Loss Leading as an Exploitative Practice

Zhijun Chen and Patrick Rey
University of Auckland and Toulouse School of Economics

December 2013
ACE Conference

Loss Leading in Retailing

- Large retailers often adopt *loss leading* strategies
  - UK: adopted by 90% of large retailers, 6% of turnover
- Concerns: smaller rivals, consumers
  - Competition Commission (2000): hard discounters
  - Similar concerns raised by OFT and FTC
- Dilemma in antitrust
  - Not predatory: *Persistent* below-cost pricing
  - Statutes on below-cost resale (50/50 in the EU & US)
  - What type of abuse, if any?

A Simple Example

- Large retailer L offers two products, A and B
  - $u_A = 10$ and $c_A = 0$
  - $u_B = 6$ and $c_B = 4$
- Consumers have heterogeneous shopping costs
  - Half with $s = 4$
  - Half with $s = 0$
- Monopoly outcome
  - L sells both A and B to all consumers at $p^m = 16 - 4 = 12$
  - Monopoly profit $\pi^m = 8$

Simple Example

- Now a competitive fringe S also offers B at $p_S = 2$
- L then adopts loss leading: $p_B = 2 < c_B = 4$ and $p_A = 10$
  - **O**ne-**S**top **S**hoppers ($s = 4$) still buy both from L
  - **M**ulti-**S**top **S**hoppers ($s = 0$) buy A from L and B from S
- Pricing strategy
  - L can charge *same* margin from **OSS**: $r_{AL} = 12 - 4 = 8$
  - And a *higher* margin on **MSS**: $r_A = 10 > 8$

$\longrightarrow$ Higher profit than in monopoly: $\pi_L = 9 > \pi^m = 8$

Main Insights

- Loss leading as an *exploitative* rather than an *exclusionary* strategy
- It allows L to extract extra surplus from consumers
  - Discriminates **MSS** from **OSS**
  - Hurts smaller rivals as a by-product – but needs them!
- Banning loss leading
  - Hurts large firm
  - Benefits consumers, smaller rivals and society

Robustness and Application

- Robust in a variety of dimensions
  - general distribution of consumers' shopping costs
  - elastic demand for A and/or B
  - imperfect competition on A and/or B
  - A and B being (imperfect) substitutes or complements
- Applies to other cases with heterogeneous transaction costs
  - *Aerospatiale-Alenia/De Havilland*
  - *Microsoft*