felt the product in brick-and-mortar store before they ordered them online. (RetailDive Survey 2017)

Scenario (1): Online Retailers Free Riding B&M Retailers

- Services provided by online retailers are effective substitutes for most services provided by brick-and-mortar retailers.
- Free riding defense for brick-and-mortar sales is further weakened by the emergence of e-commerce: (Lao 2011)
  - Except for a small subset of products for which sensory experience is important to generate sales, in most cases, the abundance of information should diminish the need for in-store demonstration or knowledgeable sales assistance, thus reducing the frequency of free-riding.
  - The abundance of information should diminish the need for in-store demonstration or knowledgeable sales assistance, thus reducing the frequency of free-riding.

Scenario (1): Online Retailers Free Riding B&M Retailers

- Even if online retailers do free-ride on retail services provided by brick-and-mortar retailers, RPM is not an effective solution.
- The nature of the services on which online retailers are assumed to be free riding is such that Internet retailers are physically incapable of providing them:
  - Online retailers are inherently incapable of providing show-rooms, which allows consumers to physically experience the product and view on-site product demonstration by salespeople.
- No amount of retail margin provided by RPM can spur online retailers to provide on-site product demonstration.

Scenario (2): B&M Retailers Free Riding Online Retailers

- In contrast, brick-and-mortar stores benefit from retail services by online retailers:
  - Online retailers are better at performing other services for which brick-and-mortar retailers only provide poor substitutes, e.g. supplying detailed product information, links to professional product reviews and user opinion.
  - Recall that 75% of consumers use the retail services provided by online retailers before purchasing in brick-and-mortar stores.

Scenario (2): B&M Retailers Free Riding Online Retailers

- There are more effective ways to compensate online retailers than RPM.
- A more effective compensation scheme for online retailers is possible because of their different cost structures:
  - It is difficult to quantify the per-customer cost incurred by brick-and-mortar stores to provide in-store retail services such as product demonstration or simply on-site product display.
  - The costs incurred by online retailers to provide retail services (e.g. designing the site and uploading reviews / ratings by customers) tend to be fixed. The marginal cost for providing service to an additional customer is zero.
  - Lump sum payments to online retailers, which do not have the impact of raising retail prices, are possible.

Other Alternatives to RPM

- The advent of online sales also facilitated the adoption of new strategies to limit consumer free-riding behavior (Gundlach 2010):
- Channel harmonization:
  - Guiding customers through the pathway of different channels available to them with the goal of making it easy for customers to follow a preferred path.
  - Many manufacturers have invested heavily in creating websites with extensive product information, which can be transferred to a retailer's site at low costs. Manufacturers will often also include locators to enable consumers to find a brick-and-mortar retailer to complete the purchase.
- Crediting individual contribution:
  - Adopting ways to count the contributions of each channel to a customer's purchase and then rewarding channel members for their respective contributions.

Other Alternatives to RPM

- There are other innovative ways to compensate channel partners for their retail services. (Kalyanam & Tsay 2013)
- Double pay:
  - Easing the difficulty of tying a sale back to the specific services by directly pay a “spiff” to the retailer’s sales personnel for making a sale of specific products
- Activity-based compensation:
  - Customers order online, but storeowners deliver the merchandise, accept returns, and perform minor repairs as needed. Commissions are paid to store owners for online purchases if the store provided service and delivery.
- Incentives tied to end customer satisfaction:
  - Cisco compensates its VARs based on both behaviors and outcomes, and rewards outcomes with additional percentage discounts tied to customer satisfaction.