A Consumer Behavioral Approach to RPM

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Economic Rationale for RPM

- Homogenous product vs. differentiated product
- Four kinds of externality in a vertical structure:
  - Horizontal pecuniary
  - Horizontal promotional
  - Vertical pecuniary
  - Vertical promotional/quality
- Vertical pecuniary: double marginalization
- Vertical promotional: under-provision of promotion by retailers
- Vertical quality: under-provision of quality by manufacturer
- Horizontal pecuniary: when a retailer raises its price, other retailers benefit
- Horizontal promotional: the classic free-riding situation

Different Types of Retailers and Retail Service

- Different types of retailer:
  - Single brand vs. multibrand
- Different types 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
  - 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

Different Types of Retailers and Retail Service

- Different types of retail services:
  - General retail services:
    - Inter-retailer substitution effect
    - Interbrand spillover effect
  - Product-specific retail services:
    - 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

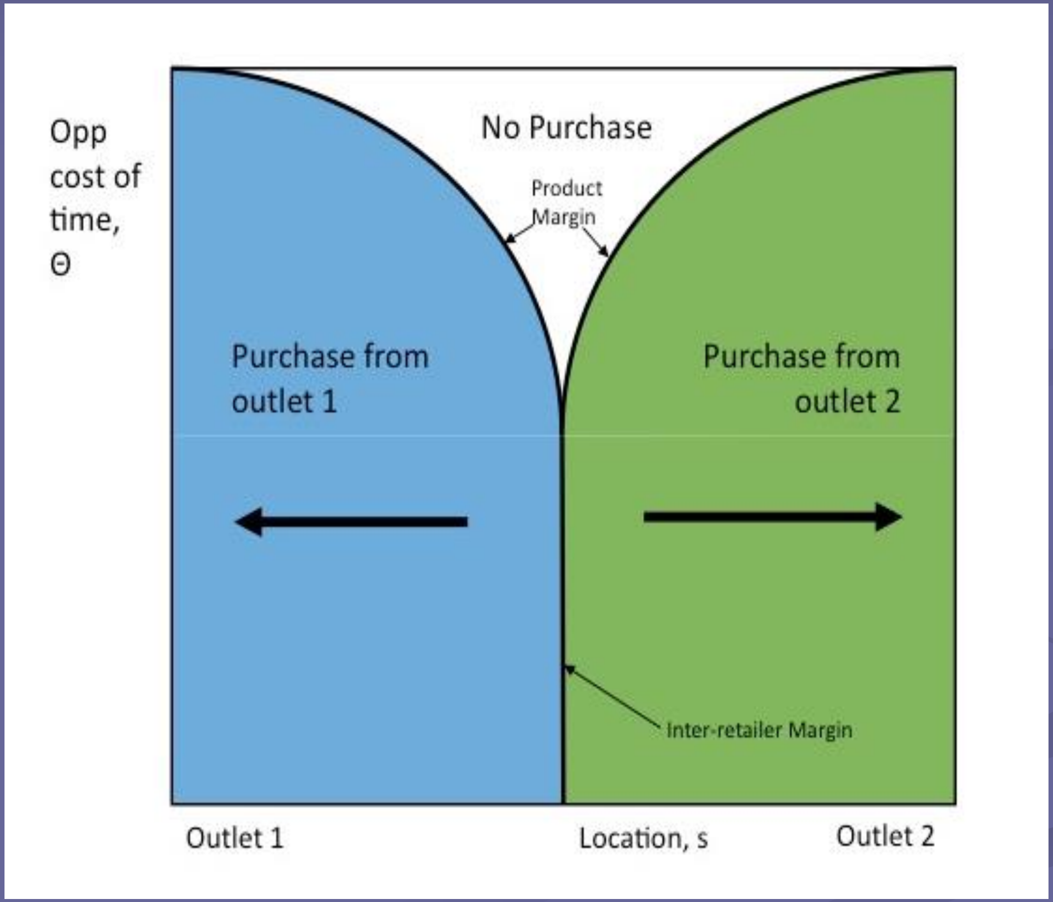
- Consumers are assumed first to choose the brand of product to purchase in a differentiated product market, and then to shop among the different retailers carrying the product for the best deal.
- At the interbrand stage, consumers will focus on a variety of product attributes, such as price, product 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.

Interbrand Primacy Model

- Mathewson & Winter (1998):



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.

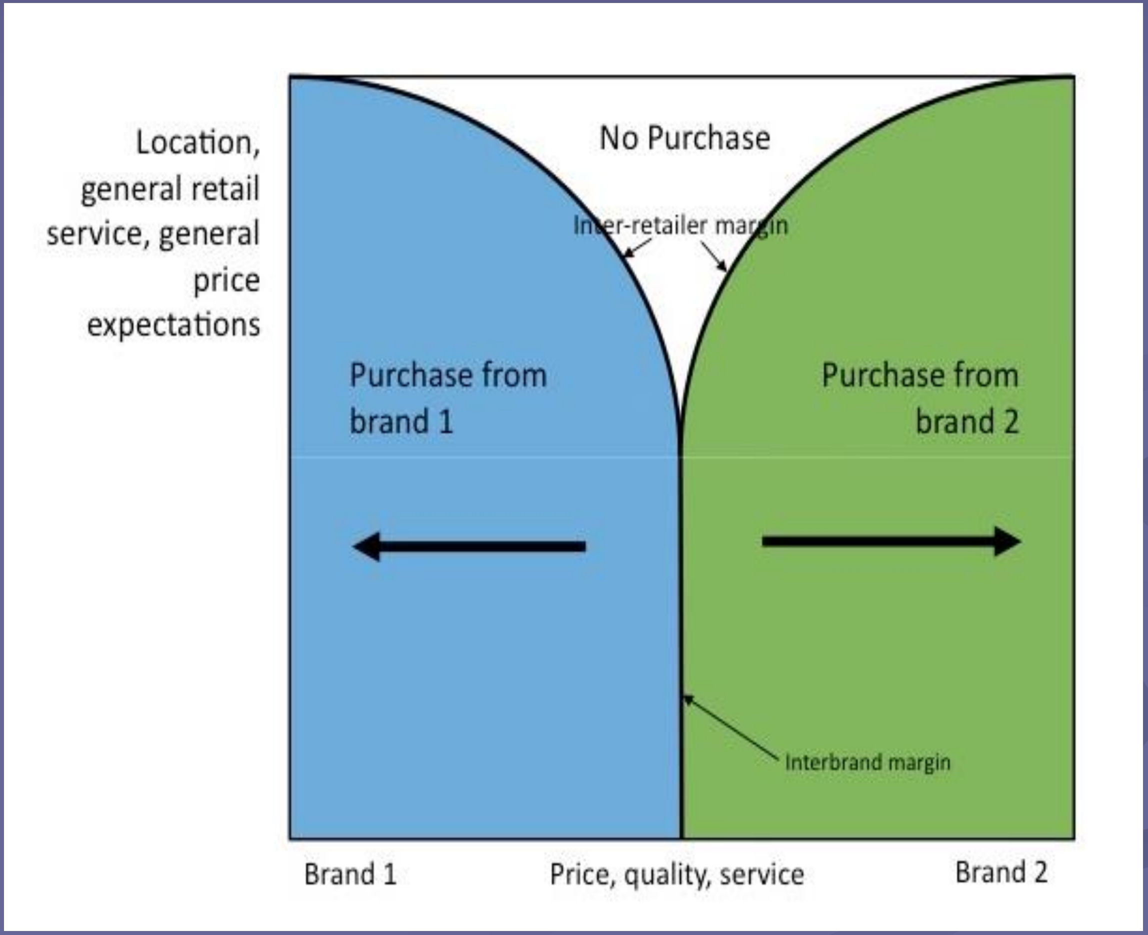
Inter-retailer Primacy Model

- 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.

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".

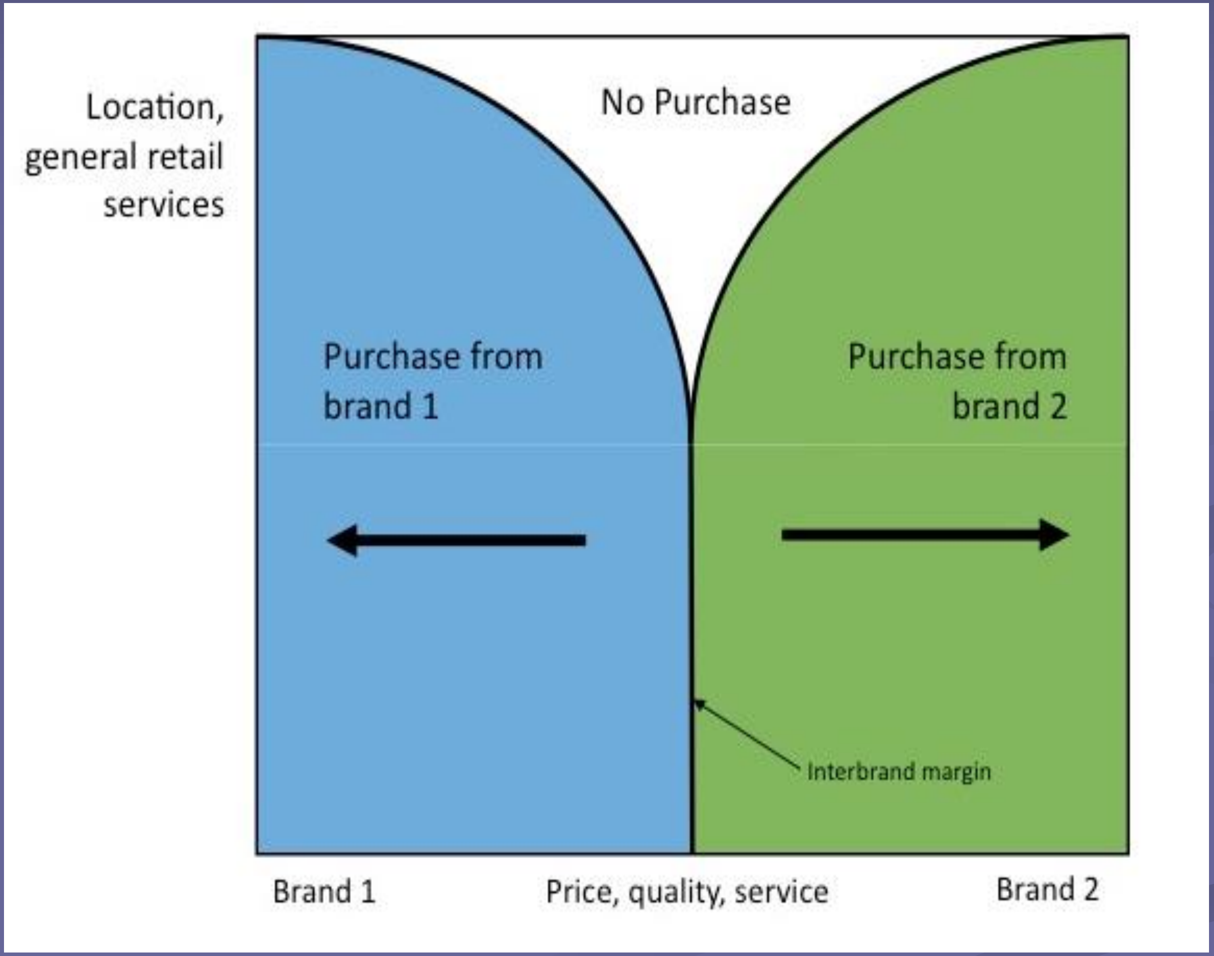
Impulse Purchase Model

- 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.

Impulse Purchase Model



Various Defenses for RPM

- Prevention of free riding (Telser 1960)
- Quality certification (Marvel & McCafferty (1984))
- Ensuring an efficient number of outlets (Gould & Preston (1965))
- Facilitation of contract enforcement (Klein & Murphy (1988))
- Facilitation of introduction of new product

The 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.

The 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.

The 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.

The 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. .

Quality Certification

- RPM is useful in inducing retailers that serve as quality certifiers in the eyes of consumers to carry the product.
- These quality-certifying retailers “serve as their customers’ agents, selecting from a wide variety of available merchandise those items [that are] most likely to appeal to their clientele. By stocking a particular product on its shelves, the retailer attests that the quality and suitability of the item in question are consonant with the retailer's overall reputation.” (Marvel & McCafferty (1984)).

Quality Certification

- What exactly does the extra retail margin cover?
- Three possibilities:
  - Product examination costs
  - General retail services necessary to maintain the exclusive image of a quality-certifying retailer
  - Nothing

Efficient Number of Outlets

- Klein: “By creating and protecting an increased retailer margin the manufacturer supports a larger number of retail outlets, which, through the resulting greater quantity of point-of-sale product display and other retailer promotional efforts, increases the demand for the manufacturer’s products.”
- Trade-off involved:
  - A supplier would lose some sales from the higher retail price resulting from the RPM. On the other hand, the supplier would gain sales from the improved availability of its product to a wider group of consumers.
  - Whether it is worthwhile to use RPM to induce opening of more outlets comes down to whether the latter effect outweighs the former effect.

Efficient Number of Outlets

- Three assumptions:
  - The role of retailers is to reduce the consumers' time costs in obtaining the product.
  - Retailers are differentiated in terms of their location and the time it takes consumers to search within a store.
  - Consumers have different opportunity costs of time. Some consumers have very high search costs and would only purchase the product from a nearby store. Some consumers have low search costs and will travel long distances to purchase a product.
- Most likely to apply:
  - To small ticket items such as clothing, grocery, and drugs.
  - In markets where consumers have the greatest dispersion in income.

Contract Enforcement

- RPM is used not to avoid free riding of sales services, but "to optimally compensate dealers on a per unit of sales basis for an increased supply of product promotion services and to prevent price competition that would eliminate the desired targeted marketing scheme."

Contract Enforcement

- Klein & Murphy:

  The manufacturer accomplishes this by creating an implicit contractual understanding with the dealer whereby the dealer agrees to provide the desired level of promotional services in exchange for a payment from the manufacturer. The contract is implicit because measurement problems prevent the manufacturer and dealer from contracting on the services directly. The payment may be made by the manufacturer with the use of vertical restraints such as an exclusive territory or resale price maintenance arrangement, … In any event, the manufacturer must always monitor dealer performance and terminate dealers who violate the implicit contractual understanding regarding the supply of promotional services.

New Product

- The idea is that dealers may need to invest in the initial promotion of the new product.
- In the absence of RPM, subsequent dealers who did not incur such promotional expenses would be able to undercut the initial dealers and prevent the latter from recouping their investments.
- Foreseeing this scenario, no dealers would agree to make the initial investments unless their future retail margins are protected by RPM.
- While this justification is cloaked in the garb of introduction of new products, it amounts to nothing more than using RPM to secure product-specific retail services, albeit in the specific context of new products.

Analysis

- What kind of retail service is at issue?
  - Number of outlets: general retail service
  - New product: product-specific retail service
  - Contract enforcement: product-specific retail service
  - Quality certification: general retail services/interbrand spillover effects
- With respect to general retail services:
  - Interbrand spillover effect and therefore interbrand free riding
  - Severe coordination problem
  - Intertemporal sales fluctuations
  - Inter-retailer variation in the margin needed

Analysis

- Contract enforcement:
  - Not susceptible to free riding as product and retail service are consumed together
  - No interbrand spillover effect as a product-specific retail service
  - The main problem for this defense is that it only applies to a very narrow subset of retail services.
  - Product display is one of the retail services that cannot be realistically consumed separately from the product. The problem with applying the defense to product display is that product display can be easily compensated by way of slotting fees.
  - One of the assumptions of their defense is that the service at issue must have serious enforcement problems if obtained through a contract. Product display is not one of them.
  - Klein & Murphy provide the example of special handling and refrigeration of beer. Apart from this example, it is not easy to come up with other examples to which this defense applies.

Analysis

- New product:
  - Subject to the same criticisms of the free riding defense.
  - If most of the services at issue are general product promotion, it is unclear why the manufacturer cannot provide it itself or obtain the service from the retailer contractually.
  - There is no guarantee that the retailers will use the enhanced retail margins to provide the service desired by the manufacturers. The retailers will be very tempted to use the margins to provide general retail services instead.
  - It is essentially only applicable under the interbrand primacy model because free riding is negligible under the inter-retailer primacy model and the impulse purchase model.