CHAPTER 1

Distribution Channels Today

1.1 INTRODUCTION

Marketers today must develop well-informed strategies for managing their distribution channels during times of significant change. Those strategies will include anticipating, minimizing, and addressing the channel conflict inevitably wrought by change. This book is about how firms can select metrics, design strategies, and implement policies that free them to adapt to the rapidly evolving landscape that combines physical and digital routes-to-market.

Our book is primarily intended for marketers and those who train them, but marketers aren't the only ones paying attention to channel dynamics. Economists, regulators, and social psychologists are also interested in how distribution channels affect competition, efficiency, and consumer welfare. They want to understand the marketing challenges of distribution channels, the causes and consequences of channel conflict, and the approaches to managing that conflict. So, while our writing is rooted in marketing, we also incorporate these other perspectives.

What is a distribution channel? By its simplest definition, it is the chain of distributors, retailers, and other intermediaries through which a supplier's product reaches end consumers, implying a unidirectional

movement of goods along one route, from the point of production to the point of consumption.[1] Even simple distribution channels are delicate systems, where suppliers and their independent resellers struggle to balance a cooperative partnership against a desire for a bigger share of the total profit available in the channel. The partners need to cooperate in ways that create value for consumers, appropriate some of that value in the form of profit for the channel, and share the profit in a way that sustains the partnership.

Modern, mainly digital, technology has complicated that partnership. These days, firms must employ a multitude of distribution channels—sometimes complementary, but almost always competing—in a way that satisfies consumers' needs for products, services, and information. What a unidirectional, one-route perspective can easily miss is the variety of interactions and conflicts among firms in the ecosystem, because each firm performs some functions and tries to appropriate some of the value created.

Conflict and power go together in any relationship between interdependent entities. The (mis)use of power can exacerbate conflict, but a channel member's power position also determines the strategies it can use to appropriate value and manage conflict. Accumulating channel power and exercising it wisely is a key to surviving and prospering in periods of change. In the words of Professor Raymond Corey of the Harvard Business School, marketers must learn "to use power without using it up."

The sources of power, and the ways to exercise it, have been complicated by recent technological, market, and legal developments. Distribution practices that were developed and refined over years have become vulnerable. Some challenges are easy to recognize (should digital books be priced the same as paper copies in book stores?) and others are more nuanced (how does resale price maintenance affect trade promotions?). Some are fundamentally new and require different thinking (how can we measure and manage distribution coverage online or assess the power of a channel member that operates a multisided platform?), while others are simply different manifestations of enduring channel issues (double marginalization,

[1]Throughout the book, we will use the term "consumers" to designate purchasers who are typically end users, meaning that they do not resell the product or incorporate it into other products for resale. Of course, products purchased by someone may be used or consumed by others (e.g., members of the same household or business). We avoid calling them "customers" because, at least in the consumer packaged goods industry, retailers are referred to as customers.

free riding, and the tug between intra- and inter-brand competition). Throughout the book, we try to distinguish what is new from what is not. The former needs fresh thinking and emerging solutions. The latter has a history with important lessons that marketers ignore at their peril.

Technology has also blurred the distinction between distribution channels and communication channels, especially since some of the new digital distribution channels mainly satisfy consumers' need for information rather than directly sell the products and services (consider Trip Advisor and Trivago for hotels, for example). A purely consumer-centric view might suggest that any sources of products or information that the consumer seeks out or is exposed to would qualify as "channels." By that definition, search engines, blogs, and social media would be "channels."

The consumer is certainly at the center of it all, but our perspective in this book is firmly rooted in firms that sell through independent distribution channels. Our view is that, for an entity to be viewed as a distribution channel, it must perform, and be paid for, at least some of the functions involved in the sale of a particular product along the route to market from a clear upstream supplier to a clear downstream reseller or end customer. So, DoubleClick is a distribution channel for firms that sell advertising, but it is not a distribution channel for the product being advertised. A wine brand's sales may be affected by what an influential wine blog writes about it, but the blog is not a distribution channel. Drawing this line between distribution and communication channels is useful to guide the strategies of marketers and it delineates the scope of the issues we tackle in this book. Of course, it is not a bright line and one can easily see how it might blur. For example, what if the blog has a link to the wine brand's site and gets paid to route demand to the wine marketer? Such an "affiliate" arrangement would make the blog a distribution partner.

Most frequently, we take the perspective of suppliers selling through independent resellers (distributors, retailers, aggregators, marketplaces, and other middlemen), but this requires analyzing the viewpoints of the middlemen too. Other disciplines, notably operations and strategy, refer to these middlemen as members of a "supply chain" or "value chain." So, what's the difference between supply chains, value chains, and distribution channels?

Our view is that the distinction is largely in perspective and emphasis. The terms "upstream" and "downstream" are used to describe those firms that are closer to the production versus the consumption "end" of the channel, and we will do that too. This kind of thinking can subconsciously imbue the upstream firm with more responsibility, power,

or authority. Our counterparts in manufacturing and operations take the perspective of a "downstream" firm—often a manufacturer looking backwards at its raw material and component suppliers.

Those in the strategy and economics domains refer to the "value chain" as the entire collection of firms and activities in producing and delivering a product or service with an emphasis on the "value added" (not too far from margins) at each stage. Value chains therefore include a firm's backward supply chain and forward distribution channels in addition to its own value-adding operations. Where relevant, we adopt some approaches from these other disciplines to enrich our understanding of how channels work and how they can become more efficient.

1.2 WHAT IS NEW: RADICAL CHANGES IN THE NAVIGATION OF DISTRIBUTION CHANNELS

The sustainability of channel partnerships is a goal that businesses value highly. Pricing, marketing communications, and even products are quite often easier to change than distribution-channel relationships. Frequently, businesses are built around serving end-consumer markets through a specific set of immediate customer-distribution channels. For example, automobile manufacturers have learned to market through their dealers, major soft drink manufacturers Coke and PepsiCo through their bottling networks, and Avon and Natura through their independent consultants. Learning to serve these channel customers along with end consumers is a critical competency. Channel affiliations are also often personal relationships, even friendships, that go well beyond golf games once a year. That's why a channel partnership is not often severed, and only happens after some serious soul searching (or its commercial equivalent).

Often, growth necessitates expanding into new channel relationships while maintaining existing ones. Retailers add more suppliers and categories while also opening more stores and expanding into new markets. Manufacturers add more retailers, expanding to service new geographic markets. They also add new types of retail formats that service additional market segments. Although these types of expansions are sure to bring "growing pains," businesses today are encountering challenges far beyond normal growing pains. That is why, even though channel management is a well-worn topic in marketing, we believe it is worth a new look now.

We see four general areas of change in the economy that call for a renewed study of the management of multiple routes-to-market. To some degree, all four areas have been affected by digital technologies.

1.2.1 Changing Business Models

The first set of changes relates to new business models for distribution that derive from technology. Firms based on these new business models are inserting themselves into traditional routes-to-market, bringing corresponding opportunities for suppliers to gain or lose strategic advantage by managing or mismanaging their distribution channels.

When products are digitized, the marginal costs of manufacturing and distribution may approach zero though the fixed costs remain high, making pricing challenging. Witness the difficulty of pricing and monetizing digital distribution of books, news, streamed music, and video. Variety that was expensive in a purely brick-and-mortar world may be much cheaper to offer but organizing and presenting that variety in a meaningful way and pricing it appropriately is more important.

Another technology tradeoff: the Internet and mobile technology allow shoppers to search for the best price without moving from their desks or the aisle in a store, but the online world is increasingly tailored and targeted. Marketers can use information about consumers in real time to tailor offers to each consumer—through different products, presentations, messages, and prices—often without consumers even realizing it.

More than 50 years ago, Wroe Alderson, one of marketing's preeminent scholars, captured the nature of distribution channels when he wrote, "economic progress has consisted largely of finding more efficient ways of matching heterogeneous supply with heterogeneous demand."[i] The web and mobile are wonderfully efficient at facilitating that matching, so companies are disintermediating (a fancy word for cutting out the middleman) channel members and going direct to consumers.

At the same time, though, new business models have emerged primarily by unbundling the functions that used to be provided by traditional channels. Along with the traditional channel members in the physical world of bricks (top half of the figure), Figure 1.1 shows new intermediaries in the virtual world of clicks (bottom half of figure). Some new middlemen deal in the flow of information rather than the flow of physical products. They present information

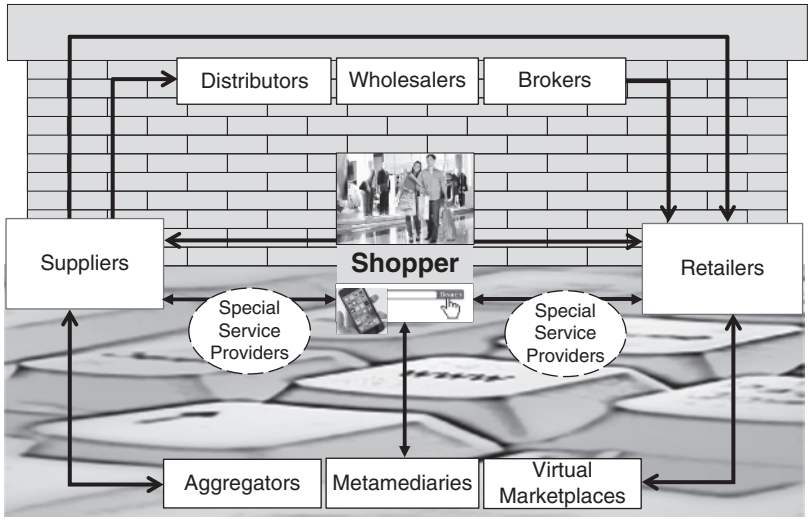

Figure 1.1 Physical and digital distribution in today's channel ecosystem.

on multiple options to consumers who can comparison shop and then be seamlessly routed elsewhere for making a purchase. Some new middlemen are digital versions of physical malls or retailers. Many of them are platforms, such as Etsy's marketplace or TripAdvisor's meta-search site, that have two or more sets of customers with interdependent demand. The value that one set of customers (e.g., suppliers) derives from the platform depends upon the demand from the other set of customers (e.g., consumers). It is worth noting that many of these new platforms are thriving, while classic two-sided markets like newspapers and shopping malls are struggling to survive. Other new middlemen are special service providers who perform narrow but important functions like delivery or payment processing or reverse logistics.

1.2.2 Omni-Channel Retailing

The second change is the relentless pressure for resellers to become omni-channel, as a consumer may become aware of a product in a brick-and-mortar store or catalog, check reviews and compare prices on the website, make a purchase on the mobile app, and pick it up (and perhaps return part of it) in the store. When retailers intend to serve customers in one channel but they end up buying from another channel, marketers used to refer to it as "leakage"

or customers "escaping," implying a failure of strategy or tactics. Instead, the concept of omni-channel embraces the inevitability of needing physical, online, and mobile arms, and of managing one's social presence to serve their best customers better. Omni-channel strategies focus on integrating activities within and across channels to correspond to how consumers shop.

In the face of omni-channel efforts by their downstream resellers, suppliers have to adjust their own channel management practices. They must decide which, if any, of their brands and product lines they prefer to distribute in a multi-channel rather than omni-channel way, for example, by making different brands or product lines available through different channel partners. And, for others, they need to weave together, manage, and reward a combination of many types of channels to match how consumers want to search, buy, and return. Managing omni-channel distribution is like recruiting and coaching a team of players with different roles and skills. Linemen rarely make touchdowns, but they protect the players who do. So, if some channels increasingly get used as showrooms while purchases get made elsewhere, the showrooms need to be rewarded. Becoming omni-channel is not easy for retailers.[2] It's even harder for suppliers to build a team, integrating not within one organization but across many independent ones.

1.2.3 Data

The third change relates to the type of data that technology has made available, some owned by suppliers, some by their channel partners, and some (actually, a lot!) by third parties. The data are coming in at an accelerating pace of data volume, timeliness, and richness. Figure 1.2 shows some of the changes in data availability that are directly relevant to the management of distribution channels.

The bar code scanner, and more powerful, cheaper, and smaller computers, took us from tracking quarterly shipments and inventories to knowing daily store movement of individual SKUs; from self-reported diaries to scanner and home-scan panels; and from counting loyalty points to capturing and using detailed purchase data from program members. Then came computer cookies, clickstream data on what consumers do in the virtual world, followed

[2] We recommend a good look at the 2015 special issue of the *Journal of Retailing,* co-edited by Peter Verhoef, P.K. Kannan, and Jeff Inman.

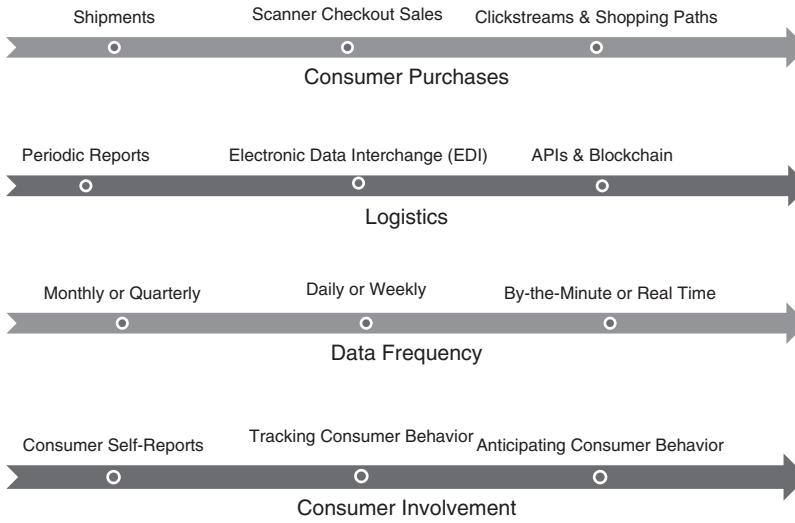

Figure 1.2 The progression of data available in the channel, 1970–2018.

by mobile IDs and GPS technology that allow us to also pinpoint where consumers are in the physical world. Mobile technology lets the consumer compare retail prices in real time and order instantly from whichever channel she chooses. But it has also reestablished the importance of physical location, redefined convenience and in-store visibility, and increased the reach, in both space and time, of savvy marketers. Avi Goldfarb wrote, "the internet killed distance; mobile brought it back,"[ii] and David Bell, after documenting several ways in which physical location influences online behavior, argued: "location is still everything."[iii]

Although the integration of offline and online data is not nearly seamless yet, we are farther along than we were even a couple of years ago. Sophisticated software and the ability to analyze big and not-so-big data now allow us to profile consumers, anticipate what they will buy next, and tailor not just prices but assortment, presentation, and messaging in real time. We used to think of artificial intelligence in the context of autonomous cars and robots, but platforms like Amazon and Alibaba are using AI to predict what consumers might be interested in and to offer them more precise search results and recommendations for products and content.[iv] They are in a uniquely advantageous position to integrate information about consumers from a whole range of activities, including product search, purchases, payments, social media activity, and newsfeed

and other content consumption—a near-omniscience that no single supplier or retailer can match.

Other technologies, such as RFIDs, QR codes, and now Blockchain, make it possible to track information up and down the distribution value chain, ranging from the source of our Chicken McNuggets, to the conditions a product was exposed to during transportation, to the shopping path a consumer takes in a store, to whether the item she buys came from a regular shelf or a special display. Sensors in malls and stores track shoppers' movements, building flowcharts of their shopping paths and heat maps of the areas and products they spend more time with, enabling marketers to make improvements in store layout, employee deployment, and more, in real time.

All of these are making more data available faster to evaluate programs and decisions and, as Google's ex-VP of Consumer Solutions Jim Lecinski likes to say, "data beats opinion." Which parties in the channel ecosystem have what data, how effectively they use the data, and how much of it they share with their partners, is impacting power positions, negotiations, and all terms of trade, ranging from product assortment and shelf placement to logistics and pricing.

1.2.4 Regulation

The final set of changes consists of legal and regulatory shifts. Channel practices that used to be illegal per se are now under the more lenient *rule of reason* (only prohibiting actions that unreasonably restrain trade). Most notable is Minimum Resale Price Maintenance (minimum RPM), which came under the rule of reason with the 2007 U.S. Supreme Court's decision in Leegin Creative Leather Products, Inc. v. PSKS, Inc.[3] At the same time as RPM opportunities have increased, however, some promotional practices such as loyalty discounts and bundled discounts have come under increased scrutiny for their exclusionary and predatory potential.[v]

The variation in regulations across geographic regions—not just different countries but also different states within the U.S.—makes it more challenging for both suppliers and their channel members

[3]However, minimum RPM remains in flux: Maryland passed its own law in 2009 enacting the illegality per se of minimum RPM, and other states, such as California, New York, and Kansas, took the position that the Supreme Court decision does not affect their own state laws. As a result, suppliers did not rush to take advantage of the opportunities for price control. But that may change as they continue to grapple with showrooming and price erosion online.

to manage distribution. Uber faces varying degrees of regulatory opposition state by state and country by country in its bid to be treated as a digital service and not a transportation service. Tesla fights similar battles against individual state franchise laws in its efforts to sell cars directly to consumers in the U.S.

According to some economists, the tenets of economic theory used in antitrust have to be modified for multi-sided platform businesses. The most commonly cited example is pricing below marginal cost: it's traditionally viewed with suspicion by competition authorities, but can be fully consistent with efficiency for a platform, who may price below marginal cost for one set of customers because it can reap the benefits from increased demand by another set of customers. For example, Open Table charges restaurants for bookings made on its site but doesn't charge consumers anything, even giving them reward points that can be redeemed at restaurants in the Open Table system. The nature of interdependent demand can be asymmetric or competition can have different effects on two sides of a platform, potentially reducing prices on one side and increasing them on the other.[vi] But there are several other aspects to the economics of platforms, and antitrust perspectives are still in flux.[vii]

New business models also pose challenges as regulators figure out what functions the new intermediaries perform and how they should be viewed. For example, it's unclear whether Uber's drivers should be treated as independent contractors or employees—a question that will have major implications for its profitability. In a related vein, it may be unclear whether some new intermediaries, such as travel aggregator Booking.com, are independent distributors or agents—an important distinction when it comes to antitrust regulations.

As new and different intermediary models evolve, the services that the intermediaries provide, the costs and risks they incur, and the ways in which they are compensated, are becoming increasingly important, not just from a channel management perspective, but from a legal and antitrust perspective as well.

1.3 THE ROAD AHEAD

This book is about developing, executing, and adapting distribution strategy, and managing channel conflict and power in the new channel ecosystem. Our goal is to provide an analytically grounded and metrics-based approach to channel management in a time of change. How will we get there? Well, before we can manage something, we need to have a clear mental model of how it works. So, we use Part I

of the book (Chapters 2–6) to introduce an organizing framework for how suppliers work together with their channel partners; impart a clear understanding of the fundamental causes of conflict in today's channels; lay out a map of the intermediaries in the new channel ecosystem and their functions; and explain the sources, indicators, and outcomes of power in the channel. Part II (Chapters 7–12) is devoted to the metrics, tools, and frameworks that can help a supplier select the right type and intensity of physical and online distribution coverage. In Part III (Chapters 13–16) we discuss the strategies related to product line, channel pricing, and promotional incentives that can be used, in the lingo of economists, to "coordinate" the channel and manage ongoing conflict.

ENDNOTES

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ii. Goldfarb, A. (2013). The Internet Killed Distance, Mobile Brought it Back. *MIT Technology Review* 117 (1): 62–63.

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vi. Federal Trade Commission (2009). Policy Roundtable on Two-Sided Markets (4 June).

vii. Here are a couple of recent reviews and perspectives: Evans, D. S., and Schmalensee, R. (2015). The antitrust analysis of multisided platform businesses. In: *The Oxford Handbook of International Antitrust Economics,* vol. 1 (eds. R. D. Blair and D. D. Sokol), 404–449. Oxford: Oxford University Press.

viii. Katz, M. (2019). Platform Economics and Antitrust Enforcement: A Little Knowledge is a Dangerous Thing. *Journal of Economics and Management Strategy* 28: 138–152.

ix. Melamed, D.A. and Nicolas, P. (2019). The Misguided Assault on the Consumer Welfare Standard in the Age of Platform Markets. *Review of Industrial Organization* 54 (4): 741–774.