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Retailer Pricing and Competitive Effects

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Abstract

Until recently, retailers have taken an either/or approach to competition: either reacting fiercely to competitive price changes or ignoring them altogether. Today, however, firms make a concerted effort to determine and quantify competitive effects. In this paper, we focus on how pricing and competitive effects interact as a general phenomenon, particularly as it applies to retailing. We attempt to construct a general framework that enhances our understanding of the emerging research issues in the area of pricing and competitive effects, and we examine their implications for practice. The areas that show high promise/opportunity are in the online setting for all types of goods—fashion, perishable and packaged staples, and durables—particularly with respect to pricing for profitability and understanding the impact of competition. Other opportunities include understanding the pricing and competitive effects in the perishable goods category sold in specialty, discount, and convenience stores.

Keywords: In-channel competition; Cross-channel competition; Price and product customization; Product type and complementarity; Manufacturer interaction; Cross-price effects; Retailer pricing; Competitive effects

Introduction

Pricing is a key aspect of the marketing mix. It is the only marketing element where managers expect customers to part with their dollars. And since consumer dollars spent at one retail store may imply fewer dollars spent at a competing retail store, it is not surprising that competitive forces may play a key role in determining prices at various outlets, such as online stores, department stores, specialty stores, discount stores, grocery, drug, and convenience stores. The pricing strategies at any one of these stores are likely to impact demand at another store. Moreover, many competitive price effects may be "less easily observable" in the sense that one may not observe demand shifts in the near term due to competition. While retailers traditionally took a black-or-white approach to competition (either reacting fiercely to competitive price changes or ignoring them altogether), more and more firms currently are engaged in determining and quantifying competitive effects. Further, while some competitive effects may be within a category—say, the impact of Minute Maid refrigerated orange juice on the sales of Tropicana and vice versa—other price effects on sales are across categories, stores, and formats—for example, the impact of cola prices on orange juice sales or discount stores on regular department stores or online versus off-line. Despite their ubiquity and importance, however, there has been little effort to categorize pricing and competitive effects or link customer, store level, and situational factors to the direction, magnitude, and nature of competitive effects. The purpose of this paper is to focus on the interaction between pricing and competitive effects as a general

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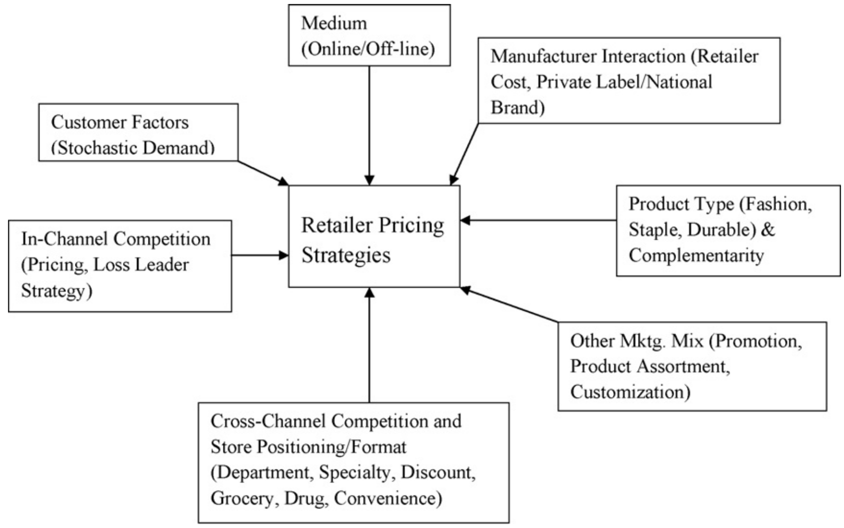

Fig. 1. Overall framework for retailer pricing and competitive effects.

phenomenon, with a particular application to the world of retailing.

Retailing has unique features that affect pricing in a competitive environment. A key component of the output of retailing is a set of services, such as location, information, assortment, delivery, and ambience (Betancourt and Gautschi 1990; Betancourt 2004). Because these services lower transportation and search costs and possibly provide other benefits, consumers are willing to pay for them. From the retailer's standpoint, services such as location and ambience are like public goods, and their cost is largely independent of the number of store patrons and the specific items sold. Retailers normally do not charge separately for these services but still must cover the cost of providing them. Similarly, since transportation and other costs of shopping that consumers incur are specific to the trip and independent of the items bought, consumers seek to minimize the cost of obtaining those items (Bell, Ho, & Tang 1998; Messinger and Narasimhan 1997).

Because of these forces, retail pricing is a matter of setting a menu of prices on individual items to recover the cost of providing various services, a similar problem to a government setting an optimal set of sales taxes (Bliss 1988). Competition should result in segmentation of the market into store formats that provide different services in return for different margins (Ehrlich and Fisher 1982; Ratchford and Stoops 1988). Within formats, differences among consumers in location, information, and propensities to search provide a scope for price discrimination in the form of periodic promotions (Narasimhan 1988; Varian 1980) or different margins on specific items that exploit these differences among consumers; loss-leader promotions might be an example of the latter. In sum, the fixed costs of service provision on the retailer side of the market and the fixed costs of shopping on the consumer side make setting retail prices in a competitive market both a difficult problem to study and a difficult problem to solve in practice.

A considerable amount of prior work has addressed key competitive effects in pricing. Economic work on cross-price effects (Moorthy 2005); studies of cross-store competition and promotional strategies (Bell and Lattin 1998; Kumar and Leone 1988); the literature on price image (Cox and Cox 1990), store format choice (González-Benito, Muñoz-Gallego, & Kopalle 2005), and online pricing (Venkatesan, Mehta, & Bapna 2007); studies of loss leaders (Walters and Rinne 1986) and price wars (van Heerde, Gijsbrechts, & Pauwels 2008); and much of the work in private label and national brand interactions focus on various types of competitive effects in pricing. Here, we attempt to look across these areas to construct a general framework for understanding the emerging research issues in the area of pricing and competitive effects.

From a managerial perspective, it is important to present the interactive effects of pricing and competitive effects for three reasons. First, current pricing practices appear too reactive, perhaps driven by a need to match competition, by short-term business needs, or both. Second, pricing strategies are not tied to customer insights. Third, typical firms do not have the data, energy, or analytics to understand complex linkages with respect to pricing, customer reactions, cost, and competition.

Evaluating research opportunities in retailer pricing and competitive effects

Following Bolton, Shankar, and Montoya (2007) and Levy et al. (2004), Fig. 1 provides an overall framework with respect to seven different factors that impact retailer pricing strategies. These include (1) in-channel competition, which can be broken down to (i) within- and cross-store price competition and (ii) the impact of loss leaders on traffic; (2) cross-channel competition which includes store positioning/format choice; (3) integration with other marketing mix variables (e.g., price and product customization); (4) customer factors that lead to demand uncertainty and the corresponding joint optimization of price, promotion, and product assortment; (5) product type and complementarity; (6) manufacturer interaction; and (7) medium—that is, online or off-line—which can be subdivided into (i) understanding online pricing practices and (ii) multichannel retail pricing. Below, we discuss each of the above factors in detail, first examining