Implications of Buyer Power and Private Labels on “Vertical Competition” and Innovation

RCS.

Research & Consulting Services

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Background: Buyer power in (grocery) retailing

- High and growing concentration in many European markets
  (e.g., CR5 in Germany > 75%)
  - and notably also among non-discounters.

- Spread of private labels
  (in many markets > 30%)
  - and their changing role.

Vertical competition over functions

Changing role of retailers ?

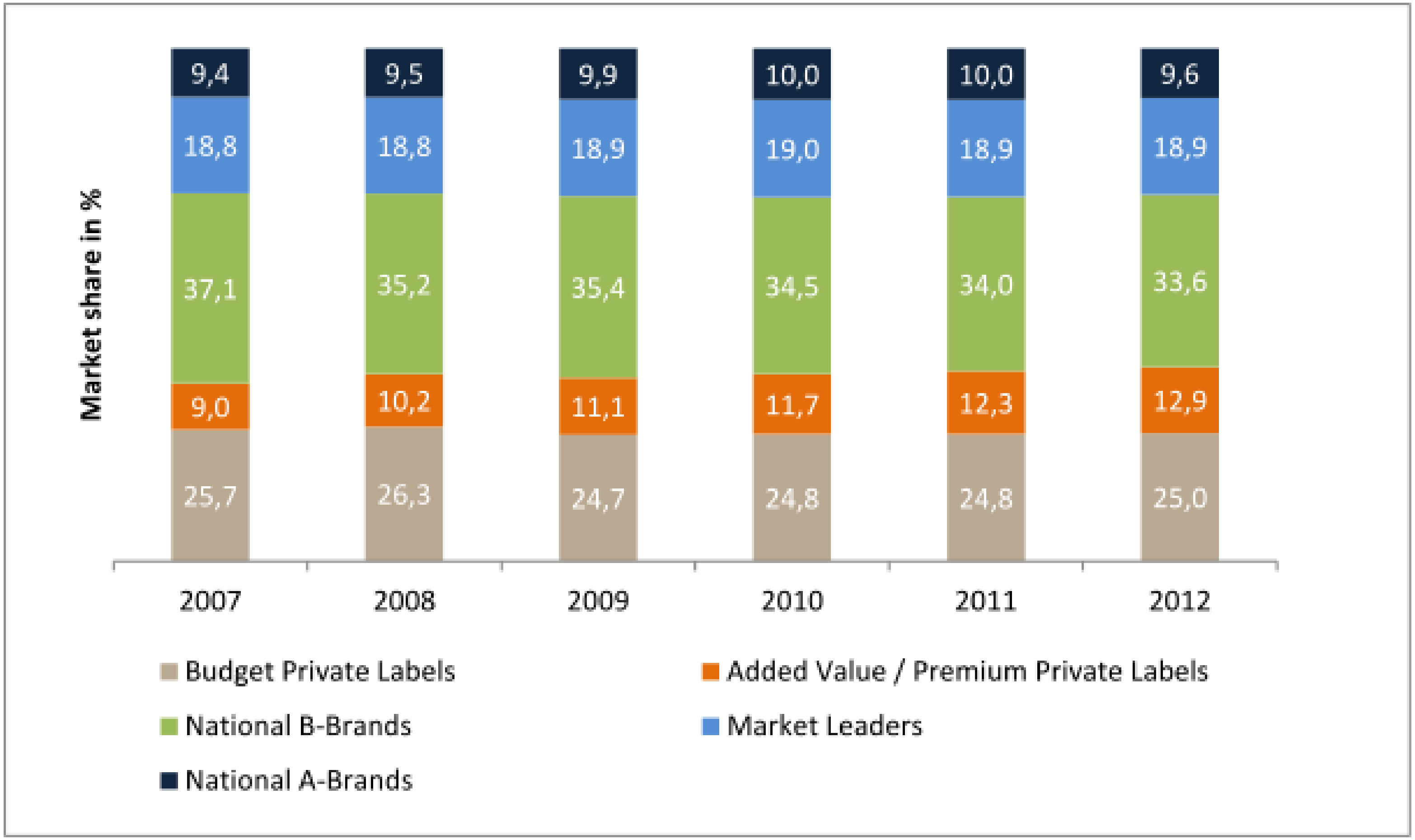
- Typically, economists have either ignored retailing or viewed it just as a bridge between manufacturers and consumers.
- This view disguises the increasing role that retailers play across all functions, such as *distribution, advertising, certification of quality … and innovation.*

Questions for competition policy

- Is vertical competition functioning well ? Or does the exercise of retailer market / buyer power lead to inefficiencies ?
- Do other enforcement policies (e.g., of RPM) distort vertical competition ?

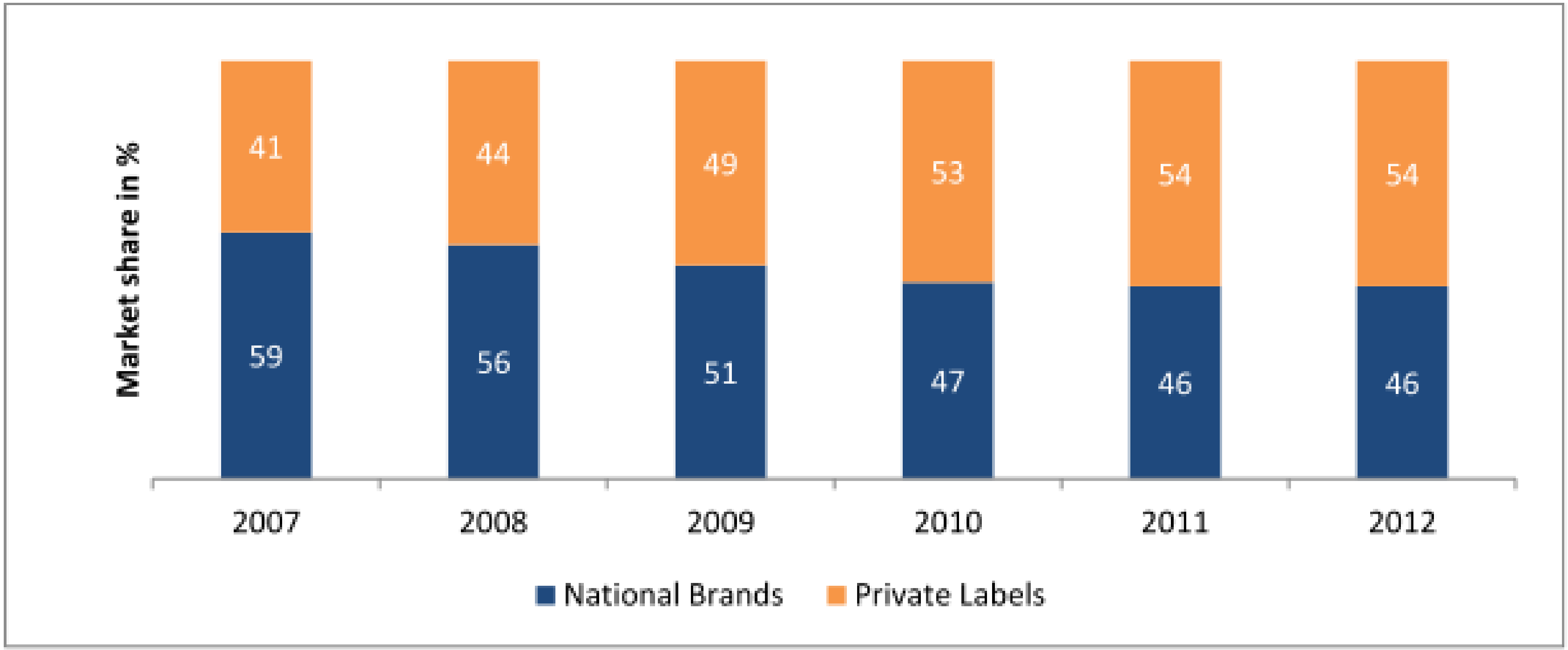
Changing role of private labels in Germany

Market shares: Brands vs. private labels



Changing role of private labels in Germany II

Market shares in organic food and beverages



A formal analysis of competition over innovation I

- Key decision variable: Investment to innovate.
- ***Model 1:*** One manufacturer – one retailer

  *I find that as the retailer's size allows also the retailer to undertake the innovation, retailer investment can <u>inefficiently crowd out</u> manu*facturer innovation*. Essential for this is the retailer's <u>gate-keeping function</u>.*
  Precisely:

  1. Large retailer has (relatively) too high incentives to invest ("rent appropriation motive").
  2. Manufacturer has (relatively) too low incentives to invest ("hold-up problem").

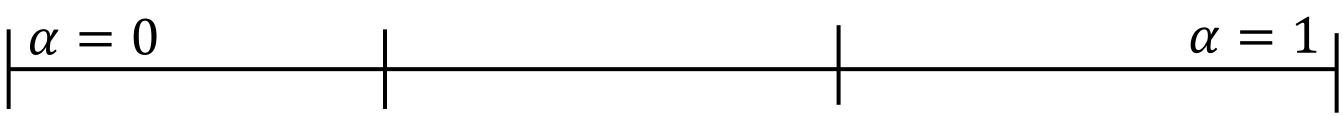
Note: *Inefficiency further exacerbated by threat of retailer imitation (in case of manufacturer innovation).*

A formal analysis of competition over innovation II

Illustration of results of Model 1:

- Joint profits from innovation Δ.
- Investment costs higher if retailer undertakes innovation: $I_R > I_M$.
- If manufacturer invests, must still agree with “gatekeeping” retailer: Manufacturer’s share of the net surplus α .

Result



Retailer invests | Manufacturer invests | Retailer invests

Hold - up | *Rent appropriation*

A formal analysis of competition over innovation III

Model 2: Retailer competition. One large, several small retailers.

- *Finding 1:* Potential for inefficient duplication.
- *Finding 2:* “Innovation waterbed effect”.
  - Large retailer investment reduces manufacturer incentives to innovate.
  - Small retailers have no access to innovation.
  - Reduction of competition and further retail consolidation.

Note: *Large retailer incentive to strategically pre-empt manufacturer innovation.*

Conclusion for competition policy

- Results of conceptual work:
  - Potential for inefficient shift of functions (in vertical competition) from brand manufacturers to large retailers.
  - <u>Source 1:</u> Gatekeeping leads to *“rent appropriation”* and *“hold up”.*
  - <u>Source 2:</u> *“Waterbed effect”.*
- Sufficient grounds to warrant interference ?
  → Possibly only additional effect in “buyer power trade-off”.
- More generally, supports creating *level playing field* for vertical competition, rather than distorting vertical competition
  – as accomplished by strict enforcement of RPM ?

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