

Private Label Entry as a Competitive Force?*

An analysis of price responses in the Norwegian food sector

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Abstract:

According to existing theory, the introduction of a private label has an ambiguous effect on the prices of competing national brands. We undertake an empirical analysis of the effects of private label entry on national brand prices in the Norwegian food sector. We observe a large heterogeneity in price responses. When we apply a dynamic panel data approach, we find heterogeneity with both negative and positive significant price responses. However, by conditioning price responses on different product characteristics we also establish that highly distributed and ranked products seem to be more influenced by private label entry than less distributed and ranked products (“weaker” national brands). We also find some support in our data that more successful PL entry – as measured by the PL market share – has a larger impact on the national brand prices.

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1. Introduction

Retailer-owned brands, often denoted by private labels (or simply store-brands), have had an enormous growth in the last decades in many countries and many product categories (Dobson, 1998; Connor *et al*, 1996, Bergès_Sennou, Bontemps and Rèquillart, 2004, ACNielsen, 2005). The overall market share based on sales value of private levels in Europe in 2004-2005 was 23%, ranging from 4% in Greece to 45% in Switzerland (ACNielsen, 2005). Most of the academic literature on private labels is primarily empirical studies trying to explain the variation in private labels penetration across product categories (e.g. Sethuraman, 1992; Hoch and Banerji, 1993; Dhar and Hoch, 1997). Others are concerned about whether introduction might shift the relative channel power from the national brand manufacturer to the retailer (Chintagunta *et al*, 2000; Kadiyali *et al*, 2000; Messinger and Narasimhan, 1995). Although the predominant public opinion seems to be that the growth of private labels have had a pro-competitive effect (see Harris *et al*, 2002), there are rather few theoretical as well as empirical studies actually investigating the competitive effect from private label introduction. The purpose of this article is to test empirically what effect private label introduction has on the prices of competing national brands in the Norwegian grocery sector.

According to existing theory, private labels have an ambiguous effect on prices on national brands. On the one hand, it is argued that the introduction of a private label may lead to lower retail prices of the competing national brands. The argument is simply that the introduction of a private label would lead to intense price rivalry between the national brand and the private label (see Mills, 1995). On the other hand, if consumers' demand elasticity is heterogeneous, private label introduction may result in higher retail prices on the national brands. One reason is that the introduction of a private label leads to intense rivalry for the price sensitive consumers. The national brand producer may then give up fighting for the price sensitive consumers and instead concentrate on consumers with low demand elasticity,

and then at a higher price than before entry of a private label (see Perloff *et al*, 1996). Another reason to expect a price increase on national labels following private label introduction is that the national brand producer may initially have met the challenge of private labels by offering the retailer an exclusivity contract. In this contract the retailer is offered a low wholesale price contingent on that no private label is introduced in the relevant product category. However, if the retailer at some point in time refuses such a contract, and introduces a private label, the response from the national brand may be to increase his price (see Gabrielsen and Sjørgard, 2006).

As discussed above the theoretical predictions of the price effects of private label introduction are mixed, and so are also the results from the empirical literature. Putsis (1997) analyse the price response from national brands on private label introduction, and finds that private label introduction on average lowers the prices of national brands. Cotterill *et al* (2000) investigate the effect from private label market coverage (distribution) on the price of the national brand. These authors find that in some product categories an increase in private label market coverage will increase the prices of national brands, while the opposite is true in other product categories. Finally, Harris *et al* (2002) find that increases in the market share of private labels leads to a rise in the price of national brands in some product categories, whereas the opposite is true in other product categories.

We argue that according to theory it is important to focus on the price effect of the private label *introduction*. The reason is that private label introduction at a particular point of time may identify a termination of an exclusive dealing relationship with the national brand producer, and may as such be a genuine reason for a price increase on the national brand. We have therefore, in contrast to Cotterill *et al* (2000) and Harris *et al* (2002), chosen to focus on the price response from national brands to the introduction of a private label. Putsis (1997) also looks at price responses to private label introduction, but that study reports the average

price effect of a private label introduction. According to theory, the price of national brands may increase in some product categories and fall in other product categories. It is therefore natural to focus on individual product categories. In addition it is of interest to trace any systematic regularities between product categories. In accordance with this, we report the price effect on national brands of individual private label introduction and whether there are some characteristics across product categories that explains why the prices of some national brands go up and others go down.

The dataset is provided by ACNielsen Norway. It consists of 83 private label entries over a period of 4 years. We apply a reduced form dynamic panel data approach where we model the price development in national brands. We find heterogeneity with both negative and positive significant price responses, and the average price response is indistinguishable from zero. However when we condition price responses on product characteristics we establish that highly distributed and ranked products typically seem to be more influenced by private label entry than less distributed and ranked products (“weaker” national brands). We also find some support in our data that more successful PL entry – as measured by the PL market share – has a larger impact on the national brand prices.

One important lesson from our study is that it is too simple to argue that more private label products leads to more intense price rivalry. The main result is that product “strength” matters. That is, the prices of the largest national brand products in terms of ranking or distribution are more influenced by private label entry than number 2 and 3 products, or less distributed products.

2. Theory

Recent theoretical work on private labels includes Mills (1995), Narasimhan and Wilcox (1998), Raju *et al* (1995), Perloff *et al* (1996) and Gabrielsen and Sørsgard (2006). All these

authors focus on the effects on wholesale and retail prices on national brands from private label introduction. In Mills (1995) private label introduction is always beneficial for the retailer as national brand producers are forced to price concessions. Private label introduction is also beneficial to society because their introduction alleviates problems due to double marginalization and therefore excessively high consumer prices. Much in the same vein is Narasimhan and Wilcox (1998). In their model some consumers incur switching costs when starting to buy the private label. Again private label introduction triggers a battle over market shares which leads to price concessions from the national brand producer. Due to a rectangular demand assumption, consumer prices are unaffected by private label introduction, but introduction is always beneficial for the retailer due to lower wholesale prices from the national brand producer.

In Raju *et al* (1995) the main focus is on how the introduction of a private label affects a retailer's profits and which factors determine the private label's market share. Comparative statics concerning how the introduction of a private label affects prices on national brands is not reported. Perloff *et al* (1996) apply a Hotelling model and find that the introduction of a private label may even increase the price of the national brand. After entry of a private label each producer of a national brand may find it attractive to sell only to the consumers located close to its product in the characteristic space. This may lead to an increase in the price of the national brand, since it before entry sets a low price to attract consumers located far away from its location.

Finally, Gabrielsen and Sørsgard (2006) add to the strategy set of national brand producers by allowing them to react to a threat of private label introduction not only by lowering wholesale prices, but to do so in exchange for national brand exclusivity. This option implies that the mere threat of private label introduction may affect the equilibrium outcome. The model distinguishes between loyal and switching consumers. Loyal consumers

never consider buying a private label, switching consumers may switch if the price differential is sufficiently large. When private label entry is feasible, one of three situations may emerge. First, national brand exclusivity (no introduction of a private label) may still arise as an equilibrium outcome. If so, the price of the national brand will be reduced as compared to a situation without private labels (the monopoly outcome). The reason is that the producer of the national brand may lower its exclusive dealing wholesale price so as to make it unattractive for the retailer to introduce a private label. Second, if the private label is introduced the producer of the national brand may increase its wholesale price compared to monopoly and thereby induce an increase in the retail price of the national brand as well. The reason is that the competition for the switching consumers is harsh after private label introduction, and the national brand producer chooses to concentrate on his loyal consumers and increases his price. Third, the private label may be introduced leaving the price of the national brand unaffected. This happens when the national producer serves only the loyal consumers before entry, and thus sets a high wholesale price both before and after the introduction of a private label.

In addition to these theories there are also more general theories that can explain why national brand producer may respond to private label introduction by increasing their prices. One strategy that national brand producers may use when faced with private label entry is to increase the quality of the goods they produce, or alternatively intensify advertising. These strategies will increase costs and may also increase brand loyalty, which both will tend to increase prices. Second, Salop (1977) have shown that a firm can be better able to exploit ignorant consumers by increasing consumer uncertainty. A national brand producer can create noise by selling the same product under different labels (brand proliferation). It is well known that many national brand producers also supply a virtually identical product to grocery stores under a private label. Provided that the cost of brand proliferation is small it may be

profitable to sell the branded product at a high price and the private label at a low price compared to selling only the branded product at an intermediate price.

3. Empirical predictions

It should be clear from the previous sections that the predictions on how prices on national brands respond to private label introduction are ambiguous. If private label introduction alleviates problems due to double marginalisation on branded products, we should expect lower prices on national brands. However, two other effects may overturn this effect. First, if the national and private labels are differentiated one might observe a price increase or no price change at all. Second, if a brand has loyal consumers in the sense that these consumers will never consider purchasing the private label, the number of loyal consumers may be important. The more loyal customers, the more likely one is to observe price increases on national brand. For more homogenous products with few loyal consumers a price increase is less likely, and with few loyal consumers prices on national brands might depreciate after entry of a private label (henceforth PL entry). Finally, we do expect that the price change of the national brand is more significant in product categories where the private label has a high market share than in product categories where it has a limited market share. The intuition is simply that a large market share by the private label triggers a large price response by the national brand.

The discussion can be summarised in three central predictions:

Prediction 1: We expect price increases in some product categories, and price reduction in others after PL entry. Heterogeneity should be present.

Prediction 2: “Strong” national brands should on average increase their prices more often than “weak” products after PL entry.

There is a potential third prediction: If PL entry is successful in terms of market shares, we expect a larger impact on the national brand price than when PL entry is less successful. Note, though, that we should be careful with such a prediction. This prediction does not follow directly from the models discussed above. In particular, also alternative interpretations apply. For instance, a private label with a large market share has a large impact on a national brand price, suggesting a causality from private label market share to the price of national brands. However, we could have the opposite causality. A large price increase on the national brand can result in a large market share for the private label. Moreover, we could have a substantial price reduction on a national brand to prevent a private label from capturing a large market share. If so, we could observe that a significant price reduction on the private label in a product category where the private label did not succeed. That would not be in line with this third prediction.

4. The market in question

We analyse the Norwegian food market. During the last ten years we have seen a structural change at the retail level, where four large chains; “*Hakon gruppen (HG)*”, “*Reitan gruppen (RG)*”, “*Forbuckersamvirket (FS)*” and “*Norges gruppen (NG)*” have increased from representing less than 50% of the market to nearly 100%.¹ Table 1 shows the development in market shares in the Norwegian food sector.

[Table 1 approximately here]

However, most of the takeovers and mergers took place before 1995. The last ten years the chains have had relatively stable market shares. We use a data set from ACNielsen Norway. The dataset is a weekly panel with 197 weeks of information on prices, markets

¹ FS was renamed in October 2000, and its name is now Coop.

shares, distribution on both private labels and national brands for the period January 1997 to October 2000. The dataset is described in more detail in Appendix A.

This market may serve as a particular good case, since the private label “invasion” was still relatively “new”, in the analysed period but at the same time the PL market share increases rapidly. The national brands have been exposed to the threat from PL entry for only a relatively short time period, and have during our data period been forced to react to the private label “invasion”.

In Figure 1 the development in market shares of private labels are shown; in less than four years the market share is nearly doubled. Newer figures including also the RG-chain suggest a private label market share above 10% by the end of 2000.² The increase in private label share has been a common strategy for all chains. In Figure 2 we decompose the private label shares for each of the chains, and as we see the same growth pattern is present for all four chains.

[Figures 1 and 2 approximately here]

To be able to obtain a tractable dataset we have restricted our analysis to 83 private label introductions. These introductions are chosen according to several criteria. First, we have only considered private labels introduced in the period January 1998 to January 2000 and that reached a national market share within its product group above 2% by May 2000. This is to obtain a long enough *pre-* and *post* entry period, and to include only “significant” entrants. Second, product groups where a lot of noise is anticipated due to other factors as seasonal products (e.g., “Easter soft drinks”), “price signal products”, “structural changes” etc. were excluded. Finally, we excluded groups where it was difficult to identify who the rival or rivals

² The chains have a declared strategy to increase the number of private labels. An FS chain representative said in March 2000: “*All unprofitable products will be removed from our shelves*” (source: Dagens Næringsliv 01.03.2000). One month later the HG-Chain representative Svante Nilsson said: “*We will make more room for our own private labels in our stores. Private labels are more profitable to the chain than national brands, and are also important in distinguishing our chain from our competitors. Today the private label share is only 5%, we hope to increase it to 10%.*” (Dagens Næringsliv 27/4-2000).

were. The remaining group is both representative for the Norwegian food sector, includes 41 different market segments, and covers the most important private label introductions in our data period.³

As discussed in the previous section, theory suggests some heterogeneity with regards to price responses to PL entry. By looking at our data we can get a first impression of this heterogeneity.

In figures 3 and 4 we show the price development for some of the analysed products. In Figure 3 the prices of ready-made frozen French fries are shown. We observe an upward shift in the price of the national brand after PL entry. FRIONOR is a large producer with relatively strong products in a differentiated product segment. This suggests that a possible explanation for the increase can be loyal consumers, increased quality or spatial competition. The market share of the private label was 23.5% in May 2000.

In Figure 4 the prices of a more typical homogenous product are shown – spaghetti. The price effect of the PL entry differs from one national brand to another. One national brand (Sopps) seems to increase its price, the other national brand (Maretti) reduces its price after entry. The two national brands have each approximately 30% of the market in this chain, but in the aggregated Norwegian spaghetti market, Sopps (47%) is nearly twice as big as Maretti (27%). Hence, the market leader increases its price and the closest rival reduces its price. The PL entry was quite successful in this chain, usurping a market share of 30% by may 2000.

Finally, in Figure 5 we have shown the price development for a very homogenous product – flour. Here the entry leads to a large price decrease of the national brand (Mølleren). Still, the entry was extremely successful. The private label dominates this segment by May 2000, with a market share of 73%.

³ The data period is restricted to four years since this is the longest period ACNielsen was able to provide data for directly from their database for this period. Furthermore, earlier data is of a lower quality.

[Figure 3 to 5 approximately here]

The three Figures suggest that we will find both price increases and reductions following PL entry. More interesting though, is to see whether we can detect systematic patterns in the national brand price shifts. This is what we turn to next.

5. An econometric modelling framework

To our knowledge, our study is the first to use micro data to test directly the price response of the introduction of private labels. However, within a very parallel literature on generics in the market for pharmaceuticals, several price response studies have been conducted. Grabowski and Vernon (1992) studied the effect of generic entry on prices for 18 high sales volume pharmaceutical products that were first exposed to generics during the years 1983 to 1987. For each drug the authors examined prices prior to entry and prices one year subsequent to generic entry. Using a relatively simple regression model they estimated the impact of the number of generic suppliers in a market on the ratio of the generic price to the name brand price.⁴ Their result suggested that name brand prices rose relative to generic prices subsequent to generic entry.

Caves *et al* (1991) suggest that simple pre-entry versus post-entry brand name price comparisons or regressions of price on numbers of generic entrants may understate negative entry effects on prices because other omitted factors have caused brand-name prices to rise over time. One such variable is producer price index for pharmaceuticals. They argue that empirical price regression models must be specified so as to minimize bias from these unobservable time-varying factors. Caves *et al* (1991) include fifty different intercepts to represent category-year groups average changes, in addition to several other time related

⁴ The model included two covariates along with the number of generics; the total dollar sales in a market in a given year and a time dummy.

dummy-variables, linear time trends and quadratic time trends. They found evidence that suggested that entry led to reductions in name brand prices.

In this paper, we pursue two econometric test strategies. First, we formulate a basic dynamic price model that will be used to undertake an exploratory analysis of our dataset. This will enable us to uncover heterogeneity in the outcome for the different product types, and get a first grip on possible systematic patterns. Second, Section 5.2 extends our dynamic price model to take advantage of the panel properties in our dataset. Here we are able to test statistically some of the more suggestive results from the exploratory tests in the first subsection. The models will be in line with those of Caves *et al* (1991). However, we include a dynamic element by explicitly modelling the autoregressive element of the price process as an AR(1) model.

5.1 A reduced form dynamic price model and some descriptive results

The most commonly used statistical model to describe price development is the autoregressive first order model (AR(1)). Last period's price is the main predictor for this period's price. We assume that the development in a price series x_t is described by; $x_t = \rho \cdot x_{t-1} + \varepsilon_t$, where $\varepsilon_t \sim iid(0, \sigma)$. This model has been widely applied within the literature on market integration and efficient markets, and offers several advantages.⁵ First-order serial correlation is captured within the model, and when extended with more variables it allows us to distinguish between short and long run effects. The AR(1) model is therefore a better statistical price model than the ones used in the earlier empirical studies discussed above. It has a sound statistical foundation, and has also been widely used as a common way

⁵ See e.g., Isard, (1977); Richardson, (1978); Beck, (1994); Ardeni (1989); Goodwin and Schroeder (1991); Doane and Spulber (1994), Sauer, (1994); Schwarz and Szakmary, (1996); Asche, Salvanes and Steen (1997); Asche, Bremnes and Wessels (1999).

of describing price processes in the economic literature.⁶ In our case we would like to include other factors as well. In particular, prices may rise over time due to a general price increase on food. To account for this, a linear trend (t) and the consumer price index (CPI) are included (see Caves *et al*, 1991). Furthermore, the different product prices will have different means which is accounted for with a constant term (α):⁷

$$(1) \quad P_t^{NB} = \alpha + \rho \cdot P_{t-1}^{NB} + \lambda t_t + \gamma \text{CPI}_t + \varepsilon_t.$$

where P_t^{NB} is the national brand price. To measure any possible shift in the national brand price after PL entry we also include a dummy variable ($D \text{int}^{PL}$). This variable takes the value “1” if entry of a private label in the same market segment as the national brand.

$$(2) \quad P_t^{NB} = \alpha + \rho \cdot P_{t-1}^{NB} + \lambda t_t + \gamma \text{CPI}_t + \beta D \text{int}_t^{PL} + \varepsilon_t$$

Equation (2) is our basic price model, which we will use throughout the analysis. A β significantly different from zero will indicate that the national brand price is significantly influenced by the PL-entry. A positive β suggests a price increase, and a negative β indicates a price reduction. The price variable P_t^{NB} , and the CPI index are measured in logarithm.

⁶ Caves *et al* (1991) apply a GLS model that accounts for first order serial correlation. However, our AR(1) specification is a better way of dealing with serial correlation, since instead of “removing” the autoregressive component (as in GLS) we use it to obtain a better price model.

⁷ For all the coffee products we also include an international coffee price, expressed in NOK. This is to prevent any noise from fluctuating international coffee prices.

We estimated first (2) for the 83 product matches we have in our dataset, providing us with 83 OLS regressions.⁸ This gave us a first idea about the effect of PL entries; have the PL entries any significant price effects on the national brands, and if so, which products experience a price increase and for which products has the price gone down? For most of the 83 product matches we have 197 weeks of price observations, for some of them we have fewer observations. We observe a large heterogeneity, with both significantly positive and negative β s. Second, most of our β s are positive, 51 of 83 estimated parameters (or more than 60%) are positive. This pattern is even stronger when we consider the significant parameters. Using a two-tailed test, 15 parameters are significantly positive on a 5% level, whereas only *two* is found to be significantly negative. This is in line with the findings in Harris *et al* (2002).⁹ Hence, it seems that the introduction of a private label typically leads to higher prices on national brands. When looking at the product categories we get the impression that the degree of product differentiation and the number of loyal customers might matter. The most significant and largest price reduction for national brands was found for *flour*, probably one of the most homogeneous product group in our sample (see Figure 5). When looking at product groups with positive shifts in national brand prices, we find several “strong” products. For instance, for the six product matches of coffee in our sample, four PL entries are found to increase national brand prices significantly. We also find several soft drink matches where the same thing applies. Also Frionor significantly increased its price on French fries in response to PL entry (see Figure 3).

Turning to market shares, the average private label market share for all 83 products is 33.7%. For the 15 significant positive β s the average is considerably higher, 41.7%. For the two negative β s the market share is above 73% for both products. Finally, none of the PL

⁸ These results are not reported here but can be found in Gabrielsen, Steen and Sørsgard (2001).

entries that lead to a significant price increase had less than 7% PL market share. This suggests that significant changes in national brand prices are typically observed in product categories with successful entry of a private label. Moreover, no national brands seem to reduce their price as a response to an unsuccessful (small) introduction, whereas some increase their price. The latter result is important, since the alternative to our third prediction – significant price reduction on a national brand in a product category where a private label is not successful – found no support. In such a case an unsuccessful entry should be linked to a reduced national brand price. We would anticipate negative significant β s in these cases, since a significant reduction in the national brand price would reduce the room for potential private label success. However, this is not what we can observe in these first descriptive regression results.

The descriptive regressions provide some support for our predictions. However, we need to go a step further to statistically validate our conclusions. In order to try to single out what is a strong product we might condition our test on variables that can serve as instruments for the “strength” of a product, alternatively, the number of “loyal” customers. In addition to market shares we therefore use two more variables, the actual distribution ratio of each product in all Norwegian stores, and a ranking of the products according to size. The distribution ratio is a number between 0 and 100, where 100 means that the product is distributed in all stores. The only national brand in our dataset that covers 100% of the stores is Coca-Cola. The rank variable tells whether the national brand is a number 1, a number 2, or a number 3 product in terms of market share.

⁹ These authors state: “*We have a remarkable result. Despite the large number of estimated coefficients (288) every statistically significant coefficient is positive.*” Actually they found one fourth of their coefficients to be positive on a 5% level, in our case the number is close to this; one fifth.

5.2 A reduced form dynamic panel data model for national brand price responses

Using distribution, rank and market share information we extend model (2) to take advantages of the panel properties to see whether the descriptive “suggestions” also are valid in an econometric model based on the full data set of 15 761 observations. Our basic panel model is:

$$(3) \quad P_{i,t}^{NB} = M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \beta Dint_{i,t}^{PL} + \varepsilon_{i,t}$$

where M_r is a set of dummy variables that vary according to market segment. For example, market segment number 14 is coffee and includes three different coffee-product matches within one chain. There are a total of 41 different market segments with 1 to 7 product matches; $r=1-41$. The market segment dummies are included to account for different price levels in each market segment. Hence, the model we use includes both a dynamic AR(1) component for each product match, and a “fixed effects” element through the 41 market segment dummies.¹⁰

Now we extend (3) in two levels. First, we estimate three models where we condition $Dint_{i,t}^{PL}$ on private label market share, and the national brands’ rank and distribution level:

$$(4.1) \quad P_{i,t}^{NB} = M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \beta_1 Dint_{i,t}^{PL} \cdot DISTR_1^{NB} + \beta_2 Dint_{i,t}^{PL} \cdot DISTR_2^{NB} + \beta_3 Dint_{i,t}^{PL} \cdot DISTR_3^{NB} + \varepsilon_{i,t}$$

¹⁰ Since we here include a lagged endogenous variable problems might arise since the lagged endogenous variable can be correlate with the error term in a dynamic fixed effect model (Anderson and Hsiao, 1982; Nickell, 1981). However, this problem is present if (as is most common) the cross section element dominates the time dimensional element, i.e., the number of cross sectional observations exceeds usually by far the number of years included in a dataset. In our case, the opposite is true, the time dimension is weekly with 197 observations, which is considerably more than the 83 product matches.

$$\begin{aligned}
P_{i,t}^{NB} &= M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \\
(4.2) \quad &\beta_1 Dint_{i,t}^{PL} \cdot RANK_1^{NB} + \beta_2 Dint_{i,t}^{PL} \cdot RANK_2^{NB} + \beta_3 Dint_{i,t}^{PL} \cdot RANK_3^{NB} + \varepsilon_{i,t}
\end{aligned}$$

$$\begin{aligned}
P_{i,t}^{NB} &= M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \\
(4.3) \quad &\beta_1 Dint_{i,t}^{PL} \cdot MS_1^{PL} + \beta_2 Dint_{i,t}^{PL} \cdot MS_2^{PL} + \beta_3 Dint_{i,t}^{PL} \cdot MS_3^{PL} + \varepsilon_{i,t}
\end{aligned}$$

The distribution, rank and PL-market share variables are all dummies and have the same structure; “1” denotes high (distribution, rank or PL-market share), “2” medium and “3” low.

For instance, MS_3^{PL} refers to a low private label market share and will accordingly take the

value ‘one’ when this is the case, and ‘zero’ otherwise. $RANK_2^{NB}$ represents a national brand

that is ranked as number two etc. The exact definitions of these variables are given in

Appendix A. By estimating these three models we will be able to uncover whether

differences in distribution, rank or PL-market share are important for the price response of the

national brands.

Finally, we extend the model even further. The third step is to look at two

combinations of models 4.1 to 4.3, where we condition $Dint^{PL}$ on rank and PL-market

share, and distribution and PL-market share. The model that combines distribution and private

label market share is:

$$\begin{aligned}
P_{i,t}^{NB} &= M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \\
(5.1) \quad &\sum_{j=1}^3 \sum_{k=1}^3 \beta_{jk} Dint_{i,t}^{PL} \cdot DISTR_j^{NB} \cdot MS_k^{PL} + \varepsilon_{i,t}
\end{aligned}$$

where j refers to distribution level and k to PL market share size. Hence, the parameter β_{11} measures the price response of the national brand for those national products that have a large distribution and where the private label has acquired a large market share. Correspondingly, β_{33} measures the price response for those products that have a relatively small distribution and where the private label only has gained a small market share. In the next model, we condition on rank rather than distribution:

$$(5.2) \quad P_{i,t}^{NB} = M_r + \rho \cdot P_{i,t-1}^{NB} + \lambda t + \gamma CPI_t + \sum_{j=1}^3 \sum_{k=1}^3 \beta_{jk} D_{i,t}^{int PL} \cdot RANK_j^{NB} \cdot MS_k^{PL} + \varepsilon_{i,t}$$

Now the parameter β_{11} measures the price response of the national brand for those national products that are ranked as number 1 and where the private label has acquired a large market share, etc.

These five extended models allow us to test whether differences in rank, distribution or the private label market share, or combinations of these can explain the heterogeneity in price responses uncovered in the previous section. In particular, this panel data framework allows us to use all information simultaneously, and also permits various statistical tests of the validity of our results.

The models 3 to 5 are presented in Table 2. The statistical properties are good, with a high explanation power, and a clearly significant AR(1) parameter; ρ is estimated close to

0.80 in all six models, suggesting a stationary process.¹¹ The trend and CPI variables are both non-significant and have different signs. However, these two variables are strongly positive correlated (with correlation > 0.90), and therefore multicollinearity applies with large standard errors. The trend parameter picks up the positive price trend, and the CPI variable any possible negative deviation from this trend. The coffee price variable is significant and positive in all models.

[Table 2 approximately here]

Turning now to the parameter β , several interesting things can be observed. In model 3, β is non-significant, suggesting no change in national brand price. This result, which is more like an average effect, disregards the underlying heterogeneity. In the extended models, we try to decompose the heterogeneity and condition it on distribution level, rank and PL market share. The first extension – model 4 – suggests some more action. In models 4.1 to 4.3 one of the β s is significant, indicating a negative shift in national brand price for products that is ranked as number one – but only at a 10% level. A joint F-test (bottom Table 3) of the effect of conditioning the price response on rank, distribution and PL-market share; $H^0 : \beta_1 = \beta_2 = \beta_3 = 0$, cannot be rejected for distribution and PL market share, but is clearly rejected for rank. Hence, rank seems to pick up some of the observed heterogeneity. As discussed later, the non rejection of the market share model (4.3), suggests that PL market share alone cannot explain the heterogeneity in price responses and therefore suggests that the potential endogeneity between national brands' price responses and PL market share development is not a significant problem here.

Models 5.1 and 5.2. extend the potential differences in product characteristics even more. It is now evident that also more of the heterogeneity is accounted for. Out of 18

¹¹ Even though we know that the AR(1) parameter will have a negative biased variance, a test of $\rho=1$ is

different β s, 9 are significant. The majority of these suggest a positive price response. On a 5% level, all significant β s are positive in the distribution vs. PL market share model (5.1). The results are summarised with signs in Table 3.

[Table 3 approximately here]

When we look at the significant β s, we observe some regularities. In particular, β_{11} , β_{12} and β_{13} are significant in all models. The products that either are ranked as number one or have the highest distribution are thus most influenced by private label entry. These are those products where we would anticipate most loyal customers and “strong” products (see prediction 2). Furthermore, β_{11} in both models are significant on a 1% level and positive. Hence, a large PL market share, or a successful entry, leads to a price increase on the highest ranked and distributed products. Correspondingly, β_{13} is significant and negative in both models, suggesting that the national brands are more likely to reduce price after less successful PL entry (low PL market share).

Of the remaining 12 parameters (medium and low rank or distribution) only 3 parameters are significant. β_{21} is negative, suggesting that number 2 products are more likely to compete with successful PL entrants, whereas number 2 products that face “smaller” PL entrants increase their price ($\beta_{23} > 0$). The last significant parameter β_{33} in model 5.1 is harder to interpret at first glance. It suggests that the national brands that have the lowest distribution increase their prices when faced with a “small” PL entrant. However, within this group we typically find “niche” products that might have very loyal customers within more narrowly defined market segment.

rejected with t-values in the range of 39 to 49, clearly indicating a stationary process.

We perform different joint F-test in models 5.1 and 5.2. First, we jointly test the importance of the degree of distribution and rank. We impose a joint zero restriction on the three parameters that correspond to each distribution/rank level. For instance, $H_0^1: \beta_{11} = \beta_{12} = \beta_{13} = 0$ implies that there is no national brand price response in the high distribution or number one product group. The different hypotheses are summarised and test statistics provided in Table 3 and 4. The same pattern as was seen in the individual parameters can be traced also here. The null of no price response in the high distribution/rank one group (H_0^1) is clearer rejected than the medium and low hypotheses (H_0^2 and H_0^3). When we test whether differences in PL market share have different effects in terms of price response, we find that the null hypothesis of no national brand price response is rejected in five out of six tests. Most clearly for the high PL market share group ($H_0^4: \beta_{11} = \beta_{21} = \beta_{31} = 0$), and the low PL market share group ($H_0^6: \beta_{13} = \beta_{23} = \beta_{33} = 0$). In the distribution/PL market share model (5.1) all three PL market share hypotheses were rejected. The PL market share test results are interesting, since these give support to our third empirical prediction: the degree of success of the PL entry – the size of the PL market share - matters for the national brand price response.

[Table 4 approximately here]

Our predictions from theory thus seem to have found some statistical support. We do find heterogeneity also in the panel data models, with both negative and positive significant price responses; prediction 1. There is also a pattern where highly distributed and ranked products are more influenced by PL entry than less distributed and ranked products (“weaker” national brands); prediction 2. This is seen in both the individual parameters and the joint tests. Finally, our third prediction that more successful PL entry – as measured by the PL market share – should have a larger impact on the national brands finds some support. The

joint null of no price response of national brands on the most successful PL entrants ($H_0^4 : \beta_{11} = \beta_{21} = \beta_{31} = 0$) is most clearly rejected in Table 3. However, as opposed to what the descriptive single equation results suggest, we now also find two out of six cases where national brand prices are reduced significantly in market segments where the PL market share is low. The empirical evidence is mixed, though, since out of the remaining four cases we find two significant positive estimates. It is also interesting to note that in our model 4.3, where we condition price effects only on differences in PL market shares none of the introduction dummies were found significant. It is first when we combine product strength indicators through distribution and rank in models 5.1 and 5.2 that we find significant price effects. Thus, the results are not driven by PL market share differences alone.

6. Some concluding remarks

We observed a large heterogeneity, in price responses to private label entry. Our descriptive single equation approach found more than 60% of the price responses to be positive. This tendency is even stronger when we consider the significant parameters. 15 parameters are significantly positive on a 5% level, whereas only *two* is found to be significantly negative. Hence, it seems that an introduction of a private label predominantly leads to higher prices on national brands.

We now formulate a dynamic panel data model where we condition the price responses on distribution, rank and PL market shares. The same picture with heterogeneity in price responses is verified. In particular highly distributed and ranked products seem to be more influenced by PL entry than less distributed and ranked products (“weaker” national brands), supporting our second prediction. Finally, even though we are more careful here, we also find some support in our data that more successful PL entry – as measured by the PL market share – have a larger impact on the national brands price responses.

We have thus to a large extent been able to condition the heterogeneity observed in the data on distribution, rank and PL market share. However, there is still some heterogeneity that is not accounted for. One candidate is marketing activity by the national brands, and another candidate could be product quality characteristics.

One important lesson from our study is that it is too simple to argue that more private label products leads to more intense price rivalry. What we have found, though, is that product “strength” matters. That is, the prices of the largest national brand products in terms of ranking or distribution seem to be more influenced by PL entry than number 2 and 3 products, or less distributed products. We also find that the prices of national brands predominantly increase after an introduction of a private label.

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Figures and Tables

Figure 1 The development in private label shares from January 1995 to January 1999, Source: ACNielsen 1999 (excluding RG).

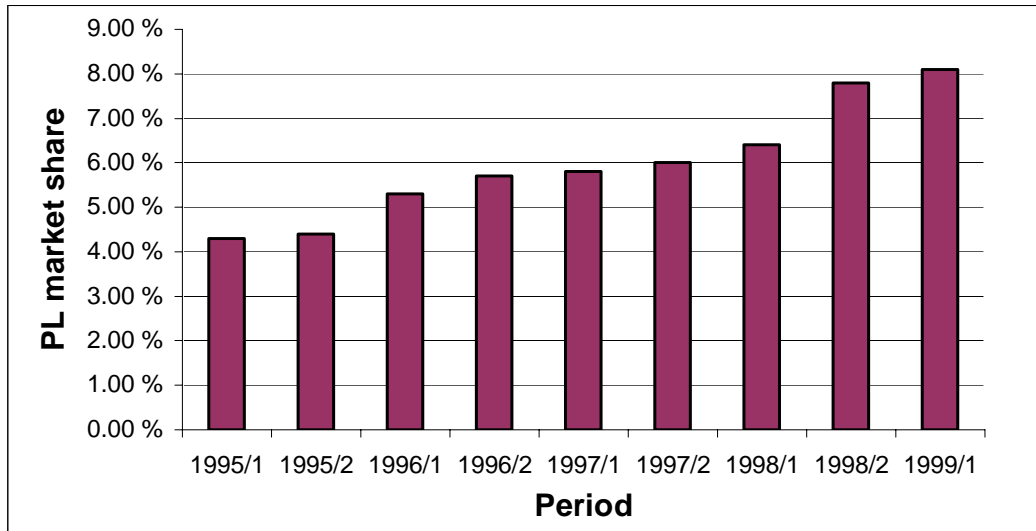


Figure 2 Development in private label market shares for the four Norwegian chains (Source ACNielsen 1999)

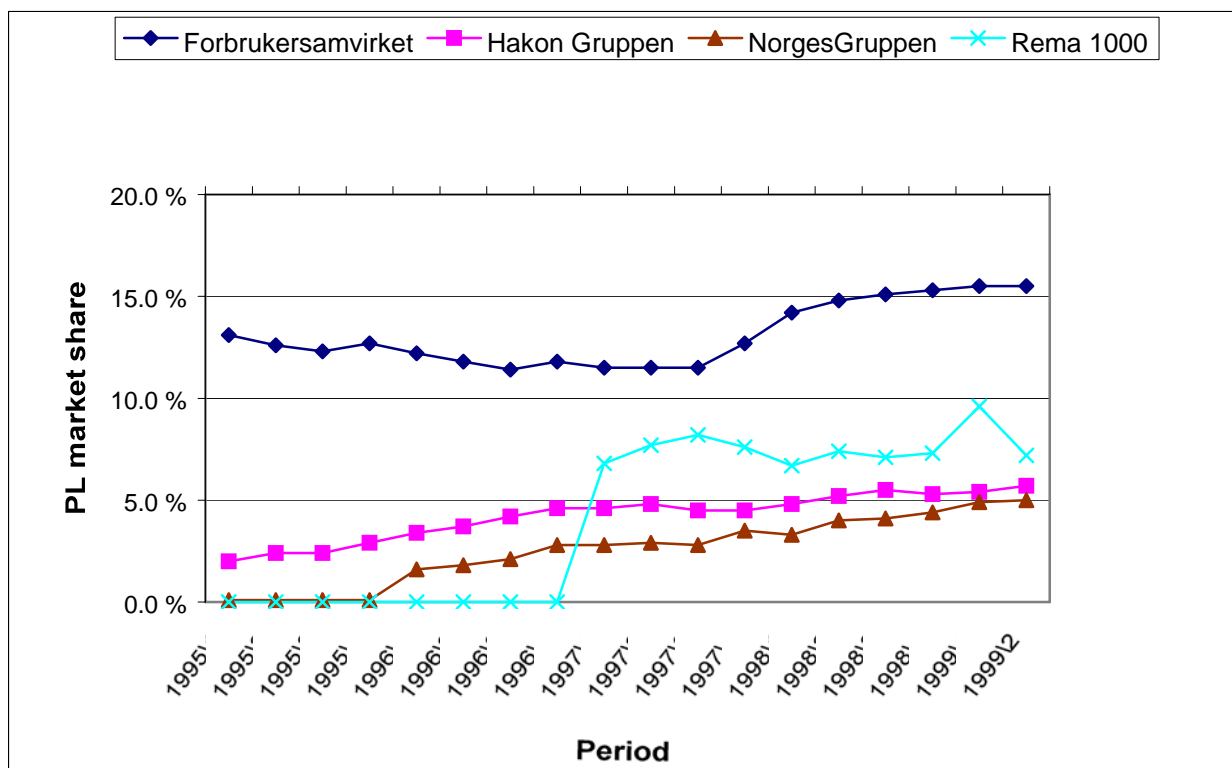


Figure 3 Price development French fries (Source ACNielsen)

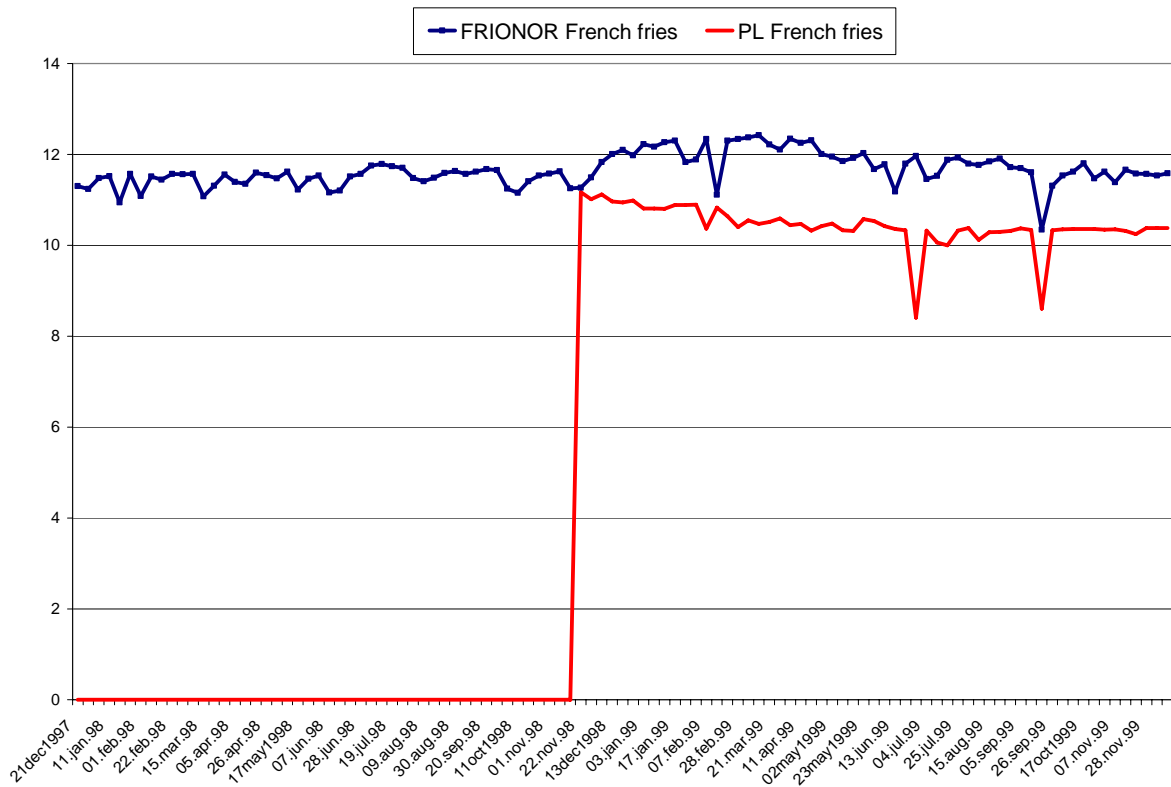


Figure 4 Price development Spaghetti (Source ACNielsen)

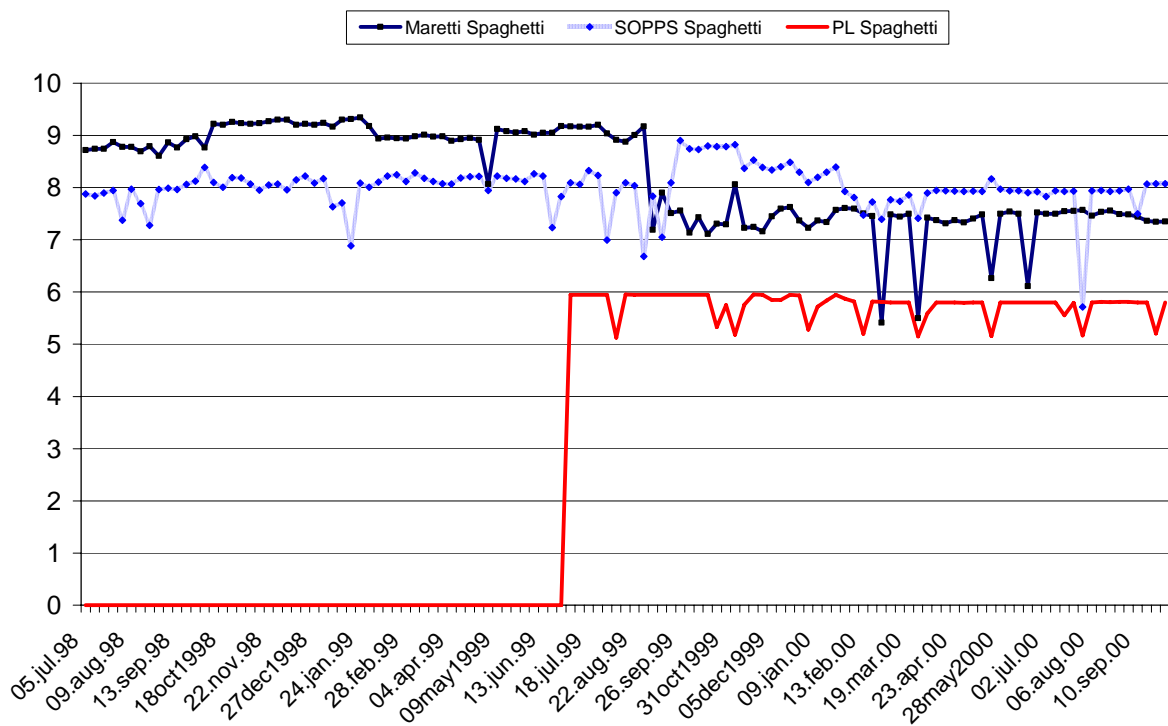


Figure 5 Price development Flour (Source ACNielsen)

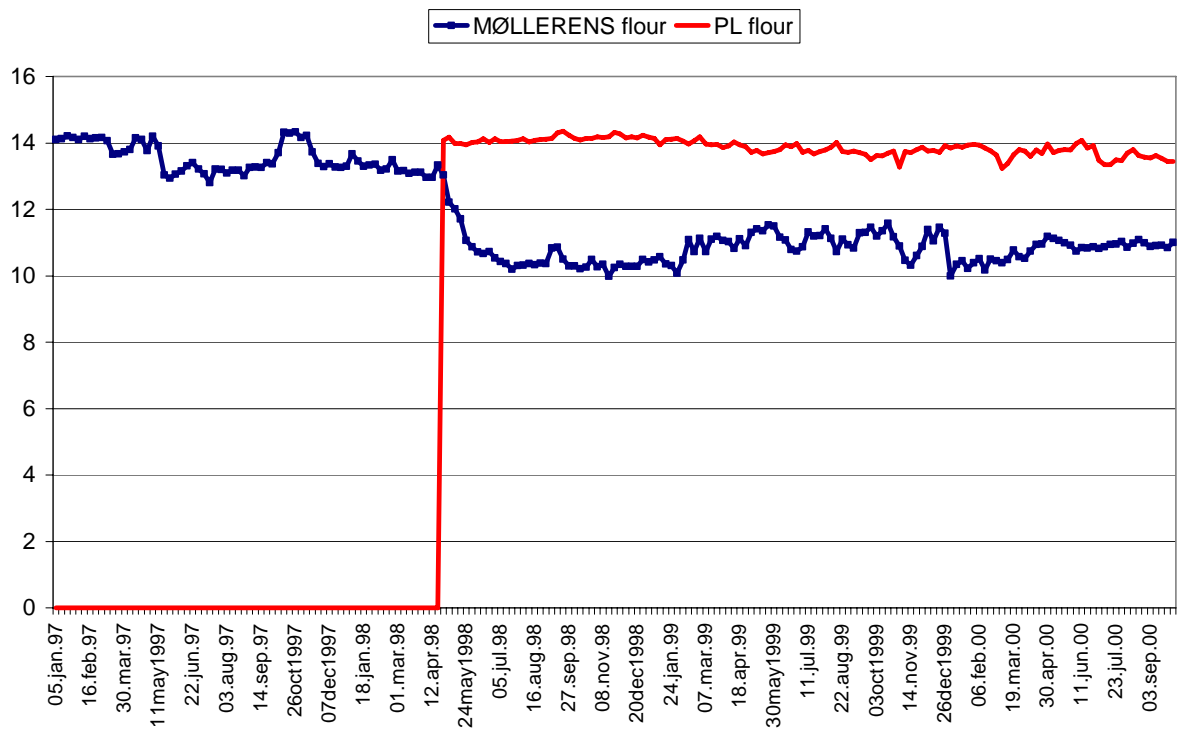


Table 1 : The development in market shares of the Norwegian food chains.

År	HG	RG	FS	NG	Others
1990	10,2	5,7	22,8	7,1	54,2
1992	16,8	11,0	23,0	16,5	32,7
1994	24,0	11,3	24,4	37,1	3,2
1995	27,7	11,8	24,9	32,7	2,9
1996	28,6	11,8	25,2	32,1	2,3
1997	28,3	12,5	25,2	32,6	1,4
1998	28,0	13,2	24,9	32,7	1,0
1999	27,7	13,7	25,2	33,2	0,2
2000	26,3	15,4	24,2	33,4	0,7
2001	24,5	16,2	24,5	34,1	0,7
2002	23,9	16,7	24,3	34,5	0,6
2003	23,6	17,4	23,7	34,7	0,7
2004	22,4	17,5	24,6	34,8	0,7

Source: *Notes from the Norwegian competition authority 1/2000 and report 2005*

Table 2 Empirical results for the dynamic panel data models 3 to 5

	Model 3	Model 4.1 (distrib)	Model 4.2 (rank)	Model 4.3 (PLms)	Model 5.1 (β_{jk} j: distrib k:PL ms)	Model 5.2 (β_{jk} j: rank. k:PL ms)
ρ	0.804* (0.004)	0.804* (0.005)	0.802* (0.005)	0.803* (0.004)	0.797* (0.005)	0.796* (0.005)
λ	0.0001 (0.00009)	0.0001 (0.00009)	0.0001 (0.00009)	0.0001 (0.00009)	0.0001 (0.00009)	0.0001 (0.00009)
γ	-0.167 (0.178)	-0.167 (0.178)	-0.183 (0.178)	-0.165 (0.178)	-0.165 (0.177)	-0.181 (0.178)
Coffee price	0.039* (0.013)	0.039* (0.013)	0.041* (0.013)	0.039* (0.013)	0.048* (0.013)	0.041* (0.013)
β	-0.0003 (0.002)					
β_1		-0.0002 (0.0025)	-0.004*** (0.0025)	0.0019 (0.0037)		
β_2		-0.0007 (0.0030)	0.004 (0.0029)	-0.0020 (0.0032)		
β_3		-0.00007 (0.0031)	-0.003 (0.0036)	-0.0001 (0.0028)		
β_{11}					0.041* (0.008)	0.022* (0.006)
β_{12}					0.014* (0.006)	-0.006*** (0.003)
β_{13}					-0.006*** (0.003)	-0.007* (0.003)
β_{21}					-0.006 (0.006)	-0.039* (0.010)
β_{22}					-0.007 (0.005)	5.6e-06 (0.005)
β_{23}					0.006 (0.004)	0.006** (0.003)
β_{31}					-0.002 (0.005)	-0.003 (0.004)
β_{32}					-0.006 (0.004)	-0.0008 (0.007)
β_{33}					0.008** (0.004)	-0.003 (0.004)
R^2	0.999	0.999	0.999	0.999	0.999	0.999
N	15761	15761	15761	15761	15761	15761
$H^0 : \beta_1 = \beta_2 = \beta_3 = 0$						
F-test _(3, 15713)		0.02	4.86*	0.33		

*/ Significant on a 1% level **/significant at a 5% level, ***/significant on a 10% level

Table 3 Joint tests of hypotheses the dynamic panel data model 5

	Model 5.1 β_{jk} <i>j: distrib k:PL ms</i>	Model 5.2 β_{jk} <i>j: rank. k:PL ms)</i>
<i>Joint importance of Distribution or Rank</i>		
High Distribution or Rank = 0 $H_0^1 : \beta_{11} = \beta_{12} = \beta_{13} = 0$	12.96*	8.04*
Medium Distribution or Rank=0 $H_0^2 : \beta_{21} = \beta_{22} = \beta_{23} = 0$	2.54	6.65*
Low Distribution or Rank = 0 $H_0^3 : \beta_{31} = \beta_{32} = \beta_{33} = 0$	2.53	0.42
<i>Joint importance of PL market share</i>		
High PL market share = 0 $H_0^4 : \beta_{11} = \beta_{21} = \beta_{31} = 0$	9.95*	11.72*
Medium PL market share = 0 $H_0^5 : \beta_{21} = \beta_{22} = \beta_{23} = 0$	4.28*	1.32
Low PL market share = 0 $H_0^6 : \beta_{13} = \beta_{23} = \beta_{33} = 0$	5.02*	8.99*

*/ Significant on a 1% level **/significant at a 5% level, ***/significant on a 10% level

Table 4 A summary of the results from models 5.1 and 5.2 (β s and joint F-tests)

		PL market share			
		High K=1	Medium K=2	Low K=3	<i>Joint test of "row"</i> (Table 4)
<u>Distribution</u>					
High	J=1	+*	+*	-***	H_0^1 *
Medium	J=2	0	0	0	H_0^2
Low	J=3	0	0	+**	H_0^3
<i>Joint test of "column" (Table 4)</i>		H_0^4 *	H_0^5 *	H_0^6 *	
<u>Rank</u>					
"1"	J=1	+*	-***	-*	H_0^1 *
"2"	J=2	-*	0	+**	H_0^2 *
"3"	J=3	0	0	0	H_0^3
<i>Joint test of "column" (Table 4)</i>		H_0^4 *	H_0^5	H_0^6 *	

*/ Significant on a 1% level **/significant at a 5% level, ***/significant on a 10% level

Appendix A – Data and variable description

The data set is from ACNielsen Norway, and contains weekly prices on national brands and private labels for the period 01.01.1997 to 01.10.2000. In addition we have data on market shares, distribution level of the national brands and the ranking of these in May 2000. Totally we have 83 product matches in 41 different market segments. Totally this give us a panel of 15761 observations. The consumer price index is from the Statistics Norway (SSB).

The dummy variables used in models 4 and 5 are defined as:

$\mathbf{MS}^{\text{PL}}_1$	=	1 if the PL market share is $\geq 20\%$
$\mathbf{MS}^{\text{PL}}_2$	=	1 if the PL market share is between 8% and 20%
$\mathbf{MS}^{\text{PL}}_3$	=	1 if the PL market share is $\leq 8\%$
$\mathbf{Rank}^{\text{NB}}_1$	=	1 if the national brand is ranked as number 1
$\mathbf{Rank}^{\text{NB}}_2$	=	1 if the national brand is ranked as number 2
$\mathbf{Rank}^{\text{NB}}_3$	=	1 if the national brand is ranked as number 3
$\mathbf{Distr}^{\text{NB}}_1$	=	1 if the national brand has a distribution level $\geq 70\%$
$\mathbf{Distr}^{\text{NB}}_2$	=	1 if the national brand has a distribution level between 30% and 70%
$\mathbf{Distr}^{\text{NB}}_3$	=	1 if the national brand has a distribution level $\leq 30\%$