THE DETERMINANTS OF BRANDS' MARKET POWER - ARE THEY CHANGING?[i]

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Presented June 3, 2011 at the Oxford Symposium on Retail Competition

1- SOME DETERMINANTS FOR A CONSUMER GOODS MANUFACTURER

I begin by examining the determinants of a brand's market power in a consumer goods industry with differentiated products in which there are suppliers, manufacturers and retailers who resell to household consumers. The demand curve faced by the manufacturer is not simply derived from the schedule of consumer preferences for his brand, as it would be were the retail stage perfectly competitive instead of imperfectly competitive as it is in real world markets. Rather, the demand curve the manufacturer faces is a function of 3 additional effects – his brand's retail penetration, dealer support and the gross margin of its retailers (RGM). Retail penetration is the combined market shares in the category of the stores that stock his brand. Dealer support is the store display, local advertising and other promotional efforts of its retailers. Its RGM is (retail price – factory price) ÷ retail price expressed as a %. $ RGM is retail price – factory price.

A 4th.determinant of the manufacturer's demand curve and of his market power is his standing as a vertical competitor. Manufacturers seek to beat down the margins of their suppliers from whom they buy to obtain lower invoice costs and the margins of their retailers to whom they sell to obtain a larger share of their brand's retail price. This bargaining is the vertical form of competition. The manufacturer that is the most successful vertical upstream and downstream competitor in the category will buy cheaper and sell dearer than rival producers. This competitive advantage will shortly enable the manufacturer to take horizontal market share from its less successful vertical competitors including those that had higher horizontal shares.

The process of vertical competition is well recognized by participants in consumer goods industries. Yet the term seldom appears in U.S. antitrust jurisprudence which restricts the use of the word competition to the adversarial relationship between firms at the same horizontal stage, implying that competition does not occur among firms at successive stages.[ii] By contrast, the concept of vertical competition has started to gain acceptance in the U.K. and E.U.[iii]

The exercise of vertical upstream and downstream competition continues even after a merger to monopoly in which state a monopolist manufacturer has no more horizontal market share to capture.[iv] Vertical and horizontal competition reinforce each other. A firm's total market power is a combined function of its standing as a horizontal and vertical competitor and the competence of its staff and management.

2 - THE INVERSE ASSOCIATION BETWEEN THE MARGINS OF MANUFACTURERS AND RETAILERS FOR BOTH POWERFUL AN WEAK BRANDS

Interactions among the above determinants of market power produce an inverse association between the margins of manufacturers and retailers when the manufacturer's brand is either powerful or weak. This regularity, one of the strongest in the consumer goods economy, is again

entirely familiar to industry participants, yet is seldom found in economic models nor recognized in the older or new U.S. Horizontal Merger Guidelines.[v] Most economic models silently assume that the retail stage can be ignored because it is perfectly competitive, or at least "analytically neutral" in the words of R.B. Heflebower, [vi]. The erroneous conclusion that the retail prices consumers pay will vary in the same amount and direction as changes in factory prices follows from this false assumption.

The market power of the consumer goods manufacturer and the retailers who resell his brands reflects the store and brand-switching propensities of consumers. When a store drops a brand because its factory price was increased, or for whatever reason, are most consumers disposed to switch brands within store or stores within brand? In the first case, retailers will have high margins and manufacturers thin ones. If consumers' store and brand switching propensities are reversed, so are the relative margins at the two stages. The eminent economist, Alfred Marshall, briefly described these outcomes over 90 years ago as the new phenomenon of manufacturers' brand advertising swept across Great Britain and the United States. [vii].

A famous "must have" brand is ubiquitously distributed and receives strong in-store and local advertising support from its dealers. Consumer search is efficient. Shoppers can readily identify a famous brand and its prices across stores .Retailers do not want to be caught with a higher price on what consumers recognize as the identical item. Merchants believe that shoppers use the store's relative prices of famous brands to judge whether the store is a high or low price vendor on the balance of its offerings. It is difficult for retailers to drop a famous brand or even to stop featuring it despite severe price cutting lest consumers walk out of their store. These conditions produce vigorous intrabrand competition, the competition among retailers on the same brand, and force down their RGMs. Simultaneously, consumers' refusals to switch brands within store robs the average retailer of his vertical upstream bargaining clout with the famous brand's manufacturer. So the manufacturer can make modest increases in his factory price without losing retail penetration and dealer support, despite his brand's thin RGM, and therefore will have a lofty margin. However, the factory price of a famous brand, while still affording its manufacturer a substantial margin, will be constrained by the vertical upstream clout of a dominant retailer.

By contrast, a weak brand has a far smaller retail penetration and enjoys scant dealer support. In the trade's wonderful descriptive term it is a "blind item." Shoppers do not readily recognize a thinly distributed brand and its prices across stores. Intrabrand competition is feeble, so dealers take the higher markups that characterize differentiated items. In categories where few brands enjoy a loyal consumer following, even small retailers can successfully play off one manufacturer against the others in search of a better price. For consumers will not walk out of his store should the merchant drop weak Brand A and substitute weak Brands B or C for it. Thus, while retailers have high margins, manufacturers' margins are pressed down close to cost.

Per Ward Bowman[viii] where there is "mutual dependence" between a manufacturer and his retailers with modest and roughly equal amounts of market power, this relationship provides an incentive for RPM. So margins at both stages rise and are therefore positively related.

3 - HOW I LEARNED ABOUT THE INVERSE RELATIONSHIP

I do not recall hearing about the inverse association during my undergraduate and graduate level economics courses. It was only later when I returned to Cincinnati to join our then small family toy manufacturing Co., Kenner Products, that I discovered it to my great surprise. Kenner's Building Sets had a small market share and faced many competitors. In the 1950s few toy brands enjoyed a loyal following with consumers. The trade honored manufacturer's suggested retail prices. Few children read print ads. They mostly learned about new toys during a post-Thanksgiving visit to a department store where they confided their choices on the lap of the store Santa Claus.

But in the late 1950s the new medium of television with programs directed to children appeared. As a salesman, I had observed the strong pulling power of TV on some early advertised toys. With some difficulty, I persuaded my father and uncles to give me a budget of $ 2,100 to televise our Girder and Panel and Bridge and Turnpike Building sets in the Cincinnati market.
Shortly after the campaign of about 35 spots began, children started begging their parents for a Kenner Building Set and stores began competing for the patronage of shoppers by chopping their previously maintained prices. Despite the price cutting our department stores did not drop our Building Sets, as they would have done before. Instead, they were pleading with us to expedite their reorders. By the end of 1958, our Cincinnati Building Set sales were several times 1957 sales, while sales in other markets had not improved. In subsequent years we gradually expanded our TV campaigns on the Girder and Panel and Bridge and Turnpike product lines until they became nationally advertised.[ix]

While Kenner's profits rose, the Building Sets' gross distribution margin, which includes both wholesalers' and retailers' margins, plunged from about 50% to about 33 %. In 1960 we raised our factory prices but by far less than the drop in the $ gross distribution margin, so output continued to expand. I recall thinking that the ability to increase factory prices while retail prices fell and unit sales rose was the mercantile equivalent of the mythical Fountain of Youth. Of course, it doesn't always turn out that way. Yet it is invariably true that when a brand's popularity and sales are rapidly growing, its retail price will rise by less than the increase in its factory price due to the falling % RGM. And when its popularity is plunging, its factory price is likely to fall further than its retail price due to the rising % RGM.

4 - NATIONAL BRAND/PRIVATE LABEL COMPETITION.

Per Harvard Business School professor Neil Borden,[x] retailers originally introduced their private labels (PLs) = store brands out of a "desire to be free from the direct price comparisons upon merchandise that consumers knew to be identical." This produced razor thin margins on the leading advertised brands. Since the store brands of rival chains were not identical, retailers could mark them up much higher than leading advertised brands. But there were problems.

The superior reputation of the advertised brand forced the imitative store brand to be retailed for considerably less. The advertised brand was also a far larger seller that would earn more gross margin dollars, despite its lower %RGM, unless the chain could purchase its PL very cheaply and also expand its sales (See the predictions of the Lynch Model [xi]). PLs also face strong headwinds in categories with a dominant advertised brand, such as P&G's Tide. In 2010 the U.S.

PL$ market share in laundry detergents was a meager 3%-4%.[xii] Yet P&G's laundry detergent business is very profitable even though Wal-Mart is its largest customer.

In a structure I've termed "The Mixed Regimen" a handful of leading advertised brands battle on relatively equal terms against high market share PLs. The 2 kinds of brands "keep each other honest" and consumer welfare is maximized. The thin national brand RGMs keep a lid on store brand retail prices, while the upstream bargaining clout of the major chains and the consumer acceptance of store brands restrains the factory prices of manufacturers' brands.

Should store brands decisively win the contest with manufacturers brands, retailers could mark them up much higher. For stores of the same chain do not compete by price on the chain's own PL, eliminating intrabrand competition, the chief force that disciplines retailers' margins. And rival chains do not stock each other's PLs, eliminating interbrand competition within store, the second force disciplining retailers' margins. [xiii]

5 - 2 SIGNIFICANT NEW TECHNOLOGICAL DEVELOPMENTS.THAT REDUCE CONSUMER SEARCH COSTS.HOW FAR WILL THEY REDUCE MARKET POWER AND RETAIL PRICES?

.The first is the advent and rapid growth of online retailing with its websites that enable consumers to engage in comparative price shopping far more efficiently than previously when they had to visit a number of bricks-and-mortar retail stores to obtain the same information. From various websites one can now obtain the retail price of a manufacturer's brand at different stores. The far easier search should intensify intrabrand competition and depress retailers' margins and market power. From the same website the shopper can also type in the name of a rival manufacturer's brand and discover its price at the same stores. If Brand A's price is higher than Brand B's at the same stores and the shopper assumes that a store marks up the 2 Brands equally, she may conclude that all Brands of Manufacturer A are overpriced which would intensify interbrand competition and depress manufacturer's margins and factory prices.

By contrast, since the PLs of different retailers are not the same brand, the shopper must visit the websites of each retailer to obtain that store's private label's price.So online comparative price shopping should put less downward pressure on retailers 'margins and prices of PLs than it does with manufacturers' brands.

The second new development is the ability of consumers when in a store to snap a picture of a brand's barcode with their Smartphones. Then, using an apps, they can obtain its prices in nearby outlets. This exercise stimulates intrabrand competition. Some shoppers state they received a prompt reduction from the store manager when shown that his store's price was too high. But the store the shopper is in doesn't stock other retailers' private labels, each with its own barcode. So PL search costs are not reduced and their retail prices are not affected.

Conclusion – Can we then conclude: 1 - That the lower search costs of the new technologies will reduce retailers' margins on the sale of manufacturers' brands and possibly also the factory prices of the category's manufacturers? And 2 – That while there will be a far smaller direct

effect on private labels, retailers' margins and prices will be somewhat depressed because of the reduction in the retail prices of competing manufactures' brands?

NOT SO FAST! Major manufacturers will resist cuts in their own margins and factory prices and will also come under strong vertical upstream pressure from their retailers, unhappy that their margins have been forced down by more efficient consumer search. With a "Branded Variant" program, a venerable strategy that has been growing, the manufacturer offers a slightly different version of his branded item to at least his major retailers. This frustrates online price searching because the versions carried by at least the major retailers are different brands. It eliminates in-store Smartphone price searching, for like PLs, the barcodes of each Branded Variant are different. . Since consumers no longer view the branded versions of rival stores as identical, retailers can now take the higher markups they apply to differentiated items. By satisfying a manufacturer's major retailers, the Branded Variants strategy enables it to maintain its pre-existing level of retail penetration and dealer support and thereby removes the threat to its sales.

Exclusive territories is another strategy that can greatly mitigate the margin depressing effect of the 2 new searching technologies. Still another effective strategy that can accomplish this result is resale price maintenance, which in the U.S. is no longer per se illegal and must be judged under a rule of reason standard.

To the extent that their market power may have been somewhat reduced by the present searching technologies, manufacturers' strength as vertical upstream competitors might be diminished, permitting suppliers to increase their prices. But more efficient price-searching technologies may emerge that will tilt vertical bargaining power with suppliers in the manufacturers' favor. Hence, it is too early to foresee the direction of future changes in the vertical competition between consumer goods manufacturers and their suppliers.

I therefore predict somewhat less of an overall price-depressing effect from the 2 new technologies than at first glance appears. Results will vary across product categories depending on the character of the merchandise, the market power of manufacturers' brands, the market share of competing store brands and the extent to which consumers search both online and in terrestrial stores. Tracking these outcomes should make a great research project.

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[i] Presented at THE OXFORD SYMPOSIUM ON RETAIL COMPETITION, Organized by the Institute of European and Comparative Law and the Oxford Centre for Competition Law and Policy June 3,2011. Sponsored by Bristows.

Many fruitful discussions with William Comanor, Morris Morkre and especially with Michael Lynch have helped sharpen my analysis of the themes expressed in this presentation.

[ii] Bork, Justice Stevens, Muris, among others, state that all competition is horizontal. *See* Robert L. Steiner, *Vertical Competition, Horizontal Competition and Market Power,* 53 Antitrust Bulletin, #2 (Summer 2008) at 252, 253.

[iii] This has been due in part to the greater focus on the dynamics of national brand, private label competion, although of course vertical competition exists equally in categories without private labels. The greater awareness is also owing to the work of Ionnis Lionas, *The Vertical/Horizontal Dichotomy in Competition Law: Some Reflections with Regard to Dual-Distribution and Private Labels,* Chapt. 8 in Ariel Ezrachi and Ulf Bernitz, Eds.PRIVATE LABELS, BRANDS AND COMPETITION POLICY, Oxford Univ. Press (2009) and the work of Ariel Ezrachi,

Unchallenged Market Power? The Tale of Supermarkets Private Labels and Competition Law. World Competition 33 #2 (2010), Kluwer Law International.

[iv] *Supra* note 2 at 265

[v] Robert L. Steiner, *The Inverse Association Between the Margins of Manufacturers and Retailers,* The Review of Industrial Organization, vol. 8 #6. (1993), also *The Leegin Factors – A Mixed Bag.* 55 Antirust Bulletin, No.1 (Spring 2010). and *Market Power in Consumer Goods Industries.* Chapter 4 in PRIVATE LABELS, BRANDS, AND COMPETITION POLICY in Ariel Ezrachi and Ulf Bernitz, Eds. Oxford U. Press, 20009.

[vi] R.B. Hefflebower, *Internal Trade,* in INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL SCIENCES 49 (1968).

[vii] Alfred Marshall, INDUSTRY AND TRADE, MacMillan 3rd. Edit. (1920). On pp 301-302 Marshall masterfully describes why manufacturers earned high margins and retailers slim ones on popular advertised brands. He also noted that brands without market power were forced to provide their retailers with high, maintained margins.

[viii] Ward Bowman, *Resale Price Maintenance – A Monopoly Problem.* 25 Journal of Business, pp141-155 (1952). The manufacturer and retailer here are "mutually dependent…partial monopolists" where the profits of each depend on those of the others. I describe a common situation that gives rise to RPM in *The Inverse Association…Supra* note ii pp 731-732 and in *The Nature of Vertical Restraints.* 30 The Antitrust Bulletin (1985) pp 164-165.

[ix] *The Inverse Association…Supra* note v. *See* pp 729-731 re Kenner Building Sets and note 9 on the advent of TV advertising on Kenner's Spirograph toy in France. The marketing revolution in the toy industry rolled across the U.S. and internationally where there was TV advertising to children, discount stores and newspaper price ads - with outcomes similar to what Kenner experienced on its Building Sets.

[x] Neil Borden, THE ECONOMIC EFFECTS OF ADVERTISING, Richard D. Irwin Inc. Chicago, 1942.

[xi] Analyzing a U.S. data source, Michael Lynch found that the profit-maximizing price of a store brand was equal to the retail price of the leading manufacturer's brand in the category less the difference in their factory selling prices divided by 2. Lynch applied his model to a study reported in the U.K. Competition Commission Report. The model's predicted store brand retail prices were quite close to the actual ones. Lynch's empirical work and his Model provide strong validation of the inverse association between the margins of manufacturers and retailers. *See Market Power in Consumer Goods Industries, supra* note v pp 90-98 for Lynch's pioneering work.

[xii] Based on reported data, IRI estimated the PL$ share at 2.87%, but that excluded Wal-Mart who no longer furnishes its data. Using its extensive consumer diary program, A.C. Nielsen estimates that Wal-Mart accounts for 20% of overall U.S. private label sales. However, I do not have Wal-Mart's share in laundry detergents.

[xiii] *Supra* note v, *Market Power in Consumer Goods Industries,* at 87-88.