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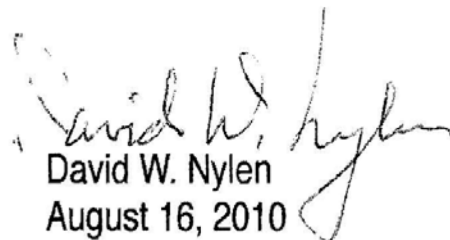

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August 16, 2010

SECTION A: CONCEPTS FOR SITUATION ANALYSIS

A.1 Competitive Market Structure

MARKET STRUCTURE CLASSIFICATIONS

Competitive market structure describes the competitive conditions within a market and provides insight into the nature and degree of rivalry to be expected within that market. Competitive market structure is one of the **environmental variables** that influences product markets (see GLOSSARY entry A.4). It is usually analyzed as a part of the **situation analysis** to provide decision-making information for marketing strategy formulation.

Origin of the Concept. The concept of competitive market structure stems from the microeconomic theory of the firm. Early microeconomists assumed only one market structure, that of pure competition, but as economies and economics matured, there was recognition that forms of imperfect competition existed and that these resulted in different forms of competitive behavior. The primary purpose of economists in describing the forms of competition in the marketplace was to enable them to predict the price setting behavior of the firm. While marketers are still interested in the impact of market structure on pricing, the concept of competitive market structure also provides useful guidance in setting other marketing strategy variables.

Four Market Structures. Economists identify four market structures: pure competition, monopolistic competition, oligopoly, and monopoly. It is best to view these four structures not as discrete classes, but as part of a continuum or scale with pure competition on the most competitive end and monopoly on the least competitive end as shown below in Figure A.1–1.

In order to apply the concept of competitive market structure, the marketer needs to determine which of the four market classifications best describes the industry in which the firm's product competes.

- *Pure Competition.* Under **pure competition,** the market is one in which there are a large number of buyers and sellers, so many that no one competitor can influence price. The product sold is the same for all competitors. In marketers' terms, the product is undifferentiated. Both buyers and sellers are assumed to have perfect information about prices and products. There is no collusion between either buyers or sellers and no government interference with the freedom of the market. Both entry into and exit from the market are unhindered. The individual firm under pure competition has a perfectly elastic demand curve, which means that at the market price, the firm can sell any amount that it wishes, but at a price above the market it can sell none. (See GLOSSARY entry A.14 on **price elasticity.**)
- *Monopoly.* At the opposite end of the continuum from pure competition is monopoly. In **monopoly,** the supply of a good, for which there is no close substitute, is controlled by a single firm. In the pure case, there is no regulatory interference, there are substantial barriers to entry into the market, and the buyers of the product do not have equivalent monopoly power. The demand curve of the monopolist is the same as the industry demand curve since the monopolist is the only supplier. Its elasticity characteristics will be largely determined by the closeness of available substitute products.
- *Monopolistic Competition.* Under **monopolistic competition,** the structure closest to pure competition, several of the requirements of pure competition are relaxed. There are still many

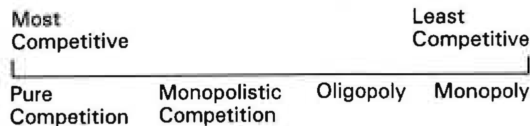

FIGURE A.1–1

The Range of Competitive Market Structure

small buyers and sellers, but products are differentiated. The demand curve of the individual firm under monopolistic competition demonstrates some inelasticity because the differentiation of the product makes competitive products less acceptable as substitutes. The greater the differentiation, the greater the inelasticity of demand.

- *Oligopoly.* In the broad range between monopolistic competition and monopoly lies **oligopoly,** a market structure in which there are only a few sellers of a good which may or may not be differentiated. Because of the small number of sellers, the actions of one competitor can create changes in the marketplace and are likely to stimulate reactions on the part of competitors. Oligopolists are highly sensitive to competitive changes in any marketing variable, especially price. As a result, the individual oligopoly perceives its demand curve to be "kinked," with an elastic segment above the prevailing price and an inelastic segment below. Competitors are perceived to be highly sensitive to price changes, fearing the outbreak of a price war. Hence, the oligopolist perceives that any price reduction will immediately generate competitive retaliation resulting in little or no market share gain and that a price increase may not be copied by competitors, resulting in large market share losses.

Identifying Market Structures. Having defined an industry or product class for analysis, it is relatively easy to approximate where it lies on the market structure scale. Examples of pure competition are rare; the most often cited examples are agricultural commodities. However, there are other product classes with many competitors where product differentiation has largely disappeared, often through copying, with the result that they have many of the characteristics of pure competition. Monopolies, likewise, are rare and most of them are regulated. Public utilities are an example. Some firms have gained near monopolies through patents, copyrights, or secret processes. Polaroid's instant photography is an example.

However, the vast majority of cases fall between these two extremes and most of these cases, especially in developed economies like that of the United States, are oligopolies. Oligopolies can be identified by examining two questions: (1) Are there only a few major competitors in the geographic market? (2) Do the individual firms react to the pricing and other marketing moves of competitors? In national and international markets, automobiles, television sets, and detergents would be examples of oligopolies. However, even on a local level, such small businesses as barbershops, bookstores, and fast-food restaurants might be considered oligopolies because of the small number of competitors in their trading areas.

Degree of Competitiveness. One purpose in identifying market structure as a part of the situation analysis is to permit an estimation of the degree of competitiveness the marketer will face. The market structure scale shown in Figure 1 provides a general estimate of competitiveness, with the pure competition end representing the most competitive situation and the monopoly end the least. Pure competition is most competitive since the individual firm has no market control and thus little control over its own destiny. Monopoly is the opposite case with monopolistic competition and oligopoly representing steps in increasing market control.

Since so many markets are classified as oligopolies, it is often useful to go beyond this simple classification to examine the underlying factors that determine the degree of competitiveness within oligopolies. Porter has identified five underlying structural factors that govern the competitiveness of an industry.[1] These are (1) the threat of new entries into the industry, (2) the bargaining power of buyers, (3) the threat of substitute products or services, (4) the bargaining power of suppliers, and (5) the level of rivalry among existing firms in the industry. Examination of these factors is termed **structural analysis** and should take place as a part

[1]Michael F. Porter, *Competitive Strategy* (New York: The Free Press, 1980), chap. 1, or Michael F. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* (March–April 1979), pp. 137–45.

of the situation analysis to further define the competitiveness of the industry.

APPLICATION OF THE COMPETITIVE MARKET STRUCTURE CONCEPT

Determination of market structure and the degree of competitiveness are processes that are normally carried out as part of the **situation analysis** (see GLOSSARY entry A.17) or as part of the analysis for a specific marketing problem. As Oxenfeldt and Moore have pointed out, this orientation to competition is not incompatible with the consumer orientation recommended by the **marketing concept** (see GLOSSARY entry A.9). The two orientations are compatible and should be combined.[2]

Use in Forming Product Marketing Strategy. Understanding the market structure of a product class can be used to both predict competitive marketing approaches and guide formulation of the marketing strategy for the firm's own product. Competitive market structure acts as a constraint to which marketing strategy must adjust. These constraints are outlined by market structure class below.

- *Pure Competition.* The most undesirable situation in which a product can find itself is pure competition, for in this case the market rather than the marketer has complete control. The result is that there can be no marketing strategy for the product. The product is a homogeneous one offered to the total market at whatever price the market dictates. Competition limits profits to the market-dictated return on invested capital. There is no product promotion because no available funds are available for it and because with a homogeneous product there is nothing to promote. The marketer caught in this highly competitive situation must bend every effort to move the product to a more controlled situation. The principle tools used in doing so are **market segmentation** (GLOSSARY entry B.3) and development of a differentiated **marketing mix** (GLOSSARY entry C.16). If this cannot be accomplished, another alternative, of course, is **product elimination** (GLOSSARY entry C.26).
- *Monopolistic Competition.* The first step in escaping pure competition and gaining some market control is by monopolistic competition. If through segmentation and differentiation of the marketing mix the product gains this slightly less competitive class, there is need for a marketing strategy. The marketer should focus on a segment of choice and every effort should be made to maintain and enhance the differentiation of the offering. Since the demand curve will now demonstrate some inelasticity, higher prices should be possible, thus improving profits beyond the subsistence level. Promotion should be possible and will be essential to communicate the product's advantages to the target segment.
- *Oligopoly.* As a product class matures and enters the mature stage of the **product life cycle,** weaker products tend to be forced out of the market (see GLOSSARY entry A.15). The stronger products gain market share until, in some cases, only a few producers are left and the market tends toward oligopoly. In the progression from monopolistic competition to oligopoly, marketing strategies must change to reflect the increasing sensitivity of marketers to their competitors. Market segmentation continues to be important, but as oligopolists grow, they should consider introducing line extensions or additional products, selecting additional target markets as a means of building volume and extending market control (see GLOSSARY entry B.4). The emphasis in the marketing mix should also change to avoid destructive pricing actions. Marketers should be cautious in initiating downward price moves that could spark retaliation and a destructive downward spiral of prices (GLOSSARY entries C.23, C.21). Price rises may be attempted on a trial basis to see if competitors will follow. The temptation for collusive pricing is greatest in this situation and must be avoided (GLOSSARY entry D.2). Instead of pricing action, oligopolists may elect to focus efforts on other elements of the marketing mix that are less threatening. Distribution should be intensified and product improvement efforts should be continued even though product enhancements tend to be quickly copied. Promotion

[2]Alfred R. Oxenfeldt and William L. Moore, "Customer or Competitor: Which Guidelines for Marketing?" *Management Review* 67 (August 1978), pp. 43–48.

tends to become very intensive, often focusing on relatively narrow product differences and short-term **sales promotions.**

- *Monopoly.* If firms gain monopoly or near monopoly power for a product, their marketing strategy again tends to change. Rather than segment the market, the marketer should direct the product offering to the total market since there is little or no competition. Product varieties can be offered to enlarge the market. The monopolist has the freedom to price in order to maximize profits, but in most cases some constraints on pricing will be felt. These constraints may dictate moderate prices designed to enlarge the total market and discourage both competitive entry attempts and regulatory intervention. The marketing mix should stress enlargement of the total market with promotion used to attract new users, distribution should intensify, and product development should generate additional product varieties. There should also be strenuous product development efforts aimed at extending the monopoly power through new and protected products or additional geographic coverage.

Use in Strategic Market Planning. **Strategic market planning** is concerned with setting the direction for major business units in the firm rather than for individual products. (See GLOSSARY entry A.20.) Understanding the competitive market structure in which the business unit operates is an important determinant of the strategic direction of that unit.

Strategic market planners must decide which businesses the firm should enter, which they should exit, and what level of resources should be committed to each existing business. Knowledge of competitive market structure allows the marketer to select less competitive markets for entry and for support.

In planning for the firm's existing business units, marketing strategies are developed that move businesses from the highly competitive to the less competitive end of the market structure scale. Knowledge of the structural factors governing the competitiveness of the market gives powerful guidance to structuring a marketing strategy that moves the business toward more protected and, hence, more profitable sectors of the market. Studies that link increased profitability to larger market share also encourage the marketer to move toward the oligopoly/monopoly end of the competitiveness scale where individual firms enjoy larger market shares.[3]

SUGGESTIONS FOR FURTHER READING

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[3]Robert D. Buzzell, Bradley T. Gale, and Ralph G. M. Sultan, "Market Share—A Key to Profitability," *Harvard Business Review* (January–February 1975), pp. 97–106.