Loss Leading as an Exploitative Practice

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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 $p_A = 10$
  - One-Stop Shoppers ($s = 4$) still buy both from $L$
  - Multi-Stop Shoppers ($s = 0$) 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: $r_A = 10 > 8$

  $\rightarrow$ 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

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