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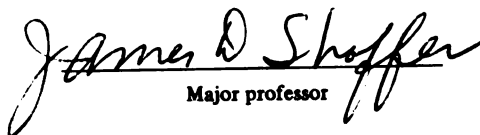
Food Distributor Procurement Practices:
Their Implications for Food System
Structure and Coordination

presented by

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FOOD DISTRIBUTOR PROCUREMENT PRACTICES: THEIR
IMPLICATIONS FOR FOOD SYSTEM STRUCTURE AND COORDINATION

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By

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ABSTRACT

FOOD DISTRIBUTOR PROCUREMENT PRACTICES: THEIR IMPLICATIONS FOR FOOD SYSTEM STRUCTURE AND COORDINATION

By

Larry G. Hamm

This research 1) describes procurement practices of food manufacturers and retailers for processed fruits and vegetables, 2) analyzes the economic impacts of procurement practices on the structure and vertical coordination of the United States food system and 3) assesses the implications for producer groups, formation of public policy and future research. The research was undertaken in part in response to the frequent question--why are fluctuations in farm prices so poorly reflected in retail prices?

The analytical approach used for this research was comprised of an expanded structure, conduct, and performance framework generalized to analyze vertical subsectors. Because grocery procurement takes place within large and complex firms, concepts from theories of firm organization and behavior were included in the framework. Particular emphasis was given to standard operating procedures (SOPs) as units of enumeration and analysis.

Personal interviews were conducted with 80 buyers and sellers of canned and frozen fruits and vegetables. The interviews were controlled to reflect the existence of brand and private label products; geographic dispersion of production; and differences between canned and frozen products.

Procurement procedures of retailers were identified for selection of new items, procurement of existing products and decisions to eliminate products. The two most important criteria used in the selection, retention and elimination decisions by retailers for brand products were consumer advertising and retail trade promotions given to the products.

For retailers, distributor (private label) product procurement is more complicated than procurement of brand labels. Retailers need to specify, buy and market private label products. This research documented procedures retailers develop to 1) design product specifications and labels; 2) monitor product quality; 3) assure a constant supply of the product; 4) establish wholesale prices; 5) coordinate transportation of these products; and 6) obtain lists of suppliers. Also analyzed was food retailer vertical integration, the trend toward generic food products, and different procurement practices between canned and frozen products and between agricultural (commodity) and manufactured products. Retailers make distinctions between commodity items and manufactured products since commodity-based products are composed of a raw product which can vary in price and quality. Often changes in value occur after the commodity item has been produced causing increased risk for retailers and processors.

Basic retail merchandising practices work equally well for brand and private label products and they can greatly influence product sales. Brand manufacturers who use consumer advertising and the resources of field personnel get differential access to the marketing power of retailers. Commodity products require demand adjusting merchandising actions by retailers to coordinate their subsectors.

When the SOPs for procurement of brand labels, distributor labels, and retailer merchandising are combined and their dynamic interactions analyzed, several significant vertical coordination and structural implications were identified. Part of the historically observed price-quantity cycles in commodity subsectors are a function of retailer controlled vertical coordination consequences. Private label processors bear nearly all of the costs of those consequences because brand manufacturers are abandoning their commodity products. Because of procurement and merchandising SOPs, commodity items lose out in the competition for retail shelf space reducing the market for these products and limiting the variety available to consumer. Contemporary coordination practices have induced grower bargaining; enhanced the movement toward formation of processing cooperatives; and increased the importance of marketing orders and grower-sponsored advertising.

Current retailer SOPs are simultaneously causing increased concentration in the brand manufacturing and distributor label processing segments of the food system. Future structural configuration of the food distribution system will be determined by the changing power relationships between manufacturers and retailers.

Dedicated to my wife, Sue.

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I would like to thank Professor James Shaffer, my academic and research supervisor for his guidance. His insights, patience and perseverance are embedded in this research and my education. Professor Donald J. Ricks with his continual support, effort and friendship assured the completion of this project. I would also like to thank Professor John Allen for giving me the opportunity to teach his course and share his expertise and industry contacts. Professor Bruce Allen also provided input at critical stages of the project.

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Producing a final version of a manuscript this size is a formidable task. It could not have been done without the technical support of many people. Ms. Sandra Gross was a patient and tenacious editor. Ms. Lois Pierson typed the final text and Ms. Sherrie Tiefenthal assisted in preparing the final tables and footnotes. Over the course of the research, preliminary drafts and interview transcripts had to be prepared. Special thanks goes to Debbie Andrews, Karen James, Cheryl Foster, Sherry McKenzie, and Kathy Reed for their help.

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CHAPTER 1

INTRODUCTION

1.1 A Not-So-Modern Problem

At a recent meeting on food system policy, at which distinguished agricultural economists periodically gather to ponder broader research and policy issues facing the profession, Don Parlberg indicated that during his eight years as close advisor to the Secretary of Agriculture and Director of Agricultural Economics, the most persistent question raised was "Why is it that when farm prices change, prices of food do not change?" He felt that of all the questions he was asked, the answer he had to give to this one was the least satisfactory. This research attempts to bring greater understanding to this phenomenon.

Dr. Parlberg's concern is not new. Ever since the turn of the century when raw agricultural products began to be processed in significant commercial quantities producers have questioned the lagged response of processed product prices to raw product prices. With the development of mass distribution of food through chain stores in the late 1920s, these producer concerns increased. In fact, one of the first nonlegislative projects of the fledgling National Association of Food Chains (NAFC) was to develop a grower-to-retailer communication link whereby commodities in excess supply at the farm level could be merchandised and sold. With much fanfare, citrus and canned fruit crop

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sales were coordinated between farm/processed and retail levels. Within a decade, this retailer sponsored program gradually disappeared.

During the 1950s and 1960s, the complexity of the food system grew as the number of transactions between the farm gate and the final consumer increased. Yet in every commodity price cycle, the same charge was leveled at the distribution system; when farm prices fall, retail prices do not. Although growers were concerned when farm prices fell, they were less concerned about the observation that when farm prices rose, retail prices did not rise as fast.

Professional agricultural economists soon developed a standard answer for the growers' question: that is, prices do adjust but there is a lag both on the up and down side of the cycle. Much professional attention was directed at developing sophisticated mathematical approximations of these lags. These efforts were aimed at providing price analysts and market modelers with more accurate forecasting and prediction tools. Little attention, however, was given by agricultural economists to why these lags exist. The standard response was "it's just a transaction cost of the system." As these incongruous price patterns continued and the lags increased in some commodity subsectors, several agricultural economists began to express concern about the consequences of inflexible prices in the food system. They argued, quite correctly, that price changes at the farm level were necessary to help balance supply and demand. If prices were not adjusted in the system, this information flow would be short circuited. The likely consequences would be that both consumers and producers would receive and act on improper economic signals. The end result would be that the affected commodity subsectors would have ineffective coordination conditions.

These economists argued that to understand the vertical coordination process it is necessary to understand how and why these lags in food price response occur. This research is dedicated to starting to answer these not-so-modern questions.

1.2 Some Research Postulates

Food distributor buyers occupy a privileged position in the food system as they stand at a pivotal informational conjunction. The procurement practices of these food distributor buyers were used as the unit of analysis for this research which will be guided by a set of research postulates. These postulates are as follows:

Postulate 1. The detailed study and analysis of food distributor procurement practices will provide useful insights into the operation and performance of the United States Food Distribution System.

Postulate 2. It is possible to classify and categorize these procurement procedures.

Postulate 3. It is possible to describe and explain the Standard Operating Procedures (SOPs) used to procure food.

Postulate 4. Contemporary food distributor procurement SOPs are instrumental in the vertical coordination of commodity subsectors.

Postulate 5. Contemporary food distributor procurement practices have some significant impacts on food system organization and structure.

From the beginning, this research was intended to produce a base document which other food system researchers could consult for facts and understanding about the procurement behavior of the food retailing industry. Some of the intended users were consulted at the formulative stages of this research and revealed two broad lines of research interest. One group was primarily interested in the effects of procurement

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practices on vertical coordination (Postulate 4), while another was more concerned with the effects of procurement practices on food system structure (Postulate 5). In response to these interests the analysis of the effects of procurement practices on the food system will carry two distinct themes. Thus the research document will describe the existing procurement practices of food distributors, analyze the impacts of those practices on vertical coordination, analyze the impacts of these practices on food system organization.

1.3 Research Methodology

A rather basic research approach was used on conducting this descriptive analysis of food retailer procurement practices consisting of a comprehensive literature search and an extensive set of personal interviews with retailing and manufacturing personnel and executives.

The purpose of the literature search was to 1) establish the relevant position of this study with other economic and academic research done in the past, 2) provide a sufficient background in trade and industry research and literature to design the research so that it is concise enough to study effectively, yet broad enough to provide generally applicable results and conclusions, and 3) identify specific research issues raised by previous studies which can be wholly or partially addressed by this research. The first part of the literature search is discussed below. The discussion of the trade literature review and the development of the interview format and schedules is included in Chapter 3. The discussions of specific research issues identified by previous work are incorporated systematically in the body of the thesis. A complete outline of total research effort is contained in Chapter 2.

1.4 Food Retail Procurement Research in Perspective

1.4.1 Research into the Structure of Food Retailing

Traditionally, economists have viewed food retailing as an industry. Therefore economic analyses of food retailing have tended to view research and policy questions as horizontal, independent issues. The development of Industrial Organization Theory has resulted in a series of studies on the organization, behavior, and performance of the food system which are heavily weighted toward examination of the structural characteristics of food retailing and more recently, the structure-performance link in food retailing. A few aspects of these studies pertain to vertical organization. Willard F. Mueller and Leon Garoian in 1961 dedicated two chapters to vertical integration by food chains and distributors.¹ For the most part, their concern about vertical integration is the effect it has on potential entry into food retailing. Another vertical organization issue is the role played by the Robinson-Patman Act. Mueller and Garoian discuss this issue only briefly.²

Approximately at the same time, the Federal Trade Commission (FTC) conducted an economic inquiry into food marketing.³ Part 1 of this inquiry was directed at the food retailing industry. Again the main procurement-oriented concern was retailer integration. However, this study did go further into trying to document the extent of concentration in buying power held by major distributors selling their own private labels. Parts 2 and 3 of this report explore this aspect in much more detail for the specific frozen and canned fruits and vegetables.⁴

Most reviews of economic analysis of the food marketing system fall back on the benchmarks set by the work of the National Commission on

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Food Marketing. This study is no different. Technical Study No. 7, Organization and Competition in Food Retailing, deals with three specific procurement issues.⁵ Again the extent, motivations, and implications of retailer integration into food manufacturing were covered.⁶ The most complete analysis of the concentration of buying power by retailers was conducted and the basic conclusion is that buying concentration is much greater than selling concentration.⁷ This suggests that this study of procurement practices is vital to understanding organizational trends in the rest of the food system.

The final aspect of procurement covered by the Commission was a complete study of private (retailer as opposed to manufacturer) label practices of food distributors. Much of the detail of the study was reported in a Special Study by the Commission.⁸ Again the concern of the private label study was to describe the structure and operation of private label systems. Basic variables in private label systems include the percent of various products sold, price structure, and its use by various sizes and organizational forms of food distributors. There seems to be no mention of the procurement process or the implications of that process on system vertical coordination. The only aspect of the system researched was the extent of dual branding (buying brand and private label products from the same supplier) evidenced in retailer procurement.⁹

Structural research took a bit of a respite during the next ten years. Concern was directed toward the merger activity of the largest food chains. The next significant research made its stormy public debut in April 1977.¹⁰ The Joint Economic Committee Report was a detailed study of the relationship of retailing structural variables to pricing and profit performance of large chains in various markets. No part of

the study dealt with vertical relationships. However, the study did re-examine the relationship of brand and private label pricing.¹¹

The studies listed above are probably the best known "classic" research reports on food retailing. Buyer concentration, vertical integration, and private label-dual branding are the only areas addressed in past research which deal with vertical aspects of the food system. All of these are analyzed with a concern for their impact on the structure of food retailing and the resulting structure-performance relationship. There is little in these discussions as to the role of retailer conduct or behavior. This research attempts to bridge this gap by examining one key area of retailer behavior (procurement practices) and relating that behavior to food system structure and performance outcomes.

1.4.2 Research on the Theory and Practices of Food Retail Pricing and Operations

Past studies into food retail pricing and operations provide some help for designing a research methodology for this research. Perhaps the best and most complete study of the organization and operation of supermarkets was Bob Holdren's study in 1959¹² which consisted of two parts. First, it is a complete descriptive dissertation on the basic nature of food retailing including philosophies of price competition, nonprice competition, merchandising policies, and cost segmentation. Although dated, Holdren's basic observations still hold for today's supermarkets. Consequently, his work serves as a foundation for many of the observations made below.¹³

Secondly, Holdren's study develops the theory of the multiproduct retail unit,¹⁴ a theoretical formulation incorporating the behavioral characteristics of supermarkets he found in the first part of the study.

He concludes that observed behavior is not inconsistent with predicted behavior of an economically rational, profit-maximizing, multiproduct firm. There was however no empirical testing of the theoretical model. One basic problem to be overcome was the assumption of complete and perfect knowledge needed by firms in order to behave in the predicted manner.

Lee Preston's 1963 article addressed the problem of information directly.¹⁵ First, he examined the basic nature of food pricing by making the observation that retailers cannot possibly know all factors such as price elasticities and consumer demand functions. Therefore, in retail stores they adapt "rules of thumb" for making the everyday pricing decisions. Preston demonstrates that these rules of thumb are compatible with theoretically derived behavior. He then tested actual retail pricing behavior to see in fact whether these rules of thumb held. He concludes they did for the most part. However, there was still a large amount of unexplained variance in pricing behavior in the real world. Suggestions about the origins of this unexplained variation were inconclusive.¹⁶ What is important about this research is that it hypothesizes that managers use rules of thumb to make thousands of everyday pricing decisions. If this is a valid finding for retail pricing, might not a study of "rules of thumb" used in retail procurement be appropriate?¹⁷ The research reported here is formulated as a descriptive study to delineate procurement rules of thumb.

A later study by Paul Nelson and Preston was designed to test some of the theoretical conclusions reached by Preston,¹⁸ namely, what are the implications for market structure and prices of a variable-price merchandising study? Some important findings of this study are that

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there is not necessarily a short- or intermediate-term correspondence between consumer demand for individual food products and their prices. Also, the general pattern of retail price changes observed did not appear to be readily explained by changes in purchasing cost price.¹⁹ Therefore, retail food pricing of individual items is accounted for largely by diverse and independent managerial decision making by individual firms and stores in food markets. Thus, an understanding of the coordination process taking place in the food system requires an understanding of the internal workings of food retailers, for their reactions to demand changes and supply changes in the system are sifted and implemented.

1.4.3 Research Into the Vertical Coordination of the Food System

This research is envisioned as a component of the vertical organization work being done by North Central Region Research Project NC-117 on the Organization and Control of the United States Food System. Much of the vertical coordination research currently published has been authored by researchers affiliated with the project's Vertical Organization Subcommittee. The studies and concepts developed by Bruce Marion were instrumental in developing the conceptual framework used in this research.²⁰ The studies reported below share the common bond that the foci of analysis are vertical subsectors. They are reported to give the reader a feel for the relative distribution of research interest among the various organizational nodes within subsectors.

A base document on vertical coordination is the NC-117 monograph Coordination and Exchange in Agricultural Subsectors.²¹ The producer-first handler exchange arrangements of eight different commodities are examined. This analysis serves as a base document for subsequent

studies of coordination in entire subsectors. The studies of the dairy and egg subsectors have been published²² while several other subsector studies are in progress.²³ The Coordination and Exchange Monograph also has an extensive section dealing with vertical coordination mechanisms.²⁴ Thus in addition to subsector studies, researchers have concentrated on vertical coordination mechanisms and/or failures in those mechanisms. In an early study, Gerald Campbell and Marvin Hayenga investigated the coordination consequences arrangements in hog contracting and leasing.²⁵ Mahlon Lang investigated the effects of various bargaining rules on vertical coordination.²⁶ A recent symposium and corresponding monograph sponsored by NC-117 explored in depth the implications for various subsectors when the market price coordinating mechanisms begins to misrepresent the transactions in subsectors.²⁷

Vertical coordination studies tend to concentrate on the producer end of the food system since researchers are agricultural economists and most familiar with farm production data and practices. In addition, there are probably more available suitable data for analysis at the producer-first handler level. The impacts of organizational change in the food system have been felt by producers who are most vocal about its effects. Therefore, more public research support has tended to be available for studies of this type. Also, many agricultural products lose their unique identity as they are moved through the vertical processing and distribution system. Consequently, it becomes extremely difficult or inappropriate to trace individual commodities. In essence, the definition of a vertical subsector changes as the character of a commodity changes.

There have been a few attempts to study vertical coordination beyond the producer-first handler level. Joseph Uhl in his 1969 study tried to link market organization and vertical coordination in the fresh fruit and vegetable industry.²⁸ While this study attempted to encompass a whole subsector, it was limited to examining only one aspect of vertical system performance, namely farm price stability. The rich descriptive data presented tended to confirm important relationships between market organization and subsector performance, however, attempts to empirically measure these same relationships were less than successful. More recently Robert Boynton has used a similar descriptive analytical technique to investigate vertical coordination implications of dairy cooperatives "dealings" with proprietary milk handlers.²⁹ This study marks another attempt to expand the horizons of vertical coordination research.

In a search conducted to find food-retailer procurement studies which addressed vertical business relationships, three were found. None however investigate vertical coordination hypothesis. The latter 1950s saw some particularly significant evolutions in produce procurement practices. A USDA study investigated the trend of retail food chains to begin direct buying of produce.³⁰ It concludes that this trend would cause structural change in the wholesale produce industry and would most likely result in increased price instability.

Ten years later retail milk-procurement practices were in a state of flux. Food chain integration or contractual arrangements were having a significant affect on the fluid milk processing industry. A study documenting this trend, detailed that significant structural changes were taking place.³¹ No mention was made of vertical coordination variables.

The final study in this group was not one on procurement per se, but rather a development of a hypothesis of vertical organization. C. R. Handy and D. I. Padberg postulate the nature of vertical linkages between the processing and distribution industries.³² In this conceptualization, the large, well-organized, chain distributors form a loose vertical alliance with small- and medium-size processors, whereas, the large powerful manufacturer processors form an alliance with the small chain and independent distributor. The authors conclude that competition and thereby performance in the food distribution system must be viewed differently than the traditional Industrial Organization theory does. The policy norms of this study are consumer retail performance issues. No real coordination hypotheses are proposed or investigated. Because this dissertation analyzes both brand and private label procurement practices, it provides a good opportunity to re-examine some of the Handy-Padberg assumptions and conclusions.

1.5 The Need for a Procurement Practices Study

The cursory literature survey presented above indicates a paucity of academic research targeted at the food retailing industry. Moreover, what research is done tends to be structurally oriented. Concerns for vertical relationships are usually limited to questions of integration and buyer concentration.

Research attempts to explain and investigate the theoretical underpinnings of the pricing behavior of food retailers have been only partially successful. A greater understanding of the firm's internal organization characteristics which generate specific actions is needed. Empirical observations of actual firm behavior provide the basis for analysis.

Recently interest has developed in the theoretical and empirical investigations of coordination in vertical food subsectors. Since most research-to-date concentrates on coordination at the producer-first handler interface, the coordination process taking place between retailers and suppliers needs documentation to help facilitate "complete" subsector coordination studies.

This research was initiated to provide information about this aspect of vertical coordination process. The main emphasis will be to analyze the vertical coordination consequences of food retailer procurement. However, in keeping with previous research precedents, the structural consequences of retailer buying behavior to both food suppliers and retailers will also be analyzed.

1.6 The Organization of This Study

The remaining seven chapters of this study proceed as follows. Chapter 2 develops a framework for analyzing vertical coordination in the food system while Chapter 3 deals with a perspective and methodology. The first part briefly examines the organization of the food system for the purposes of identifying the basic economic forces and structural conditions affecting food retailers. The classification of procurement SOPs is developed from a brief description of the internal organization of food distributor organizations. Chapter 3 concludes with an explanation of data collection procedures and methodology.

Chapter 4 is an analytical description of brand grocery products and Chapter 5 follows a similar format to describe distributor label procurement practices. Chapter 6 is devoted almost entirely to merchandising of brand grocery products. This chapter is necessary to trace the

demand- and supply-adjustment process through the retail stores to consumers. Without this analysis, it is difficult to analyze vertical coordination consequences.

Chapter 7 contains the analysis of food distributor procurement and merchandising practices on food system structure and coordination. Included in this chapter are analyses of the probable impacts from selected policy proposals on the food distribution industries. Chapter 8 concludes with a summary of the results of the study and a few recommendations for future research.

CHAPTER 1

FOOTNOTES

¹Willard F. Mueller and Leon Garoian, Changes in Market Structure of Grocery Retailing (Madison: University of Wisconsin Press, 1961), pp. 68-114.

²Ibid., p. 145.

³Federal Trade Commission, Economic Inquiry Into Food Marketing, Part 1, Concentration and Integration in Retailing (Washington D.C.: U.S. Government Printing Office, 1960), pp. 251-303.

⁴Federal Trade Commission, Economic Inquiry Into Food Marketing, Part 2, The Frozen Fruit Juice and Vegetable Industry and Part 3, The Canned Fruit, Juice and Vegetable Industry (Washington, D.C.: U.S. Government Printing Office, 1965).

⁵National Commission on Food Marketing, Organization and Competition in Food Retailing, Technical Study No. 7 (Washington, D.C.: U.S. Government Printing Office, 1966).

⁶Ibid., pp. 59-74.

⁷Ibid., p. 74.

⁸National Commission of Food Marketing, Special Studies in Food Marketing, Private Label Products in Food Retailing, Technical Study No. 10 (Washington, D.C.: U.S. Government Printing Office, 1966), pp. 1-21.

⁹Ibid., pp. 47-56.

¹⁰U.S. Congress, Joint Economic Committee, The Profit and Price Performance of Leading Food Chains, 1970-74 (Washington, D.C.: U.S. Government Printing Office, 1977). For a shorter version with a few additional analyses see Bruce Marion, Willard F. Mueller, Ronald W. Cotterill, Frederick R. Geithman, and John R. Schmelzer "The Price and Profit Performance of Leading Food Chains," American Journal of Agricultural Economics 61 (August 1979): pp. 420-33.

¹¹U.S. Congress, Joint Economic Committee, The Profit and Price Performance of Leading Food Chains, 1970-74, pp. 67-70.

¹²Bob R. Holdren, The Structure of a Retail Market and the Market Behavior of Retail Units (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1959).

¹³This is particularly true for the formulation of the first parts of chapter 3.

¹⁴Ibid., pp. 134-153.

¹⁵Lee E. Preston, Profits, Competition, and Rules of Thumb in Retail Food Pricing (Berkeley: University of California, Institute of Business and Economic Research, 1963).

¹⁶Ibid., pp. 39-40.

¹⁷While rules of thumb for retail pricing are derivatives from demand theory, derived demand theory may be too far removed from reality to generate procurement rules of thumb. The theory used to generate procurement rules of thumb is addressed in sections 2.2 - 2.3. following.

¹⁸Paul E. Nelson and Lee E. Preston, Price Merchandising in Food Retailing: A Case Study (Berkeley: University of California, Institute of Business and Economic Research, 1966).

¹⁹This is the only mention of vertical price relationships found in these pricing studies. For a complete discussion see Nelson and Preston, pp. 85-93.

²⁰This area is covered extensively in Section 2.1 following.

²¹North Central Region Research Project 117 (N.C. Project 117) Coordination and Exchange in Agricultural Subsectors, Monograph 2 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1976), pp. 11-112.

²²Hugh L. Cook and others, The Dairy Subsector of American Agriculture Organization and Vertical Coordination, NC-117 Monograph 5 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1978) and Lee F. Schrader and others, The Egg Subsector of U.S. Agriculture: A Review of Organization and Performance, NC-117 Monograph 6 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1978).

²³Some of these include tart cherries, sweet corn, snap beans and peas, and beef.

²⁴N.C. Project 117, Coordination and Exchange in Agricultural Subsectors, pp. 123-195.

²⁵Gerald R. Campbell and Marvin L. Hayenga, Procurement Contracting and Sow Leading in Hog - Pork Subsector (East Lansing, Michigan: Michigan State University, Department of Agricultural Economics, 1973).

²⁶Mahlon G. Lang, "Vertical Coordination and Vertical Coordination Mechanisms: Analysis and Case Studies," NC-117 Working Paper No. 12, Research Division, College of Agriculture and Life Sciences, University of Wisconsin, Madison, 1977.

²⁷Marvin L. Hayenga, ed. Pricing Problems in the Food Industry (With Emphasis on Thin Markets), NC-117 Monograph 7 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1978).

²⁸Joseph N. Uhl, "Market Organization and Farm Price Stability in the Fresh Fruit and Vegetable Industry" (Ph.D. dissertation, Michigan State University, 1969).

²⁹Robert D. Boynton, "Performance of the U.S. Dairy Subsector as Affected by the Vertical Coordination Processes Between Cooperatives and Proprietary Handlers," (Ph. D. dissertation, Michigan State University, 1978).

³⁰William E. Folz and Alden C. Manchester, Chain Store Merchandising and Procurement Practices, Marketing Research No. 417, AMS, USDA, (Washington, D.C.: U.S. Government Printing Office, 1960) pp. 1-24.

³¹James W. Gruebele, Sheldon W. Williams, and Richard F. Fallert, "Impact of Food Chain Procurement Policies on the Fluid Milk Processing Industry," American Journal of Agricultural Economics, 52 (August 1970): 395-402.

³²C.R. Handy and D.I. Padberg, "A Model of Competitive Behavior in Food Industries," American Journal of Agricultural Economics, 53 (May 1971): 182-190.

³³A detailed discussion of the Handy-Padberg model is contained in section 7.11 following.

CHAPTER 2

A FRAMEWORK FOR THE ANALYSIS OF VERTICAL COORDINATION IN THE FOOD SYSTEM

This chapter outlines the development of the analytical framework used for this study. The object of the research is to examine the procurement procedures of food retailers in order to assess their effects on food system coordination and organization. The chapter commences with a brief discussion of the conceptual approaches to vertical systems analysis, including a characterization of the approach used in this project followed by a detailed discussion of the internal firms' decision making process. The object of this discussion is to generate research categories and variables to be used in examining the vertical coordination process. The next section presents the author's current understanding of vertical coordination. A summary of the conceptual framework to be used as the foundation for this study concludes the chapter.

2.1 Vertical Systems--Conceptual Approaches

The scope of a vertical coordination problem considered depends on the perimeters of the systems studied and issues involve the interests of two adjacent stages in one or more subsectors (i.e., coordination mechanisms). Vertical coordination concerns may also center on the flows of control and information among most, if not all, of the stages within specific subsectors. The germane concern here is with the food distribution system and specific subsectors in that system. Setting the bounds

or perimeters to vertical systems is, however, extremely difficult. This is especially true of vertical commodity subsectors when the identity of the products and firms is lost somewhere within the overall system. This is symptomatic of many food products as they enter the distribution channels.

Bruce Marion's formulation presented in Figure 2.1 provides a general paradigm with which to categorize and organize vertical coordination issues.¹

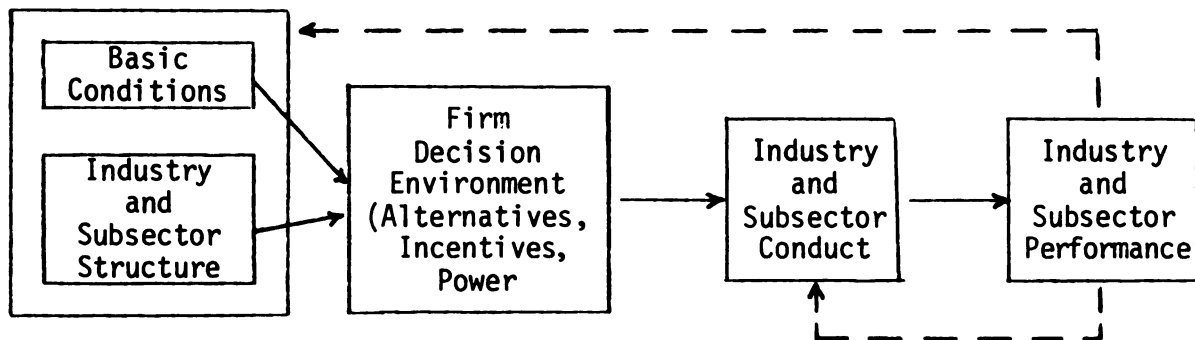


FIGURE 2.1 General Paradigm for Vertical Subsector Studies

By defining the industries involved in the subsector, the bounds begin to form. Eventually, a general description of subsector institutions, behavior, and performance arise. One such general description is provided by Marion.

Subsector institutional organizations include:

- Functional structure
 - Location, timing and clustering of functions
- Number of stages
- Number of parallel channels

Information system

Type of information (grades, market conditions, etc.)

Distribution

Cost

Structure of authority, right and control

Decision anatomy

Exchange institutions (auctions, buying stations, etc.)

Types of exchange (spot, contracts, typing agreements, etc.)

Risk sharing institutions and arrangements

Inter-stage differences (location, size of enterprise,
seasonality, production characteristics)Nature of assembly, sorting and synchronizing tasks²

Subsector structure is analogous to industrial structure as defined in conventional industrial organization. However, subsector structure is broader in that it includes those institutions which facilitate vertical interface and whose authorities transcend the boundaries of individual firms.

Basic conditions are likewise analogous to those used in conventional industrial organization theory--including the constraints imposed on the subsector from the economy and society at large. These constraints could include such factors as the general level of inflation, stabilization policy, induced interest rate levels, and trade policies fostered for domestic or foreign affairs.

When subsector institutions are characterized by complex organizational forms such as government program and large corporate bureaucracies, the internal structures and behavior of these organizations need to be studied. It is within these internal decision making structures that the economic forces generated by basic economic conditions and subsector structure are categorized, interpreted and acted upon. This internal firm decision making process is discussed in detail below in Section 2.2.

The actions taken and strategies adopted by the various firms coalesce to form subsector behavioral patterns. Many of these behavioral patterns can be categorized and therefore provide a taxonomy for studying subsector conduct including:

- Efforts to shift control
 - Type of exchange used
- Coordination activities
 - Prediction of future supply, demand, and price
 - Information communicated
 - Quality specification
 - Scheduling and timing synchronization
 - Efforts to influence inter-stage cooperation/conflict
- Process of determining terms of exchange (private treaty, administered, bid-offer-acceptance, etc.)
- Response to change forces

The subsector institutional organization combined with the subsector's behavior produce a set or combination of outcomes or results. One set of performance categories for a subsector might include the following:

- Allocative accuracy
 - Extent to which supply offerings match demand offerings
 - re: quantity, quality, timing and location
- Stability of output, prices and profit
- Technical and operational efficiency
 - At each stage and in linking stages (transaction costs)
- Equity distribution
 - Return vs. investments and risks
 - Rights and control vs. investments and risk
- Accuracy, adequacy, and equity of information distribution
- Subsector adaptability
- Level and type of employment
- Waste and spoilation
 - Product waste
 - Resource conservation
 - Capacity utilization

The preceding lists provide a fairly complete enumeration of basic subsector organization, behavior, and performance. As indicated in Figure 2.1, it is generally assumed that the direction of causal flow is firm decisions made within the constraints imposed by subsector organization. Basic subsector conditions produce the subsector behavior which, in turn, combines with subsector organization to produce the set of consequences or subsector performance. This is about the most detailed level of subsector analysis on which there is general agreement. When discussion begins on the fundamental origin and intensity of causal flows and the dynamic feedback links, consensus on the detailed formulation for subsector analysis disappears.

In the studies on vertical systems by various scholars coming from diverse disciplines, their approaches differ on problematic concerns and conceptual frameworks because of their differing backgrounds. The study of systems is a recent (10-15 years) academic concern and one generally accepted doctrine has not yet evolved. However, major streams of thought have carved some discernable conceptual approaches.

Since Marion has classified the various schools of thought,³ there seems to be no real need to modify his classification. Therefore, the following discussion is directly taken from Marion's work to provide the reader with an understanding of the origin of the basic concerns of this research.

Marion describes the first basic school of thought as the technological determinism school which concentrates on the design of systems from a logistics-production economics point of view. Adherents to this school tend to view changes in technology and technological efficiency as the engine driving structural and institutional change. Exogenous shocks

induced by new technology or changes in market size result in implementation of new technology or new plants which result in improved economic performance. In this process, the subsector may be restructured, which may lead to other behavior and performance consequences. This school frequently employs quantitative and mathematical models to determine the optimum number, size, and location of subsector entities. The theoretical foundations for this conceptual framework are grounded in basic neo-classical micro-economic theory. The area is indebted to such scholars as George Stigler, R. G. Bressler, and Ben French.⁴

Marion classifies the second main school of thought as behavioral which focuses on how the system functions with strong emphasis on conduct affecting inter-firm vertical relationships. There are several different approaches within this school. The approach of cybernetic feedback control looks at the microdynamic general systems simulation models which examine decision rules, delays, and decision points. The ultimate goal of these models is a matching of supply and demand. Jay Forrester typifies this approach.⁵

A somewhat more loosely defined behavioral school is the conflict-cooperation approach. Adherents to this approach are concerned with coordination, harmony, and conflict within vertical networks and forms.⁶ The writers are mainly faculty members of business schools. Ray Goldberg and Louis Stern concentrate on the inter-firm relationships⁷ whereas Richard Cyert and James March emphasize the intra-firm coordination process.⁸

The final behavioral oriented approach is the market failure concept developed by Oliver Williamson.⁹ While acknowledging that the system's structural factors are important, he sees the opportunistic behavior of

system's participants reacting to market failures, as the driving force behind subsector structural change, particularly vertical integration.

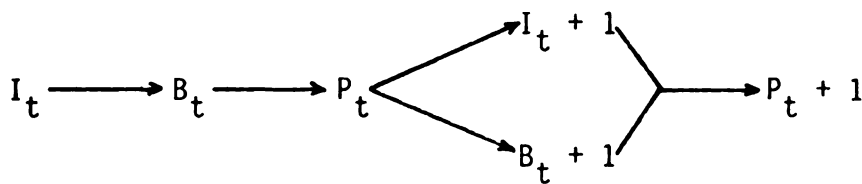
While all of the behavioral approaches to vertical systems recognize the importance of system structure, it is the conduct (reaction-feedback, cooperation-conflict, opportunistic behavior) of the system which dominates the analysis. This differs significantly from the emphasis of the third and final broad conceptual approach to vertical organization.

The institutional approach tends to emphasize the structure-performance relationships or, at the minimum, makes explicit mention of the role played by the institutional structure. As with the behavioral approach, there are several discernible variants in emphasis which are not necessarily independent or comparable with one another, market structure, legal-institutional, and coordination adaptation.

The market structure approach has been important recently and probably has a growing following. The relationships between vertical structure (vertical integration, tying agreements, conditions of entry) and performance are studied. Emphasis is usually placed on private institutional structure. Closely akin to the market structure, yet distinct, is the legal-institutional emphasis which examines the role of public and legal institutions as they relate to the performance of private institutions. The distribution of rights and returns is of particular concern. The market structure-legal institutional approaches overlap in the economics of anti-trust.

The other institutional area of emphasis characterized by Marion as the coordination-adaptation approach, attempts to understand how the structure and the coordination within the system affect system performance and evolutionary adaptation of the system over time. Considerable

attention is placed on understanding the relationship of structure to coordinating behavior and structure and coordination to system performance. The conduct or behavior of the system helps to condition the system institutions which, in turn, helps shape future system coordination and performance. Thus while the institutional structure-performance relationship is of ultimate importance, the approach studies coordination and adaptation as a vehicle to delineate the institution-performance relationships. Schematically, the coordination adaptation approach might appear as follows (I, B, P represents Institutions, Behavior, and Performance respectively).¹⁰



One unique feature of this approach is that it tends to be inclusive; entire subsector systems are the focus of the analysis. The performance array studied is very broad and defined to include not only desirable outputs but also the feedback consequences on subsector institutions and behaviors. To make studies manageable, emphasis is often placed on the implications of vertical coordination within more narrowly defined subsectors.

As stated earlier in this discussion, understanding the approach taken by the researcher helps explain why certain relationships and variables are chosen as objects of analysis. This research develops from the coordination-adaptation approach to analysis of vertical systems. Therefore, the fundamental area of interest in this research is the vertical coordination of food subsectors. Specifically, how does the

internal decision-making framework of individual firms affect vertical coordination and therefore, food subsector performance.

2.2 Firms' Decision Making

Indeed, I anticipate that measures of internal organizational structure will eventually be joined with measures of market structure in attempting to explain conduct and performance in industrial markets and subdivisions thereof.¹¹

This section and subsequent analysis is designed to join internal firm decision theory to broader institutional and behavioral forces. The conceptual framework postulated above (See Figure 2.1) assigns a critical role to the firm decision environment and process. Firms' decisions act like the bottom of a funnel. The fundamental economic conditions and subsector structure interact. Firms interpret, classify, condense, and act. A flow of firms' decisions are made which in the aggregate produce subsector behavior and ultimately performance. A theory of firm decision making thus must deal with this condensation process and the preceding goal formation process. In fact, the choice or decision process is often rather routine and automatic once the preconditions are met.

A study of the firm decision process can, therefore, take two related yet distinct approaches. The first is how the firm interacts and adapts to basic economic-sociological-political conditions and how it shapes and is shaped by the industry institutional structure. The second is to examine the decision process proper and research the implications of the firms' decisions. This study is oriented toward this latter approach although two aspects of the former approach are also germane to this study. The structure of the firm's decision process weights the various decisions made. Knowledge of the decision structure

is also necessary to predict the firm's behavioral responses to changes in basic environmental factors of the firm of industry structure.

With this cursory background, this section develops as follows. First, a theory of the firm is presented and discussed in light of the need to study the relationship of decision making to vertical coordination. Second, a brief analysis of the dynamics of the decision process is presented--designed to help toward developing predictive ability. Finally, the first two parts of the chapter are summarized in such a way as to emphasize the relevant aspects of the dynamic decision theory particularly relevant for examining the impact of food retailer procurement on food system coordination.

2.2.1 A Theory of Firms' Behavior

The basic parameters of research usually define what is an appropriate theory. For the problem at hand, the theoretical framework should be able to encompass the following conditions. For the most part, firms are large and handle thousands of products. Thus the decision-making process is fragmented within the bureaucracy of firms. Firm ownership and control may be separated. Therefore, the theory must allow for multiple goals. Since firms operate in an imperfect and uncertain world, the theoretical framework should recognize and handle uncertainty. Finally, as firm decision making is behavioral, the theory should handle behavioral relationships as the center of the analysis--not by assumption.

It is hoped that the framework provided by Cyert and March in their book A Behavioral Theory of the Firm is adaptable to this task.¹² They postulate a theory based on empirical observations of large, multiproduct

firms operating under uncertainty in imperfect markets. The discussion which proceeds follows their theory emphasizing certain aspects appropriate for this research. In doing so, a concerted attempt will be made not to cause misunderstanding or misinterpretation of their ideas. Much of their theory deals with evolutionary and dynamic relationships. Since the concern is to aggregate variables, those elements of the theory which interface with a firm's environment are stressed more than those aspects of the theory which explain the internal decision processes of the firm.

A theory performs two major tasks. First, a theory provides a set of general concepts where variables observed in the system can be assigned an appropriate niche. Cyert and March employ a trilogy of categories (organizational goals, expectations, and choice) to classify firm behavior. Second, a theory makes statements about the critical relationships which explain the interaction and evaluation of system variables.

2.2.2 Some General Concepts

The set of organizational goals is the first general concept in the Cyert and March framework. The goals of an organization are derived from the ambiguous preference set of the "organizational mind," and are the set of achievements which the organization prefers. There are two sets of variables affecting the goals of an organization. The first set affects the dimensions of the goals. What things are viewed as important by the organization are influenced by the coalitions forged by participants, the division of labor in decision making, and the definition of the problems facing the organization. Goals change as participants leave and enter the organization and as the organization faces different

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problems. The operational goals for any particular decision are the goals of the subunit charged with making that decision.

The second set of influences affect the aspiration level on any particular goal dimension, the aspiration level being a weighted function of the organization's past goal and past performance, and the past performance of other "comparable" organizations.

The unidimensional goal economists frequently assume for firms is profit maximization. For the modern large bureaucratic firms, other conscious goals are also present such as sales growth, increasing market share, long-term survival of the firms, and industry innovation leader. Which of these goals predominate and are operationalized in a particular firm or organization are dependent on the factors described above. With different organizations there will be different goal sets depending upon the basic organizational coalition in power within the organization. The relative strengths of various departments are manifested in the setting and ordering of goals. Given these factors, it should be possible to aggregate industry behavior if the various goals of the firms involved are relatively homogeneous across firms. Individual firms therefore, would tend to operationalize these goals in similar ways. The aggregation process will therefore probably be independent of the individual organization goal ordering process.

The second major concept in the Cyert and March formulation is organizational expectations which are drawn from available information, especially the organization's monitoring of its recent performance and environment. Thus, the process by which information is made available to the organization is critical to understanding its behavior and the evaluation of its goals and procedures. Expectations and aspirations are

closely related. The dynamic evolution of firms' behavior is dependent upon the formation process of organizational expectation.

The final general concept and the one with the most relevance to this research is the concept of organizational choice. Namely, how do firms make decisions? Decisions take place in response to problems and are made by using standard rules and procedures. Only if the proposed solution is acceptable to the relevant group and subgroup goals, will that solution be acceptable.

Three classes of variables affect organizational choice. First, all those variables which influence the definition of the problem, in essence, determine the parameters within which choice will be made. Second, the factors which influence and/or alter the standard decision rules change the choices made. Third, given limited time and resources, those forces which shape the agenda determine which decisions get made.

2.2.3 Standard Operating Procedures

The most significant choice variables explaining organizational behavior are what Cyert and March call standard operating procedures (SOPs). Sometimes called rules of thumb, SOPs are fairly well-defined rules which determine firms' behavior in response to short-run feedback from its environment. Business firms are constrained by the uncertainty of their environment, the problems of maintaining viable intrafirm coalitions, and the limitations on their capacity as a system for assembling, storing, and using information. There is no way for the firm to be omnisciently rational as assumed by conventional economic theory.¹³ Rather, firms are adaptively rational--that is rational in that they use

standard decision rules to solve short-run problems. In response to problem solving, the organization adapts and evolves.

Cyert and March postulate three basic principles of organizational choice. First, firms avoid uncertainty. Second, they maintain their decision rules; abandoning them only under duress. Finally, the rules (SOPs) adopted tend to be simple. "Individual judgement" or lists of "considerations" are used to modify the basic simple rules. Thus, SOPs would be expected to be fairly stable over time, comprehensible to informed laymen, and amenable to classification.

One general classification scheme developed by Cyert and March, is presented here to provide a background on which to view the subset of SOPs being studied in this research. Four major types of standard operating procedures are used to make decisions in organizations. One deals with task performance rules, two deal with handling information, and the others are concerned with organization planning.

Task performance rules are the operating procedures firms use to produce their intermediate and final production and provide two important organizational requirements. Simple standard rules allow for coordination of internal processes within the firm and provide a system for transferring past organizational experience to new employees and situations. Task performance rules originate from three sources: past procedures of the organization; procedures and rules introduced through recruitment and selection from other organizations and institutions; and a great many rules more general than the specific firm identified as a more pervasive code, called "standard industry practice," "standard business practice," "ethical business practice," or "good business practice." Outside participants can, over time, have significant influence

on the task SOPs of firms. Trade associations and consulting groups provide the communication and legitimation of practices which then become industry practice. In the longer run, universities may affect organizations via their training programs.

Function is one way of subdividing task performance rules. There are sales, merchandising, procurement, and warehousing SOPs. Of primary interest to this research are the standard operating procedures for food retailer procurement tasks. Often these are interrelated with other task rules. Merchandising SOPs are closely related to procurement SOPs. Understanding retail firms' behavior may require a familiarity with both procurement and merchandising SOPs and how they interact.

Another general type of standard operating procedures are those dealing with records and reports internal to the firm used for control and prediction. These types of SOPs are more broadly based in the organization than are most of the task rules. The records kept define what is important and what types of variables are examined regularly. Participants in the organization tend to judge their performance in light of the kinds of records kept and such records influence the organization's reactions to its environment.

A general type of SOPs very similar to that above are those dealing with reports and records which monitor internal firm performance. The information handling rules are more concerned with transmitting non-organization generated knowledge. The information handling SOPs prescribe what information is taken into the firm and how it is condensed and distributed, how internally generated questions and responses are transmitted, and what kinds of information leave the firm. Information handling rules have routing and filtering functions. Routing of

information is essential: Even if information exists, it may not be used if the relevant division or person does not receive it. Information filtering in the organization tends to be biased: Sales departments bias sales estimates, accounting departments bias costs, etc. Internally the organization over time tends to adjust for such biases, however, external participants may not be aware of the biases. The information handling SOPs of organizations which transmit knowledge to external sources are absolutely crucial to the subsequent performance of external entities.

Information handling SOPs (for both internal and external participants) are intimately related to procurement SOPs. Those aspects of information handling important to procurement are identified and analyzed along with procurement SOPs because of the critical role played by information in the vertical coordination process (See Section 2.1.1).

The standard operating procedures also deal with firms' plans and planning rules. Plans serve as goals, schedules, theories, and precedents. As long as the operationalized results of a plan are achieved, plans become standard simple rules to be followed in succeeding years. Thus understanding of planning SOPs provides clues to composition of current operating procedures and an eye toward predicting future short-term organization behavior.

Large-scale bureaucratic firms have interdependent and interrelated goals, perceptions, and choices. The relevant variables interact and affect one another. Yet, the outside world is more aware of an organization's choices and/or decisions. Given a relatively stable environment, it would be possible to catalog the standard decision-making procedures. In addition if there is some degree of homogeneity in firms'

organizations, goals, and perceptions, it would then be possible to derive aggregated industry SOPs. If however, there is a desire to alter industry behavior to achieve a different performance in the system, it is necessary to understand how goals, expectations, and choices are related to each other.

2.2.4 Relational Concepts

Cyert and March complete their Behavioral Theory of the Firm with four major relational concepts. When observing firm behavior over time, they noticed certain types of general reactions by firms which are ubiquitous; the forces which determine the evolution of the firm through time. Understanding them leads to a better explanation of present behavior and criteria for predicting short-term organization adaptation.

Organizations consist of coalitions, the members of which often have competing goals. Normally, it is assumed that a system for resolving conflicts exists (bribes, side payments, etc.). However, in many organizations, there is much latent conflict which is only partially resolved. One relational concept is the quasi-resolution of internal firm conflict. The implication of which is that satiation of independent, locally rational goals results in decision solutions which leave excess resources in the organization. The existence of this organizational slack allows the organization to function in spite of latent conflict.

Uncertainty is a feature of organizational decision making with which organizations must live. Much academic attention has focused on dealing with procedures for finding certainty equivalents (e.g., expected value) or introducing rules for living with the uncertainties (e.g., game theory). Cyert and March observe that modern firms do neither of these,

rather they attempt to avoid uncertainty, by concentrating on decision rules emphasizing short-run reaction to short-run feedback rather than developing long-run strategies for dealing with long-run uncertainty. They also avoid uncertainty by negotiating with their environment, organizations imposing plans, SOPs, industry tradition, and uncertainty-absorbing contracts on the environment.

In short, they achieve a reasonably manageable decision situation by avoiding planning where plans depend on predictions of uncertain future events and by emphasizing planning where the plans can be made self-confirming through some control device.¹⁴

Another rational concept deals with how firms look for solutions to problems. It is argued that organizations use acceptable-level goals (as opposed to unknowable optimum-level goals) and select the first alternative they see that meets those goals. Search is stimulated by a problem and is halted by an acceptable solution. This probabilist search process is motivated by a problem. It is simple-minded in that it proceeds on the basis of a simple model of causality until forced to a more complex one. Finally, search is biased. Solutions are biased by the training and experience of the various parts of the organization reflecting the various hopes, expectations, and information communicated in the organization.

As a consequence of conflict resolution, avoiding uncertainty and using acceptable-level goals, organizations learn, adapting and evolving over time. Adaptation occurs in their goals, in their attention to what is important, and in their decision and search rules. The rate of adaptation is determined by the rate and magnitude of changes taking place in the firm's environment, and the process is biased and myopic.

The preceding discussion of Cyert's and March's A Behavioral Theory of the Firm is not doubt brief to a fault. Within their basic conceptual and relational framework, there are many subdivisions and classifications of variables and phenomena which were ignored. Emphasis is placed on those elements of their theory which appear most relevant for designing this research. The application of some of their concepts will necessarily be out of context. It is therefore, imperative to remember their basic general theory, a formulation intended to explain and predict the behavior of a firm. Aggregating concepts over many firms is beyond the original intent of their theory. Any unproductive results from the aggregating process should not cast asperations on their theory.

2.2.5 Toward an Evolutionary Theory

The preceding theoretic formulation should be of value in describing and explaining the origins of a specific firm's behavior. Often prediction of future behavior is desirable. Predictive ability requires that dynamic evolutionary components be added to be above conceptual framework. The addition proposed is the basic concept of behavioral psychology (i.e., operant reinforcement). B. F. Skinner developed the concept that when organisms are stimulated, they respond to that stimulus, and then are reinforced by the consequences of their response.¹⁵ The pattern of reinforcement to response thus shapes and alters the behavior of organisms over time. The costs or consequences incurred in response to stimulus are the contingencies of reinforcement faced by the organism. By extrapolating this concept to social and private institutions, dynamic and evolutionary components can be added to institutional theory. Extrapolation must be used with caution. The patterns of reinforcement

become more complex and unwieldy as the order of organism (institutions) rises. Thus the precision and accuracy of prediction is affected. In addition, the length of the recognition and reaction to reinforcement may become temporarily protracted which also affects the precision of prediction. Despite these limitations, operant reinforcement principles seem to be useful for at least hypothesizing the effects of policy-induced stimuli on the evolution of institutions. This theory is particularly germane to two aspects of the Behavioral Theory of the Firm as applied to the retailer-procurement problem.

First, is the dynamic evolution of the firm over time. Firms set goals upon which they make decisions, goals which are the conscious management of the contingencies of reinforcement facing the firm. How well the managed reinforcement pattern dovetails with the exogenously generated contingencies of reinforcement facing a firm's behavior determines whether or not the firm survives. How the firm adapts to incongruity between the two sets of reinforcers determines the evolution of the firm over time.

The second important application of Skinnerean reinforcement to the Behavioral Theory of the Firm is much more micro in scope, dealing with the behavior of individuals within the firm. The response of any given firm's employee to a given stimulus will depend on the pattern of reinforcement encountered by him/her. This pattern of reinforcement is a product of the task performance rules given to the employee, conditioned by the implicit constraints erected by the need for maintaining functional coalitions within the firm. In order to predict (or at least hypothesize) how individual buyers would react to changing market and institutional conditions, knowledge of buyers' reinforcement patterns is

imperative. These two aspects interact when firms change decision rules to react to a changing environment and this causes the pattern of rewards or penalties for individuals within the firm to change.

The above formulation is rather elementary and simplistic. Since Cyert and March, conceptualization of and research into organizational behavior has blossomed into a sizeable segment of interest by business schools. In addition, the early 1970s produced a lot of interest in the industrial buying process.¹⁶ The literature in these areas was extensive, but as it was somewhat tangential to this study, it was not reviewed in any detail.

2.2.6 Application to This Research

The major concern of this research is the effects retailer procurement has on vertical coordination. Thus specific elements of the Theory are particularly germane to this study including a firm's goal composition, a firm's choice via standard operating procedures, classification of those SOPs, and analysis of the origins and evolution of those relevant SOPs.

Successful (noncontorted) aggregation can lead to aggregated choice procedures. Aggregated industry-wide standard operating procedures provide an important link between subsector structure and subsector conduct. The subset of choice SOPs dealing with procurement highlighted in this study includes a comprehensive description of their detail, an analysis of their origins within the internal structure of the firm, and their evolution over time. The evolution is examined in light of changes in the reward and incentive patterns facing those charged with executing procurement SOPs.

All the above is a prelude to the main themes of this research; that is, an analysis of procurement practices on vertical coordination and food system organization. The next section explores one view of vertical coordination with the goal of providing a blueprint for this analysis.

2.3 Vertical Coordination as a Process

As currently viewed by the author, vertical coordination is the composite behavior of vertical systems and is the conduct of the individual economic agents in the system which combines to produce a discernable flow of actions which link the institutional structure to vertical system performance. As such, vertical coordination is a process or set of processes by which the production and marketing decisions of various subsector participants are harmonized with other decisions made upstream and downstream in the vertical channel.

Some aspects of coordination (vertical subsector conduct) have been enumerated including coordinating activities such as communicating information, scheduling and timing synchronization, predicting supply and demand, determining terms of trade, responding to change forces, shifting or resource control, and assigning of system functions. Many other types of coordinating activities result when specific subsectors are studied. Most of the vertical coordination process can be classified under two broad, interdependent categories, information and control.

2.3.1 Information and Vertical Coordination

The essence of the coordination process is the embodying of information. Before discussing information, two points should be stated. First, discussing information as a category in and of itself does not in any way imply that information is independent of control. This arbitrary

breakdown is merely for analytical simplicity. Second, the discussion which follows is not and cannot be exhaustive. Whole disciplines have arisen to study the nature and significance of information.¹⁷ What is presented here is an attempt to classify the role of information in the vertical coordination process.

Information flow in the coordination process has several dimensions including its composition, completeness, accuracy, and timeliness. What is contained in the information is a function of the given subsector. However, there are some general components of information which are jointly determined and communicated such as the quantity of a given type of product. Another component is quality which can include size, color, maturity, nutritional and adulteration provisions. Price, that component of information composition of which most observers are aware, can take on several different functions depending upon how explicitly other components of information composition are made. Typically, price is to act as a signal to elicit a certain set of actions and as a reward (payment) for fulfillment of those desired actions. Price has definite meaning only when the other aspects such as quality and quantity, are explicitly or inexplicitly recognized. The trilogy of price, quantity, and quality, along with temporal and locational considerations, are the commonly recognized pieces of economic information communicated.

The information embodied in coordination carries other messages, however, and too often these messages are not explicitly examined. These messages, to be called the function assignment, includes instructions as to which stage and/or firm is to perform certain functions. These functions can be either those required for subsector functioning or a transfer of specific production activities to other stages or firms in the

subsector. In other words, who does what, using what techniques, at what costs, are all part of the composite information package which flows through vertical subsectors.

The second important dimension of information is its completeness. Incompleteness arises when the composition of the information does not include all the relevant components for proper coordination. Relevant information is often absent because it is unknown and has not been generated. Other times, however, information germane to coordination behavior exists but is impacted in the subsector. Impacted information may exist because of the processors of the information have no incentive to release or do not recognize the importance of that information to others. However, often the possession of information is a strategic advantage and thus valuable to its owner. Thus, information may be released or held without any consideration for the impact on the coordination problem and is one of the key aspects of control and vertical coordination.

A consideration of the third dimension of information, accuracy, closely parallels the discussion of completeness. Inaccuracy can arise from ignorance or design. Designed inaccuracy is often called strategic misrepresentation. Given that systematic application of strategic misrepresentation destroys its user's credibility, its use may not be commonplace. The ability to successfully supply strategically inaccurate information is another aspect of control. Since strategic misrepresentation destroys credibility, the control it generates is short lived. However, if the industry has a great deal of new entrants, or a large number of firms, strategic misrepresentation can be important over an extended period of time.

Information's fourth dimension is temporal. It is not enough that complete, accurate information exists. It must be transmitted at the proper time in order for the recipients to make the best use of it. Often failure to transmit information on time is a result of the incentive/reward structure of the subsector. Those possessing the information may not have any incentive to forward it at a time most useful to other subsector agents. As with other aspects of information, timing the release of information can be a strategic advantage one set of firms has over another.

Total information (i.e., perfect knowledge) can only theoretically exist. Nature produces stochastic variation which forecludes totally complete and accurate information. Strategic misrepresentation or impacted information also results in less than perfect information. Incomplete information is the genesis of uncertainty. Resources must, therefore, be committed to deal with uncertainty and may be in the calculation of certainty equivalents, purchase of insurance, or the acquisition of additional information.

The greater the uncertainty, the higher the resource expenditures needed to coordinate subsectors. Excessive uncertainty results in subsectors which devote large amounts of resources to dealing with uncertainty and, as a result, produce a smaller output than is possible with less uncertainty.

The study of vertical coordination then necessarily involves designing mechanisms to deal with uncertainty, identifying uncertainty caused by impacted information, and studying the effects on uncertainty of alternative rules affecting the ownership and control of information.

The factors discussed above are some of the critical researchable links between vertical subsector structure, vertical coordination, and subsector performance. Some other links involve the relationship between control and coordination.

2.3.2 Control and Vertical Coordination

Some of the relationships between control and coordination have been hinted at above. Control has countless definitions. A useful one defines control as the ability to direct the flow of decisions. Control can be active or passive. Active control is the power to command that resources be allocated in some given manner while passive control is the ability not to accept a given decision or function. Both active and passive control are present in both horizontal and vertical control.

Although this research has been based on the premise that vertical control can exist independently of horizontal control, there is some disagreement on this point among theorists. If one acknowledges the existence of resource-using exchanges and vertical alignments which require different functions at different stages, the vertical power can arise independently of the horizontal power found at any specific stage. Proximity to or access to certain information may give one stage a differential advantage over another. For example, food retailers by virtue of their proximity to the final consumer may have a strategic advantage in knowledge of demand. Similarly, if the number of products produced exceeds the system's capacity to handle all these products, or if consumers are unable to process all the information available to them, retailers gain power from being the customers' buying agent. This power is independent of the horizontal power of individual retailers or chains.

In understanding vertical control, it is necessary to recognize the types of authority and decisions involved. Authority might be ownership, contract, traditional or sovereign. Decisions may be unilateral, bilateral, multifirm, or institutionally imposed. Because vertical systems require resource expenditures for information, communication, and coordination, influence over these expenditure requirements is the genesis of vertical power.

The origins and manifestation of horizontal control and power are well known. It is the economic power which economists are most concerned with. While the proposition discussed above was that vertical control is an entity in itself and thus in the abstract can exist independently of horizontal control, in reality, vertical and horizontal control often co-exist. Horizontal power generates the resources with which firms have some discretion. If they desire, they can affect vertical control by buying information, changing the rules, or even vertically integrating. Horizontal power affects vertical power by increasing the opportunities available to those firms which horizontal dominance. Thus, when vertical organization is examined in detail, those elements of the subsector with horizontal control tend to be highly visible in a vertical context.

As discussed above, information and control are the two basic dimensions of vertical coordination and they are interdependent. Simply stated, those with access to information usually have control which arises because decisions are made with information. He who shapes the distribution of information shapes the decision process.

There are several ways that control can be exercised through information. The party controlling information can strategically misrepresent

facts, usually a short-run strategy since misrepresenting facts destroys credibility and in the long run, the information supplied by that party is discounted. Another avenue for control via information is through strategically impacted information which may take several forms. The controlling firm may release only favorable information or information calculated to elicit the desired responses by the receiving parties or the timing of the release of information may be calculated to bring benefit to the controlling party. There is also the possibility of releasing different information to different firms. In the aggregate, this has the effect of creating market uncertainty because conflicting perceptions of reality will exist.

Control via information has still another dimension (i.e., the use of information to generate other information) which is often accomplished by playing one party off against another. A firm wishing to get a differential advantage on a rival may reveal information about that rival to the information controlling firm. The controlling firm in turn, uses that information to its advantage when dealing with the third firm.

Much of the above discussion about the conscious use of information to affect decisions has been conceptualized by Randall Barlett.¹⁸ When an assumption about the ubiquity of uncertainty is made in addition to the normal assumptions of self-interest motivated rational behavior, the deliberate management of information of control decisions is not only possible but economically advantageous. Williamson makes most of the above arguments concurrently in his latest book.¹⁹

Another important manifestation of control in vertical systems is who assigns or can assign resource-using functions which may be connected with the needs of the vertical commodity subsector or may result from the

needs of one horizontal industry/firm. As previously noted, markets are not costless; someone pays for the transactions. The distribution of the costs becomes an important economic variable. One assignment of rights, responsibilities, and risks might use less resources to perform these functions than another assignment. In that case, who does what becomes a germane policy issue.

Much of the subsector vertical responsibilities derive from the omnipresent supply-and-demand risks. Control in a vertical context often is passive (i.e., participants may have the power to elect not to bear risk and/or costs). Contingency commitments are often made which allow one segment of the system to pass on unforeseen consequences to another segment. Examples of this process at the producer, first-handler level, are reported by Mahlon Lang.²⁰ Further documentation of this aspect of control is needed as a precondition for judging sector performance.

The shifting of production responsibilities to another segment of the system is the manifestation of active control in vertical coordination. For example, processors have long been providing the storage of retailers' inventory of many products. Over time, the assignment of these types of functions become common business procedures. Therefore, their effects on overall system resource use and performance may not be questioned.

The last aspect of control in vertical subsectors discussed is the relationship between vertical control and horizontal industry, probably the most familiar of any of the aspects of vertical control since the importance on vertical systems of horizontal power is a debated topic among Industrial Organization theorists. Some scholars argue that in the

"perfect" world of competition or monopoly, vertical integration can, at worst, be neutral and, at best, beneficial to resource utilization.

Other Industrial Organization economists point out that those conclusions are inappropriate for a less-than-"perfect" world of monopolistic and oligopolistic firms.²¹ The effects of vertical integrations usually discussed are both structural and behavioral. The structural argument is that vertical integration results in market foreclosure and, therefore, raises entry barriers in the integrating industry. One effect of vertical integration on behavior is that "price squeezing strategies" become viable options. Another consequence for conduct is that vertical integration "rigidifies" certain exchanges which once had pricing flexibility which leads to adjustments in resource use.²²

Nearly all discussion of the effects of horizontal power on vertical organization has, however, focused on the performance consequences to the horizontal industries involved. The concern here is with the effect horizontal power has on vertical control and, therefore, on the vertical coordination process. One obvious observation is that coordination behavior seems to be different. This is evident when one compares coordination processes in grain and livestock subsectors versus those in fruit and vegetable subsectors. Although different coordinating arrangements and institutions exist in the different subsectors, the significance of these differences is yet to be discovered.²³

In summary, the fundamental proposition is that the vertical coordination process has a basic dimension of control. That is, the process involves the use of a transmission of rights and responsibilities through the vertical subsector. Significant control factors in the vertical coordination process include power over the generation, access, and

transmission of information; power over the assignment and distribution of risk and responsibilities; and power conferred from horizontal industry power. Information and control are dimensions of the aggregate conduct of vertical food systems. As such, they embody the behavioral forces generated by subsector institutions which lead to the aggregate set of outcomes known as system performances. Knowledge and evaluation of subsector performance is the basic research goal. Understanding how the vertical coordination process influences performance is a key to attaining that goal.

2.3.3 The Interface of Procurement SOPs and Vertical Coordination

Vertical coordination is a process analogous to a flow (i.e., a constant movement of economic influence). To analyze a flow it is necessary to examine the vehicles which carry the flow. The elements of vertical coordination identified in Section 2.1 above are just such vehicles. Procurement and merchandising SOPs are hypothesized to be instrumental to the coordination process. The following analysis concentrates on the impacts that food distributor SOPs have on the flow of vertical coordination consequences in the United States food system.

One set of coordination implications has to deal with the future structure and organization of the food processing and retailing industries, the recognition of which lead to another major theme for the analysis. Procurement SOPs were evaluated as to their direct effects on food system organization. Thus the combined impacts of procurement SOPs on coordination-induced structural change and the direct structural consequences was the second major analysis theme.

When applicable these analyses are interspersed with policy discussions. It is hypothesized that some SOPs may be the result of behavior different from that being assumed by policy makers. If that is the case, proposed policy actions may not automatically result in the outcomes predicted by decision makers. Some contemporary policy proposals are therefore analyzed simultaneously with the coordination and structural implications of food distributor SOPs.

CHAPTER 2

FOOTNOTES

¹Bruce Marion, "Applications of the Structure, Conduct Performance Paradigm to Subsector Analysis," NC-117 Working Paper No. 7, Research Division, College of Agriculture and Life Sciences University of Wisconsin, Madison, 1976.

²Ibid., p. 3.

³In addition to the above citation by Marion, earlier classification attempts include: Bruce Marion, "Vertical Systems Analysis and the Organization of Agriculture." ESO No. 121. (Columbus: Ohio State University, Department of Agricultural Economics and Rural Sociology, 1972) pp. 2-7, and "Vertical Coordination and Exchange Arrangements Concepts and Hypotheses" Coordination and Exchange in Agricultural Subsectors, NC 117 Monograph 2 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1976) pp. 184-88.

⁴A complete summary of the work done by this school is contained in Ben French, "An Analysis of Productive Efficiency in Agricultural Marketing--Models, Methods, and Progress," Part II A Survey of Agricultural Economics Literature, vol 1 (Minneapolis: University of Minnesota Press, 1977).

⁵Jay Forrester, Industrial Dynamics, (Cambridge, Mass.: MIT Press, 1961).

⁶For an example of an application of this approach, see B. Marion and H.B. Arthur, Dynamic Factors in Vertical Commodity Systems: A Case Study of the Broiler System, Research Bulletin 1065 (Wooster: Ohio Agricultural Research and Development Center, 1973) pp. 1-48.

⁷Ray A. Goldberg, Anti-business Coordination: A Systems Approach to the Wheat, Soybean, and Florida Orange Economics (Boston: Division of Research, Harvard Business School, 1968) and Louis W. Stern Distribution Channels: Behavioral Dimensions (Boston: Houghton-Mifflin Co., 1969).

⁸Richard M. Cyert, and James G. March, A Behavioral Theory of the Firm (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1963).

⁹Oliver E. Williamson, Market and Hierarchies: Analysis and Antitrust Implications (New York: The Free Press, 1975).

¹⁰Adapted from class notes of Professor James D. Shaffer. Agricultural Economics 809, Institutions Behavior and Performance, Michigan State University Fall 1976.

¹¹Williamson, Market and Hierarchies: Analysis and Antitrust Implications.

¹²Cyert and March, A Behavioral Theory of the Firm.

¹³This is the same problem discussed by Williamson, Markets and Hierarchies: Analysis and Antitrust Implications.

¹⁴Cyert and March, A Behavioral Theory of the Firm.

¹⁵A more recent discussion of Skinnerian reinforcement is in B.F. Skinner, About Behaviorism (New York: Alfred A. Knopf, 1974), 33-45, 167-88.

¹⁶For an example, see Frederick E. Webster, Jr., and Yoram Wind "A General Model for Understanding Organizational Buying Behavior" Journal of Marketing, 36 (April 1972): 12-19. This model is partially based on Cyert and March and reaches many of the same conclusions as to which forces drive buying behavior.

¹⁷Three classic articles linking economics and information include Armen A. Alchian and Harold Demsetz, "Production, Information Costs, and Economic Organization," The American Economic Review 4 (December 1972): 777-95; Kenneth J. Arrow, "Limited Knowledge and Economic Analysis," The American Economic Review (March 1974): 1-10; and Kenneth E. Boulding, "The Economics of Knowledge and the Knowledge of Economics," American Economic Review (May 1966): 1-13.

¹⁸Randall Bartlett, Economic Foundations of Political Power, (New York: The Free Press, 1973).

¹⁹Williamson, Markets and Hierarchies, Analysis and Antitrust Implications.

²⁰Mahlon Lang, "Collective Bargaining between Producers and Handlers of Fruits and Vegetables for Processing: Setting Laws, Alternative Rules, and Selected Consequences," (Ph.D. dissertation, Michigan State University, 1977).

²¹For a very succinct discussion of these arguments, see Peter Helmerger and Willard F. Mueller, "Vertical Integration Theory: Its Use in Researching the Organization and Control of Agriculture." Paper presented at meeting of North Central Technical Committee (NCT 105), Chicago, November 16-17, 1972.

²²For a complete discussion of the effects of integration, see Fredric M. Scherer, Industrial Market Structure and Economic Performance (Chicago: Rand McNally & Co., 1970).

²³One of the basic charges given the vertical organization subcommittee of the North Central Region Research Committee on "Who Will Control Agriculture?" is to investigate that relationship.

CHAPTER 3

FOOD SYSTEM ORGANIZATION: IMPLICATIONS FOR DESIGNING AND IMPLEMENTING A STUDY OF DISTRIBUTOR PROCUREMENT PRACTICES

3.1 Introduction

A brief review of the organization of the United States food system, food distributors, and the processed fruit and vegetable subsectors is presented here. The first section on food system organization attempts to provide an overall view of the vertical linkages within which coordination flows take place. This section is followed by a review of retail food distributors including discussions highlighting the internal structure of food retailers, reviewing food distributor ownership and control patterns, and describing distributor brand organizations. The third section explains the advantages and problems in selecting processed fruit and vegetable products to study the impacts of procurement procedures. A description of interview methodology and sample design concludes the chapter.

This chapter represents information gathered in the initial literature search of trade source materials. Aside from the examination of the academic research, much valuable information was absorbed and developed from the food retailing industry trade literature which included extensive use of the Super Market Institute's (SMI) library in Chicago, Illinois.¹ A thorough search of their files was made; all references to procurement were duly noted. Approximately thirty different journals and/or periodicals were reviewed. Most articles, however,

were contained in four leading periodicals. These included Supermarket News, Progressive Grocer, Chain Store Age (various editions) and Super-marketing. The Vice President of Research for SMI provided valuable suggestions and directions. Toward the end of this literature review, preparation for class work helped to gel and coordinate many of the thoughts presented below.²

The material presented below is intended to provide an overall perspective to food retailing organization and operation. As such, some may find the following discussions to be too brief. Also the general level of abstraction might be too contrived for some; especially close industry observers. However, I have endeavored to capture the essence of the food retailing functions without becoming too encumbered by detail.

3.2 An Overview of Food System Organization

The United States food distribution system is one of the most complex systems in the economy. Figure 3.1 is presented to help show where this study "fits" in the scheme of the food distribution system. Many actors and links have been ignored in this very simple diagram. More than one vertical stage may often be vertically integrated.

Consumers get food from several sources; one of which is grocery stores. Grocery, specialty (meat stores, bakeries, etc.), and convenience stores are usually considered the at-home food sector since food is purchased for further preparation and consumption at home. The restaurant and institutional segments of the food system are often referred to as the away-from-home food sector and is the faster growing, but smaller, sector. In 1979, American consumers spent an estimated \$268 billion on food (excluding alcoholic beverages). Of this amount, 75 percent (\$200

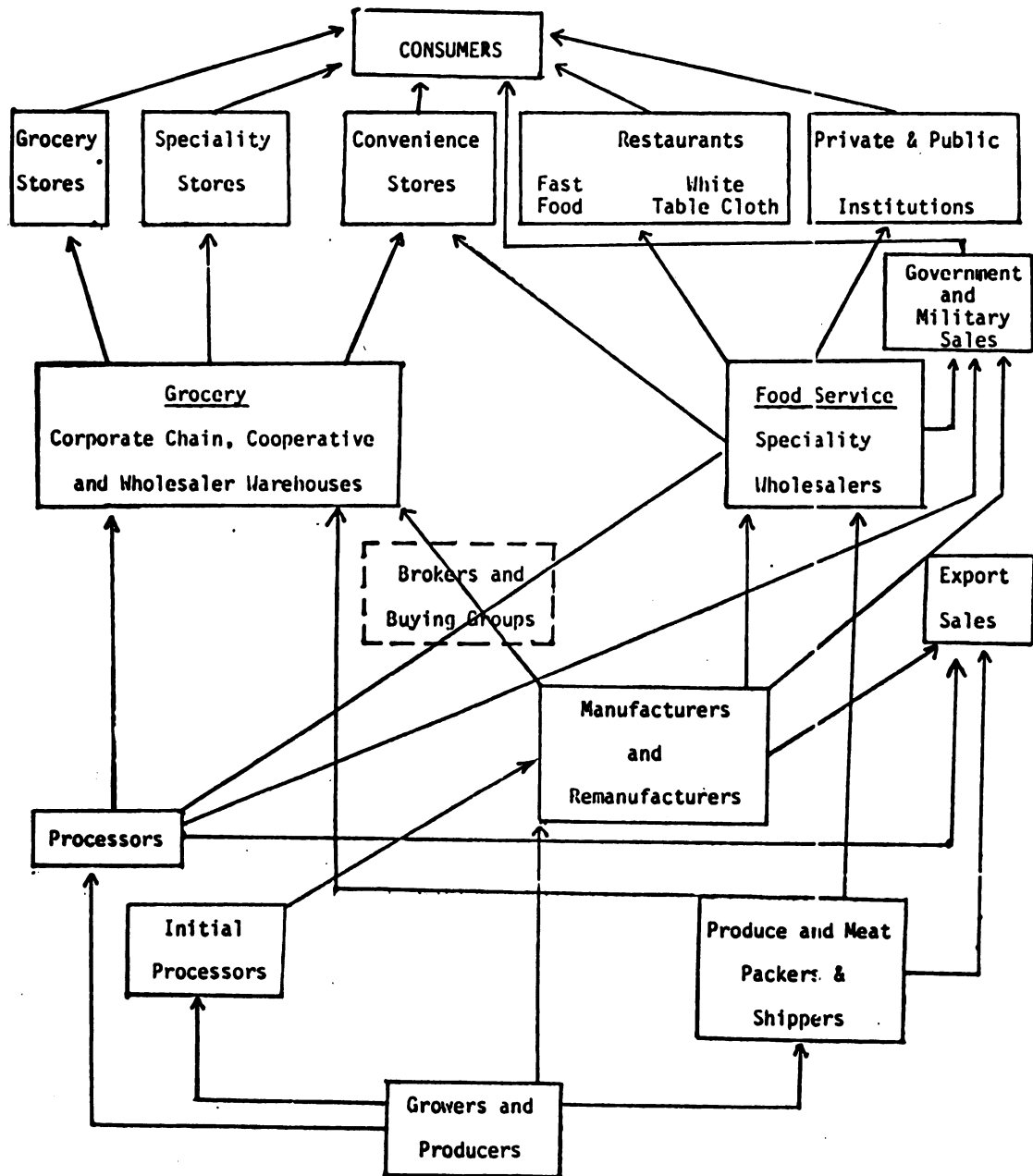


FIGURE 3.1--A Simplified Diagram of the Flow of Food Through the U.S. Food System

billion) was spent on food for use at home and 25 percent (\$68 billion) was spent for food eaten away from home.³ The vast majority (95 percent) of at-home food sector purchases are made in grocery stores or supermarkets.⁴ Therefore consumers perceptions about the performance of the United States food system are in a large part a direct function of their experiences and perceptions of the grocery store.

The wholesaling set of functions are closely linked to the grocery retailing functions. Grocery stores receive most of their products from warehouses which may be integrated directly via ownership, indirectly via cooperative or affiliated agreements, or independent. The retailer-wholesaler interface is discussed in more detail in Section 3.3.3 below. Wholesaling is often divided into two categories; general line wholesalers carrying a general assortment of products and specialty wholesalers with a very restricted product line. Often specialty wholesalers deal only in produce, meat, tobacco, liquor, or candy. In other instances specialty wholesalers concentrate their business efforts on limited outlets, like restaurants. Because of the products chosen for study, this research concentrates on general line warehouses for the grocery segment.

Grocery warehouses obtain their inventories from three basic sources: packer-shippers, manufacturers and processors. Produce or meat packers and shippers are first-handlers of those agricultural products which undergo relatively little change in form during their flow through the food system. Products which undergo substantial form change are produced by manufacturer-remanufacturers and processors.

The distinction between manufacturing and processing is critical for this study. Manufacturers take raw product or initially processed

ingredient food commodities and process it into different forms. Then marketing activities are added to the product, the most discussed being branding which involves design of labels and logos, advertising plans, and activities directed to the retail trade. Processors, on the other hand, only take raw products and/or basic ingredients and add value only by changing the form of the product. They add little in consumer or trade marketing efforts. Processors often sell to other firms which add these values. In processed fruit and vegetable subsectors these firms usually sell primarily retail distributor label products to food remanufacturers who buy processed products as ingredients for further formulated products.⁵

Conventional economic statistics such as the Standard Industrial Classification System (SIC Codes) obscure this processing-manufacturing distinction because they assume all firms who operate similar physical plants have similar production functions. In reality, manufacturers have much different "production" functions because they need to "produce" products and marketing services.

Figure 3.1 contains a dotted box entitled brokers and buying groups which are marketing extensions of manufacturers and processors (brokers) and procurement extensions of retailers (buying groups). The dotted line indicates that, for the most part, these firms and/or individuals do not take title to the products. They are agent middlemen and act as information and labor inputs to the food system. Manufacturers' own retail sales forces provide the same functions as do brand brokers.

This study in essence concentrates on the entities toward the left side of Figure 3.1 focusing on food retailers, their own or affiliated wholesaler supply networks, brokers, manufacturers, and processors.

3.3 Food Distributor Organizations

3.3.1 Some Possible Factors Affecting SOPs

According to the theory outlined in Chapter 2, specific task standard operating procedures are partially influenced by organizational factors in the firm and in the industry. This section examines three sets of organizational characteristics of food distribution which influence the definition and operation of procurement SOPs. These organizational characteristics provide one side of the matrix (Table 3.11) used to guide interview selections.

3.3.2 The Internal Organization of Food Retailers

The very basic organization of food retailing helps determine not only the SOPs, but the importance given to the various SOPs whenever conflicts arise. The interim store level and functional organization of food retailers arises directly from their basic economic goals.

A. Retailing Goals

The basic goal of food retailers is to make a profit. As with all other firms,

$$\text{Profit} = \text{Total Revenue} - \text{Cost of Goods} - \text{Fixed Cost} - \text{Operating Cost}.$$

Food retailers commonly think in terms of gross margins defined as follows:

$$\text{Gross Margin} = \text{Operating Costs} + \text{Fixed Costs} + \text{Profit}.$$

In the food system gross margins are the cost of the retailing function. Retailers typically assign relatively fixed gross margins to individual products and product groups. Profits are thus increased primarily by

1) increasing product sales volume through existing facilities and 2) holding operating costs to a minimum.

Food retailers not only sell food products but a package of retailing services. Each successful retailer differentiates his package of services so as to develop consumer loyalty and attract competitors' patrons. Retailing services have many components: product selection, display, and prices; convenient location; pleasant employees and short check-out lines; lighted and drained parking lots, cleanliness, interior lighting, decor, and music; fresh produce and meat. Not every consumer has the same demand for the same set of services and some of these components move in opposite directions. For example, food prices can be lowered by restricting product variety and other market services.

Retailers thus have an imprecise, highly complex set of procedures which they must manage in order to increase their profitability. The imprecision of their marketing and operational decisions produces a great deal of discretionary power over prices and movement of individual food items and even whole product categories. This study focuses on the embodiment of this discretionary power into SOPs and their implications.

B. Functional Organization of Food Retailing

Certain functions or jobs must be accomplished in order to deliver the food retailing "product" to the consumer. Irrespective of ownership and/or control of these functions, they still need to be executed.

Figure 3.2 is a very basic enumeration of the functions performed in food distribution which have been divided into the two broad categories of merchandising and operations. Operations is the management of the expenses or costs of doing business (excluding cost of goods) and thus,

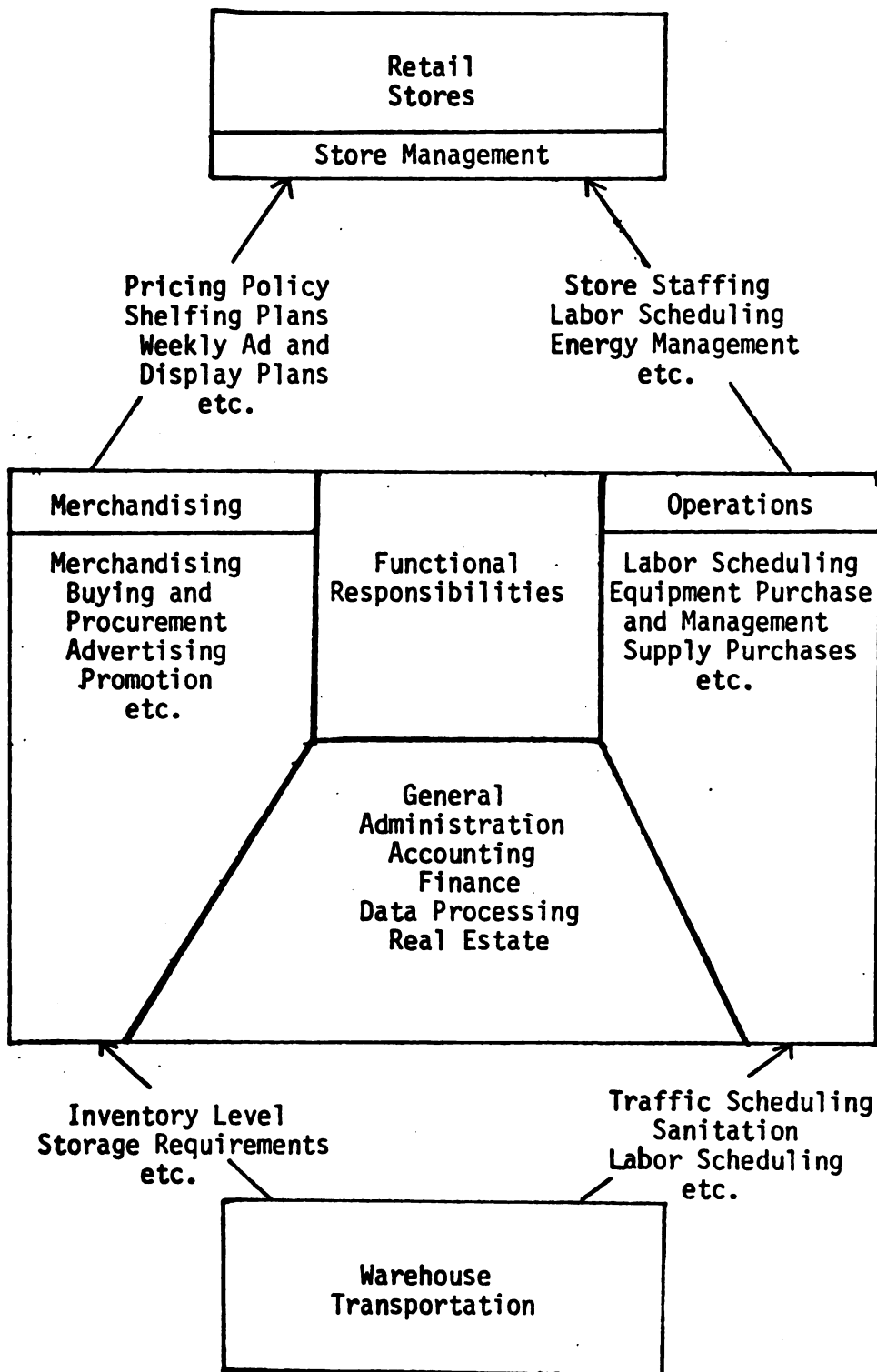


FIGURE 3.2--Functional Tasks and Responsibilities Needed in Retail Food Distribution

interfaces and reacts with every facet of food distribution. Figure 3.2 indicates some of the basic variables or concerns with which operations personnel deal. As would be expected, much of their emphasis is in cost control and labor management, especially labor scheduling at both stores and distribution centers.

Retailer merchandising has the two goals of generating customer movement to and through the stores and enticing those consumers to buy more of what the firm has to sell. Some of the more important functions merchandisers perform include directing the composition of the product line stocked, determining the pricing and gross margin strategies, directing store design and layout, and coordinating all promotion and advertising campaigns. They receive inputs and suggestions from the advertising, pricing, and buying units in these tasks. The flow of information and directives from the merchandising section and the operating section merge at the store level and the distribution level.

The possibility of conflicting directives and interests is evident. Often ideal merchandising conflicts with maximum cost efficiency. For example, the merchandiser might like elaborate end aisle displays with special pricing. This would require extra labor working over time which operations people interested in cost minimizing want to avoid.

Rather than resolving these conflicts on a daily basis, most firms have a simpler solution since one faction usually controls upper-level management positions. When senior level decision makers rise from operations, the organization has a cost-control operations orientation. The reverse is true when merchandising people control those decisions.⁶ As will become apparent in latter chapters, which faction controls the retail grocery firm plays an important role in vertical coordination.

A pivotal function in food distribution is buying or procurement. The buying process interfaces with nearly every other distribution function. Buyers are some of the largest users of data processing. The terms on which they buy profoundly shape the financing of the firm and the work priorities established within accounting departments; however, the impacts of buying performance are on the store services, merchandising, and the warehouse activities. If a buyer does not buy on time the store may run out of the product. If the buyer misses a "deal" or a new product, that firms' stores are at a competitive disadvantage compared to neighboring stores. If the buyer does not buy at the "right" price, his store's products may be uncompetitively priced. The buyer is the individual who generates deals and promotional offers which merchandisers use to develop their sales plans. An ineffective buyer will not provide the merchandiser with as large and/or "exciting" array of "deals." The way a buyer purchases can play havoc with a warehouse. A "really" good deal of five carloads of a product which only has a one carload slot in the warehouse inevitably puts the warehouse director and buyer at odds. Large purchases also increase inventory costs.

Buyers' actions affect other upstream and downstream retail functions. Conversely, system changes at retail, at processing/manufacturing, or at farm level can influence buyers behavioral patterns. It is the high degree of procurement functional interdependence which is critical in vertical coordination processes.

3.3.3 Ownership and Control Patterns in Food Retailing

A complicating factor in studying retail food distribution is that the various retailing functions (procurement, merchandising, wholesaling,

etc.) may not be executed within the same organization. There can be and are a multitudinal array of ownership and control patterns which direct various aspects of food distribution.

Different ownership forms imply different distributions of retail functions. The basic unit of the industry is the store which is either independent or part of a chain. A retail grocery chain incorporates within one organization all of the retail distribution functions. The size of the chain operation is important to some degree. Very small chains sometimes forego the buying and management of a private label program. Very large chains essentially conduct all the functions outlined in Figure 3.2 in each division and then link these semi-autonomous divisions via a national headquarters. The retail food chain is thus an organization which has integrated all distribution functions. Some large chains have also integrated some manufacturing functions.

The independent retail sector separates the ownership of distribution functions. The independent store usually is run by a store manager-owner. The owner-manager performs certain functions, while others are acquired by other means. How buying and wholesaling functions are acquired leads to the historical division of independent retailers into cooperative affiliates and wholesaler affiliates. Retail buying cooperatives are retailer-owned, cost-plus operations implemented to provide buying and warehousing services for the retail owner-member. Other retailers are affiliated with profit-seeking wholesalers to obtain buying and warehousing services. Buying these services gives independent operators some advantages, the greatest of which is that they have the option to change suppliers without divesting themselves of wholesaling and buying facilities.

Individual store owner-managers or management of small nonintegrated chains usually manage the store-level operation and merchandising. Typically, they schedule labor, control pricing and shelving policy, and plan ads and promotions. Most buying-wholesale organizations (both cooperative and wholesalers) provide custom services for their affiliated stores. These include accounting and record keeping, financing, real estate planning, supply and equipment purchases, advertising and promotion layouts, and merchandising suggestions. Normally any services generated by national and divisional headquarters for chain stores are usually available to affiliated independents via their buying-warehousing organizations. These usually are provided at cost in order to help the independent store to be competitive with the chain store.

Since most grocery chains operate their warehouses at cost and not as profit centers, other wholesalers and cooperatives are likewise required to run wholesale operations at very close to cost. An at-cost operation is no problem for cooperatives; however, it is for wholesalers who are not integrated into retailing. If wholesalers cannot make profits on warehousing and services provided, they must make it elsewhere. This is usually done via buying and transportation: Buyers and trucks can make a significant difference in their profits.

One would expect most grocery buyers to have similar standard operating procedures. However, insofar as the ownership and control of various distribution functions varies by the organizational form used, buyer behavior might be affected by organizational form. Organizational form was therefore a control variable for the interview design.

To summarize two important points must be examined. First, ownership and control are not necessarily synonymous. An independent owner

may run his store but not really control the majority of the operational and merchandising aspects of his store. Financial and informational ties to his supplier may have transferred much of his entrepreneurial authority to that organization. In the final analysis, the entity that maintains control in the food system is the one which controls distribution of products. Chains can force products into their stores. If an independent store owner does not have the authority to control which products are sent to his store and when, he does not have control of his store. The same logic applies to relationships between brokers and principals. Therefore, a critical variable to analyze when studying the food system is who is the "gatekeeper" for the flow of products. Second, merchandising is the selling function in food retailing. Procurement is the buying function. In food retailing the seller and buyer are usually not the same person. In addition, they are often separated by distance and organizational form. Control of each function may be in different firms. As will be seen, this is perhaps the key determinant of vertical coordination in the food system.

3.3.4 Food Distributor Brand Organizations

Food retailers sell products to which they add value. Some of those products, primarily dry grocery items, travel through the distribution channel with a consumer identity given by the manufacturer. Other products gain their identity from the retail outlet including fresh meat and produce items and processed products which carry the store or the distributor's name.

The brand identification process involves several other activities which add value. As such, procurement of private brands and marketing tends to be specialized. Consequently, specific procurement SOPs have

evolved in the private label system. This section enumerates and explains the types of organizations which have developed to procure and distribute private label products. The goal as with Section 3.3 above is to provide a logical set of categories for developing an interview sample.

A. Types of Private Label Organizations

Table 3.1 is a detailed summary of the five basic types of private label organizations. The first two, retail grocery chain and grocery distributors, are very similar, the only difference being the ownership of the warehousing function. Nearly all large chains have their private label procurement facilities located at one central location in corporate headquarters. While brand product procurement is often assigned to nearly autonomous units in division headquarters, private label products is usually purchased in only one location. This is also true for the very large cooperatives and wholesalers. Brand procurement may be spread among many divisions, but private label is centrally coordinated and controlled. Distribution of centrally purchased products however goes to the same divisional organizations as brand product shipments. The sophistication of chain and distributor private label programs varies by individual firm. However, larger firms tend to have larger capital and manpower investments and greater numbers of products and volume committed to private label products. Types 1 and 2 are considered the normal private label procurement arrangement by most casual observers of the food system. The other private label organizations are more complex.

Types 1 and 2 are applicable arrangements for firms that are large enough to support a private label organization. The minimum size firm to efficiently use its own in-house private label procurement system is

TABLE 3.1--A SUMMARY OF THE BASIC TYPES OF PRIVATE LABEL PROCUREMENT ORGANIZATIONS

<u>Type</u>	<u>Brief Description</u>	<u>Label Ownership</u>	<u>Label Distribution</u>	<u>Example</u>	<u>Comments</u>
1. Retail Grocery Chain	All facilities and employees are owned and paid for by the corporate organization	Exclusive Chain Property	Products available in corporate stores only	Safeway, Kroger	The size and sophistication of these operations vary by chain organization.
2. Grocery Distributor	Similar to above except facilities are owned and managed by:				Basically analagous to chain operation except that individual stores control distribution to retail shelves. Some wholesalers also serve local chains.
a. Cooperative	Retail cooperative	Retail cooperative	Available to retail store owners only	Spartan	
b. Wholesaler	Wholesaler	Wholesaler	Available to affiliated stores only	Super-VaVu	
3. Chain owner PL buying organization.	Retail chains form a cooperative to establish private label procurement facilities.	Cooperative organization	Products available only to member chains	Topco Asso.	Organization analagous to retail cooperative warehouse. Individual owners are chains and/or wholesalers rather than retail stores.
4. Distributor owned PL buying organization	Similar to 3 above except owners are distributor warehouses instead of chains.				Individual stores affiliated with the owning warehouse still control distribution to the retail shelf.
a. Retailer Cooperatives	Facilities owned by a cooperative of cooperative warehouses	Buying organization	Available only to individual cooperative warehouses	Surfine Central	
b. Wholesalers	Facilities owned by a group of wholesalers	Buying organization	Available to small affiliated stores only	IGA.	

TABLE 3.1--(cont'd)

Private Label Brokers	Brokerage firms which represent many private suppliers to retailers through broker owned private label facilities.			Suppliers pay brokerage with which brokers pay for their operations. Retail account often pay for custom retail service supplied by broker.
a. Multi-market	Owns several labels and therefore can supply different retail accounts in the same market.	Brokerage Firm	Any account desirably private label service	Federated Foods
b. Single-market	Develops label for one account per market	Brokerage Firm	One account per market area	Alliance Assoc.
c. Limit-customer	Provides products for customers' own labels	Retail Customer	Retail customers stores only	Richman Assoc.
				Usually can supply a full complement of private label services.

an(wholesaler or retailer) organization with annual food sales somewhere between \$600 and \$700 million.⁷ Many firms or distributors do not attain that sales volume. Because distributor brands offer competitive advantages at the retail level, smaller chains and distributors have cooperated to form Type 3 and Type 4 organizations, chain owned and distributor organizations to buy private label products.

Small retail corporate chains have cooperatively formed buying organizations. Larger cooperative organizations have been formed by cooperative food retailers' warehouses. Similarly, wholesalers have formed a larger wholesaler to buy private label products for them. In the former group, retailers control the organization whereas in the latter, wholesalers have control. These super organizations usually own the common labels used by the individual warehouses or chains. As explained in Chapter 5, developing consumer confidence in a private label is a fairly long-term process. Firms therefore have substantial vested interest in the private labels they distribute. The ownership of a label per se is a significant variable in the food system. If a retail chain or a distributor warehouse wishes to change private label distributors or start its own label program, it forfeits the use of the labels they have used to build consumer confidence. The decision to exit an existing private label program is not taken lightly. Even though most users of many exclusive labels have the legal right to exit on a short-term basis, (prenotification of 60 days to 1 year), they are usually not economically or competitively in a position to do so. Thus the private label procurement system which is already concentrated seems partially shielded from the most likely entrants.

Private label brokers (Type 5--Table 3.1) are brokers "employed" by suppliers. They have close, direct, and usually long term arrangements with retail distributors (chains and wholesalers). Types 5a and 5b, multi-market and single market, are similar; differing only in their scope of operation. They provide retailers with a set of labels for their use in their markets. These "retailer"-labeled products are, of course, supplied by the brokers' principals (suppliers). Private-label brokerage firms often provide their distributor accounts all the other services which customarily come along with a private label program including quality control, product specifications, and advertising programs. Some are considered broker services to distributor accounts while others are purchased by retailers. Type 5c, limit customer, is a type of brokerage firm with few accounts and the labels used on suppliers' products are owned by the retail chain and distributor; not the broker or supplier.

Private-label brokers are considered buyers in this research because they are closely tied to retail distributors. They perform many of the functions performed by private-label buyers in distributor-owned organizations. It is expected that these brokers and their employees be some of the most knowledgeable people in the private label business. Even though they work closely with retail distributors, they are paid by suppliers. It is incumbent upon them to also understand the perspective of the private-label supplier.

The above classification scheme illustrated in Table 3.1 may not be inclusive. Other types of private label arrangements are used which are some combination or hybrid of the five basic types enumerated above.

B. Brand Terminology

There are national brand labels, regional brand labels, packer brand labels, private brand labels, and control brand labels; advertised brands, unadvertised brands, retail brands, distributor brands, house brands, and no brand "brands." The major division is between manufacturers' brands and distributors' brands, although either can be advertised brands and therefore name brands.

Manufacturers' brands can be national brands, regional brands, or packer brands. The first two are advertised and differentiated whereas packer brands usually refer to unadvertised (undifferentiated) brands which usually appear sporadically and with no fanfare. In this report, "national brand" or "branded" products refer to differentiated manufacturer labels which may be manufactured by either national or regional companies.

Distributor brands are brands sold by food distributors through their facilities backed by distributor marketing funds. These may or may not carry the name and logo of the distributor as part of the label. Retailer brand and private label are synonymous and imply that the brand is owned exclusively by the retailer user. These are brands used by Types 1 and 5c in Table 3.1. Controlled labels are distributor labels owned by the distributor but assigned to individual retailers, chains, or wholesalers for their use. The consumer sees both private labels and controlled labels as being house brands. In Table 3.1 the labels used by Type 2a,b, 3, 4a,b, and 5a,b are all controlled labels.

In this study, distributor labels, private labels and controlled labels are considered interchangeably. As with manufacturers' brands, distributor brands may be advertised or unadvertised. The important

factor which determines the nature of a brand is "who is responsible for that brands' marketing support?" Manufacturers are responsible for brand products marketing, while distributors are responsible for private label product marketing.

3.3.5 Factors for the Interview Sample

For some private-controlled label products there are three buyers. The grocery manager "buys" the product from his warehouse. The buyer at the warehouse then "buys" the product from the warehouses private label buying organization. The buyer for the private label distributor organization then "buys" from the suppliers.⁸

Since understanding vertical coordination is the object of this analysis, those buyers which deal directly with suppliers are the buyers who can best describe procurement practices and how these practices adjust to changing economic conditions. The buyers further downstream view private label products just as they would any other grocery product. Their behavior then would be analogous to that of any buyer procuring brand grocery products. Interview resources were therefore concentrated at the initial purchase point for private label products. To check on the possibility that organizational characteristics affected private label procurement, an attempt was made to interview some buyers from each type of private label organization. If the organization of private label procurement significantly affected procurement practices, this sample selection would help identify any important differences.

Similarly, interviews concentrated on those brand product buyers who deal directly with suppliers and their representatives. These buyers usually operate out of distribution centers which are usually at division

headquarters for multimarket chains; corporate headquarters for single market chains; and at cooperative and voluntary warehouses and headquarters. The interview sample thus attempted to control for organizational differences among food distributors. This also allowed comparisons to be made on the coordination impacts of the assignment of buying and merchandising functions in food distribution.

3.4 Processed Fruit and Vegetable Subsectors

3.4.1 Further Limits to the Study

The preceding section helped to focus the categories of food retail buyers (See Table 3.1) while this section does the same thing for grocery sellers. The first part of the section explains why processed fruits and vegetables was the product group selected. The latter parts examine the internal configuration of processed fruit and vegetable subsectors and how these might lead to relevant interview categories.

The enormity of the food distribution system precludes a study of the procurement of all food sold through grocery stores. Therefore a sample set of grocery products were selected which included both canned and frozen fruit and vegetables. This set of products has characteristics which make it appropriate for this study including 1) variables which generate observations about vertical coordination consequences, 2) the relative sales importance of these products, and 3) the exhibition of significant product, geographic, and brand diversity. In addition, there is an expressed need by various researchers in the NC-117 research program⁹ for a better understanding of what happens to the fruit and vegetable products after they are processed. Studying these products provides an excellent opportunity to provide input into other research

while at the same time developing information on the general nature and importance of retailer procurement practices.

3.4.2 Processed Fruit and Vegetables in the Grocery Store

In 1978, grocery store sales were about \$162.6 billion (Table 3.2). The grocery trade usually classifies store sales into four categories; perishables, dry groceries, grocery products, and general merchandise/health and beauty aids (HBA). The two largest perishable departments are fresh meat and produce. Neither of these categories have extensive brand marketing and because of their perishable nature both have evolved extensive and specialized procurement networks. In the perishables category only frozen food procurement closely resembles grocery procurement.

Within the dry grocery department, canned foods is the largest and probably the oldest product category. Generally, trade literature and interviews indicate that canned food procurement practices closely parallel those used for all other dry and general grocery products.

Table 3.3 demonstrates the relative importance of fruit and vegetable products in the canned goods and frozen foods departments. The frozen vegetables, fruits, and juices category is next to the largest frozen category. In addition, many frozen prepared foods also contain fruit and vegetable products. Thus, fruit and vegetable products play a prominent role in frozen foods.

Canned vegetables, fruits, and juices made up 53 percent of the canned goods sales (Column 3, Table 3.3) and clearly dominate the canned goods category. On the basis of sales canned vegetables are almost twice as large as the canned fruit category.

TABLE 3.2--GROCERY STORE SALES BY PRODUCT DIVISION, 1978

Product Division	19 Grocery Store Sales ^{a,b}	Percent of Total Store	Percent of Total Store In 1958
Perishables			
Baked Goods	9,847	6.0%	7.4%
Dairy Products	12,129	7.5	8.8
Frozen Food	7,782	4.8	4.0
Fresh Meat, Fish, Poultry	35,422	21.8	25.0
Produce	17,581	10.8	10.7
Dry Groceries			
Canned Foods ^c	9,469	5.8	7.9
All Other Food and Beverage Products	33,806	20.8	26.9
Grocery Products (Household Supplies, Pet Foods, Tobacco)	20,441	12.6	9.6
General Merchandise/HBA	16,133	9.9	4.6
TOTAL	162,640	100.0%	100.0%

^aIndependent and chain grocery stores

^bSales calculated at retail dollars

^cExcludes sales of infant formulas which are included in the figures in Table 3.3

SOURCE: "The 32nd Annual Consumer Expenditures Study," Supermarketing, September 1979, p. 61.

TABLE 3.3--GROCERY STORE SALES FOR SELECTED DEPARTMENTS AND PRODUCT GROUPS, 1978

Department Product Group	(1) Grocery Stores Sales ^{a, b} (000)	(2) Percent of Store Total	(3) Percent of Department Total
All Frozen Foods	\$7,782,250	4.78%	100%
Frozen Baked Goods	551,230	.34	7
Ice Cream	881,720	.54	12
Frozen Toppings	117,560	.07	1
Frozen Meat, Fish, Poultry	1,746,970	1.07	22
Frozen Prepared Foods	2,385,960	1.47	31
Frozen Vegetables, Fruits, Juices	2,098,810	1.66	27
Canned Foods	\$9,468,900	5.82%	100%
Baby Foods	842,270	.51	9
Canned Fish and Sea Foods	1,243,440	.77	13
Canned Fruits	1,290,840	.79	14
Canned Juices and Fruit Drinks	953,550	.59	11
Canned Meat and Poultry	1,649,980	1.01	17
Canned Milk	330,140	.20	3
Canned Soup	975,900	.60	10
Canned Vegetables	2,200,780	1.35	23

^aIndependent and chain grocery stores

^bSales calculated at retail dollars

SOURCE: "The 32nd Annual Consumer Expenditures Study", Supermarket-
ing, September 1979, pp. 64-68.

In 1978, frozen and canned fruits, vegetables, and juices accounted for 5.1 percent (Table 3.3) of grocery store sales. These products are representative of the brand and private label procurement practices used by food distributors for nearly all processed food items.

3.4.3 The Relative Importance of Various Fruit and Vegetable Items

Literally hundreds of individual processed fruit and vegetable items are found in grocery stores. To further limit this project, some fruit and vegetable product subcategories (family groups) were ignored including dried fruits and vegetables and fruit juices (citrus juice and citrus products); since these products are unique it would have taken a substantial time commitment to fully understand and integrate into the study. The reasons for the unique nature of citrus products are the close link between processed products and fresh market sales, the geographic concentration of production, the dominant position held by cooperatives, and the large amounts of promotion and market development money spent to different citrus products. Citrus products are probably best studied as a separate research project.

Table 3.4 through 3.6 are presented to illustrate the relative importance of individual fruit and vegetable products in canned vegetable, canned fruit, and frozen products categories respectively. In the canned products category (Table 3.4) the combined tomato and tomato products categories dominate canned vegetable sales, followed by beans, corn, and peas. These top six categories comprise 75 percent of categories sales. Later analyses in this report differentiate between major and minor products. Major products refer to these high volume items.

TABLE 3.4--CANNED VEGETABLE PRODUCTS: 1978 SALES VOLUME AND MARGINS ^a

Product Group	Percent of Department Sales	Dollar Volume (Millions)	Average Gross Margin Percent of Retail
Beans (Green, Lima, Wax, Kidney, etc.)	18.36%	415.4	21.9%
Tomato Products (Sauce, Paste, Puree)	15.26	345.0	18.1
Corn	10.86	245.6	20.2
Tomatoes	11.29	255.3	22.8
Baked Beans	10.43	236.0	20.1
Peas	8.23	186.3	21.5
Mushrooms	6.96	157.3	24.3
Asparagus	3.17	71.8	21.0
Beets	2.81	63.5	23.3
Sweet Potatoes	2.01	45.5	18.0
All Other Canned Vegetables	10.62	240.1	----
Totals	100.00%	2,261.8	21.2%

^a Sample of 1,500 supermarkets selling \$1 million or more in 1978.

SOURCE: "1979 Sales Manual", Chain Store Age, July 1979, p. 46.

TABLE 3.5--CANNED FRUIT PRODUCTS: 1978 SALES VOLUME AND MARGINS ^a

Product Group	Percent of Department Sales	Dollar Volume (Millions)	Average Gross Margin Percent of Retail
Peaches	21.85%	216.7	20.7%
Applesauce	15.2	150.4	20.2
Pineapple	17.95	178.0	20.7
Fruit Salad & Cocktail	12.79	127.0	18.7
Pears	9.46	93.8	21.9
Berries	6.53	64.9	16.4
Citrus	3.89	38.6	22.3
Pie Fruits & Fillings	4.87	48.3	23.5
Apricots	2.50	24.8	24.2
Cherries	1.53	15.2	25.3
Plums & Prunes	1.25	12.4	23.7
All Other Fruit	2.18	22.12	----
Totals	100.00%	992.22	20.7

^aSample of supermarkets with more than \$1 million sales in 1978.

SOURCE: "1979 Sales Manual", Chain Store Age, July 1979, p. 48.

TABLE 3.6--FROZEN FRUIT AND VEGETABLE PRODUCTS: 1978 SALES VOLUME
AND MARGINS^a

Product Group	Percent of Department Sales	Dollar Volume (Millions)	Average Gross Margin Percent of Retail
Vegetables			
Regular (Blanched)	10.05%	931.5	28.8
Special (Sauces, Comb., etc.)	5.32	492.7	28.3
Potato Products	4.63	429.2	31.9
Fruits and Berries ^b	1.43	132.5	28.6
Orange Juice	14.09	1,306.9	25.9
Pies (all types)	3.08	285.7	27.7

^aSample of 1,500 supermarkets with more than \$1 million in 1978 sales.

^bStrawberries for about 67% of this category.

SOURCE: "1979 Sales Manual", Chain Store Age, July 1979, p. 123.

Baked bean products are an important product but somewhat unique to the category. Baked beans are a dry pack (manufactured) product as opposed to a commodity. Therefore the economics of baked-bean manufacture and coordination differ from other products.

The top five canned fruit products (peaches, applesauce, pineapple, fruit cocktail, and pears) comprise about 77 percent of the sales in this category and products are similar except for pineapple. Pineapple production is localized in Hawaii and there are relatively few processors. Generally private label buyers have fewer supplier firms. Thus pineapple products tend to have a slightly different merchandising and procurement pattern.

Frozen fruit and vegetable products in contrast carry substantially higher retail margins than their canned counterparts (Table 3.6). This is partially a function of their level of movement and higher handling costs in the retail store. However, frozen products tend to be more profitable to both retailer and suppliers. Regular blanched vegetable constitute 10 percent of the frozen foods department sales. One trade publication lists, in decreasing order of importance, green peas, sweet corn, broccoli, green beans, asparagus, spinach, lima beans and cauliflower as the leading blanched vegetables sold at retail.¹⁰ The single product of orange juice (14.1 percent) exceeds this total. Of any single vegetable product, potatoes (4.6 percent) are the largest seller. Frozen fruit products are a relatively minor product in the frozen food category. Frozen strawberries constitute the lion's share of frozen fruit available to consumers.

The distribution of retail sales of processed fruit and vegetable products suggest that most research effort be focused on relatively fewer

major products. Suppliers interviewed were selected partially on the basis of the commodities they processed. As it turned out, many of these suppliers also processed minor products. Therefore with the exception of citrus, the research coverage of the fruit and vegetable industry was fairly comprehensive.

3.4.4 Geographic Distribution of Fruit and Vegetable Production

Complete coverage of the processing sector of major commodities required a geographic selection of processors. Tables 3.7 through 3.9 are presented to demonstrate the concentration of processing of various products in various regions. Table 3.7 clearly demonstrates the overwhelming predominance of Midwest firms in the processing of canned vegetable products, the only exceptions being tomatoes and asparagus. The trend has been toward more asparagus canning in the Midwest, especially in Michigan. Essentially, the vegetable canning industry is in the upper-Midwest with Wisconsin and Minnesota the leading states. Fruit canning with the exception of pears, pineapple, applesauce, cherries, and plums (not shown on Table 3.8) is centered in California. The freezing industries are located in the Pacific Northwest or California. Green beans, corn, peas and potato products are processed in the Northwest. All of these products basically have production specialized for processing, i.e., the fresh market supplies of these products are grown in different regions by different growers. The California products (broccoli, cauliflower, asparagus, spinach and strawberries) are all produced in areas close to fresh-market production and their processing is therefore closely tied to fresh market conditions.

TABLE 3.7--SELECTED CANNED VEGETABLE PACKS BY GEOGRAPHIC REGION, 1976

Product	Processing Location % of Pack		
	Midwest ^a	West ^b	Rest of U.S.
Asparagus	29.8	42.2	28.0
Green Beans	52.0	23.2	24.8
Lima Beans	50.7	--	49.3
Beets ^c	53.1	16.0	30.9
Carrots ^c	59.4	19.2	21.4
Sweet Corn	77.5	17.5	5.0
Peas	76.8	16.7	6.5
Tomatoes	8.2	81.9	9.9

^aIllinois, Indiana, Michigan, Minnesota, Nebraska, North Dakota, Ohio, and Wisconsin.

^bCalifornia, Colorado, Idaho, Montana, Oregon, Utah, Washington and Wyoming.

^c1975

SOURCE: National Cannery Association (Washington, D.C.), Canned Food Pack Statistics 1976-77, pp. 38-55.

TABLE 3.8--SELECTED CANNED FRUIT PACKS BY GEOGRAPHIC REGION, 1976

Product ^a	Processing Location % of Pack		
	California	Northwest	Rest of U.S.
Apricots	100.0	--	--
Sweet Cherries	--	81.9	18.1
Fruit Cocktail	100.0	--	--
Peaches ^b	97.9	--	2.1
Pears	39.9	60.1	--
Pineapple ^c	--		100.0

^aApplesauce not included because of lack of comparable data.

^bBoth cling and freestone

^cAll produced in Hawaii

SOURCE: National Canners Association (Washington, D.C.),
Canned Food Pack Statistics 1976-77, pp. 62-69.

TABLE 3.9--SELECTED FROZEN FRUIT AND VEGETABLE PACKS BY GEOGRAPHIC REGION, 1976

Product	Processing Location % of Pack			
	Northwest	California	Midwest	Rest of U.S.
Asparagus	a	90.2	--	9.8
Green Beans	57.9	b	9.0	33.1
Broccoli	3.5	96.5	--	--
Carrots	41.4	42.7	--	15.9
Cauliflower	--	76.6	--	23.4
Sweet Corn	67.8	c	23.4	8.8
Green Peas	76.0	5.9	10.8	7.2
Potatoes	88.1	--		11.9
Strawberries	30.4	66.4	c	3.2

^aIncluded in California calculation

^bIncluded in Northwest calculation

^cIncluded in Rest of U.S. calculation

SOURCE: Edward E. Judge & Sons, Inc. (Westminster, MD), The Almanac of the Canning, Freezing and Preserving Industries, 1977, pp. 497-504.

Therefore the basic processed fruit and vegetable products purchased by food distributors are bought in three basic regions: California for canned fruit and frozen vegetable and fruit products; the Pacific Northwest (Oregon, Washington, Idaho) for canned pears and frozen vegetables; and the upper-Midwest (Wisconsin, Minnesota, Michigan) for canned vegetable products. The processors queried about the procurement practices of food retailers were selected to reflect this geographic distribution.

3.4.5 Organizational and Brand Distribution Factors

From the beginning of the study, there was a suspicion that the organizational form of the supplier might have an effect on retail buyer behavior and thereby on vertical coordination. A conscious decision was made to control the supplier selection process so as to include a diversity of organizational forms. Where grower-owned processing cooperatives play a significant part in commodity processing there were included in the interview process. Also, an attempts was made to have a cross section of firms by size. These include small-limited-line proprietary firms, medium and large multiple-line proprietary firms, and regional, national, and international proprietary firms.

A. Brokers

In addition to processors and manufacturers, agent middlemen (brokers) deal directly with food buyers and either work for the seller or buyer. Most food brokers are sellers brokers and are extensions of the manufacturing-processing sector. Brokers and manufacturers' own representatives are some of the best informed of any system participants about the everyday details of food retailer procurement practices. They

are in a position to provide unique information for this study as they see both sides of the retail buying transaction.

Modern brokerage firms are often very sophisticated and specialized. Three types of brokerage specialties appear germane to this study: brand product grocery brokers, frozen food brokers and private label brokers. Brand product grocery brokers represent those brand grocery products which are not represented by manufacturers' own direct sales force. They usually provide some retail store coverage.

Frozen foods usually have separate brokers because frozen food buyers are different buyers than grocery buyers and frozen foods often require more and longer store visits. Some brokers handle both frozen and canned products, but the trend seems to be toward increasing specializations.

Some private label brokers deal exclusively with retailers and retail services (See Table 3.1). Others fulfill the traditional brokerage function and are located in the retail markets. Still others are field brokers whose firms are located near processing areas and represent processors to retailers and other private label brokers from the production area. The distinction between the two is that whereas field brokers are specialists in supply information, traditional private label brokers specialize in customers and market demand condition.

B. Brand Distribution

The food system has dual product flow channels to the grocery store for strong brand and for private label products. Retailers stock both national and regional brand merchandise and private labels. Presample evidence suggests that private-label processing and manufacturing are not

done in the same firms. In addition, trade literature indicated that retailers have separate procurement procedures for brand and private label products. In order to get the suppliers perceptions of these separate procedures, it is necessary to include both brand and private-label suppliers in the interview sample.

The question remained as to what proportion of each type supplying firm to include. A decision was made to weight the supplier sample toward the private label processors. There are several reasons for this decision. Processed fruit and vegetable products tend to have a relatively large proportion of their retail sales through distributor brands. Table 3-10 presents some systematic figures on individual categories. Overall private label sales comprise about 15 percent of all grocery store sales. With the exception of frozen prepared vegetables, processed fruit and vegetable products command a much greater proportion than the average private label sales. Frozen regular (blanched) vegetables were the category in the food store with the greatest penetration of private label sales. The figures in Table 3.10 are product category averages. Individual canned and frozen products often have much higher private label shares (See Appendix Table 3.1).

A second reason for weighting the supplier sample with private label processors is because there are more of them. There are relatively fewer national brand manufacturers to interview. There are no national brand product concentration ratios available but all evidence seems to suggest that brand canned and frozen fruit and vegetable sales are highly concentrated. For example, in 1977 Green Giant (a subsidiary of Pillsbury) was the leading firm in all canned corn (20-25 percent of national sales), canned peas (20-25 percent), canned mushrooms (14-18 percent) and

TABLE 3.10--PRIVATE LABEL PRODUCT SALES OF PROCESSED FRUITS AND
VEGETABLES, 1975

Product Group	Percent of 1975 Grocery Sales Accounted for by Private Label
All Food and Non-Food Sales	14.85
Frozen Regular Vegetables	58.0
Frozen Juices and Drinks	46.4
Frozen Fruits	39.4
Frozen Prepared Vegetables	3.7
Canned and Bottled Fruit	38.1
Canned Vegetables	32.3
Canned and Bottled Juice	25.9
Pickles and Relishes	24.6
Dried Vegetables	20.7

SOURCE: Reported in Progressive Grocer, October 1976, pp. 48-49.
Data based on SAMI (Sales Area Marketing Information, Inc.)
Figures.

asparagus (21 percent), and was second leading brand in beans (18 percent). In frozen vegetables, Green Giant has a 50 percent share of the market in 14 of the 18 best selling items.¹¹

Finally, there is a greater lack in knowledge in academic and government circles about private label procurement than there is about brand product procurement. This seemed like an opportune time to concentrate on private label procurement.

3.4.6 Summary of Factors for Supplier Interview Sample

Processed fruit and vegetable items were selected as the product category to examine the procurement SOPs of food distributors. Given the dual product system, the sampled suppliers were divided into brand and private label categories. Other factors which were thought a priori to be important for supplier interview selection included ownership characteristics of the processors and product specialization (canned versus frozen). The interviews attempted to include brand and private label brokers and to reflect the geographic dispersion of processing fruit and vegetable production regions.

3.5 Interview Methodology and Sample Design

As previously stated, information and data for this research originated through (a) a thorough survey of trade literature and (b) a series of extensive personal interviews with retail grocery trade and supplier personnel. The fundamental goal of this research is to ascertain the procurement practices of grocery distributors and analyze their effects on the vertical coordination process in food subsectors. Thus the interviews were designed to develop that kind of information.

3.5.1 The Mirror Image Technique

Asking retail food buyers how they buy seemed an inadequate strategy for meeting these research goals. Some checks need to be made on the accuracy of the information provided. For example, retailers might tell an interviewer how they want him to think they buy products rather than how they actually do buy products.

Also, a large component of vertical coordination is information flows. If the suppliers "read" incorrect inferences from retailer procurement practices, vertical coordination might be hampered. One method to check both possibilities is to use the research technique of "mirror image" interviewing which is used and explained in Wayne Purcell's article on vertical coordination in the beef subsector.¹² In a "mirror image" questioning procedure interfacing decision makers are questioned about activities along the same dimension, but in terms of the perspective from which they operate. In this study, buyers were asked about the relevant buying procedures they used and sellers were asked, from their vantage point, what are the relevant buying criteria procedures that retailers use. This technique qualitatively deals with both problems alluded to above. Supplier responses act as checks on the accuracy of buyer responses and vice versa. Also, it would be evident rather quickly if the buyer-seller interface was pervaded by misconceptions on either side.

Therefore, the units of data for the study are specific exchanges (communication possibilities) between buyers and sellers. These exchanges are examined for those standard operating procedures affecting various aspects of vertical coordination. Four basic procurement SOPs were identified as relevant for analysis including 1) new product procurement

procedures; 2) order-reorder buying; 3) procedures for discontinuing items; and 4) private label procurement methods. Many specific inquiries were made about each of these four basic procedural sets.

3.5.2 The Interview Selection Process

The interviewee selection process proceeded in a "directed" ad hoc sequence. A strict random sampling interview selection process was not used because the populations of buyers and sellers were not known well. Instead, professional colleagues were asked for any names of buyers and sellers they might know and some of these were interviewed. Those interviewed would then be asked for their suggestions of other people who were knowledgeable and amiable to questioning. Another method was to "knock on doors" and "shake hands." This approach was used when there were a priori reasons for interviewing specific firms and the first method above did not yield any contacts. This approach provided entrance into major brand fruit and vegetable processors and some of the private label buying organizations. The interviews were monitored to stay within the basic control bounds set by Table 3.11.

It is impossible to quantitatively test for possible biases caused by sample selection. Some concern might be expressed at the small numbers of interviews in some of the buyer categories. This merely reflects the fact that there are very few organizations which fit some of the various types of private label buying organizations. Private label procurement is highly concentrated in the United States. The type of organization was thought to be a critical variable in explaining vertical coordination phenomena. The decision was made to deal with more categories with fewer observations in order to add explanatory power in latter chapters.

TABLE 3.11--THE NUMBER AND DISTRIBUTION OF PERSONAL INTERVIEWS WITH GROCERY BUYERS AND SELLERS

Grocery Buyers Grocery Sellers		Brand Product Buyers			Private Label Buyers				
		Large Chain Buyers	Small Chain Buyers	Wholesaler Cooperative Distributor Buyers	Type 1 Chain PL Buyers	Type 2 Distributor PL Buyers	Type 3 Chain owned PL Group Buyers	Type 4 Distributor owned PL Group Buyers	Type 5 Private Label Brokers
		14	2	6	2	8	2	3	1
Processed Food Manufacturers (Fruit, Vegetable, Canned and Frozen Products)		49	2	6	2	2	0	1	1
		11	11	13	11	13	8	3	2
			2	6	2				
		4	3	5	3				
Brokers for branded fruit and vegetable products			2	6	2				
			5	9	6				
Other non-fruit and non-vegetable manufacturers and brokers		9	9	11	9	15	10	11	
Proprietary Processors					7	2	3	1	5
Cooperative Processors					13	6	8	6	7
Frozen Vegetable Processors		11	7	7	7	11	17	11	12
Private label brokers (both canned and frozen)					6	1	2	1	3

Note: Sales of products between processing firms and traders of products between buyers can not be shown on this table.
For miscellaneous interviews, see Appendix Exhibit A.1.

The dual selection procedure might also cause some bias. This is especially true when an individual interviewed recommended other persons which could lead to sampling only "closed" procurement arrangements. A conscious effort was made to interview those people recommended by several sources. Hopefully, this adjustment helped minimize any bias resulting from the selection process. The large number of interviews, the tendency of information from those responses to converge, and conscious efforts to prevent bias, leads to the qualitative conclusion that the sampling procedure produced an appropriate, relatively unbiased set of interview observations.

3.5.3 Interview Questionnaire Development

Interview questions were developed by the following procedure. The trade literature search culminated with an extensive (28 pages) set of possible questions to be asked of various buyer and supplier categories. These were then circulated among professional agricultural marketing economists in the USDA, Michigan State University, and University of Wisconsin for their comments. Their comments were duly noted and incorporated into a revised set of questions.

The reviewers concluded that the questions were fairly germane and exhaustive except for the area dealing with private label products. This reflected the lack of trade information on private label. To overcome this problem the sequence of the interviews was adjusted in order to provide for the gradual development of private label expertise. Brand product buyers were interviewed first. During this period, a few strategic interviews were made with private label buyers. It was then possible to develop more complete and relevant questions for the private label sector.

The extensive set of questions were committed to memory and boiled down to very brief outlines which enabled direct questioning during the interview. Only those sets of questions appropriate for a buyer's or supplier's experience and expertise were asked of that person. The question covered the four basic procurement task SOPs. The brief outlines used in the questioning form the basis for the outline of Chapters 4 and 5.

In retrospect, the interview process was dynamic and evolutionary. Some areas were answered at an early stage in the interview process and as the interviews proceeded, previously unrecognized areas for questioning were identified and other areas were found to be irrelevant. The author tried at all times to keep the interviews as objective as possible. Only on a few occasions was it obvious that the person being interviewed was trying to direct the interview and conclusions toward his point of view. All in all, the interview process seemed to be objective and professionally received by the interviewees.

One major shift in emphasis occurred toward the end of the interview process. Part way through the sample interviews, it became obvious that buying SOPs were only partially responsible for the state of vertical coordination in the food system. Retail merchandising practices have as much impact on coordination as do their buying practices. A study of food retailer merchandising practices is a study in and of itself. Clearly, it was impossible to study merchandising also. However, in order to be able to understand anything about vertical coordination, the basic retail merchandising practices must be understood at the very least. As a result of this dilemma, a number of interviews with private label buyers stressed merchandising SOPs. This change in emphasis

provided at least some of basic merchandising SOPs used in private label marketing. While a more complete study of merchandising is desirable, this brief foray was extremely helpful in explaining a number of vertical coordination aspects (discussed in Chapters 6 and 7).

3.5.4 The Interview Matrix

Table 3.11 summarizes the results of the interview process. The columns in the matrix represent the buyer categories used in the study (See Section 3.3 above). Similarly, the rows represent the seller categories explained in Section 3.4. Each large cell in the matrix represents a possible buyer-seller exchange opportunity. For example, the upper left cell represents the sales exchange between a large retail food chain grocery buyer and an employee of a brand fruit and/or vegetable product manufacturer. Each cell has a corresponding interpretation. The nine upper left most cells represent the brand product procurement buying exchanges. The twenty lower right cells represent the private label procurement system exchanges. These represent the two very basic areas of analysis for this research. The shaded areas in Table 3.11 have specific meaning. If the brand product sector and the private label sector were independent of one another, there would be no exchanges made in the shaded areas. The shaded areas represent dual branding opportunities. The fifteen upper right cells would indicate the private label activity of brand manufacturers. The twelve lower left cells represent the brand marketing activities of private label manufacturers. The number of exchange observations made in these areas during the interview process give a rough estimate of the level of dual branding activity. The estimate is rough because of the way in which interviewees were

selected. Dual branding of both types are covered in detail later in the report.

The numbers under and aside of the buyer and supplier headings indicate the number of individual people with experience in that respective category interviewed about the nature of procurement procedures. These numbers do not necessarily correspond to the number of firms interviewed. In most cases when more than one person from an individual firm was interviewed, each had different functions related to procurement within the firm. In addition, individual interviewees who had just recently changed jobs were questioned about their former roles. For example, an executive of a private label processing firm who just retired and become a private label broker was questioned about both roles and their relationship to retailer procurement. These dual interviewees represent less than 10 percent of the interview observations, but were unusually informative.

The numbers in each cell indicate the coverage of that exchange category and the relative coverage obtained from the buying side and supplying side. Take for example the exchange cell for Type 1 private label buyers and proprietary canned products processors. That particular buyer-seller interface could have been explored on thirteen different occasions in the interview process. The number for each cell is in the small box in the lower right corner of each cell. Of the thirteen possible question opportunities, six would have been presented in supplier interviews (number in lower left corner) and seven would have occurred in buyer interviews (number in upper right corner). This does not imply that each of the possible thirteen question occasions were equally and completely explored. The interviewee might have described in detail the

procurement practices of another cell in detail. He was then asked to compare and contrast his observations on the other exchange relationships with which he is involved. The numbers in the small boxes are thus fairly indicative of the amount of interview "attention" received by each exchange cell.

There were thirty personal interviews with grocery buyers. One-third of those interviews were with brand product buyers. The remaining twenty interviews were held with private label buyers.

Supplier interviews were about evenly split between brand product and private-label product suppliers and salespersons. (Twenty-four brand-product related interviews and twenty-five private-label product interviews.) There were more supplier interviews (forty-nine) than buyer interviews reflecting three basic facts: 1) there are more suppliers than buyers, 2) suppliers tend to be more concentrated geographically, and 3) suppliers seem more willing to talk to an economic researcher.

On balance then, relatively more interview time was spent on private-label procurement practices and exchange relationships than was spent on brand product buyer-supplier relationships. This was by design because of the relative lack of written information currently published on private label procurement.

3.5.5 Summary

The data collected during the interviews is qualitative in nature. Attempts were made to interview individual buyers and sellers from typical or representative firms. At all times these knowledgeable people were answering questions not only about their operations but

about how the system operates. What follows in the remaining chapters are descriptions and analyses of how wholesale processed-food procurement takes place and is evolving over time.

APPENDIX TABLE 3.1--PERCENT OF RETAIL SALES IN PRIVATE LABEL FOR
SELECTED FRUIT AND VEGETABLE PRODUCTS IN
SELECTED YEARS

Product	Proportion of Retail Sales Through Private Label	Sales Year	Reported In	Basic Data Source
Blanched Frozen Vegetables	55.0%	1975	<u>Quick Frozen Foods</u> November, 1976	A.C. Nielson Company
Frozen Orange Juice	54.6%	1974	<u>Quick Frozen Foods</u> April, 1975	SAMI
Frozen Raspberries	45.2% 37.4%	1973 1972	<u>Progressive Grocer</u> May, 1974	SAMI
Frozen Spinach	65.2% 61.4%	1973 1972		
Frozen Onions	16.4% 21.8%	1973 1972		
Frozen Asparagus	57.6% 60.2%	1973 1972		
Frozen Corn	41.5% 44.9%	1973 1972		
Frozen Mixed Fruit	11.0% 14.2%	1973 1972		
Frozen Southern Vegetables	47.6% 50.4%	1973 1972		
Frozen Mellon Balls	45.2% 47.4%	1973 1972		
Canned Apricots	69.0% 65.9%	1973 1972		
Canned Apple Juice	27.8% 24.8%	1973 1972		
Canned Mixed Vegetables	30.0% 27.6%	1973 1972		

APPENDIX TABLE 3.1-- (cont'd)

Product	Proportion of Retail Sales Thru Private Label	Sales Year	Reported In	Basic Data Source
Tomato Puree	14.3% 12.0%	1973 1972	<u>Progressive</u> <u>Grocer</u> May, 1974	SAMI
Canned Fruit Cocktail	49.5% 47.4%	1973 1972		
Canned Peaches	47.9% 45.9%	1973 1972		
Canned Cherries	38.0% 43.4%	1973 1972		
Wax Beans	53.4% 57.5%	1973 1972		
Beets	36.4% 40.2%	1973 1972		
Canned Mushrooms	30.3% 33.6%	1973 1972		
Branded Fruit Juices	50.9% 54.1%	1973 1972		
Canned Asparagus	32.8% 34.9%	1973 1972		
All Supermarket Sales	13.21% 13.19% 12.53%	1973 1972 1970		

APPENDIX EXHIBIT 3.1--MISCELLANEOUS INTERVIEWS NOT INCLUDED
IN TABLE 3.11

The following are other personal interviews held with people who are not either grocery buyers or sellers.

- Executive of large employment agency for the food retailing industry.
- Two editors of a leading trade publication for the fruit and vegetable industry.
- Two independent owner - operators of grocery stores.
- Executive of private label food and non-food products manufacturer.
- Three present and former executives of food retailing trade organizations.
- Various fruit and vegetable specialists in the USDA's, Economics, Statistics, and Cooperatives Service.
- USDA fruit and vegetable procurement agents.

CHAPTER 3

FOOTNOTES

¹The Super Market Institute (SMI) and the National Association of Food Chains (NAFC) has since merged to form the Food Marketing Institute (FMI). The former SMI library still exists, but has been moved to FMI headquarters, Washington, DC.

²The material covered in "Agricultural Economics/Marketing and Transportation Administration" 831 taught by the author at Michigan State University, Spring 1977, closely parallels that in this chapter.

³U.S. Department of Agriculture, Economic Research Service, National Food Situation, NFS-161, September 1977, p. 16.

⁴Convenience stores sell only 4.8% of the grocery store sales.

⁵For example, many Michigan freezers produce an undifferentiated frozen cherry product which is an ingredient for pie manufacturers.

⁶Basic economic factors help change these behavioral patterns. For example, during recessions and inflation, firms tend to become more operations oriented. During periods of growth and rising incomes, merchandising gets the upper hand. The industry is currently in an operations "state". See for example, "Therein Lies a Tail," Supermarket News, March 27, 1978 p. 2.

⁷These are estimates given to the author in confidential interviews with executives of two retail organizations which have just recently decided to set up in-house private-brand procurement systems. More detail is forthcoming in Chapter 5.

⁸This is a typical sequence of buying for a Type 4a or b private-label procurement system.

⁹North Central Region Research Project, Research Division, College of Agriculture and Life Sciences, University of Wisconsin, Madison.

¹⁰"The 30th Annual Consumer Expenditures Study," Supermarketing, September 1977, p. 46.

¹¹American Institute of Food Distribution, Weekly Food Digest, April 15, 1978, p. 5.

¹²Wayne D. Purcell, "An Approach to Research on Vertical Coordination: The Beef System in Oklahoma," American Journal of Agricultural Economics 55 (February 1973): 65-67.

CHAPTER 4

BRAND GROCERY PRODUCT PROCUREMENT PRACTICES

4.1 Introduction

Two distinct sets of standard procurement practices are used in the grocery trade: brand product and private label product procurement practices. Chapter 5 covers private label product procurement in detail. This Chapter concentrates on brand product procurement practices and has four main sections. The first examines the origins, job descriptions, and evaluation systems of brand grocery buyers. The second describes the new brand product procurement system. The third section examines the ordering and reordering of grocery products already in distribution. The standard rules used to discontinue products are enumerated in the fourth section. A brief summary section concludes the Chapter.

4.2 Brand Grocery Buyers and Buying Systems

This section briefly examines the professional and corporate experiences which condition the attitudes and behavior of grocery buyers. Allowing for the fact that there are always exceptions to any generalization, the following describes the "typical" grocery buyer types.

4.2.1 Buyer and Buyer-Merchandiser Procurement Systems

Nearly all grocery buyers employed by chains start their careers in the grocery department in a supermarket. Therefore, the buyer usually has grocery and store management experience. Promising buyer candidates

are transferred to headquarters where they begin their buyer apprenticeships. Junior buyers are often assigned "go-for" jobs and are assigned to make long-term product category reviews using the firm's computer movement records. New buyers are assigned "simple" categories which are fairly stable, rather minor, and fairly easy to master. Examples might be baby foods, or baking needs. As the buyer proves himself, his buying jurisdiction and responsibilities are increased.

Buyers are referred to in the masculine gender because there are very few female buyers because of the management background required in stores. Although few women in the past have pursued, for voluntary or involuntary reasons, careers in supermarket management, this is changing.

In Chapter 3, the principle of the separation of the buying and selling functions was discussed with reference to private-label procurement organizations. The separation principle holds also for brand-product procurement and therefore results in a basic breakdown of grocery-buyer job descriptions. In the trade, brand-product procurement agents are either buyers or buyer-merchandisers.

A buyers' basic job is to procure products for the firm at the best volume, prices, and freight rates consistent with the overall sales and operations goals of the firm. Exhibit 4.1 is an actual job description for a grocery buyer for a retail division of a chain retailer.¹ A quick reading provides a feel for where a grocery buyer interfaces with other functions of the retail firm. The buyer would need to interact with the accounting/record keeping department, warehouse, traffic department and the merchandising department. The buyer usually reports to the grocery merchandiser. In a buyer system the buyers buy products which are sold by the merchandisers. The buyer is thus the link between

EXHIBIT 4.1--JOB DESCRIPTION FOR A GROCERY BUYER**GROCERY BUYER (CONSOLIDATED DIVISION)****REQUIRED RESULTS:**

1. Achievement of the procurement of all grocery product at the best volume price and freight rate, consistent with dollar volume and inventory management considerations, to best service the stores.
2. Achievement of effective grocery inventory control.
3. Achievement of an effective merchandising-oriented, trained buying department staff.
4. Achievement of a favorable working relationship with suppliers, stores and departments.
5. Achievement of an effective working relationship with the grocery merchandising staff in the division being serviced.

MAJOR ACTIVITIES:

1. Purchase grocery product, including non-food items, for two divisions giving full consideration to the separate division requirements affecting variety, convenience, demand, price, etc.
2. Maintain good inventory control through control of over-stocks and over-buying. Provide each division with information about residual inventory from surveys. Maintain the minimum number of uncommon items in the warehouse to accomplish greater efficiency and improved turnover rate through knowledgeable counsel provided both divisions.
3. Supervise the maintenance of accurate records on product movement, cost and retails for accounting and the merchandising departments. Develop a system of check and balances to minimize error and to assure each division of its proper allocation of costs and profits.
4. Initiate and execute all performance contracts, count and recount, advertising contracts and bill backs to properly identify, perform, and divide promotional monies and allowances between divisions. Co-ordinate promotional purchases for both divisions on special offerings, allowances and allotments providing equal service to both, adequately meeting their separate needs.
5. Supply grocery merchandisers of both divisions with timely information about all deals, special buys and allowances available for use in sales planning and retail pricing.

EXHIBIT 4.1--(cont'd)

6. Maximize hauling earnings by co-operating closely with the traffic and transportation departments.
7. Make prompt and accurate floor stock protection charges on common and uncommon items according to available information.
8. Maintain separate order guides for each division, providing line numbers and product groupings. Update continually to reflect new, discontinued, temporarily not available, and reinstated items.
9. Keep informed of promotions, special programs, mailers and continuity plans of each division to provide ample supplies of needed product. Purchase for survey each week feature items from each division's sale plans. Provide coverage by the best possible scheduling of orders to maximize earnings available from performance contracts.
10. Make effective and maximum use of the machine ordering system. Implement a program for purchasing frequency and lead time to time receipt of merchandise with its need as closely as possible. Supervise, evaluate and utilize the semi-annual arrival variation study.
11. Purchase in larger pallet or unit loads where possible to lower handling costs in accounting and distribution.
12. Review weekly with buying department staff the inventory reports and advise on percentage of service, inventory levels, current demand and future projections.
13. Establish and communicate the results of each job in the department. Regularly review and evaluate the performance of each person against his results. Provide the atmosphere, counsel and direction to stimulate employee interest and co-operation and, where possible, to enable employees to develop into positions of greater responsibility.
14. Maintain favorable relations with all salesmen, both factory representatives and food brokers, local and regional.
15. Encourage all department personnel to be most helpful and co-operative with all divisional, store and outside personnel with whom they must work
16. Regularly visit stores of both divisions for the purpose of coordinating most effectively buying with local merchandising efforts as well as to make variety and price comparisons.

REPORTING RELATIONSHIPS:

Reports to: Grocery Merchandiser

May Supervise: Assistant Buyer, Buying Assistant and Clerical Staff

supply (from manufacturers) and consumer demand which is influenced by merchandisers.

The other common buyer system is known as the buyer-merchandiser system. The buyer-merchandiser position combines in one person both the buying and selling function. The buyer-merchandiser has responsibility for the profit and sales of his assigned product categories. This is in addition to the responsibility for profit goals at the warehouse level. Basically, the buyer-merchandiser decides what items to buy, what deals to take, designs the schematic for the department, determines placement, facing, pricing and profitability of his assigned products. The buyer-merchandiser often has control over the merchandising of private-label products in his department. He usually does not buy the product, but orders it from an in-house or affiliated private label procurement organization. Exhibit 4.2 is an actual copy of a buyer-merchandiser's job description. The thirty-four specific tasks illustrate the total authority over a grocery department exercised by a buyer-merchandiser.

The buyer versus buyer-merchandiser dichotomy has some important implications for coordination in the food system. For the most part, the buyer-merchandiser system is more responsive to change because one communication point is eliminated. The buyer-merchandiser is able to implement a price change directly to one retail store. A buyer, by contrast, needs to communicate the price change to a merchandiser who then has to decide what to do with that information. Thus it would appear on the surface that the buyer-merchandiser system is a desirable organizational form from the standpoint of vertical coordination.

EXHIBIT 4.2--JOB DESCRIPTION FOR A GROCERY BUYER-MERCHANDISER**GROCERY BUYER-MERCHANDISER**

Reports to Division Manager and is responsible to him for:

1. -the personal conduct that reflects a high company image to the public and employees.
2. -producing a Division budgeted retail grocery gross profit.
3. -producing a Division budgeted wholesale gross profit on grocery and grocery supplies at the Distribution Center.
4. -carrying out all directives from Division Manager.
5. -developing Division grocery merchandising programs in conjunction with Division Manager.
6. -selecting and buying new items and grocery supplies, and pricing all grocery and frozen foods for Distribution Center, and interviewing salesmen to keep abreast of current grocery marketing conditions.
7. -informing Division Manager on all new items available and action taken.
8. -ordering and merchandising private label items if operating a Distribution Center in Division.
9. -recommending any addition or deletion of a line of merchandise for approval of Division Manager.
10. -training and developing District Manager-grocery Supervisor in effectively carrying out Division merchandising programs.
11. -evaluating District Manager-grocery Supervisor in regard to Grocery Department merchandising and reporting results to Division Manager.
12. -projecting quarterly ad allowances to Division Manager.
13. -projecting grocery ad losses for all stores, auditing weekly ad loss reports, and informing District Manager and grocery Supervisor of any necessary corrective action.
14. -selecting ad items consistent with budgeted ad loss set by Division Manager, advising Advertising Manager three (3) weeks in advance.

EXHIBIT 4.2--(cont'd)

15. -making regular store visits with District Manager-grocery Supervisor to evaluate grocery merchandising, effectiveness of Supervision, and to observe all other departments.
16. -consulting with District Manager-grocery Supervisor on featured display items and on grocery merchandising.
17. -consulting with Advertising Manager on all grocery ad layouts before approving.
18. -preparing a semi-monthly list of compulsory display items for Supervision and Store Managers.
19. -maintaining up-to-date rebate records, collecting all monies on delinquent M-115's, M-140's, and keeping Division Manager informed.
20. -directing a retail cost program as directed by Division Manager to determine grocery mark-up and flow and advising Division Manager of results.
21. -insuring that sufficient merchandise is on hand with grocery suppliers to meet Division demands.
22. -maintaining up-to-date price books and issuing bi-weekly to Store Managers.
23. -preparing and issuing timely grocery bulletins to Store Managers and Supervisors.
24. -maintaining proper relations with all suppliers and vendors.
25. -informing Division Manager of any significant grocery marketing change.
26. -recommending to Division Manager any profitable change in established Division grocery merchandising policy.
27. -handling customer product complaints related to vendor responsibility.
28. -laying out and merchandising new store Grocery Departments or remodeling of existing Grocery Departments in conjunction with District Manager-Grocery Supervisor and Store Manager and forwarding to Division Manager for approval.
29. -analyzing weekly sales, customer counts, commodity movement, special promotions and gross profit reports, and taking corrective action as required.
30. -informing District Manager-Grocery Supervisor and Store Managers when to prepare for quarterly store inventories.

EXHIBIT 4.2--(cont'd)

31. -maintaining quarterly accumulative sales and ad loss figures to properly evaluate inventory results.
32. -specifying delivery dates to grocery suppliers in conjunction with Distribution Manager.
33. -acting as liaison between stores and transportation on special deliveries.
34. -checking competition weekly for price, quality and merchandising.

Nonetheless, the buyer-merchandiser system does have some drawbacks. A buyer-merchandiser has more responsibilities, other things being equal, and consequently he cannot deal with as many individual products as can a buyer. Therefore a buyer-merchandiser system requires more individuals than does a buying system. A buying system has to have an accompanying merchandising department. Since there may be economies of organization, the combined total of merchandisers and buyers in a buying system may be less than for a buyer-merchandiser system when both handle the same number of products. Firms might try to minimize the number of buyer-merchandiser positions. If this is the case, buyer-merchandisers would have less expertise and understanding about individual products. This would tend to give well-known, established products a comparative advantage. There is no empirical evidence available in this study to verify or reject this hypothesis.

Buyer-merchandisers are judged primarily by the sales and profit (in addition to other factors) contributions of their product categories. Their incentive is to use sales and merchandising strategies designed to attract attention to their shelves generated by advertising, coupons, and price concessions on items normally purchased by consumers. In general, these are the product characteristics of high-volume, well-known, national brand grocery products. Therefore, there is a natural tendency for buyer-merchandisers to favor the big volume popular brand items. As a result, interest and attention to minor items and some private label items tends to wane. A buyer in contrast responds to percentage changes in prices. They usually notice all items' movement and supply conditions. Buyers still have to "sell" the "good deal" to the merchandisers. However, if minor products' deals are relatively better

than other products, suppliers of these products, at least, get the active attention of someone in the firm.

In summary, the buyer-merchandise system has the inherent advantage of being quicker and therefore able to respond to system changes faster. However, the buyer-merchandise system may tend to have a systematic bias toward certain kinds of products. It coordinates more effectively for some products, but not for many minor products. In addition, most buyer-merchandisers almost never deal directly with private label suppliers and are therefore usually uninformed about supply and coordination conditions in private label products.

Within the trade the buyer-merchandise system is not extensively used because the independent retailing sector has buying and selling separated by ownership. Individual owners make the final merchandising decisions. Cooperative warehouses and affiliated wholesalers often have merchandising staffs which usually only prepare a series of merchandising options from which the owner-operators choose. For the most part, the buying departments and merchandising departments are separate units in the affiliated independent supply sector. Therefore, only chains have the viable option of choosing between buyer-merchandising and buying systems. Based on numerous trade contracts, it is estimated by the author that about one-third of the chain organizations use the buyer-merchandise organization.

4.2.2 Buying Committee Systems

Another internal organizational vehicle which is important to coordination is the buying committee which can operate in either buyer or buyer-merchandise systems. A buying committee is a committee of people within a firm or an organization which meet on a regular systematic

basis to make buying decisions usually on 1) new products, 2) product cuts and 3) promotion acceptance. The theory of buying committees is to bring together all people who have a direct stake in a buying decision. Included on buying committees are buyers or buyer-merchandisers, merchandisers, corporate/division executives, store/department managers, sales/marketing executives, operations executives and advertising managers.² Therefore buyers take the initial information from suppliers, screen what is appropriate for the committee's consideration, and make presentations to the committee at its regular meeting. The committee passes judgement and its decisions are then communicated back to the suppliers by the buyers.

In theory, the committee is able to make a more complete assessment of products' potentials. For example, a canned goods buyer might logically accept a new canned product which would increase the sales and profits in his department. However, that new canned product may just cannibalize sales from an existing frozen item which might make more profit because it has a greater gross margin. The committee would recognize this while the buyer of canned goods might not or choose not to recognize this fact. Thus, more information and expertise is brought to bear on any given decision. Also, the buying committee allows for interaction between inexperienced buyers and more experienced hands. By removing the decision in time and place from the salesman-buyer interaction, the procurement decision is made in a more objective, less emotional atmosphere. Another possible reason for the buying committee is that it made under-the-table payments and kickbacks harder to accept as the individual buyer could no longer guarantee the distribution of a suppliers product. Finally, the buying committee meeting serves to

inform all participants of the latest and most important developments in all areas represented on the committee (i.e., the committee shares trade gossip).

The drawbacks of the buying committee are that 1) it lengthens the procurement procedure, thereby making the procurement system less responsive to fast changing conditions. 2) The dynamics of group behavior influence the decisions made. Some committees tended to develop the "I'll support your product if you support mine" type of behavior. In many cases, buyers had a 95 percent acceptance rate by the committee of their product presentations. 3) When a committee makes the decision, no one individual is responsible for the outcome of the decision. Buyers tended to take credit for their successes and blamed the failures on the committee system.

The trade literature indicates that the buying committee has fallen out of favor somewhat. It is still useful for those firms with high turnover rates in their buying staffs and also serves a useful intra-firm communication mechanism. Some firms still use it primarily for that purpose. Many firms have found that individual decision making and responsibility is more effective.

The material above is presented to provide a basis for future analysis about coordination, for it is within these internal firm buying formats that individual buyers must operate. These formats not only help condition how the buyers behave but also are critical to understanding the communication of information from suppliers to the final consumers. These buying formats help establish the internal contingencies of reinforcement faced by buyers.³ These sets of rewards and admonishments

condition the buyers' responses to all types of economic forces which they confront on a routine basis.

4.2.3 Grocery Buyer Job Performance Criteria

Given job descriptions, buying department formats, and internal firm organization, what are the basic performance variables with which grocery buyers are evaluated? Table 4.1 lists a few actual case examples of how grocery buyers are evaluated by different organizations. A perusal of the last column indicates that nearly all buyers are judged by their service level and inventory control abilities, whereas buyer-merchandisers' basic determinants of successes are stated sales and profit objectives. Sales goals are usually set as a means of dividing up responsibilities among buyers and as a control mechanism among the various factions within a firm.

Service level refers to product flow to the stores and is defined as the amount of product shipped to the store divided by the amount of product ordered by the store.⁴ The converse of service level is called the out-of-stocks level. A service level of 96 percent means that 4 percent of the items in the store are out-of-stock or unavailable. This is a critical variable because it indicates the possibility of lost sales. If the product is not available, the consumer cannot buy it. In addition, the trade also seems to believe that every consumer who walked into the store wanted to buy that product. This results in the almost paranoid quest for high service levels. The out-of-stocks can cause ill-will and/or legal problems. FTC rules on product availability of sale items are becoming very strict. To limit liability, firms are very concerned about supply levels of sale items.

TABLE 4.1--PERFORMANCE CRITERIA USED TO EVALUATE GROCERY BUYERS

<u>Source</u>	<u>Type of Firm</u>	<u>Position</u>	<u>Firm Planning and/or Control Mechanism</u>	<u>Performance Criteria Used to Evaluate Position</u>
1	Wholesaler	Buyer	Budgeted system of sales plans--each buyer assigned a % of sales increase goal.	1. Inventory turnover and level 2. Service level
1	Regional Chain	Buyer-Merchandiser	Yearly sales and profit goals--each buyer merchandiser assigned sales and profit goal.	1. Attainment of profit--sales goal 2. Service level 3. Inventory control 4. Number of store visits
1	Wholesaler	Buyer	Projected sales goal--each buyer sets his sales goal within the system.	1. Service level 2. Inventory
1	National	Buyer-Merchandiser	Marketing plan for market share and profits--buyer has semi-annual sales and margins goals to obtain.	1. Sales and profit goal attainment 2. Product knowledge 3. Supplier skills
1	Cooperative	Buyer	Satisfactory service to owner-stores--buyer to provide stores with lowest possible prices.	1. Service level 2. Inventory
2	Management Consultants	Personnel Consultant	What ever goals firm deems as proper--buyer should be objectively evaluated.	1. Sales increases.....15% 2. Ability to apply retail training25% 3. Margin management...20% 4. Inventory control...15% 5. "Team Spirit".....15% 6. Supplier problems...10%

SOURCES: 1. Unpublished, confidential training seminar conducted by a major food manufacturer with selected grocery buyers and buyer-merchandisers.

2. "Functions of Merchandisers," Supermarket News, February 9, 1973, p. 9.

However, for most products the critical problem with out-of-stocks is the alienation it creates among store customers. The following quote from the trade press helps set the limits of service levels: ". . . our service level might fall below 90 percent and if that happens we're going to lose business."⁵ This statement seems to indicate that a 90 percent service level is a threshold number below which the firm loses profits. A 100 percent service level is nearly impossible to obtain because of the state of the United States transportation system and stochastic variance caused by weather. In addition, very high service levels are in direct conflict with the other basic performance criteria, inventory control.

Inventory control refers to the level of inventory costs incurred by distributors' warehouses. "Inventory turns" is an often used proxy to indicate the level of inventory costs. The faster the item turns over, the less financing is required and the greater the sales over which the distribution center's overhead costs can be spread. Many firms take actual inventory (as recorded in the computer) and calculate an imputed dollar cost for that inventory which is compared to target figures. To prevent out-of-stocks, greater safety stocks must be inventoried. Therefore, the higher the service level to the stores the higher the inventory costs to the distribution center.

Service level and inventory targets are determined by the firm's management. These levels are a function of many factors including 1) the firm's marketing strategies, 2) the basic image the firm attempts to project, and 3) general economic conditions. For example, a service-oriented merchandising firm may set service-level goals of 98 percent and incur higher inventory costs. An operations-oriented firm may accept

a service level of 93 percent in order to minimize inventory costs and use those savings to project an image of low price. As the general economy forces interest rates higher or lower, firms will adjust service and inventory goals to reflect the changing cost conditions. These mandated ratios then become the performance goals for individual buyers. The manipulation of these ratios determine to a large extent how the behavior of buyers is altered to conform with corporate priorities and the dictates of the economy.

Individual buyers' inventory cost and service-level ratios are adjusted to reflect the realities of their respective product mixes. Some products are inherently more volatile. Others are slow movers. Ratios are adjusted to reflect the effects of transportation difficulties and weather. However, after these refinements are taken into account, the buyer still gets evaluated on his service and inventory record.

Exhibit 4.3 helps demonstrate how this system works. This is a copy of an actual warehouse "scratch" report of a retail distributor. Scratch reports list all products which were ordered by the stores but were "scratched" from the delivery sheets because the desired product was unavailable in sufficient quantities. The head buyer (supervisor) gets a scratch report everyday. He then looks for serious (large quantity) scratches and ascertains the reasons. The handwritten notes on Exhibit 4.3 illustrate this process. The head buyer then distributes the scratch reports to their respective buyers. This is after he records and updates the individual buyer's service-level percentages.

These percentages usually include 1) yesterday's percent service, 2) most-recent quarter percent, 3) year-to-date percent, and 4) percent last year at this date. Thus buyers are closely monitored vis-a-vis

[illegible]

service to the store. Deteriorating service levels results in quick consultation between buyers and supervisors. All division reports are sent simultaneously to corporate headquarters. Nearly all buying organizations use a very similar scratch report or warehouse out-of-stock listings.

Most firms aim for service levels between 98 and 93 percent. An interesting sidelight is that the head buyer in a division often sets his standard slightly higher than that dictated by corporate headquarters. For example, if headquarters stipulated a 94 percent service level, the head buyer will set his buyers' level at 95 percent. This is insurance against running afoul with the big boss. Another point is that these reports are widely circulated among the buyers and among the divisions. This establishes a degree of competition among the buyers. Individual buyers striving for promotion will seek to be the best within the firm.

Similar record-keeping systems exist for monitoring inventory levels. As with service levels, inventory performance is closely and quickly monitored. However, these systems seem to be more variable across firms. Basically, the corporate officers set limits or ranges into which a buyer's allocated imputed inventory costs must fall. The impression received from the interviews was that these reports are less well circulated because of their competitive importance.

Service levels to the stores and inventory cost control are the very basic performance criteria on which grocery buyers are evaluated. This is because each of these aspects of buyer performance feed back on nearly every aspect of a retail food distributing firm. In addition, they are quantifiable while many other performance aspects cannot be easily and quantifiably monitored. Thus these two aspects are given constant scrutiny.

In retail food distribution, retail store managers tend to be the pivotal employees in the organization. Their complaints and concerns get immediate attention from everyone, especially buyers. Their most frequent complaints involve out-of-stock items. Thus given the trade-off between inventory costs and stock levels, buyers tend to give more weight to the service-level criteria and are particularly sensitive to suppliers who can respond immediately to unforeseen or unusual supply problems. This factor is an underlying issue in nearly all of the following analysis.

Level of purchase price is not explicitly identified as a performance criterium for buyers. It may be that retail executives just assume that their buyers will purchase products at the lowest possible prices. Actually, executives monitor their buyers to determine that their cost of goods is equal to that of their competitors. In addition, the basic operation of the Robinson-Patman Act probably acts to assure all brand product buyers in the same market areas get nearly identical prices. Manufacturers are responsible for making sure that all their price quotes to buyers are identical when adjusted for cost differences. Generally the interviews indicated that all buyers in a market area receive very similar price and promotion offers.

What is important, however, is when individual buyers get price and promotion offers which depends on "supplier relations" which is the third major buyer performance criterium and is a qualitative evaluation. Normally, the adversary buyer-supplier exchange needs to be subject to mutual respect on each party. Buyers who are arbitrary, vindictive, and obnoxious lose the respect of salespeople. Supplier representatives tend to avoid them. Thus even though all buyers receive similar price quotes, retail firms with unpopular buyers tend to get them last. This delay puts the firm at a competitive disadvantage.

One chain in the West has a buyer who is good but is so obnoxious that representatives won't call on him. Deals are mailed to him because everyone 'hated his guts' and even this takes place after everyone else has had a shot at the deal.⁶

Many of the buyers' problems need quick attention. Professional working relationships with suppliers are necessary for the buyer to be effective.

There are other performance criteria which firms use to judge buyers such as administrative ability, personnel management skills are important. However, stock level, inventory level, and supplier relationships are the critical performance criteria. Because buyers' salaries and careers are dependent on these criteria, they are the antecedents of most of the procurement SOPs covered below. Suppliers who understand and respond to these buyer needs are able to survive and prosper.

4.3 New Product Procurement Practices

4.3.1 The Definition and Importance of New Grocery Products

New grocery item introductions and procurement generates much of the dynamic behavior visible in the brand-product grocery business. Past research has indicated that the incremental effect on product selection of the annual new item parade is enormous. In a 1976 report it was indicated that items not in distribution ten years ago:

Accounted for 55 percent of items handled

Contributed 52 percent of unit sales

Represented 52 percent of dollar sales

Earned 57 percent of the dollar margin⁷

Best estimates for 1975 indicate that new items introduced that year accounted for \$10 billion of that years' \$143.25 billion grocery store

sales. That was 7 percent of the total business. Virtually all of it originated with national brands. A 1978 study showed that of all the items in a grocery warehouse, 45.8 percent had been introduced in the last five years.⁸

Thus, introduction of new products are a very dynamic force in food distribution systems. Given the stakes and the commitments of suppliers, it is easy to understand why the procurement process of new products is the most studied and documented area of grocery procurement. The following discussion draws heavily on this past documentation.

What is a new product as defined by a grocery buyer? The definitions are numerous. The conventional definition used to generate the statistics reported in the trade press is any item which is new to the distribution center of a food retailer. Notice that this includes products which have been sold in other markets and are just currently being added to this firm's distribution.

The chief reporting system for monitoring new product introductions divides new items into four groups: 1) New brands--items on which a brand name is used for the first time by the manufacturer. 2) Established brands in new fields--the application of a known brand name to a new product category for that brand. 3) Brand extensions--the application of a brand into another segment of the same category (a dry dog food manufacturer introducing a canned product). 4) Brand proliferation--consisting of line extensions resulting from new sizes, colors, flavors, etc. The majority of items (81 percent) are classified by the Nielson Early Intelligence System as brand proliferation.⁹

Retailers use the same criteria for evaluating all four of these categories. However, the weights attached to the decision criteria change

depending on the type of new item being discussed. Also the amount of time spent on the new product decision depends on the category of new products in which it falls.

Between 1966 and 1975, an average of 807 new items per year were introduced in grocery stores (Table 4.2). New product activity has started to pick up in the last few years. There is however a great variation in the number of new items introduced in various grocery categories. The canned fruit and vegetable categories have one of the lowest new product introduction rates. By contrast the rate of frozen foods is much higher. Frozen foods averaged 141 new introductions a year. Frozen foods has the highest introduction rate of any grocery food category.¹⁰

It is not possible to extract data for frozen fruit and vegetables. However, what new product activity took place in frozen vegetables was in the boil-in-bag and mixed, specialty types of products. Therefore, for the most part processed fruit and vegetable products have had relatively little new product activity.

Conditions in the general economy significantly impact on the flow of new products. Manufacturers usually fund their research and development and marketing activities by allocating fixed percentages of their sales. In prosperous times when sales are growing there are great numbers of new items introduced. Conversely, in recessions all firms cut back. This type of behavior is procyclical.

Likewise retailers' behavior is affected by the general economy, especially the short-run interest rate. When interest rates are relatively low, retailers tend to accept more items because stock levels and inventory costs are not as binding. However, significant short-run changes in interest rates cause buyers to be more selective. Table 4.3

TABLE 4.2--TEN YEAR TREND IN NEW ITEM INTRODUCTIONS

Year	Total Introductions ^a	Canned Fruit and Vegetables	Frozen Foods
1966	723	29	120
1967	861	22	145
1968	808	24	123
1969	840	37	112
1970	774	34	100
1971	736	22	120
1972	774	21	165
1973	802	17	163
1974	931	24	179
1975	<u>1,023</u>	<u>33</u>	<u>186</u>
	8,272	263	1,413

^aIncluded here are new products, flavors and colors of national and regional brands. Excluded are new size introductions. These numbers are not collected with the same definitions or methods as used by A.C. Nielson Co.

SOURCE: "New Product News", Dancer-Fitzgerald sample reports cited in "Brand Power Study", Progressive Grocer, December 1976, p. 38.

TABLE 4.3--GROWTH IN THE NUMBER OF NEW ITEMS AND WAREHOUSE ACCEPTANCES

Year	Change in the Number of New Item Introductions	Change in the Number of Warehouse Acceptances of New Items
	(Percent)	(Percent)
1971-72	+5	+38
1972-73	+4	-27
1973-74	+16	-5
1974-75	+9	+3

SOURCE: Progressive Grocer, "The Brand Power Study", December, 1976, p. 40.

illustrates this fact. Between 1971 and 1975 new item introductions by manufacturers increased by about 8.5 percent a year.¹¹ In contrast, retailers dramatically changed their acceptance rate of these new products. When interest rates increased dramatically in 1972-74, the rate of retailer acceptances (Column 2, Table 4.3) dropped dramatically.

During this period (1971-1975), the new product selection criteria used by retailers did not change. There is no publicly available evidence to indicate whether success or failure criteria were changed to reflect economic conditions. The best guess is that retailers maintained their trial periods but checked these new products more closely at the end of the introductory period.

The flow of new products seem to be continuing. However, very few of these products are new in a revolutionary sense. The proliferation of brand items introduced is, however, very important to the dynamic rivalry among various food manufacturers.¹² As a result, the grocery buyer of individual brands is confronted with a great number of new item decisions each year.

4.3.2 Pre-Introduction Activities for New Brand Items

A new food product has had a substantial incubation period before it ever is presented to grocers for sale to consumers. The research and development process and test marketing theory are discussed extensively in business school curriculums. Only certain parts of that early life are critical to the new product selection process of food retailers. Discussions with buyers interviewed indicated that proper test marketing and sales force preparation are necessary conditions for the acceptance of new food products by grocers.

Ideally a test marketing program should include a test city on the East Coast, another in the Midwest, one in the South, and one on the West Coast. Each of these cities should be fairly autonomous (isolated from spill-over into neighboring cities) and should contain the whole array of ethnic, and socio-economic groups. Although relatively few cities have these properties at any period of time, the same cities tend to be used for test marketing by most manufacturers. Grand Rapids, Michigan, was a good example, When it became linked to the Detroit market, it lost its isolated characteristic.

A test program needs to be quickly implemented and executed. The product must be presented to grocers, advertised, and data must be collected and evaluated in the span of a few weeks. The results of the tests must then be incorporated into the introduction program for the new item.

The use of test markets has been changing in the past few years. Extensive testing with broad samples, exposes the new product to scrutiny by the firm's competitors. Several very successful products are currently being marketed by firms which shortened the testing procedure and beat their competitor to market. Today supplying firms have tended to use a minimum amount of pre-introduction testing in order to limit the product's exposure to competitive scrutiny. With shorter or no market test periods, the risk of product failure increases. The largest national brand manufacturers are better able to endure a new product failure because of their diversification and financial strength. Thus continued new product rivalry which downplays test marketing increases entry barriers into food manufacturing.

Another pre-introduction process which is very important to the buying process is the extent and adequacy of training of salespeople for presenting a new item since a grocery buyer typically allows only fifteen minutes for a salesperson to present a new product. A successful presentation requires that all the relevant information required by the buyer be presented quickly in a way which will elicit a positive decision. The necessary procedures and mechanisms must exist to implement a training program for each new product. The presentation and follow through, to a large extent, condition a buyer's perception of the reliability of the supplier which is one of the basic decision criteria used by buyers in evaluating new products.

The pre-introduction activity for a new product is long and varied and directly impinges on the buying process via test marking and the implementation of sales presentations. Supplying firms which have inherent advantages in these areas will have a much greater success ratio for their new product introductions. The largest national brand manufacturers with their marketing, advertising, and sales departments tend to have significant advantages over less-sophisticated rivals.

4.3.3 An Example of a New Product Introduction Program

The buyer often faces an elaborate new product introduction program formulated by the manufacturer. The example presented below serves to illustrate some of the basic forces taking place in the food distribution system. It is an actual introductory program for a family of eight related frozen products implemented in 1977. Present indications are that it was a success.

Each buyer was presented with a folder containing all relevant material included in the introductory program. Included in the "trade packet" were the following:

- Labels to be used on the products

- Point-of-purchase (POP) display materials to be installed and used by the manufacturers' representatives

- Copies of coupons and price reduction labels to be used on the product

- Schedule of events for all market areas in the United States (as defined by the manufacturer) (See Exhibit 4.4)

- Narrative versions of all the national T.V. ads to be run during the introduction

- A detailed analysis of the product category in which these products will be sold

- A report of the test market results

- A complete list of product facts including UPC code, item name, pack size, product description, shipping weight, case cube, unitized load data, case cost, suggested retail price, and gross margin

This company used a specialized test market firm which ran a test for six months in Charleston, West Virginia. The test market results reported to buyers included 1) the percents of product category users trying the new product, 2) the percent of the initial users who are repeat buyers, 3) the relative sales volume of this product compared to category leads, 4) the new product's share of the category, and 5) the percent of volume accounted for by new customers to the category.

Exhibit 4.4 gives the calendar of events summarizing the total manufacturers program for the introduction of the new products. Introductory programs comprise both a consumer and a trade program. The consumer program encompasses the material and effort directed at consumers to induce

EXHIBIT 4.4--CALENDAR OF EVENTS FOR A NEW PRODUCT INTRODUCTION PROGRAM

CALENDAR OF EVENTS

EVENT	MAY			JUNE			JULY			AUG.			SEPT.			OCT.			NOV.			DEC.												
TELEVISION NETWORK 1500 Gross Rating Points Approximately 150 Spots	2	9	16	23	30	6	13	20	27	4	11	18	25	1	8	15	22	29	5	12	19	26	3	10	17	24	7	14	21	28	5	12	19	26
PRINT NEWSPAPER ROP NEWSPAPER INSERT																																		
DIRECT MAIL																																		
COUPONS NEWSPAPER ROP NEWSPAPER INSERT DIRECT MAIL																																		
TRADE ALLOWANCES																																		

them to buy the new product while trade programs are designed to induce the buyer to authorize new products for distribution to retail stores.

The relative distribution of monies between consumer programs and trade programs indicated whether the manufacturing firm prefers the "pull" or "push" marketing strategy. Over time, the successful food firms have been firms emphasizing pull techniques. Television advertising, direct mail, and newspaper insert coupons are considered consumer oriented activities and comprise part of the "pull strategy." Newspaper ROP (print and coupons) and trade allowances are usually assigned to trade programs and comprise part of the "push strategy."

ROP stands for Run of Press. This is an advertising term which indicates material printed along with normal newspaper runs and usually included in the retailers ad. Consequently, ROP has also come to stand for black and white print of advertising and coupons in newspapers.

A. Consumer-Directed Promotion Activity

The launch of the new items in Exhibit 4.4 is the first week in August. The T.V. advertising begins the last week in July. Both national T.V. and local spot advertising is used. National advertising is composed of national sponsored programs and nationally directed spot advertising. Most of this consists of spot announcements specifically targeted in local and/or regional markets. The amount of national T.V. advertising provided is measured in Gross Rating Points (GRPs) which indicate the relative market exposure a product gets through advertising. Market areas are defined by ADIs (Area Dominant Influence). These usually coincide with the broadcast coverage of local television stations. In each ADI a universe of targeted households is identified. One Gross Rating

Point equals exposure to 1 percent of those targeted households in one week. Thus a program with 100 GRPs means that the equivalent of each household in the ADI will receive that advertising message during a given week or, 10 percent of the households may receive 10 ad exposures and the remaining 90 percent receive no ad exposure.

Local spot ads are usually ROS (Run of Schedule) and are sometimes called package buys. The advertiser buys a package of 10 ads to be run on the station's schedule at its discretion. Retailers prefer spot ads because they are targeted directly at their markets. They use GRPs to compare the relative advertising commitments between products. The promotion in Exhibit 4.4 has 1500 GRPs, 100 for the first five weeks, and 150 for the next four.

Additional T.V. advertising (55 GRPs for two three-week periods) has been committed after the main thrust of the introduction which coincides with the time when retail buyers evaluate the product's potential. Products would then be ordered and stocked for the main introductory period. An often-heard complaint of buyers is that manufacturers put all their money into the initial thrust and ignore the product at a later time period. Programs with follow-up advertising are thus given preferential consideration by buyers.

The use of direct mail, insert, and ROP coupons complements T.V. advertising. Potential customers who have been reached by T.V. will want to redeem coupons at their local stores. This consumer reaction helps induce retailers into carrying the new products.

One important observation can be made about this sample program. During the week of June 27 before any other consumer promotion activity has been launched, a consumer coupon distribution for 10 cents-off

coupons for the macaroni and cheese product offered. Company officials explained that this activity was designed to "get the buyers' attention." In order to have products stocked and available for sale during the T.V. advertising campaign, buyers had to order in early July. Distributing coupons to consumers early would make them enter stores looking for this product. They would question store managers who would in turn question headquarters and headquarters would come down on the buyers for not having the item in stock. This ploy would then induce the buyers to order the other items. All the remaining consumer-oriented activity is centered in the promotion period.

B. Trade-Directed Promotion Activity

Trade promotion is the total package of activities used to induce the retail trade into stocking the new item and has two basic components. The first, and largest, is the allowance or price concession given to retail buyers. In the example shown in Exhibit 4.4 two allowance periods were given. The first one was on all eight items and had extended terms. Normal terms are 2%-30 days. However, on new items, manufacturers are encouraged by grocery buyers to provide longer terms. In addition to these buying allowances, manufacturers usually provide advertising and promotion allowances. Generally, retail firms prefer manufacturers to plan and coordinate the television advertising while they prefer to have some control over the distribution of newspaper advertising, feeling they have comparative advantages in setting newsprint ads. In the trade packet of this introduction, there was a complete breakdown by city, newspaper, and edition of all the newspaper advertising scheduled during the introduction. Suppliers state that buyers are very sensitive to

whether their newspaper will have ad coupons. Suppliers have also stated that their advertising agencies recommend that nearly all advertising expenditures should be allocated to television because it is the most affective promotion medium. Therefore most of the newspaper advertising used by manufacturers is geared to retailer needs. This helps gain favorable decisions from buyers.

The total anticipated cost (without allocation of manufacturer overhead costs, R&D expenditures, etc.) of this program was \$3.5 million. This seems to be a typical, well-structured new product introduction program for a nationally distributed product. These programs are partly designed to influence the consumer. However, a great deal of effort and resources are also expended to influence and appease the buyer's expectations. In many cases this buyer influence is as important or more important than the design of the consumer program.

4.3.4 Standard Provisions of New Product Introduction Trade Programs

The example above illustrates the approach manufacturers use in introducing new products. Their emphasis is on the consumer-oriented portion of the program. Retailers, on the other hand, are more concerned about the contents of the trade-oriented portion. Over the years, specific and standardized provisions have evolved as part of trade-oriented programs.

A new product introductory deal refers to the introductory price or product concessions granted to retailers by manufacturers. The deal often includes buying, advertising, and/or merchandising allowances which are price reductions off of list price. Introductory deals may also include extended buying terms and special display and merchandising aids

(complete with manufacturer set-up labor). The size, composition, and combinations of these provisions varies with manufacturer, product type, and market area.

Retailers frequently request free goods from the manufacturer, the standard request usually calling for the manufacturer to provide the distributor with one free case per store. This provision provides free initial stocking of the retail buyers' stores and therefore the manufacturer bears the majority of the retailers' introduction cost. Trade literature implies that most manufacturers who do provide free goods do so only on a quid-pro-quo basis (one free case for every X cases ordered).

Another attempt by buyers to shift introduction costs back to manufacturers is the use of slot charges. A slot charge is a cash payment or credit often requested of manufacturers by retail distributors intended to cover the overhead costs of entering a new product into the retailer's warehouse and computerized record-keeping system. Slot charges are calculated in many different ways and vary by product and manufacturer. The most frequent method of payment is to give the buyer a credit such as \$.50 a case for the first eight-hundred cases purchased. Slot charges are nearly always paid in addition to introductory price concessions.

Perhaps the complete protection provided to retailers by manufacturers on new products is a guaranteed sales provision: If the consumers do not buy the merchandise, the manufacturer agrees to repurchase the merchandise. The repurchase can be, and often is, at retail price. Guaranteed sales are nearly always standard for test market products. Evidence as to the extent of its use for new product introductions was not available. However some trade people interviewed indicated that

guaranteed sales provisions are included in many new product introductory packages.

The ultimate protection to the retailer is "guaranteed profit." In this scheme the manufacturer agrees to pay the retailer the difference between pre-introduction profits and post-introduction profits if they are less. Thus if the product fails, the retailers suffer no loss in profit. There were rumors in the trade which indicated such schemes were used, but the author found no evidence to either verify or refute these rumors.

Some of the above provisions are not unique to new products but are used by manufacturers when promoting existing items. The composite effect of standard manufacturer introductory packages is to merely cover the retailers' costs of integrating the new item into the retailers' system. The cost of new product introductory packages to the trade is the manufacturers' ante for being able to deal in the grocery game. The size, execution, and relative importance of this ante has significant implications for determining who gets to play.

The typical manufacturers' salesperson is equipped with trade packages, colorful flip charts, and portable color video tape displays. The number of different combinations of introductory deal provisions by diverse firms is bewildering. Buyers require the salespeople to complete new item forms. Trade literature and interviews revealed that nearly all firms use new item forms which are not standardized across a market or the country. The trade literature reports several attempts have been made by manufacturers through food distributor trade organizations to develop and implement standardized new product forms which have been partially successful.

Information needed by the buyers includes 1) what deal the supplier firm is giving, 2) what the physical characteristics of the product are, 3) what the current status of this product in the market area served by this grocery firm is. During the fifteen-minute interview granted to the manufacturer by the buyer, specific points on the new item form are clarified and additional information may be requested. It is during this interview process that the buyer gets a "feel" for the organization and implementation of the introductory program. These subjective evaluations are remembered and taken into a buying committee meeting.

Provisions of introductory deals have already been discussed. Physical description of the product and basic cost data are needed as input into the grocery firm's inventory and buying computer programs (See Section 4.4.3). Some firms also request shipping information. Many chains and affiliated distribution centers have their own truck fleets for distributing products to their respective stores. These firms are always looking for backhaul arrangements and request freight allowances from manufacturers.¹³ Freight allowances refer to the amount per case the manufacturer is willing to reduce the price when the product is transported by the distributor's trucks from plant to warehouse.

The current status of the new product in the market is critical information for the buyer or buyer-merchandiser which is used to assess the product's price position and profit potential. While the manufacturer suggests a retail price, the distributor makes the final decision. Basically, the price is influenced by 1) the margin assigned to similar products now in distribution, 2) the margin assigned by retail competitors carrying the product, 3) the manufacturer's suggested retail price. Since the manufacturer usually has considered the first one above,

usually retailers initially price the new product close to the suggested retail.

Exhibit 4.5 is a new item form currently in use and contains most of the items and provisions discussed above. Once completed, the form gives the buyer most of the information he needs to evaluate the new item's relative value to the retail firm and is thus readily available to help buyers compare and evaluate new products.

4.3.5 Selection Criteria Buyers Use to Choose New Items for Distribution

Buyers are concerned about the profit flow of any given product. In food distribution, success is determined by mass sales of individual units carrying a relatively small profit per unit. Thus a successful grocery product must achieve volume distribution for a protracted time span. With new items, however, there is no way of knowing what the potential profit will be. Buyers, therefore, have developed lists of criteria (proxy variables) associated with long-term product success.

Michael D. Hutt lists seven basic criteria he deduced from reading the literature and pretesting a questionnaire sent to retailers.¹⁴ My analysis and updating of the literature since 1975 (See Appendix Table 4.1) confirms that the criteria buyers use include:

Advertising support

Test market results

Quality and appearance of package

Reputation of manufacturer

Product "newness"

Introductory advertising allowances

Introductory deal (e.g., cash-off invoice)

EXHIBIT 4.5--NEW ITEM FORM

NEW ITEM FORM

DATE _____

ITEM _____ PACK _____ SIZE _____ MFG/UPC _____

REG. _____ COST PER CASE _____ REG. COST PER UNIT _____ DEAL COST PER UNIT _____

SUGGESTED RETAIL _____

INTRODUCTORY DEAL _____ EFFECTIVE DATES _____

OFF INVOICE ALLOWANCE _____ EFFECTIVE DATES _____

BILLBACK ALLOWANCE _____ EFFECTIVE DATES _____

PERFORMANCE REQUIRED _____

WGT. FROM LABEL _____ CASE WGT _____ LNTH _____ WIDTH _____ HT _____

FOB _____ TERMS _____ OPEN DATING - YES _____ NO _____ SWELL ALLOWANCE _____

GUARANTEED SALE _____ NORMAL DEL. TIME _____ HOW SHIPPED _____

FLOOR STOCK PROTECTION _____ NO. OF DAYS _____ MIN. ORDER _____ BUYING MULT. _____

MANUFACTURER _____

ADDRESS _____ ZIP _____ PHONE NO. _____

LOCAL REPRESENTATIVE OR BROKER _____

ADDRESS _____ ZIP _____ PHONE NO. _____

TEST MARKET AREAS _____

AVAILABLE FOR ChainX PICK-UP _____ FREIGHT ALLOWANCE _____

DISTR. IN OTHER ChainX DIVISIONS _____

ATTACH A PRICE LIST SHOWING BRACKET PRICES FOR _____

LIST COMPETITION NOW CARRYING THIS ITEM AND THEIR RETAIL:

These are not listed in any order of importance. The weighting of each will be discussed after they are explained in detail.

A. Advertising Support

Advertising support, briefly discussed before, is the generic term used to indicate how much consumer-oriented promotion activity is scheduled to coincide with the product's introduction and comprises three basic elements: television advertising (discussed above), print advertising, and coupon offering. Print advertising, while nominally being entirely consumer-oriented, is specifically used to influence consumers with only certain aspects. The coupon-related print media advertising, consisting of insert fliers, Sunday supplements, and ROP (Run of Press) coupons, have consumer-drawing power. Thus advertising support usually boils down to a buyer's evaluation of the structure of the proposed "coupon drop" and television ad support.

Coupons are a valuable tool for manufacturers. First, coupons put pressure on retailers to stock a new item. Retailers, basically service firms, cannot risk alienation of their customers. If a manufacturer drops a million coupons in a market area, many consumers will attempt to redeem them at their local grocery store. Should that item be unavailable, the consumer will be angered. Since retailers are quite sensitive to this, substantial use of coupons can help assure that retailers carry a new item. Another role of coupons is to reduce the product price to the consumer. This is the purpose for using coupons for existing products in distribution. The level and trend of using coupons will be discussed in the next section.

A variation in using coupons is product sampling to consumers which has been used extensively with laundry products, soap, and health and beauty aids. Product sampling is probably the most effective way to put store-directed consumer pressure on retail firms. This method of advertising is rarely used for food products.

B. Test Market Results

Although test market results were discussed above, there are a few additional comments. Just at the time large manufactureres would like to cut back on test marketing in order to reduce their exposure to competitor usurpation, retail buyers are developing a preference for more sophisticated test results. Some retail buyers now request demographic information detailing the heavy user of each proposed new product by sex, income, age, ethnic group, and education. In addition, they want test market results to indicate the best retail price, the proper shelf location, and the complementary merchandising products. Generally there is an inverse relationship between the size and stature of the manufacturer and the amount and detail of test market results demanded by buyers.

C. Packaging Considerations

The quality and appearance of the package is another important characteristic used by buyers to judge new products for different reasons. Package construction and quality is very important to the retailer. The package must be able to stand the rigors of the shopping experience.¹⁵ This includes placing it in the cart, piling other items on top of it, the bagging process, and finally, its loading, unloading, and shelving in the home. Any package which breaks down during this process creates problems. Retailers have little tolerance for items which cause their

labor expenditure for cleanup. In addition, dented, crushed, or leaky packages do not sell. If the package does not hold up for consumers, they will not repurchase the product. Also, package design affects shelf space location and allocation. Packages that do not stack well or are loose do not have much appeal to retailers. Package quality is a cost criteria.

The appearance of the package is an often-overlooked determinant of product marketing success. Grocery products are inexpensive consumer nondurable goods purchased on a frequent basis. Estimates vary, but, conservatively, 40 percent of all grocery sales are impulse sales; that is, the consumer did not enter the store with the specific intent to buy that given product. Advertising presells or predisposes the consumer toward a given product. Packaging hooks the consumer's attention and results in a sale. Experienced buyers recognize the sales impact of properly designed labels and packaging and use this ability to help pick successful items. This buying characteristic is one of those experienced developed "feel" criteria that veteran buyers develop.

D. Manufacturer's Reputation

The reputation of the manufacturer has many subtle aspects and is really a catch all category including aspects of the manufacturer's track record and the reputation of the manufacturer's representative (salesperson or broker).

Reputation is the manufacturer's recent "track record." A buyer forms a perception of a track record by asking questions such as 1) Have the last few items brought out by this company been successes or failures?; 2) Has the company delivered on advertising and deal promises;

3) Has this company dealt fairly with this buyer in the past; and 4) Does the company respond to special requests or needs of food retailer? The bottom line seems to be whether or not the manufacturer delivered on his promises and whether the execution of past programs has been professionally handled. All of these perceptions are formed by the firm's most recent activities. If the firm has had three failures in a row, its new products tend to receive more intense scrutiny. A companion phenomenon is that buyers tend to rate introductory programs against the last one the manufacturer implemented. Thus suppliers who try to adjust marketing programs to suit the needs of the product run into buyer resistance when the "new" program is inferior to their last one. Reputation and judgment is made by comparing this program against the most recent program by this supplier independent of the nature of the product.¹⁶ In addition, buyers expect more and demand more from larger firms.

The reputation of the supplier's representative is similar in some ways to the above description. Although sales people are evaluated on their professionalism, efficiency, service, and honesty, the most important measures are the salesperson's service to the buyer and to the stores.¹⁷ Basically, service depends on the salesperson's dependability (providing promised services) and honesty (not giving competitors better deals) in his dealings with the buyer. Firms whose representatives have problems with buyers will suffer.

E. Product Originality

Product "newness" is another catch-all phrase which stands for the type of "new" product featured. The Nielson definitions presented in Section 4.3.1 summarized the different classes of new products. New

sizes, flavors, colors, and similar new products are evaluated differently from other types of new items. Basically buyers determine if this new size or flavor fills a void and therefore provides the consumer with new value. If it does not fill a void but replaces another product, the buyers look at the item on a purely quid-pro-quo basis. If the new product's manufacturer is offering a better allowance, lower prices, better service, than the existing product's counterpart on the shelf, the buyer replaces the existing item with the "new" item.

The more innovative the product, the greater the probability that buyers will accept the new product. Supermarket executives are particularly interested in items which take sales away from away-from-home food outlets rather than from other products in the supermarket. For example, frozen donuts were readily accepted by buyers because they viewed this as taking sales from donut shops (fast food) rather than reducing the sale of other breakfast items stocked by the store. Supermarkets do not quantify the cross elasticity effects of the pricing and stocking implications of a new product on other products in the store. Most buyers are not concerned as long as their increased sales come from another buyer's department. The buying committee system theoretically could adjust for this effect. In reality, the "politics" of buying committees usually results in the cross-product implications being politely ignored. However, veteran buyers again have a "gut" feeling for the net effect of introducing a new item. This factor is only consciously recognized when the net sales impact is within one family product group; i.e., new sizes and flavors.

Generally speaking, the more original the product, the greater its chance of being accepted. Also the newer the product, the more willing

buyers are to trade-off other buying criteria.

F. Trade-offs Among Criteria

As with most sets of criteria, individual criterion are weighted differently at different times. When asked what is the most critical criterion for buyer acceptance of a new product, one manufacturing executive responded, "The one your program is the weakest in."¹⁸ There is no question that the priority given to certain criterion varies with individual circumstances. However, the literature review and interviews lead to some broad generalizations about the relative importance of certain criteria. Usually advertising support, introductory allowances, and supplier reputation are the three basic criteria used by buyers to decide.

If one factor has to be singled out as the most influential it would be consumer advertising. The following quotes indicate the buyers basic attitude:

Jewel puts more emphasis on media and advertising programs than on introductory allowances.

The determining factor in purchasing a new product is the company that introduces it and the advertising support the product will get. If Proctor and Gamble, for instance, brought out a new detergent, supermarkets have to take it on because of the massive advertising behind it.¹⁹

Consumer advertising programs which are properly executed will nearly always require that a retailer stock the new item. Coupons are a vital part of this strategy. It cannot be stressed enough that advertising money is not the only determinant. Ceteris paribus, if two companies budget the same amount for a new product, but company A has been consistently successful over the years and company B is unproven or has been sporadic in past introductions, company A will always receive preference

and acceptance by grocery firms. It is not because Proctor and Gamble is Proctor and Gamble that gets its products accepted, but that they usually have a winner. Proctor and Gamble has a long track record of success on new products and many advertising dollars to spend.

The same observation generally holds for all the major food manufacturers who have established a reputation for successfully executing marketing programs. Food manufacturers have learned that through massive consumer advertising they can often control the destiny of their own products. Without this advertising program, the product would be "controlled" by food distributors. Perhaps the following quotation of a chain executive sums up the importance of advertisements' impact on new product success;

Consumer acceptance of a new product depends on how much the manufacturer is willing to spend. You could package elephant dung, and if it was properly done, it could sell well.²⁰

Among equal size firms competing in their historic product categories, advertising expenditures largely determine new product acceptance. However, as manufacturers move away from their traditional areas of expertise, the reputation with and familiarity to buyers becomes an important factor. The following are indicative of statements the author heard many times during the interview process. ". . . a manufactureres' reputation for success on new products and supporting existing products is of great importance. Track record of past promises and proven success on a long-term basis is a big factor!"²¹ New products presented by companies with whom the chain buyer is familiar have a better chance of being accepted than products from new or unfamiliar vendors. "The item from a company with a track record has a much better chance of getting his line into our stores."²²

In the interviews, buyers were asked to choose which item they would select if given the choice between a new item of an established company entering an entirely new product group versus an unknown company expanding into this category when both had identical introductory programs. Most selected the established firm. It is important to note that recognized firms are not necessarily the largest firms, however, insomuch as marketing success is linked to firm size, established reputations or track records are highly correlated with absolute size.

For certain types of new product introductions the composition and size of the trade program is critical. For those new items which are close substitutes for existing items and for those items being marketed by companies without the knowledge or financial resources to develop sophisticated consumer programs, the buyer's perception of the trade-oriented activity is often the determining buying factor.

The buyers make implicit and explicit calculations about the value of the decision to stock the item usually for two reasons: 1) It is more profitable for the firm to accept the new product, or 2) They use these new entrants to "discipline" existing firms in the product category. They do this by constantly "nipping away" at the edges of the large companies' product lines. Some evidence was collected which showed that retailers sometimes even "sweeten" a new entrant's trade deal with their own money in order to "shake the leading firm from its complacency." This evidence and the "nipping away" process will be discussed in Chapter 7.

In summary, the criteria used by buyers and buyer-merchandisers to make decisions in procuring new products are fluid in their application. The criteria used to evaluate a new product and the weights attached to these criteria are a function of 1) the "type" of new product, 2) who

produces that new item, 3) the state of the general economy and the latest industry fads (hamburger extenders, semimoist dog food, etc.) and the prejudices and perceptions of the buyer. As with most evaluation procedures, the process of buying new products is not totally objective.

4.3.6 A Comparison of the New Product Buying Practices of Retail Chains and Wholesale Distributors

Observations made from reading trade literature and the interview process suggest that when looking at new items, wholesaler and cooperative buyers differ little from their buyer counterparts in the chain store. There seems to be little real differences in the selection criteria used. Wholesale distributors, however, operate under different constraints since they usually have to stock more items because of the varying local competitive nature of their affiliates. In order to cater to as many affiliates as possible, wholesalers need to carry a greater variety of products, sizes, and flavors. Chains will make corporate level decisions. Even if an item would sell well in a locality, the chain will tend to only carry that item if it meets the overall standards of the chain.

Chains are able to implement a "forced distribution" system which means, when a product is authorized for distribution, the buyer and/or merchandiser can order that product shipped to each store. Forced distribution procedures are usually worked on standard formulas. Normally stores are sent one case for every dollar amount of sales. Thereby, larger stores receive more merchandise. The forced distribution option allows chains to react much faster than independents. In contrast, a wholesaler or cooperative must approve the item, then survey the independent stores for their orders, then collate the orders before knowing

the exact quantity to order from the manufacturer. This process usually takes two to three weeks whereas a chain can have the product into the stores within one week. Forced distribution also applies for decisions on whether to participate in deals. Therefore chains may appear to have lower prices merely because they are on the market sooner with promotional prices.

Forced distribution can help in food system coordination. If quantities of grocery products (canned corn for example) need to be moved through the system quickly, chains are usually able to act faster both with respect to product movement and price changes. Effective use of forced distribution can shorten the lag between price change and adjustment in commodity subsectors. In practice, forced distribution may not be all that effective because of breakdowns in execution at store levels. New items must be shelved, prices marked, and price changes must be made which take coordinated action by store personnel. Some chains are able to execute coordinated forced distribution; others are not. By comparison, the best chains are faster than the best independent wholesale distributors, but the better wholesalers outperform the slowest chains.

For the most part, chains and independents get the same opportunities for deals from suppliers. This is because the Robinson-Patman Act requires the manufacturer to make sure that all retailers in the market have access to the same deal. This means that the manufacturer must structure his program to suit the smallest retail grocery firm in the market area. Having different requirements for different firms because of their size or organization is illegal. As retail firms grow, the market area they cover usually expands. Therefore, the number of retailers who have to receive the same deal increases. Thus suppliers desiring

to enter the grocery business on a market-by-market basis are finding market areas regional and therefore the costs rise correspondingly. Detroit, for example, used to be an independent market area and any supplier wanting to introduce a product in Detroit only had to make sure all the Detroit area retailers had the same deal. Today that same supplier desiring to enter Detroit would have to advertise, offer coupons, and provide allowances in all of lower Michigan, northern Indiana, and northwest Ohio.

The contemporary operation of the Robinson-Patman Act has two structural implications. First, independent retailers claim that deal structures (introductory and existing products) favor chain operations. This is probably the case since deals are designed so that the smallest retailer can comply. Chains thus are able to meet deal requirements rather easily. Second, increased market size means that introductory programs must be larger and more extensive. Local advertising gives way to regional and national advertising. Coupon activities expand. Small suppliers without the financial resources and marketing know-how are foreclosed from introducing new products. Thus evolving geographic retailer growth (filtered through the Robinson-Patman Act) seems to produce a bias toward introducing new products nationally and results in concentration of food manufacturing.

4.3.7 New Product Procurement in Perspective

Table 4.4 summarizes the new product introduction process and the time required. A noticable fact in Table 4.4 is the variance among wholesalers in the amount of time it takes to fully implement a new product into retail distribution. There are fast and slow wholesalers just as there are fast and slow chains.

TABLE 4.4--TIME REQUIRED FOR A NEW PRODUCT INTRODUCTION TO BE IMPLEMENTED THROUGH THE RETAIL LEVEL

Required Time (Days)	Function to be Performed	Comments
14-21	Obtaining an appointment with a buyer	Process is faster for a known, reputable supplier
1-7	Buying Committee decision	May take longer than 1 week
3	Order Placed	
	Manufacturer processing of order	
5-12	Shipment to retailer-wholesaler warehouse	Variance increasing due to state of transportation system
1-3	Arrival at warehouse and integration into warehouse computer system	New technologies cutting this time
3-14	Distribution to chain stores	Chains use "forced distribution"
7-60	Distribution to affiliated independents.	Independents must be "sold" on the product
2	Stocking on shelves in stores	
36-122 days	Total Time (5-17½ weeks)	

SOURCE: Quaker Oats Co. "Distributor/Buyer Workshop," proceedings of conference held in Chicago, June 1969. (typewritten)

It is very difficult to precisely execute a systematic new product program. Theoretically, manufacturers know what needs to be done and what resources are required to introduce a product. In practice, successful introductions require more than money. Whenever this many people are involved in a decision, things can go wrong. Those suppliers who best understand buying systems and buying behavior will succeed.

A review of the introduction of Pringles, a potato snack made from homogenized potato batter formed into uniform shaped chips, graphically illustrates these points. Although Pringles, marketed by Proctor and Gamble--an undisputed national leader in advertising and marketing expertise, was launched with as much advertising and marketing "punch" as nearly any product in the economy, it has had only moderate success. An analysis of the concept of Pringles would indicate that it should be a great success. Certainly consumer advertising was adequate and professionally executed. Retailers were enthusiastic about the product, even though some buyers admitted frankly they did not like the taste. Pringles allowed retailers to sell potato chips in one-third the store space. Also, it took a product which was formerly delivered direct to a store and made it possible to move it through warehouses with a corresponding decrease in shrink and breakage. All in all Pringles was a revolutionary product. Yet, it had serious problems getting established because Proctor and Gamble did not accurately predict all the relevant behavioral responses.

In the warehouse, since there were no other potato chips, Pringles were classified as a snack cracker. When ordered by the store, they were shipped with the other snack foods. When they got to the store, they were on carts with the crackers, and the stockboys naturally stocked them

in the snack cracker department whereas all the other potato chips were stocked in loose racks near the bread department. In many store layouts consumers purchase bread, and consequently potato chips, before they start down the grocery aisles. By the time the consumers reached Pringles, they did not need potato chips.

Proctor and Gamble recognized the problem immediately. Their resolution was to get Pringles into the potato chip department. Since the revolutionary "tennis ball" container does not fit dump chip racks very well, Proctor and Gamble had thousands of special free standing Pringles racks built. They were given to retailers to put in their potato chip departments and Proctor and Gamble's sales force helped stock these racks. Everything went all right for a while, but the stock boys soon started to revert to their old behavior since Pringles still came into the store with snack crackers. The stock boys had to move the Pringles case around to stock the other crackers and then carry them all the way up to the chip department. As the Pringles racks got empty, they started to "mysteriously" disappear into backrooms or trash totes.²³ To this day the location problem continues. Proctor and Gamble has to constantly have its salesforce relocate Pringles and monitor its sales. Thus one of the great system savings (elimination of daily salesmen deliveries) has yet to be fully captured.

In the above example, the product would have probably failed if it had not had the total commitment of the most powerful manufacturer of groceries in the world. But even that power has not yet been able to overcome the standard operating procedures and self-interested behavior of retail store personnel.

Outside observers of the food system may tend to overlook these behavioral factors. Many analyses merely assume that these large powerful food manufacturing firms can control consumers and retailers to their own liking. There is no question that national manufacturers can influence or partially control a great number of forces in affecting the success or failure of the product. They are not, however, totally beyond the influence of food retailers. Since they still use the retailers' stores and shelves, retailer buying behavior will influence the performance of the manufacturing sector considerably.

The entire new product sales-buying process is dynamic and its nuances make it immensely complex. This results in the retail buyers playing a pivotal role in the whole process. The above discussion is capable of being generalized to all grocery products bought through central buying offices and is not limited to the procurement of processed fruits and vegetables. Buyers do not care whether the product is peaches or pantyhose in terms of their SOPs. They use the same generalized set of criteria presented above. Nor does it seem to matter much whether an individual buyer or buying committee makes the decision; they still use similar criteria. All indications are that the standard new product buying procedures are fairly constant over time, although shifts in the weights attached to criteria change to accommodate changing economic conditions.

4.4 Procedures for Buying Existing Items

4.4.1 Major Aspects of Buying Established Products

The following section documents the standard buying practices used by grocery buyers to purchase existing products. Often called

order-reorder items by the grocery trade, existing products are the brand products which have already successfully gone through the introductory process described in the previous section. These in essence are the brand products which have made it. Purchase procedures for existing items are divided into two distinct groups. The first group are those used on a daily basis to keep track of inventories and stock levels. Included under these procedures are stores' order systems, headquarters' inventory management systems, and buyer performance monitoring forms. The second group deals with the nature and use of manufacturer-generated deals on products already in distribution. The sections which deals with these procedures includes examples of actual promotions and the nature of terms of trade between buyers and sellers. This section concludes with a discussion of some miscellaneous observations about the procurement of existing brand products.

By necessity grocery buyers develop information and data-handling systems which facilitate their jobs. The following section examines the basic substance of typical buying information systems. The material presented represents the "average" state of the arts vis-a-vis buying systems. Most firms interviewed had similar systems although there were, of course, differences generated by specific information needs of individual firms. No doubt there are retail firms which have more advanced systems, however, the most common system is explained because it demonstrates the knowledge the "typical" buyer has. Also, the information-handling systems described below incorporate private label products since all grocery products are included. Therefore, this is one area of the brand procurement discussion which is directly applicable to private

label product procurement. Otherwise, the procurement of private label products is nearly independent of brand procurement.

4.4.2 Store Ordering Systems

The initial order point for a grocery item is at the store shelf placing. Most stores order once a week although many high volume stores will order groceries twice a week. Store order schedules are set up to minimize warehouse-to-store transportation costs.

There are two common store order systems. One uses an order book, a booklet printed weekly or a loose-leaf notebook which is given to the store by distribution headquarters. It contains a list of all the products available for distribution to stores (in the case of independents) or the items authorized for distribution (in the case of chain stores). Exhibit 4.6 is a page taken from an actual store order book. The columns to the extreme right are the store order strips. Those ordering for the store make a systematic pass through the store. For each item that requires ordering, they place the appropriate quantity (in cases) on the order strip. The amount ordered is entered in the store record column. The store order strips which are perforated and can easily be separated from the book, are then forwarded from each store to headquarters, where they are used to make up store orders. The shipping of the store orders triggers the headquarters ordering sequence. In the case of Exhibit 4.6, the order books are printed weekly. There are order books for all major departments.

The other store order system uses the wand, a small portable electronic unit about the size of a calculator used to scan the UPC (Universal Product Codes) codes on the unit price labels placed on supermarket

EXHIBIT 4.6--SAMPLE PAGE FROM A STORE ORDER BOOK

CODE	CASE COST	UNIT COST	REFLECT	SUCC. RET. PRICE		GENERAL INFORM.	DESCRIPTION	PACK & SIZE	PAGE 909		PAGE 909	QTY.
				REGULAR	SPECIAL				STORE RECORD			
							SARA LEE BAKERY PRODUCTS					
416-040	15.10	1.28		1.59-21	1.49-16		CHEESE CAKE LARGE	12 181oz.			416-040	
416-057	15.10	1.28		1.59-21	1.49-16		CHERRY CHEESE CAKE	12 18 3oz.			416-057	
416-073	15.10	1.28		1.59-21	1.49-16		STRAWBERRY CHEESE CAKE	12 18 3oz.			416-073	
416-081	9.95	1.66		2.09-21	2.09-21		CHOCOLATE-BAVARIAN CAKE	6 18 1/2 oz.			416-081	
416-099	9.95	1.66		2.09-21	2.09-21		STRAW-FRENCH CHEESE CAKE	6 18 1/2 oz.			416-099	
416-123	11.32	.94		1.19-21	1.19-21		CHOCOLATE BROWNIES	12 13oz.			416-123	
416-131	12.05	1.00	1.20	1.39-28	1.39-28	11/1	BUTTER STREUSEL Coffee Cake L	12 11 1/2 oz.			416-131	
416-206	12.05	1.00	1.20	1.39-28	1.39-28	11/1	PECAN COFFEE CAKE - Large	12 11 1/2 oz.			416-206	
416-214	9.45	.79		.99-20	.99-20		BLUEBERRY COFFEE RING	12 9 1/2 oz.			416-214	
416-248	13.25	1.10		1.39-21	1.39-21		APPLE FRUIT N DANISH	12 13oz.			416-248	
416-255	13.25	1.10		1.39-21	1.39-21		CHERRY FRUIT N DANISH	12 13oz.			416-255	
416-305	8.59	.72		.89-20	.98-27		CINNAMON ROLLS	12 8 1/2 oz.			416-305	
416-321	12.05	1.00	1.20	1.39-28	1.39-28	11/1	PECAN CARAMEL ROLLS	12 10 1/2 oz.			416-321	
							SARA LEE LOAF CAKES					
416-362	11.32	.94		1.19-21	1.19-21		BANANA	12 13 1/2 oz.			416-362	
416-404	11.32	.94		1.19-21	1.19-21		CHOCOLATE	12 13 1/2 oz.			416-404	
416-448	11.32	.94		1.19-21	1.19-21		POUND	12 10 1/2 oz.			416-448	
416-420	11.32	.94		1.19-21	1.19-21		ORANGE	12 13 1/2 oz.			416-420	
416-461	11.32	.94		1.19-21	1.19-21		GERMAN CHOCOLATE	12 12 1/2 oz.			416-461	
							PEPPERIDGE FARM LAYER CAKES					
416-487	6.50	1.08		1.35-20	1.35-20		COCONUT	6 17oz.			416-487	
416-495	6.50	1.08		1.35-20	1.35-20		DEVILS FOOD	6 17oz.			416-495	
416-479	6.50	1.08		1.35-20	1.35-20		GERMAN CHOCOLATE	6 17oz.			416-479	
416-636	9.55	.80		.99-20	.99-20		CHOCOLATE	12 12oz.			416-636	
416-644	9.55	.80		.99-20	.99-20		MAPLE SPICE	12 9 1/2 oz.			416-644	

gondolas (shelf structures). Those ordering hold a pencil-like stylus in their hands. For each product which needs ordering, the stylus is passed over the UPC label once for every case needed. After the order is complete, the scanner is hooked to a telephone coupler which transmits the order electronically to the headquarters computer. The computer compiles all the orders and issues itemized shipping orders for each store. The wand system is faster but its disadvantage is the lack of "hard copy" record for the store manager. Also, if those ordering lose their place, there is the tendency to over-order items.

One common problem in store ordering is that items out-of-stock in the store often have their space usurped by neighboring products. The person ordering can easily overlook those items. Thus in current systems the most popular items tend to be out-of-stock more often than need be and is one reason retailers approve of the extensive use of brokers and manufacturer representatives in store work. During their frequent store visits, they often identify and correct these problems.

Store ordering will undergo a revolution should the full potential of laser scanning be realized. The technology now exists which would permit the store-level computer to record all sales, check those sales in an ordering program, and directly execute an electronic order to the manufacturer's computers. Thus store ordering in the future could be done automatically without human assistance. However, the status of this type of retailer-supplier interaction is not clear under current antitrust legislation and implementation.²⁴

Store orders are totaled by and executed from a central buying headquarters. The actual buying takes place at this level and is basically the same across all food retailing firms.

4.4.3 Warehouse Inventory Control-Buying Systems

A. Quantity Monitoring Systems

Nearly all grocery warehouses have instituted computerized inventory control programs, many of them variations off of an IBM software package called IMPACT. Each firm modifies the IMPACT program to suit its own needs, but the basic elements of the program remain. Exhibits 4.7 and 4.8 were taken from a sample page of an existing IMPACT program and demonstrates the types and quantities of information contained on these systems.²⁵ A brief discussion follows on how one representative modified IMPACT system works.²⁶

All ordering systems collect relevant vendor (supplier) information which includes the vendor's number, which buyer is assigned to these products, and transportation and shipping information. Information directly dealing with purchasing includes the financial terms offered by the supplier (2%-10 days) and the lead time it takes to ship the product when an order is received which is critical for calculating purchase orders. In most cases, the vendor information is at the top of each computer page as with the top blocks of information in Exhibits 4.7 and 4.8. The other blocks contain the information for one product. Notice in Exhibit 4.7 there is a block of information for 16-ounce and 28-ounce tomatoes. Often individual vendors require several pages of computer printout to list off their products.

Exhibit 4.7 illustrates the basic product information used to print the order books for stores (See Exhibit 4.6) which gives the necessary information to store owner managers. Suggested retail price information is included in the order books. Included in Exhibit 4.7 is space for

EXHIBIT 4.7--SAMPLE PRODUCT INFORMATION TAKEN FROM A GROCERY
WAREHOUSE INVENTORY CONTROL-BUYING SYSTEM

IMPACT REVIEW

IM-4-2100

9

VENDOR NO. 3781040	ORDER VENDOR	DATE 04/20/77
PAGE 5	BUYER NAME	BYR A

ITEM DESCRIPTION									
SLICED POTATOES									
PACK 12	SIZE 39 OZ	FAC	M/C		CUBE .77	WEIGHT 36.0			
BULLETIN INFO 05/09-05/30				MANUFACTURER'S DEAL F .50 04/11-04/25					
UPC		CLASS 1070		P/A CODE		REFLECT		RSC	
A RETAIL 71	% 19	C RETAIL 67	% 14	Z RETAIL					
ITEM DESCRIPTION									
TOMATOES									
PACK 24	SIZE 16 OZ	FAC	M/C		CUBE .68	WEIGHT 28.5			
BULLETIN INFO				MANUFACTURER'S DEAL					
UPC		CLASS 1050		P/A CODE		REFLECT		RSC	
A RETAIL 35	% 20	C RETAIL 33	% 15	Z RETAIL					
ITEM DESCRIPTION									
TOMATOES									
PACK 24	SIZE 28 OZ	FAC	M/C		CUBE 1.15	WEIGHT 50.5			
BULLETIN INFO				MANUFACTURER'S DEAL					
UPC		CLASS 1050		P/A CODE		REFLECT		RSC	
A RETAIL 59	% 19	C RETAIL 55	% 13	Z RETAIL					
ITEM DESCRIPTION									
MIXED VEGETABLES									
PACK 24	SIZE 15 OZ	FAC	M/C		CUBE .61	WEIGHT 26.0			
BULLETIN INFO				MANUFACTURER'S DEAL					
UPC		CLASS 1060		P/A CODE		REFLECT		RSC	
A RETAIL 29	% 22	C RETAIL 27	% 16	Z RETAIL					

28 ITEMS ON THIS VENDOR									

EXHIBIT 4.8--SAMPLE ORDERING INFORMATION TAKEN FROM A GROCERY WAREHOUSE INVENTORY CONTROL-BUYING SYSTEM

COMPANY NAME		PHONE		REV	MINIMUM
SALESMAN'S NAME		LEAD	P. LST	2	42,000
SALESMAN'S ADDRESS		2.0	.0	2-10	44,000
CITY - STATE		00.68	ALTERNATE		
		ZIP	P.O.	SUPPLY	CONFIRM
		34693	T		

057281	SUG. ORD.	NEW SUG. ORD.	IOF	ADVANCE ORDER	ORD. INC.	PAT. TIE	STAT.
58	280	PPPP	22.5	15	7010X07	2	200000
WEEK 1	WEEK 2	WEEK 3	WEEK 4	WEEK 5	DATE 1	P/O 1	QTY 1
17	17	12	11	12	05/05A	2805	280
52 WK. AGO	48 WK. AGO	44 WK. AGO	40 WK. AGO	SUB. CODE	DATE 2	P/O 2	QTY 2
58	90	124	2				
RES. INV.	ALT. INV.	MAD	WK. ADJ.	YTD ADJ.	YTD SALES	DATE 3	P/O 3
		2.97	2-		59		
NEW VENDOR	NEW WAVE	NEW MAD	NEW IOP	YTD CHG.	VAR.	NET	COST
				25	340	647	660
							694

059709	SUG. ORD.	NEW SUG. ORD.	IOF	ADVANCE ORDER	ORD. INC.	PAT. TIE	STAT.
437	360		28.5	184	9015X06	2	450000
WEEK 1	WEEK 2	WEEK 3	WEEK 4	WEEK 5	DATE 1	P/O 1	QTY 1
178	216	146	283	666	04/2233425		360
52 WK. AGO	48 WK. AGO	44 WK. AGO	40 WK. AGO	SUB. CODE	DATE 2	P/O 2	QTY 2
1186	810	790	840				
RES. INV.	ALT. INV.	MAD	WK. ADJ.	YTD ADJ.	YTD SALES	DATE 3	P/O 3
		34.83	5	4	663		
NEW VENDOR	NEW WAVE	NEW MAD	NEW IOP	YTD CHG.	VAR.	NET	COST
				34-831		639	651
							676

90 G

059824	SUG. ORD.	NEW SUG. ORD.	IOF	ADVANCE ORDER	ORD. INC.	PAT. TIE	STAT.
372	550		50.5	198	5010X05	2	600000
WEEK 1	WEEK 2	WEEK 3	WEEK 4	WEEK 5	DATE 1	P/O 1	QTY 1
199	217	157	221	159	04/2233425		150
52 WK. AGO	48 WK. AGO	44 WK. AGO	40 WK. AGO	SUB. CODE	DATE 2	P/O 2	QTY 2
650	697	901	797		05/04A	2800	400
RES. INV.	ALT. INV.	MAD	WK. ADJ.	YTD ADJ.	YTD SALES	DATE 3	P/O 3
		29.32	3		675		
NEW VENDOR	NEW WAVE	NEW MAD	NEW IOP	YTD CHG.	VAR.	NET	COST
				38	856	1070	1091
							1150

060285	SUG. ORD.	NEW SUG. ORD.	IOF	ADVANCE ORDER	ORD. INC.	PAT. TIE	STAT.
106			26.0	30	9015X06	2	480000
WEEK 1	WEEK 2	WEEK 3	WEEK 4	WEEK 5	DATE 1	P/O 1	QTY 1
39	21	31	18	12			
52 WK. AGO	48 WK. AGO	44 WK. AGO	40 WK. AGO	SUB. CODE	DATE 2	P/O 2	QTY 2
58	80	84	93				
RES. INV.	ALT. INV.	MAD	WK. ADJ.	YTD ADJ.	YTD SALES	DATE 3	P/O 3
		6.61			106		
NEW VENDOR	NEW WAVE	NEW MAD	NEW IOP	YTD CHG.	VAR.	NET	COST
				135	329	509	519
							546

90 G

UNITS ORD	1,255	*INV	9,332	\$	62,399
WEIGHT ORD	43,971	*W-SALE	2,391	\$	17,500
CUBE ORD	1,006	*Y-SALE	8,787	\$	64,791
COST ORD	8,429	*Y-INC/DFC	40%	\$	18,534
IOF ORD	43,970	*SERVICE	95.56%	\$	95.16%
UNITS MOD	1,247	*WKS-ON-HAND	3.90	\$	3.76

manufacturer deal information and bulletin information. Bulletins are another vehicle used to communicate with the stores.²⁷ This type of information is usually in a column on the computer output. Specific information, however, varies with the organization. For example, chain store managers do not usually get the details about manufacturer deals.

The four products in Exhibit 4.7 correspond to the middle four blocks in Exhibit 4.8. Most of the routine buying decision on grocery products are made from the information contained in this part of the inventory-control form. Most of the fields in each product block are simple arithmetic calculations of one another.

The system works as follows. Each product is ordered in pallet size units. The number of cases in an order is determined by the size of the case and how many cases can fit on a pallet and still stay within cube specifications for slots in the warehouse. This information is contained in the upper right corner of each product box.

As store orders are shipped, the number of shipped cases is recorded per week (third row). A five-week average is calculated (WAVG--second row). This becomes a critical number. This number is divided into total inventory to get the number of weeks of product on hand (WOH--second row). Most firms try to maintain a four-week inventory. When existing inventory gets low, the program automatically prints out a purchase order for the product. Past orders are tracked on this form in the center right boxes in each product unit block. This information is contained in the Date--P O--QTY fields.

Notice there is historic information contained in the system. The historic information is presented as total five-week sales for the five weeks ending fifty-two weeks ago (fifth row). Likewise for forty-eight,

forty-four, and forty weeks ago. This information serves to alert the buyer about pending seasonal activity in the product. A quick glance can tell the buyer whether sales were increasing a year ago. Notice, however, it does not tell the buyer why sales patterns changed over that period.

Another very important number is the one labeled MAD (fifth row), mean average deviation. MAD is important because it is the number the buyer uses to force the system to override its normal operation. Operating normally the WAVG and the MAD interact to generate a purchase order. The WAVG is the average weekly usage and MAD is the variance in usage experienced by the product, and both change as they are updated weekly. By overriding the actual MAD with a large fictitious MAD, the buyer "tricks" the program into printing out a purchase order. With a purchase order in hand, the buyer can order whatever quantities he deems necessary.

The buyer may override for many reasons. Usually it involves "adding intelligence" to the system of case orders. Unusual events can cause shipments to drop or increase for one week. This can cause problems in future weeks. Perhaps the firm is planning a promotion. Weather patterns, strikes, and new stores all can change product movement changes which are not reflected in the IMPACT system. Every system encountered during the interview process had some method through which buyers could override the automated sequence and bring human decision-making to bear.²⁸

The lower right-hand corner of each product block contains price information. The cost number is the cost to the buying headquarters. The net figure is the cost of the product less the 2 percent discount. The price figure is the current list price being posted by the manufacturer.

The bottom block in Exhibits 4.7 and 4.8 contain the summary information generated on this particular vendor. As indicated in Exhibit 4.7, this supplier ships 28 different items to this grocery distributor. There are some interesting things calculated in this area. One very important one is the service level (Exhibit 4.8) provided by this vendor, that is, the percent of ordered products shipped to the retailer's warehouses. This is a critical measurement for suppliers, especially private label suppliers.

The basic numbers, however, are those at the right hand margin of Exhibit 4.8. These are the quantities in number of cases ordered by the IMPACT program for this warehouse. They are multiples of the pallet quantities. Basically, a harried buyer takes all the product printouts and runs down the margin until he finds an order (90G in Exhibit 4.8). The buyer then makes a quick decision whether or not the order is appropriate. Aside from those which need adjustment, or those he overrides in anticipation of a planned promotion or seasonal variation, the orders are printed by the computer and routinely processed.

Interviews indicated that somewhere between 80 and 85 percent of the purchase orders are allowed to go through unrevised. The remaining orders are special cases where the buyers have made cognizant decisions to override the computer system.

B. Price Monitoring Systems

One notable type of information is missing from the computerized inventory-buying programs: price information. The IMPACT-type programs are excellent at keeping historic and current records of quantities of product sold, however, when examining those historic figures, the buyer

has no indication why the movement occurred. Not only is the "own" price of the product fifty-two weeks ago missing, but the prices of competing products, level of promotion activity as well. In order for buyers to make meaningful decisions, they need to carry another price information system along with the computerized system. Most buyers use a cardex filing system.

A typical cardex system would include a card for each product with all orders and order dates recorded, and the prices of all those orders. Many buyers use different color entries to indicate various facts. Retailer promotions might be entered in green. Supplier-initiated price changes might be in red. The buyers are able to tell at a quick glance where this product stands vis-a-vis last year's record. Any data about unusual movements spotlighted by the computer system are easily explained by referring to the cardex system. Aside from retailer promotions which the buyer remembers, cross-commodity information is not recorded. In order to check those possibilities, the buyer must initiate an extensive search within the cardex system. Most veteran buyers do, however, have a feel for the cross elasticities for various products. These are purely subjective and rarely quantified.

Some firms are attempting to merge both types of data systems together in one computer program to have this information available to buyers via cathode ray tube (CRT) terminals at each buyer's desk. Since buyers are extremely busy and they would have to initiate the task, progress in CRT installations is quite slow. Also, price information for brand grocery products is difficult to standardize. Most deals have many facets and different manufacturers have different provisions. Finally, there may be private agreements between buyers and salesmen

(especially brokers) which neither party wants publicized within the retail organization.

C. Cyclical Bias

The data systems used impart extraordinary "cycle" bias to super-market buying and merchandising. For example, assume the IMPACT system is tracking normally. All of a sudden the buyer notices that a year ago this product was shipped in quantities four times the normal volume. He then flags that product, say baked beans, and goes to the cardex file and sees that they sold extremely well for Memorial Day. This is because retailers promoted the product and suppliers offered special deals at retailer request. The buyer deduces that consumers buy more baked beans on Memorial Day, so he orders more baked beans and tries to get price concessions from suppliers. Baked beans are promoted. Consumers buy. The normal movement quadruples for two weeks. Meanwhile the buyer goes about reviewing his movement records and notices that paper plate orders increased greatly in the middle of June. Again checking records, he finds that consumers buy a lot of paper plates for the July 4th holiday.

This cycle repeats itself year after year for many, many products. Retailers sell turkeys at Thanksgiving and hams at Easter. The data system is partially responsible for this kind of self-reinforcing buyer-merchandiser behavior. It is not only for holidays, but for all weeks and countless products. In fact, many buyers have come to routinely expect X supplier to have Y deal during Z week every year. Only very unusual circumstances which shock a product sector or truly innovative merchandising materially alter this pattern of behavior.

D. System-Induced Inertia

The data systems used also directly affect price flexibility. Recall that in Exhibit 4.7 gross margins for the product are set in the computer record of that product. When the cost of a product changes, the retail price of the product will change by a set constant margin. Margins are set when the product is accepted into distribution. Only if invoice price changes show up on the computer will the suggested retail price change. This may not happen. Most deals (price concessions) by manufacturers are calculated as a reduction per case off the invoiced case costs. On many invoices the order is processed at invoice cost and the deal monies are deducted at the bottom of the invoice at the total columns. To get the cost of a true case, clerks must divide the deal monies by the number of cases in the order and subtract the case savings from the invoiced case cost. Should the clerks or key-punch people forego this step, the invoice cost and therefore the retail price will stay the same within the computer system. Thus wholesale and retail prices lose their parallel movement during wholesale price declines. With the increasing sophistication of large distributors, this type of problem has probably diminished significantly.

In Exhibit 4.7, this program allows space for manufacturers deal information. Notice, however, that prices are not automatically adjusted for the deal prices. Thus even in those systems where deals are recorded, the retailer maintains the option on whether he wants to reflect the lower price to the consumer. In addition, the system reviewed in Exhibits 4.7 and 4.8 only records formal deal periods. If there are buying and stock protection considerations (see Section 4.4.4) these will not necessarily show up on the formal product tracking programs. Thus

retail distributors have considerable discretion over passing forward price decreases. Both these factors lead to inertia-laden prices on the downside.

Price increases are not, however, encumbered by this inertia. Price increases usually show up as increased case prices on the invoice. Key purchasers immediately pick up the increase. The constant margin is then added to the increased cost and retail prices are adjusted upward. This process also helps explain the partial cyclical nature of retailers' profits. Retailers usually make more profits in inflationary times. For although the gross margin is constant, it is multiplied by a higher price. Thus retailers' gross dollar profits rise even though their gross profit margin stays constant. Since price increases usually precede cost increases, retailers' profits seem to appear better in early stages of inflation. Continued inflation means continuing increasing profits under a constant margin standard operating procedure.

Margin structures are even more rigid than price changes. It takes a conscious, concerted effort on someone's part in the retail organization to change a product's gross margin. Because there are 8000-9000 items in a grocery warehouse under the jurisdiction of only five or six buyers, it is unlikely that many items will have their margins set to reflect current economic conditions. Many fruit and vegetable margins are so set in tradition that they are only rarely evaluated. Grocery firms will have periodic margin evaluations which are usually precipitated by a price war or management-dictated change in the image portrayed by the firm. These systematic margin evaluations usually only go down to product group levels and hardly ever to individual products.

Another form of information flow in retailing is the use of headquarters bulletins which are tangentially related to buying. The bulletins inform the stores of the merchandising plan for the week, the special buys, the products with price adjustments, and other things being contemplated by headquarters. Buyers often use store bulletins to remind managers to process their Easter orders, deer hunting season orders, Halloween orders, etc. The store managers respond by ordering what sold last year and the merchandising-buying cycle continues.

This brief explanation of the buying data systems provides some insight into how the everyday grocery buying decisions get made. It helps explain the great deal of inertia facing price and quantity adjustments in the system and also helps point out the vital necessity for someone to initiate and follow through on changes in prices and quantities of individual products. How changes are initiated and executed in the system are documented in the next few pages.

4.4.4 Standard Provisions for Bargaining and Pricing of Established Grocery Products

Basically, brand manufacturers institute various programs designed to induce retail buyers to react in a way which will benefit the supplier's products. Over the years, certain sets of programs have evolved and become standard practices in the food business. Many of these standard practices were initiated by buyers in an attempt to "get a better deal." Manufacturers, responding to competitive pressures, then agreed to provide that provision in their next deal. Because manufacturers are always seeking a relative advantage over their rivals, new forms of "deals" are constantly evolving.

A. Types of Manufacturer Promotions

There are two kinds of manufacturer-sponsored promotions. The special promotion on one or a closely related group of products is designed to emphasize price and savings. These are usually short-term and often run in specific markets. Their goal is to increase product movement and increase market share. "Theme Sales" are another type of promotion, storewide sales which are giant nation-wide extravaganzas put on by large manufacturers. They usually involve a coordinated television, newspaper, and store-level display blitz of the manufacturers products. Exhibit 4.9 is an example of an announcement of a manufacturer's theme sale. It demonstrates the elements of a theme sale: coordinated coupon drops, television and newspaper advertising, and tie-in activities at store level for a whole set of products. The theme sale is a classic manifestation of the economies of promotion. The marginal cost of promoting additional products when all the national program is set is rather small. In addition, theme sales are flexible. The manufacturer can add or delete items depending on the supply and demand conditions facing each individual product (See Section 6.4.2).

Theme sales are the domain of the large diversified national food manufacturer. Smaller national and regional firms do not have the financial ability or expertise to properly execute a store-wide theme sale. In addition, the cyclical buying pattern of grocery buyers again surfaces. Buyers expect theme sales every year about the same time by the same companies. Therefore they expect a sale by Company X in the third week in October, Company Y in the first week of November, etc. Buyers and merchandisers plan on these sales. There is a limit to the number of store-wide theme sales which can be run in one year. Display

EXHIBIT 4.9--EXAMPLE OF A MANUFACTURER'S THEME SALE

A GIANT FIELD DAY OF SAVINGS

The Giant's celebrating his new crop by offering bushels of savings on his canned and frozen goods. Join the celebration. It'll mean a field day of sales for you!

7% OFF COUPONS

Head of the household, already reaping the benefits of our savings, now you can too. Just show this coupon at the Giant's Field Day sale. They'll save you more than 7% on all your purchases. That's a real field day!

7% OFF COUPONS

Two customers can save 7% on all Giant's Field Day sale purchases. Just show this coupon at the Giant's Field Day sale. They'll save you more than 7% on all your purchases. That's a real field day!

And he's spreading the word. On network TV. In newspapers. Have a field day yourself. The fun!

For more information, call 1-800-555-1234. Or visit us online at www.giantsfieldday.com. Giant's Field Day sale is a registered trademark of Giant's Field Day. © 1999 Giant's Field Day. All rights reserved.

space and attention spans of merchandisers limit store-wide sales to one to three weeks. Therefore, it is difficult for other firms to initiate theme sales.

Normal promotions by manufacturers are similar to theme sales in that they contain the same elements (advertisements, coupons and store tie-ins). They are, however, on a much smaller scale. National television coverage is scaled down. The television or radio used is usually on a local market, spot basis. Consequently the trade-oriented aspects of the promotion become much more critical for its success. The use of coupons tends to be restricted either to specific markets and/or specific media. Given that many companies may be offering promotions on many products at the same time, the structure of the "deal" to the retail trade and the nature of the buyer-supplier personal relationship become critical variables in determining which deals get chosen by the buyers for special attention within the internal workings of the buying system.

B. The Role of Coupons

Although the basics of television advertising were discussed before,²⁹ the use of coupons, however, was not discussed in detail. The use of manufacturers coupons has two distinct goals: 1) to induce the consumer to ask for a product and 2) to put a price decrease directly into the hands of a consumer instead of the retailer. Every coupon drop has both purposes in mind. However, the primary reason for coupon use changes with the type of product. The first goal predominates when coupons are used to introduce new products. Coupons, thus, force the retailer to stock a new product. In addition, cents-off coupons are useful for helping establish the price structure of a new product. Given the nature of

fixed margins and inertia pricing in retail operations, if a manufacturer introduced a new product with a "special introductory price," that price invariably became the after introduction price. Manufacturers have learned that they should introduce the product at roughly the price they want and use cents-off coupons to get a special introductory price to the consumer. However, the principal reason new products are introduced with coupons is to get retailers to stock the product.

As will be evident below, there is no guarantee that a price decrease on a product by a supplier will be shown at the retail shelf or will the consumer be made directly conscious. Therefore, manufacturers wishing to promote an existing product view coupons primarily as an assured way of getting a price decrease to the consumer. However, when a supplier offers coupons, the retailers have to adjust their orders to compensate for the greater demand for the product.

Table 4.5 attests to the growing use of manufacturers' coupons. Manufacturer cents-off coupon use increased in 1979 to a total circulation of 81.2 billion.³⁰ The majority of coupons are circulated through newspapers. These, of course, are much easier to target to individual markets and are the least expensive.

In/on pack coupons are anathema to the retail sector. Special promotion packages must be warehoused and handled separately. In addition, the special product must be sold during promotion periods and cannot be readily brought in by buyers. In/on pack coupons are still used for the health and beauty aid products because the majority of these products are handled in the store by rack jobbers or specialty wholesalers who take responsibility for the extra handling.

TABLE 4.5--MANUFACTURER CENTS-OFF COUPONS BY MEDIA, 1974-79

Media	1974	1975	1976	1977	1978	1979
	Percent Distributed Via					
Newspapers	51.8%	55.9%	55.8%	56.0%	55.6%	52.3%
Sunday supplements	12.7	11.6	9.5	8.5	7.7	9.5
Freestanding inserts	7.0	6.5	7.2	11.8	13.4	14.9
Magazines	16.7	13.8	15.4	12.5	12.5	12.2
Direct Mail	4.6	4.2	4.1	3.0	3.0	3.2
In/on Pack	7.2	8.0	8.0	8.2	8.9	7.9
Total coupons distributed (Billions)	29.8	35.7	45.8	62.2	72.7	81.2

SOURCE: A.C. Nielsen Co., Northbrook, IL

The redemption rate on coupons varies by product and media used. On direct mailings, one firm reports a 15 percent redemption rate with a rate as high as 20 percent for price-sensitive staples such as coffee. "In the four weeks after one recent mailing, the Florida Citrus Commission moved 10 million units of orange juice--all on coupon."³¹ When all media and values are averaged, an overall redemption rate of 5 percent of coupons issued probably prevails. In 1979, the average face value of a coupon was 17.1 cents. At a 5 percent redemption rate, the total value to the consumer of redeemed manufacturers' coupons in 1979 was \$694.2 million. In addition, the handling fee paid by manufacturers to retailers (assuming a 5-cent fee per redeemed coupon) amounted to approximately \$230.0 million in 1979.

The numbers of coupons available to customers in the market area is quite large. Thus retailers attempt to monitor coupon distributions by manufacturers. The buyers or buyer-merchandisers are usually responsible for this. Forms which monitor coupon distributions are circulated to all retail personnel who might be affected by it. Exhibit 4.10 is a copy of an authentic coupon-tracking document and demonstrates the types of distribution information collected. It was prepared for a buying committee meeting as part of a routine set of forms needed to inform all buyers about pending market developments.

Coupon use therefore is a two-pronged instrument. It helps induce retailers to act to consider a change to a given product's price or shift position. Also, it is the most effective method manufacturers have to get price decreases of their products to the consumer. The reason they need to use coupons to accomplish this will be apparent when the

EXHIBIT 4.10--MANUFACTURER COUPON TRACKING DOCUMENT USED BY BRAND GROCERY BUYERS

MANUFACTURER'S COUPONS

(merino 3/8)

CODE	SIZE	ITEM	VALUE	TYPE OF COUPON	NEWSPAPER	DATE
75410	48/15 1/2	Ken-L Cornu Box	28¢	S.S.	F-Press	3/27
42245	12/24	Cornu Oil	10¢	BFD	D.N.-F.P.	3/28
42250	12/28	"	"	"	"	"
42253	8/18	"	"	"	"	"
42254	6/128	"	"	"	"	"
34924	12/62	Cornu Tindur (6)	5¢	Apple	All Market	4/12
71539	48/6 1/2	Cornu Tindur (6)	1.00	Apple	Magazines	4/12
		Cornu Tindur (6)	1.00	Apple	Magazines	4/12
		Cornu Tindur (6)	1.00	Apple	Magazines	4/12
		Cornu Tindur (6)	1.00	Apple	Magazines	4/12
5180	12/18	Cornu Tindur (6)	10¢	BFD	D.N.-F.P.	3/16
5182	12/18	Cornu Tindur (6)	10¢	"	"	"
38674	8/6	Cornu Tindur (6)	15¢	SS	D.N.-F.P.	3/28
38678	8/6	Cornu Tindur (6)	15¢	SS	D.N.-F.P.	4/3

BFD - Best Food Day
SS - Sunday Supplement
NM - Direct Mail
MAG - magazine
DN - Detroit News
FP - Free Press

(15)

standard practices of retailers of dealing with manufacturer promotions are explained below.

C. Trade-Oriented Components of Promotions

The other part of any manufacturer promotion is the trade-oriented package. For new products, the trade-oriented material is designed partly as a system to defray the costs incurred by the retailer when introducing the new product. The trade package part of manufacturer deals is, simply put, the amount of effort sufficient to get the buyer and retail firm to act positively on the manufacturer's deal. This is the area of buying which is the challenge both to the buyer and seller. The seller is trying to induce buyer action with the smallest concession. The buyer, for his part, is attempting to get the best "deal" for his firm. There are many nuances to the exchange agreements made and the following discussions document the standard types commonly used in the deals on existing brand food products.

Exhibit 4.11 which serves as an introduction to this section, is an actual deal sheet on an actual product in grocery distribution and is fairly typical of the types of deals or promotions constantly being issued by manufacturers. A deal to the trade has three basic parts: 1) the allowance or terms of offer; 2) the performance required of the retailer; and 3) other standard considerations.

Promotion allowances, buying allowances, display allowances, advertising allowances, merchandising allowances--whatever an allowance is called--is a price reduction per case of the product in question. In Exhibit 4.11, it is \$1.44 per case or 12 cents per unit. All allowances are multiples of the number of units in a case. The most common

EXHIBIT 4.11--EXAMPLE OF A MANUFACTURER'S DEAL SHEET

BEST FOODS DIVISION * CPC INTERNATIONAL, INC. *



SKIPPY.

AMERICA'S #1 SELLING PEANUT BUTTER

March 11, 1977

To: Our Customers - Area #

A SKIPPY PROFIT AND TRAFFIC BUILDING PROMOTION\$1.44 SPECIAL ADVERTISING MERCHANDISING ALLOWANCE - 18 oz. Size

*** DEAL # ***

ITEM: SKIPPY PEANUT BUTTER - 12/18 oz. --- Creamy and Super Chunk

UPC Code: 27064 - Creamy 27040 - Super Chunk

DURATION OF OFFER: FIRST SHIPPING DATE - APRIL 4, 1977
LAST ORDER DATE - APRIL 22, 1977
LAST SHIPPING DATE - APRIL 29, 1977

PERFORMANCE DATES: APRIL 4, 1977 - MAY 13, 1977

TERMS OF OFFER: \$1.44 Special Advertising Merchandising Allowance on 18 oz. Skippy Peanut Butter will be deducted from the invoice or paid by IGM at the end of the performance period on all shipments during the above period providing retailer qualifies as listed below:

PERFORMANCE:

- Include in regular, principal newspaper ads or handbills a 12c (minimum value) "throw-away" store coupon. Best Foods is not responsible for any redemption or handling costs. Coupon will be good on 18 oz. Skippy Peanut Butter (Creamy or Super Chunk) at stores noted in advertisement in which coupon appears.
- Place a two column inch ad in regular, principal newspapers for 18 oz. Skippy Peanut Butter showing a 12c (minimum) price reduction below regular shelf price during the performance period.
- Display separate and apart from regular shelf space featuring 18 oz. Skippy Peanut Butter at a 12c (minimum) price reduction below regular price for at least one week during the performance period.

Standard form of performance contract utilized with all accounts.

(over)

MADE EXCLUSIVELY WITH U.S. GRADE #1 PEANUTS.

EXHIBIT 4.11--(cont'd)

- 2 -

PERFORMANCE: (cont'd.)

Wholesaler must publish to all accounts (in bulletins or manner usually used) informing accounts that they will pay allowance for a minimum period of three consecutive weeks. Bulletin should state that allowance is payable to retail customers for performing according to terms of the Best Foods contract.

STOCK PROTECTION:

For all merchandisers accepting this contract, unsold stocks in buyer's warehouse, except Foodservice and Industrial users, shipped between March 5, 1977 and April 3, 1977 and not to exceed prior 30 days shipments will be protected to the full amount of the promotional allowance, regardless of price at which billed. This applies to off-invoice allowance or to performance promotions when customer signs contract.

TERMS:

2% for cash in 10 days will be allowed on the gross amount of the invoice before deduction of this allowance, providing remittance is mailed to address designated on invoice.

ADVERTISING:

Heavy prime time network and spot TV on ABC, NBC and CBS during promotional period.

Best Foods reserves the right to limit quantities purchased by merchandiser. Merchandise sold under the terms of this allowance is offered for resale only in the above territories.

Your Food Brokerage Company sales representative will be contacting you soon to provide a contract for your signature and to assist in your merchandising plans.

Very truly yours,

BEST FOODS DIVISION
CPC International, Inc.

District Manager

AJR:es

allowances for canned fruit and vegetables are \$.48 and \$.96 (multiples of 24 cans per case). Often several allowances are combined in one deal: for example, a \$.50 a case buying allowance, an advertising allowance, and perhaps a handling allowance. They are all subtractions from case invoice cost.

There are two common ways and one uncommon way of billing this cost reduction to the retailer. With the first and most common method, off-invoice billing, the retailer simply subtracts the allowance from the invoice and remit the net balance to the supplier. The retailer only does this if he has met the performance requirements. With the second common method, bill-back, the retailer pays full cost and later upon proof of compliance with performance, the manufacturer returns to the retailer the amount of allowances earned for sales during the promotion period. In the third, rarely used method, count-recount, the manufacturer actually enters the retailer's warehouse and counts inventories at the beginning of the promotion and recounts them at the end of the promotion. The manufacturer then pays the allowance monies due.

The latter two methods favor the manufacturer because the allowance (price reduction) is not paid until the supplier has actual proof that the retailer actually lived up to the deal's performance requirement. With off-invoice, the retailer receives payment for the promotion often before he has complied with the performance requirement. Obviously, the retailers favor off-invoice billing. They can then execute the performance requirements with the manufacturer's money. In addition, accounting savings accrue to the retailer if a transaction only has to be entered and recorded once and repayment does not have to be kept track of. Equally obvious is the fact the manufacturers are at a disadvantage with

off-invoice billing. Should the retailer fail to fulfill the performance requirements, the manufacturer is then burdened with trying to collect an allowance already taken by the retailer.

D. Performance Requirements

Manufacturers include performance contracts with all deals. Exhibit 4.12 is an actual example of such a performance contract. They are rather simple, merely restating the terms of the promotion with a clause requiring retailers to repay monies taken if the performance is not met.

Retailers do sometimes fail to perform in accordance with the contract and manufacturers do bill them back for the allowance taken. Sometimes they collect and sometimes they don't. Generally, the larger the manufacturers, the less trouble there is with compliance or rebilling. Even though these are legal contracts, breaches rarely are litigated because the cost would be greater than the allowances billed. In addition, manufacturers do not take buyers to court since they are concerned about shelf space and location. If a given retail firm continually abuses the performance contracts, manufacturers begin switching to the bill-back payment methods and for extreme cases. they will institute count-recount policies.

Exhibits 4.11 and 4.12 provide examples of the standard kinds of performance manufacturers desire. The three performance requirements specified in Exhibit 4.11 represent the maximum a manufacturer can request: 1) a special off-shelf display; 2) advertising the manufacturers products in the retailer's ads; and 3) a coupon in the store's ads. These performance criteria are specified because they are the methods that work effectively in getting consumers to buy more (See Chapter 6).

EXHIBIT 4.12--PERFORMANCE CONTRACT PRESENTED TO RETAIL BUYERS

24/16oz MIXED VEGETABLESOFF-INVOICE PERFORMANCE CONTRACT

(Date)

Gentlemen:

This is to certify that I will feature on a special sale and/or display 24/16oz MIXED VEGETABLES in end-of-aisle or baskarts for one week during the period from October 3 thru November 11, 1977.

For this I will receive 72¢ per case off-invoice on all purchases of 24/16oz MIXED VEGETABLES shipped between October 3 and October 28, 1977.

It is understood that if for any reason I fail to fulfill this performance agreement within 30 days after October 28, 1977, I agree to repay promotional monies that I did not earn.

Very truly yours,

(Buyer)

(Customer)

(City/State)

(Broker)

Form No. 15
8/17/77

Performance contracts may have any one or a combination of these included. The minimum performance required is an advertisement in the retailer's weekly ad and always specify a minimum size for the advertisement used: In this case, the standard two-column inch ad. A slight digression will explain why the ads are specified in two-column inches.

There are three basic classes of newspaper ads: A, B, and C. Class C is one-column inch or less. Class B is two-to three-column inches while Class A is anything larger. Class A and Class B ads are usually large enough to include an in-store ad. Class C ads are euphemistically called obituaries. They are too small to induce much of a consumer response. In addition, retailers use them as fillers on the ad layouts. They tend to be at the bottom of the pages or in out-of-the-way places. For many years, Class C ads were the standard for performance in manufacturers' deals. A few years back, one retail chain on the West Coast took all their performance required ads and put them in the classified ad section in the back of the local newspapers. They all were one-column inch, however. Since then, manufacturers have begun requiring two-inch ads and are more specific about where they are to be run. The performance requirement for a two-column inch ad is the minimum that is usually required now.

The next greater requirement is that retailers display the product off-shelf in special end-of-aisle displays or other off-shelf methods. Both Exhibits 4.11 and 4.12 contain this provision. More than any other, this provision seems to be the most critical for the manufacturer to obtain the desired movement results. Retailers do not like this requirement because of the way it impinges on their merchandising freedom. However, given that manufacturers are providing a price concession and

most will provide the labor of sales representatives to build displays, most retail buyers will comply with this performance requirement if they agree to take this particular deal.

The third type of performance requirement is the use of a retailer-managed in-ad coupon. Retailers bear a greater proportion of the total costs of this requirement than is the case with the first two. There usually are no handling fees for in-ad coupons. In addition, the opportunity cost to the retailer of having to give up limited ad space is fairly high. Therefore, before retailers agree to these kinds of provisions, one or both of the following two conditions must exist. The allowance (price reduction) must be substantial. Second, the product must have a high market share; thereby assuring consumer-drawing power. Performance required is usually correlated with these two factors. If it is not, retailers usually will reject the deal.

For most performance specific promotions, manufacturers require "proof of performance" consisting usually of "tear sheets," torn copies of the newspaper advertisements and coupons placed by the retailer. Manufacturers usually use their own sales representatives to monitor the display aspects of performance. If retailers do not perform, manufacturers try to implement collection procedures.

E. Factors Involved in Choosing Among Various Deals

The description of standard promotions detailed above seems to imply that retailers have little discretion over the use of manufacturers' promotions. This, however, is not the case. First, retailers have many (hundreds) of deals to choose from in any given time period. Second, the other terms of promotions provide retailers with great flexibility.

At any given time, grocery buyers may have several hundred manufacturer deals to choose from. Buyers need to develop internal information systems to keep track of these deals. Most firms surveyed produce some type of internal form which lists the basic details of all deals currently available.³² Of all the deals available, two particularly important to the buyers are: new deals just announced and last buys or deals expiring in the very near future.

Exhibit 4.13 is a sample form used to summarize new deal information. The reason new deals are singled out is because of their competitive importance to the retailer. Retail firms are always trying to differentiate themselves from their competitors. Part of this strategy is to feature products at prices which make the firm stand out in the weekly food ads. Thus retail firms will jump on new offerings by manufacturers in an attempt to get them exposed to consumers first. Buyers will usually choose those new deals most advantageous to the retail firm either in drawing power and/or price concession. Thus, all retailers in the market will usually pick the same items to be features. Therefore, ironically, most retail food ads turn to look very similar anyway.

Exhibit 4.14 is a sample form used by retailers to collect in one place a list of those deals which are about to expire. This is one of the pivotal documents in all of grocery buying because it is indicative of the true power of the grocery buyer. An explanation of its importance requires a closer look at the provisions of a standard performance contract such as Exhibit 4.11.

Notice the performance dates in Exhibit 4.11. The promotion is for a six-week period. Yet all the required performance could be completed in one week. In other words, the buyer qualifies for a \$1.44 per case

EXHIBIT 4.14--INTERNAL FIRM FORM USED TO HIGHLIGHT LAST BUY POSSIBILITIES

LAST Buys										(MEETING 3/18)		V.E./DATE 3/25	
CODE	ITEM	PACK & SIZE	Reg COST	Deal COST	Deal UNIT COST	RETAIL CHANGE IN CASE COST	AVERAGE WEEKLY MOVEMENT	INVENTORY	QUANTITY ON ORDER	RETAIL	QUANTITY TO ORDER	TYPE OF DEAL 0.1.2.3.4.5.6.7.8.9.10.11.12.13.14.15.16.17.18.19.20.21.22.23.24.25.26.27.28.29.30.31.32.33.34.35.36.37.38.39.40.41.42.43.44.45.46.47.48.49.50.51.52.53.54.55.56.57.58.59.60.61.62.63.64.65.66.67.68.69.70.71.72.73.74.75.76.77.78.79.80.81.82.83.84.85.86.87.88.89.90.91.92.93.94.95.96.97.98.99.100.	EFFECTIVE DATE OF DECLINE
48212	Seven Seas Viva Italian	12/8	5.52	4.08	34	-1.44	125	148	240	55			
42910	Creamora	12/16	12.70	9.20	76.6	-3.50		75	240	99			
45910	A.J. Fresh Kosher Dills	12/32	8.45	5.60	46.7	-2.86	110	259	0	66			
45982	A.J. Fresh Kosher Dills	12/32	8.45	5.60	46.7	-2.86	110	259	0	66			
47158	Aunt Nellies Corn Relish	12/13	4.65	3.65	30.4	-1.00	3	188	0	58			
54067	Hunt Ten Juice	12/16	6.50	4.58	38.1	-2.02	600	70	200	49			Revised
55610	Cliff Star Apple Juice	12/32	5.25	4.70	39.1	-0.55	170	200	200	49			
55648	" " "	6/64	4.90	4.30	71.6	-0.60	200	128	200	88			
56529	" " Grape Juice	12/40	8.10	6.90	57.5	-1.20	120	2	200	77			
56518	Welch's Grape Juice	6/4	4.39	4.79	79.8	+0.40	120	165	0	97			
51100	Velvet P-nut Btr. (2)	6/48	11.48	10.48	1.746	-1.00	412	408	400	809			
51114	Shedd Peanut Butter	6/48	11.82	10.62	1.77	-1.00	80	51	100	397			
56342	Hi-C Drinks (3)	24/12	4.56	4.08	17	-0.48	200	260	300	23			
56348	" " (7)	12/46	5.60	5.00	41.6	-0.60	1370	4398	1176	49			
55720	Beaumont Juice	24/16	10.25	9.25	38.5	-1.00	60	87	0	47			
55725	" " "	12/32	8.50	6.50	54.1	-2.00	115	192	0	77			
61902	T-Lewis Apricots Rvs.	12/16	5.98	6.08	50.6	+0.10	40	160	26	66			
61501	" " Cocktail	12/28	34.9	3.61	30	+0.12	70	172	26	53			
61505	" " "	12/16	54.3	5.68	47.3	+0.25	115	306	100	57			
62204	" " Peas	12/8	3.43	3.55	29.5	+0.12	35	23	25	59			
68320	" " Asparagus	12/8	4.40	4.54	37.8	+0.14	20	71	0	49			
67351	" " Peas	12/8	3.45	3.89	32.4	+0.44	24	65	55	77			
LAST RINS													
												off invoice original back	
												4	

price reduction for the entire period just by performing three things for one week. The common buying practice is to order several normal purchases during the last week of the promotion which are shipped to the warehouse. After the end of the promotion, the price of the product returns to list price. The retailer thus has product at a lower price. This practice is known as "buying-in." The interviews indicated that all grocery distributors buy-in at the end of a promotion. This is why forms containing last-buy information are generated in the buying departments. They assure that buyers do not overlook any desirable buying.

Manufacturers attempt to limit buyers in several ways. One way is to limit last shipping days for items to be promoted. Thus, if a retailer wants to buy-in several months supply, he needs to carry the inventory. In the past, retailers would buy-in but not give shipping orders. Manufacturers not only sold products at a lower cost but had to bear the inventory cost also. Another way manufacturers attempt to regulate buy-ins is by using a "right to limit quantities" clause (See Exhibit 4.11). Both these mechanisms may or may not be effective. Basically, which organization (retail or supplier) has its preferences satisfied is wholly a function of the relative distribution of power between them.

An indication of the relative distribution of power is evident when "back-ins" are used. A "back-in" is the same as a buy-in, except it is executed after the end of the deal. If a buyer does miss a deal, he may request to be allowed to "back-in" to the deal. This is accomplished by back-dating invoices, extending last-order dates, and various other devices. Whether a manufacturer acquiesces to back-in requests is

largely a function of its strength. Strong suppliers say no and make it stick. Weak suppliers may say no but allow back-ins anyway. The incidence of back-ins must be tempered by the fact that the manufacturers sometimes tacitly encourage back-ins. Back-ins are much more likely to be tolerated whenever the quantity of product moved during the sales does not equal anticipated and/or desired movement.

One final point on buy-ins. They are not limited exclusively to deals. They are also used whenever the price of a product is going to increase. Retailers will buy-in if they know of an imminent price increase. Those manufacturers who announce price increases ahead of time and allow "normal" purchases to be made in advance of the price increase are recognized by the buyers. Those manufacturers who do not notify retailers of price increases are remembered. The cardex system (discussed above) provides a mechanism for buyers to record these types of behavior. Those manufacturers who start false rumors about a pending price rise are hated. Some buyers tend to buy in on these rumors and if prices do not advance they are personally and professionally embarrassed. Again, whether or not a manufacturer can withhold this type of information and get away with it is an indication of the relative distribution of power between the buyer and seller in the exchange process.

If the buyers are allowed to buy in advance of price increases, which product and how much should be bought in? The answers to those questions used to separate "the men from the boys" so to speak. The buyer of yesteryear did it through guts and "seat of the pants" decisions. In fact, not too many years ago retail firms would maintain satellite warehouses (usually rented) just to store the speculative purchases they made. Today's interest rates and other factors have made

that process nearly obsolete. Because it is so expensive to maintain inventories, retail firms have instituted rules or standard operating procedures to regulate buy-in policies. Exhibit 4.15 is an actual standard operating procedure for price advance buying (i.e., buying in). This is a rather simple rule only stating that if the price rise is going to be more than 10 percent, will buyers be allowed to buy-in and then only 45 days' worth of supply. This is clearly a recognition of the impact of interest rates and the opportunity costs of money on the profitability of buy-in policies.

Other firms surveyed have similar rules of thumb. Some firms actually have computer subroutines attached to their inventory control programs which calculate optimum buy-ins. Generally, they calculate the rate of return to be gained by buying in a unit at the current price compared to the new price. The program then determines the number of units (week's supply) to be ordered so that the rate of return from the buy-in equals the target rate of return specified in the program. This rate of return is tied directly to the current short-term interest rate on inventory. Thus, changes in economic conditions in the general economy are directly tied to buying practices.

A typical deal used by most manufacturers will result in a price decrease to the retail buyers, for a period of eight to twelve weeks. Normal deals run four to six weeks. Combine this with a four to six week buy-in and buyers have lower price merchandise available for only fulfilling performance requirements of one or two weeks. This period of eight to twelve weeks is not, however, the total length of time that the retail buyer gets a price decrease. There is one other standard provision of most manufacturer deals which also affects the net product price to the retail firm.

EXHIBIT 4.15---STANDARD RULE OF THUMB FOR BUYING AND HOW MUCH OF A PRODUCT SHOULD BE "BOUGHT-IN"

GROCERY MARKET LETTER		NO.	DATE	PAGE
PRICE ADVANCES				

ADVANCE BUY POLICY

THE MAXIMUM PURCHASE OF ANY ITEM INVOLVING INCREASES IN LIST PRICES, DEALS OR OTHER ALLOWANCES, WILL BE LIMITED TO 45 DAYS TOTAL REQUIREMENTS FROM THE FINAL SHIPPING DATE. THESE REQUIREMENTS WILL INCLUDE WORKING INVENTORY, PLUS ANY QUANTITY REQUIRED FOR SALES PLAN FEATURES DURING THIS PERIOD. IN ORDER TO QUALIFY FOR THE 45 DAYS MAXIMUM COVERAGE, THE SAVINGS MUST BE EQUAL TO, ONLY REGULAR TURN INVENTORY WILL BE ALLOWED.

UNLESS SPECIFICALLY NOTED IN THIS MARKET LETTER, ANY DEVIATIONS FROM THIS POLICY MUST BE APPROVED BY MR. OR MR.

Exhibit 4.11 contains the standard "stock protection" clause which is self-explanatory. For any buyer or merchandiser accepting the deal (agreeing to meet the performance requirements), the manufacturer will rebate to the retailer an amount equal to the allowance per case for all cases purchased one month before the start of the promotion. This provision is designed to prevent one retailer from being in a competitive disadvantage relative to another retailer. For example, if one retailer just bought a month's supply of a product one week before the promotion and another retailer bought just at the beginning of the promotion, the first retailer would be at a distinct competitive disadvantage. That is, he would suffer a loss on inventory. To prevent this, retailers have demanded and received stock protection clauses. In Exhibit 4.11, the stock protection clause starts for shipments between March 5 and April 3. Notice that the announcement date for this deal is March 11. Shipping dates are lagged anywhere from 3-10 days from order dates. Thus any orders made before March 5, say the last week in February, but not yet shipped before March 5, are also covered. Since this is to cover warehouse stocks and manufacturers do not know what stocks are in the warehouse, this clause is usually executed off of shipping and billing invoices rather than on actual warehouse counts. This is one reason manufacturers limit the total amount of product to which the stock protection clause is to apply to an amount not to exceed the total of the amount shipped to the retailer in the previous 30 days. Otherwise, the retailer could also stock products in warehouse before the sales. The stock protection clause adds another four weeks to the total amount of time that the manufacturer's promotion leads to a price reduction available to a grocery buyer. Therefore, when a manufacturer decides to

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promote one of his existing brand grocery items, he in effect gives a price reduction equal to the amount of the allowance for a period anywhere from twelve to sixteen weeks. In return for the option to purchase that product at allowance prices anytime during this period, the buyer must agree to the performance specified by the manufacturer. These performance contracts may specify that the all or part of the allowance be reflected to the consumer via a price reduction and then for only a period of one or two weeks. To ensure that a price reduction for one week gets to the consumer, the manufacturer involved in Exhibit 4.11 required a store coupon be printed to reflect the full amount of the price reduction to the consumer. However, this method is realistically available only to those products enjoying a significant consumer brand franchise. More often performance contracts specify that the retailer either display off-shelf and/or give a price reduction to the consumer.

F. Implications for Wholesale Grocery Pricing

The common practices of retail buyers using buy-ins, back-ins, and stock-protection clauses have some important implications for the food system. Manufacturer pricing behavior is affected by these practices. The bottom line is that manufacturers, especially strong brands, do not change list prices frequently, because a price change via a promotion or deal is translated through buyer behavior into a price cut for ten to twelve weeks. Several large manufacturers revealed during the interviews that their various individual products were on promotion about 50 to 55 percent of the year. However, 90 to 95 percent of the annual volume of those products were sold at promotion prices. This has some interesting implications: What is the true wholesale price of grocery products?

Using list prices published by manufacturers will significantly bias wholesale price reports upward. It is extremely difficult to adjust those prices to bring them in line with actual wholesale prices paid because manufacturer deals differ for different markets. Thus there are spatial and temporal differences for a given grocery product's net price to retailers. This combined with the fact that brand grocery products are priced on a delivered (retail warehouse dock) basis, makes it nearly impossible to get true net wholesale prices.

An important factor in the current grocery pricing strategy is former price controls. When President Nixon imposed wage and price controls in 1972, they were implemented by freezing list prices for manufactured goods. Firms which were adjusting list prices frequently to reflect relevant economic conditions were caught with list prices which had no slack in them. Therefore, as time passed, these products suffered real economic distress. As a result, manufacturers no longer use frequent adjustments in list prices. List prices are set once a year and pricing on the downside is accomplished via discounts off of list. If economic conditions warrant upward adjustments, list prices are adjusted upward. Manufacturers nearly unanimously believe that wage and price controls are inevitable. They said history indicates that governments, no matter what their form or philosophy, will attempt to control food prices if conditions cause consumer distress, pointing to the fact that the most recent episode in the United States was under a Republican president. Since true economic prices tend to be below list prices most of the time, a new wage and price control policy implemented as the last one was (freezing list prices), would result in an immediate increase in food prices of several percentage points as everyone went up to list prices.

This practice of pricing off high list has caused some problems in the exchange relationship between buyers and manufacturers. Before wage and price controls, manufacturers would list adjusted prices downward to reflect economic conditions and then would grant deals and promotions off list. Under existing practices, manufacturers grant deals and promotions off higher lists. The retail buyers maintain that today's promotions contain 1) actual promotion monies, and 2) price reductions to reflect economic conditions. Buyers judge manufacturers by how many promotion dollars they provide retailers in a year. Manufacturers say they are giving as many or more promotion dollars today as before wage and price controls. Buyers and merchandisers reply by saying, "Nonsense, you are cheating us out of our promotion money." It appears that the retailers are correct in their perceptions; they are getting proportionally less trade allowance monies. In this respect, wage and price controls have been a help to the manufacturing sector.

Contemporary buying practices combined with off-list pricing result in wholesale prices which are difficult and expensive to collect and quantify. Given the buying practices described above, how are retail grocery prices set for the consumer? With the exception of price decreases that result from requirements specified in promotion details, there is no systematic way to know if invoiced price decreases are reflected at the retail level. Each retail firm can price the product at any price it desires. Which pricing strategy any firm chooses is a function of the basic merchandising-competitive strategy it adopted; the level of retail competition it faced; and its organizational form.

Each retailer tries to project an image to the consumer which impacts directly on the buying and pricing behavior of the firm. Retailers

who want to project "the lowest price in town" image will generally avail themselves of all the stock protection, buy-in and back-in opportunities available and will pass through to retail most of the price concessions gained through these buying strategies. These firms hope to gain more profits from the increased volume a "low price" image is supposed to create. Other firms may emphasize sales on private labels. They might use brand manufacturers' deals as drawing cards to their stores but really emphasize private label within the store. These firms may or may not use maximum price reduction buying techniques (e.g., buying for six weeks instead of twelve) and therefore may or may not reflect promotion prices to consumers. Still other firms try to develop a selection, quality, and service image. These firms might not be interested in tying up warehouse space for buy-ins but instead prefer a greater mix of products, sizes and flavors.

Generally speaking, it is difficult to determine whether retail prices reflect all or part of deal invoice prices or whether there is a consistent lag in retail price response to wholesale price decreases in grocery products. These responses are influenced by internal decision making with each firm. Retailers have the incentive to keep buy-in profits and one would expect them not to pass them through to consumers.

Competition within a retailer's market, however, does provide an external force which affects retail consumer pricing. Given a greater number of independent (price-setting) stores in the market, the probability is greater that one firm (store) will feature the supplier's price decrease on any one product. This is because as firms try to differentiate their product and promotion mix from their competitors, they will try to do something different from each other. Generally, most retailers

will match prices on promoted products. This is because firms know consumers are conscious of special advertised prices. Thus the greater the number of retailers promoting, the greater the likelihood that one firm will reflect the price concession gained via a buy-in, etc. In markets with fewer firms, the probability of a price concession obtained through buy-in being "discovered" is lower. Consequently, the lack of external inducement results in price decreases at the wholesale level being overlooked at the retail level. In this case, the level of the average retail price in the market area will be higher. These higher prices can and do arise without a conscious decision by corporate management to charge higher prices in less-competitive markets. The execution of current standard buying practices combined with the lack of competitor search for differential advantages produce this result. If greater price response and reduction in price lag are desired public goals, then altering either the standard operating procedures or the competitive structure could achieve these goals.

The practices described above apply to the procurement of nearly all brand grocery items. Following the pricing practices of one such established product helps to summarize the above discussion. A manufacturer will establish a list price. The logic behind the manufacturer's setting of the list was not part of this study. Generally, however, a list price is set to hold for a given period of time (usually one year). Retailers establish gross margin percentages to be applied to that product. Gross margins are almost never adjusted on a short-term basis.

One exception is when retailers want to produce a "hot special" which is done usually by accepting the manufacturer's deal and then

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cutting their own gross margin. This adds to the price cut and makes that particular product lower in price than the competitions'. This produces the classic "loss leader." The margin adjustment entails a temporary human override of the computer system. The gross margin percentage is not changed in the computer. Therefore after the temporary "hot special" the retailers gross margin returns to the normal margin.

Invoice cost (which may or may not be list cost) is used as the basis for retail pricing. Manufacturers use sporadic promotions to lower prices and increase sales. These promotions are usually in the form of allowances per case deducted at the end of the invoice instead of being subtracted from the individual case price. Therefore, the clerk key-punching the cost into the system often does not reflect the cost reduction into the program. Thus, the invoice cost stays the same, the gross margin stays the same, and the price reduction does not show up on the retail firm's records. To counter this problem, manufacturers require performance by the distributor's buyers and merchandisers which produces the necessary human override of their computerized system. In return for performance, buyers can get a price decrease for several weeks. Whether or not the promotion-induced wholesale price decrease is reflected at retail to consumers is dependent on the discretion of the grocery buyers and merchandisers subject to the external constraints of competition.

In this system, price increases executed via increases in list and/or invoice case prices will be immediately reflected in higher retail prices. Rises in prices at retail can lag somewhat if 1) buyers are informed of pending price increases; 2) they are permitted to execute buy-ins of product at current lower prices; and 3) they reflect those lower prices at retail on bought-in merchandise after the new prices occur.

The workings of the buying system can result in price lags both on the upside and downside of price movements. The size and duration of these lags is dependent upon the actions of the buyer and merchandisers in the food system.

4.4.5 Some Miscellaneous Practices Used in Existing Brand Product Procurement

The basic elements involved in the buying of existing brand grocery products were described above. There are, however, other factors involved in the buying practice. As discussed earlier in the new product procurement system, there are many miscellaneous prerequisites required by buyers before they give full consideration to a new item including slot charges, special financial terms, free goods, and guaranteed sale provisions. Some of these are also involved in the procurement of established brand products. For example, swell allowances apply to all brand canned goods sales. Free goods are sometimes requested by buyers in lieu of allowances for existing items. In addition to these there are other types of existing programs which affect the procurement of existing brand programs.

A. Trade Incentive Programs

The first such program are TIPs or Trade Incentive Programs which usually take the form of a given prize to the buyer for buying X quantity of the product from Manufacturer Z. For example, if a buyer purchases 5 percent more of a product this year, he wins a trip to the Bahamas. There are all kinds of versions of these programs. They are similar to the incentive programs which manufacturers set up for their salespeople and/or brokers. Various retail firms have various policies regarding

buyer participation in these programs. Some firms outrightly prohibit their employees from participating and chastize the suppliers who use these programs. Others allow their buyers and/or top executives to participate. Some firms (especially buying organizations) use these "earned" prizes only for drawings and contests within their own organizations. For example, one organization earned two trips through its buying. These trips were raffled as Christmas presents to the salaried and hourly employees of the organization. Often TIP prizes are used for "Grand Opening Celebration" prizes when a new store is opened. As with other buying behavior which is the prerogative of the firm, there is a great deal of diversity in actions and philosophies among individual firms regarding TIPs. It is the author's impression that the TIPs are readily available and are used extensively. If they do affect buying behavior, it is via biasing procurement toward those products with TIPs and away from competing products without them. To the extent this happens, the ability to run a TIP becomes a condition for entry into a product category.

B. Financial Terms

Financial terms used in procurement are standard across the industry. They are a 2 percent discount for payment in ten days from invoice date or net amount on the invoice due in thirty days. Although the terms are standard, the ability of suppliers to enforce them is not. Retailers may attempt to take 2 percent-fourteen days or eighteen days, etc. Dominant manufacturers will not allow this and will usually bill back the unearned discount. Manufacturers in weaker market positions may have difficulty executing such a move because they lack the power to discipline retailers

with consumer-oriented activities. This problem is analagous to enforcing retailer performance on deals and promotions.

Retailers are currently trying to induce manufacturers to change the standard 2 percent-ten day terms. Retailers prefer "a variable discount system" which would allow longer terms, say 2 percent-twenty days on some products in return for the retailer's willingness to accept 2 percent-five day terms on other products. In other words, retailers would agree to pay faster on some products if manufacturers allowed more liberal terms on other items. Some retail food products turn through grocery warehouses 300 times a year. Others turn only ten times a year. Variable discounts would adjust terms to reflect typical turn times by product. The net effect would probably be to shift more of retailer inventory costs back onto the supplier. Currently many major manufacturers are being "asked" to implement a variable discount system; some have agreed. Trade sources indicate that should a few of the large manufacturers agree to variable discounts, the whole system would change to variable terms. To the extent that variable discounts shift inventory costs to suppliers, an additional barrier to entry would arise. Such a change will probably work to the disadvantage of suppliers of slow moving items also.

C. Transportation Considerations

The cost of holding inventory heavily influences buying behavior. One manifestation of this is the buyer's ratings of supplying firms by their transportation (delivery) performance. Nearly all computer ordering systems have shipping information included in the records. Retail buying headquarters maintain accurate records on vendor delivery

performance. Because of retail warehouse labor costs and the high costs of overtime, deliveries are scheduled very closely. Trucks are given time slots at which they must arrive and unload. If they miss their appointed time, they must reschedule at the retailer's convenience. Manufacturers with their own truck fleets are at a distinct advantage over those firms requiring the use of common carriers. Those manufacturers which use rail transportation and have excellent traffic departments able to ensure scheduled delivery are systematically preferred by retail buyers. Many retailers maintain "report cards" for all vendors. Buyers make inputs into these "report cards." Manufacturers who are having transportation difficulties will be warned and receive suggestions for improving service to the retailer. Manufacturers who use common carrier shipping are often unaware of the poor service at retail warehouses. In this respect they appreciate their "report cards."

Another aspect of transportation's impact on buying and supplier selection is the movement and number of items carried by a manufacturer. Since retail organizations do not want to carry inventory, they want products delivered frequently. Products must be transported in the least expensive manner. This means full truck or rail carloads. If the product does not move enough volume to justify full-load shipments, it must either be a mixed load shipment with other products of that manufacturer or shipped LTL (less than truckload) which are more expensive. Because of these links between transportation and inventory costs, the manufacturer's ability to manage his products' distribution to reduce retail inventory costs is a vital determinant for gaining competitive access to retail shelves.

Refer again to Exhibit 4.11. A brief sentence in the next-to-last paragraph addresses a final aspect of transportation's impact on buying. The price concessions on a product promotion are to be used only in the designated market area specified on the deal sheet. Large, multi-divisional retail chains and buying organizations have the ability to "tranship" sale merchandise from one market to another. If the price concession on the promotion more than covers the transportation and handling costs, retail organizations have the incentive to ship the deal merchandise to other markets where products are not on sale. These conditions are easily met in the densely populated portions of the United States. The most prevalent use of transshipment strategies has been in East Coast market areas. Large retail firms have a distinct advantage, because they own their own truck fleets. The opportunity cost of truck services might be lower for such a firm than the commercial transportation rates.

The ability to tranship deal merchandise is a factor often overlooked in the current policy debate concerning the implications of back-haul policy. Should retail firms be allowed to back-haul products, the whole procurement system based on market-by-market promotions might change because manufacturers could no longer assure the pricing patterns in market areas. Transshipment puts geographically specialized retailers at a distinct competitive disadvantage. Transshipment usually results in those affected retailers demanding that they be given the same deal. Thus, transshipment results in the "spreading" of the market area covered by the promotion. This may be in conflict with the desires or needs of manufacturers to balance supply and demand or execute marketing strategies. This is why the standard promotions used by manufacturers have a transshipment clause.

As with other provisions of promotion contracts, there is a varying ability to enforce the transshipment provisions. In order to effectively monitor transshipping, manufacturers first need a product-coding system and record-keeping system which allows them to trace product lots by company and markets. Second, they need a large and sophisticated sales force which can monitor product flow on the shelves of stores. Only the largest national brand manufacturers fit these requirements. Conversations with executives of these firms indicated that even with these tools, it is only possible to catch large transshipments. Transshipped products which are three truckloads or less are difficult, if not impossible, to detect. Even though the problem of transshipment is a function of size, in practice only corporate chains and large wholesalers seem to consistently have the incentive and opportunity to tranship.

4.4.6 Implications of Grocery Distributor Organizational Form on Existing Item Procurement

Exhibit 4.11 has one provision which indicates the implications of organizational form. At the top of the second page, there is a provision stating that wholesalers need to reflect the deal price to their affiliated independents for at least three weeks. This provision hints at the differences between organizational forms.

Manufacturers are legally liable by the Robinson-Patman Act to guarantee that individual independent retailers are able to get the same deal as a chain store. Therefore, they explicitly require that wholesalers and cooperative buying organizations reflect the promotions to their affiliates. Notice this is the promotion. Robinson-Patman Act says nothing about buying. The interviews indicated that wholesalers used advanced buys or buy-ins extensively. This is quite logical given

the economic structure of the industry. Recall that the chain store revolution was merely the merging of the retail and wholesale function. Chains typically run their wholesale functions as break-even operations. If this is the case, wholesalers are under competitive pressure to have their charges for the wholesaling function equal to that implicit charge made by chains. If they were significantly higher, independent retailers would be at a distinct competitive disadvantage vis-a-vis chain stores. Since the economic return to wholesaling is limited, wholesalers need to make profits elsewhere--in buying and distribution.

Wholesalers use buy-ins on promotions as a primary way of generating profits. Manufacturers nearly unanimously indicated that wholesalers are the most frequent requesters of "special" provisions on deals. Wholesaler-buyers therefore have slightly different procurement behavior when compared to chain buyers. For the same reason, wholesalers have been leaders in adapting the latest transportation and distribution technology to the industry.

Manufacturers also indicate that because of the Robinson-Patman Act, they do not have as effective promotions as would otherwise be possible. Since each store (chain or independent) must be treated equally, the performance standards set by the manufacturers are geared to the individual retail store. In other words, the performance requirements are set so that one store can fulfill the requirements. Manufacturers feel that this allows chains to get off with disproportionately less performance. They feel that they should be allowed to set differential performance requirements for different firms. Conversely, independent retailers constantly state that deals are structured for a chain's operations and therefore it is difficult or costly for the independent

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to gain equal access to them. Certain provisions of deals, especially those requiring retailer advertising and coupons, seem to be more difficult for independents to meet on an equal basis with chains. This trend toward more stringent performance requirements will probably continue as inflation increases promotion costs, market areas covered by retailers expand, and as long as the Robinson-Patman Act remains in force. This will thus continue to put competitive pressure on independent retailers.

4.4.7 Procurement Practices for Existing Items in Perspective

The following few observations will help summarize and put into perspective the existing item procurement process. Although established items flow through the food system, grocery buyers are the gatekeepers and monitors of this flow. The buying practices used are designed to facilitate this flow consistent with the external and internal constraints imposed on buyers. Those products which flow through the system and which cause the least amount of work or consternation for the buyer are given preference. The minute details involved in transportation, delivery, packaging, and cost deferment are critical determinants of product success. When the flow of a product drops or the manufacturer wants to increase the volume, the standard mechanism used is product promotion. Promotion of existing products has some similarity to the introduction of new products, but some unique aspects also. Again, those products which are promoted in a way which meets the buyer's needs within his reinforcement pattern will have successful promotions and therefore prosper. Meeting the standardized desires of buyers requires both money and knowledge. When the needs and/or desires of the buyers conflict with the needs and/or desires of the manufacturer, a confrontation

can occur. As with all bargained exchange systems, the outcome of the final solution is determined by the relative strengths and skills of the parties involved.

4.5 The Product Discontinuation Process

This section explores the procedures buyers use in deciding which products to eliminate from distribution. This aspect of procurement is probably the most dominated by SOPs and therefore, there are visible decision rules. Yet it also contains some of the least visible procedures. An explanation of three basic classes of product discontinuing procedures, simultaneous discontinuance, systematic review of product category, and competition-induced discontinuance, will follow concluding with a discussion of some exceptions to the SOP.

4.5.1 Simultaneous Product Discontinuing Practices

The majority of grocery items are discontinued simultaneously with new product introductions. The standard industry practice is to discontinue one existing item for each new item added to distribution. For example, in 1976 there were 51,939 grocery items in distribution. During the next year 7,243 were discontinued while 9,685 were added. Thus in 1977 there was a net gain of 2,442 items for a total distribution of 54,381.³³ However, the relatively small net gain disguises the large amount of dynamic changes which take place on the grocery shelves. This simultaneous discontinuing unanimously applies to those new products which are size and/or flavor extensions of existing lines. The logic for this rule is contained in the need for shelf space in the store. If a new product is to be added to a category, the shelf space for that product must come out of the shelf space allocated to existing items in

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that category. Rarely do retailers increase total space of a category on a product-by-product basis. If a new item is added and no existing item is dropped, the number of facings (store shelf positions) allocated to existing items must be reduced. Retailers rarely use this option because it requires that the shelf space be consciously reallocated among products which is a costly and very time-consuming process. There is no need for this in a one-in/one-out strategy. This standard practice is one of the most consistent of any found in the study.

Given that an existing item must be dropped with the addition of a new one, what is the selection criterion used to choose the item to be dropped? It seems to be fairly standard: a new size introduction will usually cause the dropping of the slowest mover in the category. Similarly a new flavor will cause the slowest moving existing flavor in the same product to be dropped.

A few retail buyers and firms go beyond this basic criterion and add that the item to be discontinued should belong to the firm which is introducing the item. This rule tends to freeze shelf allocation among manufacturers. This "same company" rule does not seem to be widespread.

Exhibits 4.16 and 4.17 demonstrate how this discontinuance process is manifested in everyday operations. Exhibit 4.16, a page taken from an actual order book, contains the announcement of two new Del Monte pudding cup flavors. These are launched in the third week of October and have an introductory deal (fourth column) worth \$.84 per case through November 22.³⁴ This is one way stores (in this case independent stores) are notified of new product introductions. Exhibit 4.17 is a page from a store bulletin for the same week as the order book. As stated previously store bulletins are used to point out special points to the

EXHIBIT 4.16--ORDER BOOK PAGE ANNOUNCING NEW PRODUCT ADDITION

[illegible]

EXHIBIT 4.17--STORE BULLETIN ANNOUNCING DISCONTINUED ITEMS

DISCONTINUED ITEMS

Code	Description	Pack & Size	Reason
	<u>G.R. & PLY.</u>		
048-082	Hi-C Orange-Pineapple Drink	12/46oz	
068-809	Libby Sloppy Joe Barbeque Beef	24/15oz	
083-766	Spread & Heat Pizza Sausage	24/3oz	
083-808	Spread & Heat Pizza Pepperoni	24/3oz	
100-974	Del Monte Strawberry Pudding Cup	12/4/3oz	
100-982	Del Monte Nut Flavor Chocolate Pudding Cup	12/4/3oz	
183-566	Nescafe Decaffeinated Instant Coffee	24/2oz	Inaufficient Movement
128-280	Purina Beef Flavor Cat Food	12/22oz	
128-298	Purina Ocean Flavor Dry Cat Food	12/22oz	
133-819	Purina Dog Chow Beef-Egg Dog Food	10/5#	
134-333	Purina Dog Chow Beef-Egg Dog Food	2/25#	
193-599	Jean La Foote Cinnamon Crunch	12/11oz	
181-321	PDQ Instant Chocolate Flavor Chips	12/10oz	
246-322	Reese Peanut Butter Cups Junior	12/10pk	
044-107	Borden Instant Breakfast Drink	12/21oz	
209-924	Palmolive Gold Bath Soap	48/Bath	
141-986	Hefty Kitchen Can Bags	12/15's	Change To 12/30's-141-960
136-481	Kotex Maxi-Pads	24/12's	Pack Change To 12/30's
	<u>PLY. ONLY</u>		
101-923	Royal Chocolate Pudding	12/6oz	
068-254	Krey Luncheon Meat	12/12oz	Inaufficient Movement
110-528	Swiss Miss Low Fat Dry Milk	16qt	
	<u>G.R. & PLY.</u>		
	<u>Wrappies</u>		
247-890	Apricot Nectar	24/9oz	Manufacturer Unable to Ship
045-088	Upsay-Daisy 9oz. Cold Cups	12/46oz	Till Mid November
148-528		24/48's	Seasonal
142-224	<u>G.R. ONLY</u>		
224-964	Hefty 2 1/2 Mil Trash Bags	12/15's	Manufacturer Unable to Ship
	<u>PLY. ONLY</u>		
205-922	Sani-Flush Toilet Bowl Cleaner	12/12oz	Manufacturer Unable to Ship
210-609	Easy Monday Pink Lotion Detergent	12/32oz	Manufacturer Unable to Ship
216-002	Mr. Bubble Liquid Detergent	12/16oz	Manufacturer Unable to Ship
219-147	Woolite Cleaner	6/40's	Manufacturer Unable to Ship
	Bounce Fabric Softener		Shipping Error

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stores. One page of this store bulletin lists the discontinued items and reasons for discontinuance and the out-of-stock items and reasons. Notice on Exhibit 4.17 that two existing flavors of Del Monte pudding cups are being discontinued. The reason given is insufficient movement. This coincides directly with the adding of two items by the retail organization. This is a typical example which illustrates the standard practices used by retailers which is known and recognized by all in the branded products business. It thus forms the bounds in which manufacturers compete for shelf space via product introduction.

Product introductions which are size and/or flavor extensions comprise about 80 percent of new product introductions. It would be reasonable to expect that close to that percentage of discontinuance decisions were made on the above rule. The remaining items must therefore be discontinued through other rules.

4.5.2 Competition-Induced Discontinuing Practices

Closely resembling the above process is the "better deal" discontinuance process. For most established products retailers will usually stock three or four brand products. Often the top two brands will control the major market share for that product. The third and/or fourth brands will have minor and small market shares. A typical scenario might start with the manufacturer of the number four product launching a promotion. Because this product has weak consumer acceptance, a greater proportion of the promotion monies will be allocated to trade deals. Trade deals lower the cost and increase the profit rate to the retail sector. Given that retailers view the third and fourth brands as nearly perfect substitutes and shelf space is valuable, retailers will drop the

number three product and stock more facings of the number four product. As a result the manufacturer of the third product has lost its market position. This manufacturer then starts formulating plans for trade promotions to try to regain shelf access. After a period of time the former number three manufacturer launches a promotion to displace the current number three product. If the new trade allowances are lucrative enough, buyers will drop the current number three product and replace it with the former number three product.

These products give the appearance of being treated like the "drop-one-for-every new product" process described above. These products, however, are not new but rather are reintroductions of previously discontinued items. This example illustrates that being the lowest share brand product on the grocery shelves is a difficult and expensive position. The product will always be in jeopardy of being discontinued by a similar item which carries a better profit to the retail buyer. Buyers tend to view these products as price promotable products. They will usually use the leading brand products for the advertising and in-store merchandising promotions. Thus these low share manufacturers will by necessity end up spending a greater proportion of their promotion budgets on price cuts to retailers than on advertising and promotions which help to build consumer acceptance.

4.5.3 Systematic Product Category Reviews

The third way an item gets discontinued is through a systematic product category review, a frequent agenda item of buying committee meetings and/or meetings among the buyers. Thus every week a different product group (ready-to-eat cereals, frozen dinner entrees, etc.) is

systematically reviewed. Most categories are reviewed once a year but larger categories may be reviewed twice or more a year. Their performance is compared with other categories in the store, with some imprecisely measured national norm, and with suspected performance of competing retailers. These review sessions can result in large numbers of items being dropped. These sessions can result in space being taken from this category and allocated to a faster-moving, "hotter" category. As a result, new planograms or shelf maps are designed. Again the basic criteria used in deciding on the fate of an item is movement. Any item which ranks near the bottom on a family group listing is scrutinized very closely.

Exhibit 4.18 is an actual page of a working document used in a product review session, providing some indication of the types of data buyers bring to bear during systematic review sessions. This information includes the products sales rank in the firm's major market areas; the average movement of the product; the SAMI (Selling Areas-Marketing, Inc. information) share by product category and operator (retailer's) share; percent of sub-family group; markup; and average case cost over the recent orders. The buyers and merchandisers view all of these statistics as correlated performance criteria. Different lists and rankings are compared and decisions are made. Selection criteria vary across firms. All buyers and merchandisers have "special" or "secret" criteria which they have developed over the years which shape the composition and image projected by product displays and the store.

There is however some basic logic that seems to pervade these systematic review sessions. Buyers and merchandisers consciously attempt to provide consumers with a choice of products over a broad quality and

EXHIBIT 4.18--PAGE TAKEN FROM PRODUCT REVIEW SESSION WORKSHEET

CATEGORY *Frozen Dinners*PRODUCT REVIEW
4/17/77

DESCRIPTION	RANK	AVERAGE WEEKLY MOVEMENT	SEMI \$ SHARE CAT 12 52	OPERATOR SHARE % 12 52	OPERATOR SHIPPING	% OF SUB GROUP	MU%	AV COST			
12/11/02 Bang Salis Steak Dnr	1	206	78	38	4.4	11.2	14.2	7	6.4	26.8	4.55
12/17/02 Bang M.P. Salis	2	98	32	2.7	2.4	20.3	23.5	7	5.6	21.1	9.03
12/17/02 Swan Burg Nw Sl Sth	3	64	15	2.3	2.3	23.5	22.8	7	5.1	26.4	11.85
12/10/02 Stout Pepper steak	4	47	6	1.9	1.8	11.4	16.0	6	4.6	22.4	15.45
12/11/02 Swan Salis Steak Dnr	5	106	20	2.4	2.5	10.7	17.1	7	4.5	32.5	5.69
12/17/02 Tost O Sea Shrimp Dnr	6	90	53	4	.5	100.0	94.0	*	4.3	14.4	8.21
12/11/02 Bang Mt Loaf Dnr	7	139	56	2.7	2.8	12.2	14.7	7	4.3	26.0	4.52
12/19/02 Tost O Sea Seal Plate	8	72	13	.3	.4	100.0	93.0	*	3.4	14.1	8.23
12/11/02 Bang Beans + Fries Dnr	9	102	41	2.1	1.8	14.0	16.7	7	3.2	25.9	4.59
12/18/02 Bang Fish Dnr	10	87	33	.5	.6	63.4	54.9	*	2.9	14.4	5.80
12/10/02 Swan Swiss Steak Dnr	11	55	14	1.7	1.6	15.1	17.6	7	2.8	24.8	7.65
12/19/02 WW Turkey Dnr	12	26	11	1.2	1.0	19.3	25.8	4	2.8	23.3	16.25

price spectrum. Thus for each basic product they will carry several brand products and several private label products. Normally for a large volume item there will be two strong national or regional brands, one weak national or regional brand, one quality-oriented private label product, and one price-oriented private label brand. For minor commodities, retailers will stock one strong brand per size stocked and one private label product. Specialty products will usually be national or regional brands. The review sessions evaluate which products should get more space and which ones should get less. Within each product category, the brands carried are checked to see if they are the leading sellers in the market. If space has to be cut they will usually reduce the number of sizes and/or flavors offered. Those dropped will be the slowest movers. Given essentially equal performance between two producers' products, the buyer will have total discretion on which brand to eliminate. It is during these critical reviews that a manufacturer's reputation and trade relations with retail personnel are very critical. In most cases, the products dropped are brand products.

The results of systematic reviews are often dramatic and cause strained supplier-buyer relationships. Sometimes a single supplier will have ten to twenty different items eliminated from distribution as a result of one review. Trade reports indicated that during 1973-74 interest rate rise, some retail distributors eliminated 3000 items from distribution in the span of several weeks. The reason for some mass discontinuances are often mysteries to the suppliers. Manufacturers can anticipate discontinuance caused by new product introductions and better deals by competitors but mass drops are usually unexpected and often unexplained.

The criterion common to all product eliminating decisions is the movement of that product through the distribution system. The volume criterion is important because retailers tend to ignore gross margin issues. If a product's movement wanes, the decision to drop does not consider the possibility of increasing movement or revenue by decreasing or increasing the gross margin and price. Several retailers interviewed indicated price and margin changes must be induced by the manufacturer. Basically the retailers' attitude is that their only obligation is to provide shelf space for the product. It is up to the manufacturers to take responsibility for the performances of their products. However, in unusual circumstances, systematic review sessions can result in gross margin changes. These adjustments are spurred by reasons other than movement alone, and are made on most products in the category. The most common factor inducing systematic margin reviews is the outbreak of a price war in the market area. On rare occasions, firms may change their images which may require a change in their margin and shelving policies. The most common reasons firms go through these image changing exercises are 1) significant management changes and 2) dramatic changes in the general economy which cause changes in consumer behavior.

4.5.4 Some Exceptions to Standard Product Discontinuing Rules

Although the elimination of items based on their relative movement ranking in the category is the accepted SOP for discontinuing items, there are two main exceptions to this rule. The first deals with the needs of retailers to maintain full selections. The second involves an issue of organizational form.

There are many items which rank lowest in movement within categories but are not discontinued items. Retailers must carry some items in order to provide a full mix of products. An example would be mint jelly which is a joint consumption item with lamb. There is not enough movement on mint jelly to justify its inclusion. Yet retailers maintain the product as a service to their customers. Not to carry this product would cause loss of lamb sales, customer alienation, and perhaps loss of customers. Many types of these products are carried in grocery stores. Viewed with objective movement criteria, they cannot justify their space allocation, yet each has its special reason for survival.

The established seasoned buyers know the reasons that all of these products are carried. New buyers must learn them. Thus when products are arrayed by movement, buyers just skim over these special items. These items do however come under scrutiny when systematic reviews are made.

The second exception to the discontinuance rule involves the recognition of the distribution of sales of the slow moving item. Suppose that an item in the warehouse is only moving four cases a week and that five cases a week is the discontinuance rule. Ordinarily that item would be discontinued. There are, however, differences in the distribution of sales of that item. The four cases could be allocated evenly over the whole store system or three cases could be sold through one store with the other case distributed throughout the system. In the latter case, retailers might continue to stock the item in order to serve a specific small market need.

The distribution of sales has implications for discontinuance in various types of distributors. The typical retail chain would discontinue the item in either case. The voluntary wholesaler or cooperative

retailer will discontinue the item if its sales are distributed evenly. However, if the sales are weighted toward one or several stores, they may keep the item in distribution because these organizations have learned that when they discontinue an item which is very popular in a concentrated locality, they soon hear from the owner-managers of these stores. Since these owner-managers are owners or customers of these distributors, the buyers usually recant their decision and reintroduce the item. Generally, affiliated independent distributors check the distribution of a product's sales before they make the final decisions. Chain buyers might get some inquiries from the affected store managers but the headquarters' decision rules. As a result chain buyers have not been conditioned to check the distribution of sales before discontinuing an item. This behavior explains the often-noticed fact that cooperative and wholesale distributors carry more and a greater variety of items in their warehouses than do chains. This buying behavior also explains why independent retailers are often more flexible in their product mix. Independents have always been known for their ability to have "customized" stores for specific locations and the differences in consumer preferences by location. This results from the fact that cooperative and wholesale distributors for the most part will make more exceptions to the standard discontinuance procedure. Again the reasons for these exceptions are recognized by experienced buyers and must be communicated to inexperienced buyers.

4.6 Brand Product Procurement Practices in Perspective

The previous three sections attempted to provide a complete description of the major aspects of retailer procurement of brand food products.

The analysis is generally applicable to all grocery products, not just fruit and vegetable products. In fact, these procedures describe the procurement procedures of all nonperishable, nonstore delivered, food and nonfood items in the grocery department. The relative importance of each of the three classes of buying practices vary by category. Canned fruits and vegetables, for example, experience little new product activity. Therefore, the procedures used to buy existing products and to discontinue present items are much more important.

The broad general policies which guide buying actions arise from constraints forced on the firms by general economic conditions and by the need to harmonize intrafirm relationships. The general economic conditions affecting behavior most are interest rates and the general level of retailer competition. To maintain internal harmony, buyers are responsible for seeing to it that a consistent flow of profitable grocery products wanted by consumers are available to the stores. The suppliers' advertising, pricing and promotion policies, and service level to the retailers are omnipresent in all buying decisions. Therefore, these are instrumental characteristics in supplier and item selection.

Although they were treated separately, the three classes (new, existing and discontinued product) of procurement procedures are all interrelated and tied together by the information systems used by modern distributors. The computer programs which form the basis for inventory control develop the statistics upon which many buying decisions are made. Because these numbers are product movements through warehouses and not through stores, prices play only a part in most buying decisions. The whole system is volume (movement) oriented. As a result, strategies which affect movement predominate in buyers' decisions.

Pervasive in the whole product procurement process are the relationships between buyers and suppliers including personal and corporate relationships. The importance of personal relationships between individual buyers and seller's representatives are similar to those in all business relationships; mutual respect, honesty, professionalism, are elements which may bind certain buyers and sellers together.

At the corporate level, the relationships between retailers and suppliers are a function of the basic level of the consumer franchise of the manufacturer's product(s), the retailer's perception, the manufacturers' performance and the extent to which manufacturers serve retailers' service and financial needs. The greater the degree of product differentiation enjoyed by a food product the less discretionary control retail buyers have over that item. If the buyers attempt to change pricing policy or shelf location, manufacturers can, via advertising, go directly to consumers. If, however, manufacturers' attempts at advertising and new product introductions have recently failed, the suppliers' credibility falls. The balance of power in the business relationship gradually will shift to retailers. Few, if any, manufacturers are powerful enough to ignore the grocery buyers and merchandisers. Thus manufacturers acquiesce most to the service and financial desires of retailers.

The implicit dynamic bargaining process between manufacturers and retailers interfaced with procurement SOPs leads to a very fluid wholesale grocery procurement system. The services and provisions embodied in procurement SOPs have value to buyers. This value affects the real wholesale price. Simplifying assumptions about the wholesale grocery market obscure many critical forces which explain food system behavior

and performance. The implications of brand product buying procedures on food system coordination and organization await enumeration in Chapter 7.

APPENDIX TABLE 4.1--LITERATURE FORMING THE FOUNDATION FOR SECTION 4.2.2-
NEW PRODUCT PROCUREMENT PRACTICES

Note: The literature is divided into three groups: books, trade journal articles, and unpublished material. Each section is arranged in the chronological order by date of publication.

Books

Neil H. Borden, Acceptance of New Food Products by Supermarkets, (Boston: Harvard University Graduate School of Business Administration), 1968.

Trade Journal Articles

"Chains Speak Out for the Buyer-Merchandiser," Chain Store Age, October 1967, p. 90.

"The Case for Hard-Nosed Selection," Chain Store Age, May 1968, pp. 68-70.

"Why Do Most New Products Fail?," Advertising Age, March 24, 1969, pp. 85-86.

"What Bugs Buyers," Chain Store Age, May 1970.

"The Who, What, Where, When of Buying Committees," Supermarketing, April 1972, pp. 50-60.

"New Facts on New Items and Private Label," Progressive Grocer, July 1972, pp. 36-39.

"New Directions in the Buyer-Seller Relationship," Chain Store Age Supermarkets, April 1973, pp. 36-72.

"The Salesman and the Buyer," Progressive Grocer, November 1973, (reprint).

"New Product Success," Chain Store Age, October 1974, pp. 56-58.

"How Buyers Foretell New Product Success," Co-ops and Voluntaries, December 1974, pp. 30-32.

"1976 Supermarket Outlook: Stiff Competitive Battles Ahead," Advertising Age, December 22, 1975.

APPENDIX TABLE 4.1--(cont'd)

"The Hard Road of the Food Processors," Business Week, March 8, 1976.

"Container Packs Usable in Microwave Ovens Seen," Supermarket News, May 3, 1976, p. 100.

"New Products Strategy," Supermarket News, June 21, 1976, p. 4.

"New Items Must Pass Chatham Value Test," Supermarket News, August 2, 1976.

"New Products' Acceptance Rate 10-20% at Chains: Lucky Buyer," Supermarket News, September 27, 1976, p. 25.

"New Items, \$10 Billion a Year in New Sales," Progressive Grocer, December, 1976, pp. 37-43.

"New Item Growth Intensifies Evaluation," Supermarket News, February 14, 1977, p. 27.

"New Item Introductions Following Declining Trend," Chain Store Age, October 1977, pp. 61-62.

"Chains Vary Widely in Approach to Trying New Products", Supermarket News, April 10, 1978, p. 4.

Unpublished Material

Donald R. Keough, "I Was a Buyer for Super Market Institute," Paper presented at 27th Super Market Institute (SMI) Convention, Chicago, Ill., April 27, 1964.

Henry T. Chandler, "If I Were a Grocery Buyer," Paper presented at 32nd SMI Convention, Operations Workshop, Atlantic City, N.J., May 13, 1969.

Quaker Oats, "Distributor/Buyer Workshop," Chicago, Ill., June 1969.

Michael D. Hutt, "The New Product Selection Process of Retail Buying Committees: An Analysis of Group Decision - Making," Ph.d dissertation, Michigan State University, 1975.

Other confidential private consultants' studies.

APPENDIX EXHIBIT 4.1--JOB DESCRIPTION FOR AN ASSISTANT GROCERY BUYER

ASSISTANT GROCERY BUYER

In addition to performing the duties of a Buying Assistant, and Assistant Grocery Buyer must have the experience, judgment and knowledge to perform the following with only general supervision and guidance of the Grocery Buyer.

1. Effectively perform any normal duty of the buying department described under "Major Activities" in the job description of the Grocery Buyer.
2. Work closely with all other divisional management personnel, primarily those in the traffic, transportation, advertising and accounting departments, and store and zone managers, to insure prompt and timely receipt, storage, distribution and accounting for all grocery product sold in the stores.
3. Act for the Grocery Buyer in his absence.
4. Relieve his own, or other Grocery Buyers, for an extended period.
5. Assist the Grocery Buyer in the training and evaluation of newly assigned department personnel.

The Assistant Grocery Buyer is not only fully qualified to perform the normal functions of the buying department, but is to receive training and experience in results for which the Grocery Buyer is held accountable including:

Inventory Management
Development and utilization of Computer Processed Data
Corporate and Division buying policies
Realization of the full merchandising potential of the buying function
The effect of the Basic Commodity Markets on finished product cost

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APPENDIX EXHIBIT 4.2--JOB DESCRIPTION FOR A GROCERY BUYING ASSISTANT

GROCERY BUYING ASSISTANT

Under the direction of the Grocery Buyer and/or Assistant Grocery Buyer:

1. Perform various assigned duties of an administrative nature which require the exercise of discretion and independent judgment.

These duties may include part, or all, of the individual "Major Activities" described in the job description of the Grocery Buyer. The extent of involvement and responsibility will vary with the experience in the total buying function which the Buying Assistant has acquired to date.

2. Assign and check work of the clerical staff and assist in appraising their performance and potential.
3. Co-ordinate the flow of work, both within the department and with other departments.

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CHAPTER 4

FOOTNOTES

¹Job descriptions for an Assistant Grocery Buyer and Grocery Buying Assistant are provided in Appendix Exhibit 4.1 and 4.2.

²For a percentage breakdown among these job classifications, see "New Directions in Buyer-Seller Relationships," Chain Store Age, April 1973, pp. 54-55.

³See section 2.2.5.

⁴Service Level = $\frac{\text{Total Inventory Shipped}}{\text{Total Inventory Ordered}} \times 100$.

⁵Progressive Grocer, April 1976, p. 143.

⁶"Function as Merchandisers," Supermarket News, February 9, 1973, p. 9.

⁷"New Items, \$10 Billion a Year in New Sales," Progressive Grocer, December 1976, p. 37.

⁸"New Item Study: Still Seeking the Right Formula," Progressive Grocer, October 1978, pp. 62-144.

⁹A.C. Nielson Co., Nielson Early Intelligence System (NEIS). Another new item series is the Dancer - Fitzgerald Sample.

¹⁰The only category close to Frozen Foods was HBA (Health and Beauty Aids) which had 1477 introductions in the ten-year period.

¹¹The 16 percent increase in new products introductions in 1973-74 is interesting. This was the time period for phases 3 and 4 of wage and price controls. Manufacturers may have been able to circumvent the controls by altering existing products and bringing out "new and improved" versions.

¹²This is the essential point of contention in the FTC's shared monopoly case against the major ready-to-eat cereal manufacturers. For a first attempt at quantifying the relationship, see John M. Connor, "Food Product Proliferation: A Market Structural Analysis," NC-117 Working Paper No. 41, Research Division, College of Agriculture and Life Sciences, University of Wisconsin, Madison 1980.

¹³The backhaul issue is one of the significant policy issues involving interindustry coordination in the food distribution system. Retail chains through their legislative representatives have petitioned Congress to permit backhaul arrangements. Resistance to this initiative is fostered by independent firms without their own trucks and large manufacturers who have their own distribution networks and equipment. Full implementation of backhaul awaits FTC clarification of the Robinson-Patman Act consequences of manufacturer-granted backhaul.

¹⁴Michael D. Hutt, "The New Product Selection Process of Retail Buying Committees: An Analysis of Group Decision-Making," (Ph.D. dissertation, Michigan State University, 1975) p. 61.

¹⁵Discussion here is about package design on primary consumer packages not secondary or shipping packages. The advent of automated warehouse technology raises another quality consideration for the retail firm. Because warehouse people have little influence with buyers this aspect of package quality is not usually considered in the buying decision. Likewise there is no buyer consideration on the system (modularization) consequences of package design.

¹⁶These phenomena hold for promotions on existing items as well as for programs to introduce new products.

¹⁷See section 6.4.4.

¹⁸Confidential interview with a high executive of a major food manufacturer.

¹⁹"Chains Vary Widely in Approach to Trying New Products," Supermarket News, April 10, 1978 pp. 4-5.

²⁰"New Items Must Pass Chatham Value Test," Supermarket News, August 2, 1976.

²¹Eugene Mahony, "1976 Supermarket Outlook: Stiff Competitive Battles Ahead," Advertising Age, December 22, 1975.

²²Advertising manager of Lucky Stores cited in "New Products Acceptance Rate 10-20% at Chains: Lucky Buyer," Supermarket News, September 27, 1976, p. 25.

²³Some reports indicated that the mysterious disappearances were aided by other potato chip salesmen.

²⁴For a more thorough discussion of automatic store ordering see "Supermarket Operating Conditions May Prevent Full Realization of Automated Reorder Benefits," Supermarketing, June 1978, p. 28.

²⁵This Exhibit as with selected others has had certain information removed in order to protect the confidentiality of information sources.

²⁶For a detailed discussion on the theory behind the IMPACT system see Theodore W. Leed and Gene A. German, Food Merchandising Principles and Practices (New York: Chain Store Age Books, 1973), pp. 55-69.

²⁷A brief discussion of store bulletins will be presented later (See Exhibit 4.17).

²⁸Four IMPACT type systems were reviewed during the inventory process. They all worked similarly.

²⁹See section 4.3.2 above.

³⁰These figures exclude in-ad coupons circulated by retail organizations in their advertisements. Trade estimates indicate that 10 percent of all retailer advertising involves a coupon. Thus, the total amount of coupon use is staggering.

³¹"Brand Power Study," Progressive Grocer, January 1977, p. 54. For details on the economic logic of coupons see: Ronald Ward and James E. Davis, "Coupon Redemption," Journal of Advertising Research, forthcoming.

³²A representative form of a deal is not included here. It is very similar to Exhibits 4.13 and 4.14.

³³A.C. Nielsen Co., "Early Intelligence System," Progressive Grocer, October 1978, p. 72.

³⁴Notice also that Hunt's is promoting all snack cup products for \$.75 a case for the same time period.

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CHAPTER 5

DISTRIBUTOR LABEL PROCUREMENT PRACTICES

5.1 What Makes Distributor Label Products Different

In many respects private label buying is more difficult than brand label buying. Brand manufacturers formulate, package, distribute, and market products with their own identifying brands. Grocery distributors who sell private-controlled labels must address all these functions themselves. Private label buyers, therefore, need to be knowledgeable in many areas which are not usually of concern to brand product buyers.

This chapter attempts to provide a comprehensive description of the workings of the private label grocery business. The material in the section was gathered through interviews with buyers and sellers of private label grocery products. Although the material which follows deals directly with the market for processed fruit and vegetable products, the forces discussed are generally applicable for any commodity type product sold under private label.

Commodity items tend to have the same or all of the following characteristics: 1) short production seasons; 2) quantities and prices largely controlled by stochastic forces (weather, disease, etc.); and 3) product definition (quality and uniqueness) are determined by forces beyond management control. Business people also tend to think of products with variable prices due to market forces as being commodity items. Manufactured products by contrast 1) have year-round manageable product

flow; 2) can by design be made consistently unique; and 3) may be made with commodity ingredients. There are differences in procurement SOPs for commodity and manufactured types of private label products.

As will be apparent, the private label and brand product sectors of the grocery business involve fairly distinct channels. However, the basic economic conditions and intrafirm forces discussed in the brand product procurement sections also affect the private label sector and are thus recurring themes in the following analysis. The motivations for private label buyers are similar to those of brand buyers. They do, however, often react differently.

5.2 The Private Label Buyers

Private or controlled label buyers differ from their counterparts in brand products in that private label buyers are more specialized and have more longevity. Private label buyers basically must be totally familiar with the products they buy. This includes all the quality characteristics, growing regions and conditions, and processing technology. To develop this detailed knowledge buyers usually deal with private label products over an extended period of time. As a result, private label buyers tend to follow a distinct career path. Their expertise is usually transferable only within a private label context. Once associated with private label merchandise, they usually finish their work career in the system. This phenomenon helps explain the backgrounds or origins of private label buyers.

Interviewed buyers and sellers were asked to briefly describe their career paths. In addition, a corporate recruiting firm responsible for placing retail buyers was consulted. Generally speaking, private label

buyers come from three broad backgrounds. Probably the most prevalent source of private label buyers are the few large established private label buying organizations. These may be established corporate chain organizations, but usually are private label buying organizations.

A typical buyer's career follows. A young person starts by working in the quality control department or as an assistant to a product line manager in a private label buying organization. After several years' experience, the employee might be offered the product line managership for a relatively minor group of products (e.g., jams and jellies, powdered drinks, etc.). Through time he can work up to management over larger and more complicated product categories. Finally, the buyer might become a family group private label manager (i.e., frozen foods, canned fruits and vegetables, health and beauty aids, etc.). Often at this stage or the previous stage, an enterprising and qualified buyer will leave the buying organization for a more responsible and financially rewarding position with another buying or supplying firm. Typically, the buyer will become the director of private label buying for a smaller regional chain or buying organization. After necessary experience, he may move to bigger and more diversified organizations.

Many people in the private label system have a similar kind of background. Insofar as there is a training system for private label procurement, it is included in this system of experience and mobility. An educated guess would estimate about half of private label buyers employed today come up through this kind of system. A few stay with the original organization. But as more firms expanded into private label buying, those existing private label organizations become the training grounds for the buyers needed to run the enlarging system.

Another common origin for private label buyers is the retail organizations themselves. As store managers or wholesale personnel work themselves up through the organization into brand buying positions, some seem to gravitate to private label merchandising and buying. Gradually they begin to develop more and more human capital in the private label business and they become private label specialists. Because there are more established private label buying units in existence today, probably more of tomorrow's private label buyers will be "homegrown."

A third sizeable group of private label buyers comes from the processing sector. During their tenure, they develop the needed expertise to become knowledgeable buyers. Of the three categories of buyers, there are probably fewer in this group than in the other two.

There are, of course, many other buyers with varied and different backgrounds than those discussed above, but the typical private label buyers fall into these categories. The main implication of these career paths is that private label buyers tend to know their competitor's personnel much better than brand buyers know other brand buyers. The reputations and actions of individual buyers spread rapidly in the private label industry. This communication network plays an important part in the performance of private label dealings and is a recurring theme in this analysis.

Within the private label system there are various types of buyers with varying degrees of authority and they can be either general, street, or program buyers. General private label buyers are the typical buyers found at headquarters or in private label buying organizations. They are assigned a certain group of products over which they have responsibility and is often determined by geographic location. Commodity

product buyers usually are not involved in the purchase of manufactured items.

The geographic nature of private label food products is responsible to the development and existence of the specialized private label "street" buyer. A "street" buyer is a buyer whose offices are located on California Street in San Francisco, or in the nearby Bay area. Typically, a "street" buyer is responsible for the procurement of all products bought in the western states. This includes fruits, nuts, vegetables, fish, and tuna. Because of the volume and number of products bought on the West Coast, many private label organizations find it advantageous to have a full time buying department on the "street." They are unquestionably some of the most sophisticated and qualified private label buyers and are some of the most influential food buyers in the country. Most often these buyers are subordinate to the Director of Private Label or even a lower level family group manager in the distribution firm. However, their superior experience and knowledge sometimes allows them to transcend or at least direct knowledge control. Their superiors come and go, yet the savvy "street buyers" survive.

Perhaps at the opposite end of the expertise spectrum from "street buyers" are program buyers. They buy according to a set plan given to the processor. For example, the processor may be authorized to ship a mixed product carload of items in set "programmed" quantities each week. The car may contain X cases of peas, Y cases of corn, Z cases of beans, and ABC cases of assorted other minor products. Program buyers thus reduce transaction costs to a minimum. There is little daily or even weekly intercourse between buyers and sellers. Program buyers are fairly

common in frozen fruit and vegetable products but are rare in the canned goods industry.

Within corporate bureaucracies, most often private label buyers will be in separate departments. The directors usually report to vice presidents of procurement and/or marketing. In contrast to many brand buyers, most private label buyers do not have merchandising responsibility for the products they buy. The buyer/merchandiser for that family group will often have merchandising responsibility for both brand and private label products. In those firms which have separate buying and merchandising personnel, the private label buyers must compete for merchandisers' time with all the other buyers. Since many retailers get private label products through buying organizations, buyer and merchandiser are often separated geographically and organizationally.

Some organizations adopt marketing strategies which give great emphasis to private label. Others adopt private label only because it seems to be a competitive necessity. In the former organization, the private label personnel can exert considerable influence. The converse is true in the latter organization. Firms may change strategies over time because of management, economic, or competitive changes.

The actions of private label buyers are constrained just like those of brand product buyers. Inventory costs and service levels in stores are as critical to private label as to brand products. However, the private label buyer has many other concerns. Brand product manufacturers are assumed to be responsible for their products' total performance including quality control, label design, and transportation, while these aspects of private label products are the jurisdiction of the private label buyer for the retail firm.

When the retail distributors put their names on the labels, they become responsible (in the consumer's eye) for the performance of the product. Thus the private label buyer has to be aware of and concerned with the economic forces affecting the supplying industries, and changes in government regulations affecting labeling and safety.

The private label buyer may have fewer products to buy but he has a lot more worry per product. For example, if a brand product is not available, the brand product buyer can always substitute a similar but different brand item for the unavailable product. However, if the private label buyer miscalculates and does not buy enough product, the retailer's own brand is out-of-stock and no similar substitute is available. Therefore, private labels will lose valuable market shares to brand products. Unfortunately for the private label buyer, top management does not readily differentiate between the performance of brand product and private label product buyers. Thus the private label buyer must understand and know how to mitigate all the economic and physiological factors which can impinge on the products he buys and, thereby, affect his performance. Herein arises the reason why private label buying is a specialized skill. Much of what follows in the private label discussion deals with the aspects of products with which buyers must deal and the standard procedures they have evolved for handling them.

5.3 The Theory of Private Label Merchandising

5.3.1 Why Food Retailers Stock Private Label Products

In its simplest form, the establishment of a private label program is an attempt by a retail distributor to differentiate products and create consumer loyalty to his organization.¹ While the extent of

private label sales any retailer can have may vary from zero to 100 percent, most food retailers carry a limited variety of private label items. This section attempts to briefly discuss the premises on which private label is used.

Private label programs are developed because they give retailers and/or distributors one or more of the following:

- A product that cannot be exactly matched by competitors

- A higher retailer margin than exists for comparable brand items

- Categories of products which give consumers a value choice across quality and price characteristics

- Exclusive control over the pricing, advertising, and merchandising of a group of items

If a competitor runs a special on a brand product, the retailer is under strong competitive pressure to match that offer. However, the merchandising and pricing policies adopted by a competitor will not directly affect the retailer's private label line. This is especially true if the retailer has been able to successfully create differentiated consumer preferences for his products. Private labels allow retailers to have more control over their own destinies.

Typically, private label products carry a higher gross margin (and lower retail prices) than their brand counterparts because retailers can usually buy private label products cheaper than brands. Most industry commentators state private labels sell for less because they 1) do not have to pay for manufacturer advertising, 2) often have less expensive labels and packaging, 3) do not have to support research and development departments, 4) do not have to support new product failures, and 5) can be bought and shipped directly in large units. All of these aspects reduce overall costs.

There is little doubt that in most cases private label margins for retailers are larger than for similar brand food products. Whether these higher margins translate into greater profits for retailers is, however, a debated topic. The argument revolves around whether or not retailers' accounting systems accurately allocate revenues and costs to specific products in the store. Brand manufacturers argue that retailers do not allocate the value of promotion monies, advertising support, and sales force retail work provided by manufacturers into the retailer's profit calculation. As for cost manufacturers contend that private labels do not pay their full share of store overhead and store advertising expense. Some retailers agree that these are valid points, but the debate continues.² The fact still remains, however, that retailers believe private label is more profitable to them. They therefore continue to develop and foster private label programs.

A key goal of food retailers is to present the consumer with an array of products from which to choose. In order to appeal to the greatest number of consumers, retailers align product selections to span a price and quality spectrum. Since brand products usually are formulated to fit the high quality spectrum, private label products play an important price and quality role in the stores by filling the lower price and/or lower quality niches.

Private label programs allow retailers to develop their own images and identities. By controlling quality, label design, advertising, and shelf position, the retailers can create their own image and differentiate their store from competitors'. This is done primarily by controlling quality and pricing over time.

Firms' attempts to differentiate themselves result in the adoption of private label "philosophies." These general attitudes toward the firm's private label program, are key dynamic factors in the private label business and therefore, the coordination of the food system. Two such private label philosophies, Franchise Development and Competitive Response, are identified and explained in Section 5.11 below.

5.3.2 The Golden Rule of Private Label Food Merchandising

One private label executive stated "There is but one private label concept. What varies is the ability of firms to execute (implement) that concept."³ He may be right. However, failures to implement may stem from the priorities given by firms to their private label programs. In this respect, there are different philosophies. The private label concept, which is nearly unanimously stated by all people involved in the business is "Private label products should be of equal or better quality, with lower consumer prices, and higher retailer margins than their brand product counterparts." This is in essence the golden rule of private labels when applied to first label private label products.

One standard rule for pricing private label products is as follows: "The cents gross profit per unit should be equal for national and private brands." Table 5.1 illustrates this rule. If both the brand and private label product were assigned the same gross margin (20 percent), because the case cost of private label is lower, the retailer recoups only \$.05 per unit gross margin for his private label product. Thus by selling one case of each product, he would get \$1.44 gross profit from the brand sale versus only \$1.20 for the private label sales. Since he reasons that it costs the same (shelf space, lighting, stocking) to sell a

TABLE 5.1--AN ILLUSTRATION OF A BASIC PRIVATE LABEL PRICING RULE

RULE: Cents gross profit per unit should be equal for national and private brands.

<u>National Brand</u>			<u>Store Brand</u>		
			National Brand Pricing Rule		
24 #303's	20% Gross Margin (GM)		20% GM		
Cost	\$5.76	7.20	\$4.80	6.00	
Cost/unit	\$.24	.30	\$.20	.25	
	$\underbrace{\hspace{1.5cm}}_{\$.06}$		$\underbrace{\hspace{1.5cm}}_{\$.05}$		
			Private Brand Pricing Rule		
			23% GM		
			\$4.80	6.25	
			\$.20	.26	
			$\underbrace{\hspace{1.5cm}}_{\$.06}$		

twenty-four unit case of each product, he would be making less net profit on his private label. Hence, the retailers' rule that the cents gross profit per unit must be equal is accomplished by having a higher percentage gross margin (23 percent) for private label. This rule is an approximation of industry practice. Some distributors may attempt to make a few more cents profit per item. Competitive market conditions and supply and demand conditions also can result in different pricing patterns for individual products.

Notice this general practice conforms nicely with the "Golden Rule of Private Label." The private label is priced lower to consumers than the brand, yet receives a higher gross margin. This standard practice for private labels results in store brand products usually being priced at some fixed cents per unit differential compared to their brand counterparts. The trade sometimes refers to this as "sunlight" pricing. The preponderance of this rule and the seemingly strict adherence to fixed differential pricing seems to be widespread in the food retailing industry. This pricing rule plays a critical role in the level of vertical coordination in the system (See Chapter 7).

5.3.3 Adding New Private Label Items to Distribution

There is no such thing as a totally "new" private label item since private label products are copied from brand products. A new item then is a new addition for private label offerings for that firm. The two basic variables which are examined by retailers when deciding to add a private label item are volume and adequate suppliers. The most basic factor is if there is enough volume in the product category to support both a brand and a private label. Volume of a given product is a

function of the percent of the store customers who buy the product and how often they repurchase the item. The anticipated volume must be such that private label suppliers are able to produce at or near lowest possible unit cost because of the pricing practices of private label. Usually the volume must be sufficient to support the minimum cost production for several suppliers. Private label buyers will rarely ever commit themselves to only one source of supply. Therefore the second private label product prerequisite is that there be several possible manufacturers of the product. Since private label is a price-volume market, it is logical that sufficient volume and adequate supplier numbers are the basic prerequisites for private label introductions.

There are, of course, exceptions to this volume criterion. Brands with very strong consumer franchises sometimes have such strength that private label products cannot break in at a profitable price and volume. To date private label soups are not too successful and provide examples of this phenomenon. Private label baby foods and diapers have for the most part been failures. Trade sources say that new parents will buy only the "best" for their additions to their family. When advertising has reinforced this characteristic it is difficult for private label to crack. In some cases, the brand product is superior and private label manufacturers cannot duplicate it.

The composite result is that private label products exist for only a select group of products: high volume, repeat purchased, established, and basic grocery and nonfood items. These items are presented in only basic sizes, packages, and flavors under private label. Only after a new brand product has established a volume track record at retail stores and the incidence of consumer purchases is known and stable or growing will

private label organizations attempt to introduce a private label in that product. Often this is late in the product's cycle. This is because a successful new brand product will often result in a flood of similar products brought out by rival manufacturers soon thereafter. During this period in the product's cycle there are so many deals available, that retailers cannot afford to try to develop a private label. Besides after some of these firms fail, their equipment and plants become available for private label manufacturing.

Some large private label buying organizations, by pooling orders from many smaller retail units, can garner enough volume to introduce private label products in many more items. Probably the most complete lines of private label merchandise are carried by private label buying organizations. The larger the organization the greater the number of products that become candidates for private label sales because of the minimum volume requirements. The trade estimates are that a chain has to have sales close to \$1 billion a year in order to profitably support a minimally effective in-house private label program.

5.3.4 Discontinuing Private Label Items

Since only select products are privately labelled, the number of items to be discontinued is also select. In fact very few products are discontinued which is a bone of contention between manufacturers and retailers. Manufacturers claim that retailers apply a different and lower set of standards for their own labels. Therefore many private products occupy shelf space which according to manufacturers should go to higher volume brand products. Although there is no definitive evidence available to this researcher to verify these claims, logic would

suggest that there would be a tendency for retail private labelers to react this way.

Retailers have commitments for the private label: various agreements with suppliers and product and label inventories. When systematic product reviews are held, they most likely do not correspond to the end of the market year for the product in question. For this reason, slower moving private label items might be tolerated at least for another season. The natural reaction might be to say "we'll get it next time."

It therefore is unusual for private label products to be scratched from distribution on a routine or systematic basis. Of course, retailers who buy private labels through private label organizations can usually drop items anytime. When private label products are discontinued, it is during infrequent systematic private label program reviews. These are analagous to systematic family group reviews discussed in Section 4.5.3 above which usually occur on an annual basis.

5.4 Private Label Product Specification and Label Design

5.4.1 SOPs for Establishing Product Specifications

A major consideration to a private label buyer, is quality control and product specification. When the distributor commits himself to putting his name on a product, he usually wants to be certain about what is in the package. With rare exceptions, all private distributors develop product specifications which manufacturers and suppliers must use in producing that private label product. In most cases, the quality control personnel work for or with private label buyers. Buyers determine which products are to be included in the private label program. Those responsible for quality control develop product specifications and monitor

supplier compliance with these specifications.

The standard operating procedure for establishing specifications (specs) for private label products is based on the leading selling brand in the firm's market area. This product is dissected and copied. The private label distributors try to write specs which duplicate the top brand product in the category which may or may not be a national brand. If a regional brand is the leading product, it is the one copied. The most sophisticated buying organizations will have different product specs for the same product in different markets so they can more closely match consumer preferences in various markets. The large buying organizations with affiliated members throughout the country are more likely to have a variety of specs for individual products. Some national corporate chains have one uniform spec; others have a variety.

Private label laboratories go to considerable lengths to try to determine and measure the important characteristics contained in the leading product. They will, for example, tear down a frozen meat pie; count the number of individual peas and corn kernels; determine the type of meat; weigh the amount and number of pieces; weigh the sauce and determine its viscosity; break down the components of the crust, etc. They will test packaging, cooking instructions, and shelf life. Through analysis, they attempt to know a product as well as its manufacturer does. Specifications will be written to try to duplicate the original exactly while generating the cost differential private label products need.

The quality control department might alter the private label products specs in an attempt to lower the cost. They may, for example, authorize thinner aluminum dishes or reduce the amount of meat in each pie. They

attempt to make these adjustments without noticeably altering the basic character of the product. The goal is to develop a product which is less expensive than the brand, but to do so in ways which will not cause the comparative shopper to forego the distributor's brand alternative. If they fail to retain the basic character of the product, consumers will perceive the choice as a lower quality product for a lower price. In addition, each private label firm may attempt to cut costs in different ways. Therefore, the private label products of any two organizations are not directly comparable. Generally speaking, the more complicated the product being developed, the more likely that comparability among private labels and between private labels and the copied brand will decrease. This is especially true for manufactured products.

Exhibits 5.1 and 5.2 are presented to illustrate the type of detail included in product specifications. Exhibit 5.1 is an actual canned snapbean specification currently being used in a private label program. When government grades exist for the private label product, they form the base on which specifications are written. In fruits and vegetables the brand manufacturers use their own internal grading systems. These are usually not directly translatable into United States Government standards. In Exhibit 5.1 the basic product is U.S. Grade A or U.S. Fancy. To this base, additions or specific modifications are added. In this case, the minimum score is set at 92 points which is two points higher than the U.S. minimum for Grade A. For canned fruits and vegetables, it is very common for the private label firm to stipulate minimum or sometimes a range for scores. This is again an attempt of private label firms to match national brand products or as part of their own quality label differentiation strategies.

EXHIBIT 5.1--ACTUAL PRODUCT SPECIFICATIONS IN USE FOR SNAPBEANS

PRODUCT SPECIFICATIONPRODUCT: BEANS, GREEN
& WAX, CANNEDQUALITY: FIRST LABEL

First Label Canned Green Beans and Wax Beans shall conform to U. S. Standards for Grades of Canned Green Beans and Canned Wax Beans and shall be U.S. Grade A or U.S. Fancy with the following additions and modifications.

<u>SCORED FACTORS</u>	<u>MINIMUM POINTS ACCEPTED</u>
Liquor	9
Color	14
Absence of Defects	32
Maturity	37
TOTAL	92

VARIETY: Green beans having white or light colored seeds such as Tender-green, Slendergreen or Blue Lake. Wax Beans - Kinghorn or similar variety.

TYPE: Round

STYLE: Cut, French cut, or whole as specified on contract/purchase order.

SIEVE SIZE: Cut Green Straight 3 or 4 sieve as specified on contract/P.O.
The Blue Lake variety may use up to a straight 4 sieve.

French Straight 5 sieve or a blend of 4 and 5 sieve.
Whole Straight 3 sieve or a blend of 2 and 3 sieve.
Cut Wax Straight 4 sieve or a blend of 3 and 4 sieve.

LENGTH OF CUT: 1-1/2 inch cut.

FLAVOR: Typical of canned beans, free from any trace of foreign or objectionable flavors.

COLOR: Shall possess a color bright and typical of very young and tender beans with not more than 3% by count of units which vary.

LIQUOR: Shall possess a practically clear liquor with a slight tint of yellow-green to green and not more than a trace of suspended matter and sediment.

DEFECTS: For each 8.5 ounces drained weight there may be present not more than:

- (a) two unstemmed units, or two detached stems.
- (b) a total of 10% by count under one inch in length as long as there are not more than five units less than 1/2 inch in length.

MATURITY: Seeds shall be in the early stage of maturity and the beans shall be full fleshed for the variety; tender and not fibrous and show no signs of sloughing.

EXHIBIT 5.2--ACTUAL PRODUCT SPECIFICATIONS IN USE FOR FROZEN BROCCOLI SPEARS

10 oz. UPC
24 oz. Poly Bag UPC

SPECIFICATIONS FOR ChainX FROZEN BROCCOLI SPEARS

Manufacturer guarantees to ChainX that Chain X Frozen Broccoli Spears shall be packed in accordance with good commercial practices and shall conform with the specifications set forth herein and shall comply with all provisions of the Food, Drug, and Cosmetic Act and all regulations promulgated thereunder, particularly those regulations governing nutritional labeling, artificial flavoring, imitation foods, dietary foods, and the food label information panel, as applicable. ChainX Frozen Broccoli Spears shall be produced from top-quality ingredients only, which ingredients shall be clean and free from contamination or infestation of any type. All ingredients used must be free from Salmonella and any other pathogenic organisms.

Net Weight: The average net weight of any lot of production must at least be equal to the stated net weight. Weight control must be maintained to assure compliance with National Bureau Standards Handbook 67 regarding prepackaged commodities.

Grade: ChainX Frozen Broccoli Spears shall grade U.S. Grade A when scored according to the U.S. Standards for Grades of Frozen Broccoli Spears and in addition, shall conform to the following requirements.

Length: At least 90%, by count, shall have a uniform length in which the length of the longest unit does not exceed the length of the shortest unit by more than 1". Only one stalk per package may be less than 4 inches. There shall be none less than 3½" nor more than 5½".

Diameter: The greatest cross sectional dimensions of the main stems shall not vary more than 3/4 inches.

Count: The count range shall be as follows:

10 oz.	6 - 12 stalks
24 oz.	15 - 20 stalks

Flavor: After preparing according to labeled directions, the Chain X Frozen Broccoli Spears shall possess a good flavor and odor. There shall be no objectionable flavors or odors present of any kind.

EXHIBIT 5.2--(cont'd)

Chain X Frozen Broccoli Spears

Package Code: Each package shall be legibly and indelibly coded to designate a) production date; b) batch, or production time interval (this should be based on the quantity determined by a review based on Good Food Manufacturing Practices and Hazard Analysis Critical Control Points for the specific product); c) production plant; d) filling line if appropriate; e) product identity if needed for your internal use prior to labeling; f) and any additional information required by current regulations.

In order to accommodate your coding equipment, we will not specify the nature of the code. We prefer the use of the Julian system, i.e., first three digits for day of year and fourth digit for last digit of year, June 20, 1977 = 1717, plus other appropriate symbols to meet the above package code requirements. ChainX must be kept informed of your current system at all times.

Case Code: The exterior of shipping case or outer wrapping shall have the same legible code information and UPC numbers as the retail package plus any other appropriate identification as required by ChainX procurement.

Record Keeping: In addition to quality control reports requested below, it is essential that the processor maintain production and "in-process" quality control reports that when coupled with the finished product quality assurance reports will facilitate specific product identification for any necessary follow-up. The reports should document identification of raw material, ingredients, separate component parts, packaging materials, and their related quality inspection or analysis reports, process records, weight or fill records and other specific quality evaluations (sensory as well as analytical) for the finished product.

Nutritional analysis data, in addition to appropriate quality control records, to document compliance with regulations on nutritional labeling are required.

The records must be kept on file for sufficient time to allow for the normal expected life of the product as it moves through the distribution and sales system and be made available for Kroger personnel as requested.

Shipping Records: Bills of Lading and invoices will show all codes included on shipment.

Quality Assurance: Quality Assurance certificates or quality grade sheets shall be sent to

for each day's production of private label products. These reports shall include: code, color, net weight, defects and texture.

Supersedes spec dated: May 13, 1976

Reason for change: Update Format

Originator: Approval: _____

Exhibit 5.2 is a comparable specification for a frozen vegetable. The technical provisions are about the same as those described above except, of course, they relate to a frozen product. This specification document, however, has some other important additions. Notice that many of the provisions deal with the assignment of legal responsibility and record keeping. The supplier is explicitly required to assure that the product is free of pathogenic organisms and that nutritional analysis and labeling requirements are met. The supplier is totally responsible for record keeping which the buyer might need for product recall or quality sampling.

The specifications for all fruits and vegetables, both frozen and canned, follow formats similar to those shown in Exhibits 5.1 and 5.2. As stated before the specifications will vary across firms. This will be more apparent after the various grade levels of private label are discussed.

5.4.2 Use of Multiple Private Labels

Exhibits 5.1 and 5.2 are specs for first label products which implies other labels. Almost as common as first labels are second private labels for a retail grocery firm. Some firms even carry a third private label. Table 5.2 which is based on the specs contained in Appendix Exhibits 5.1 and 5.2 help illustrate the differences among labels. In this example, first label is to be Grade B whereas second label is Grade C. Light syrup is to be used in second label. This is a cost cutting measure which allows second label to retail at a lower price.

Probably, next to the grade difference, the most important difference between first and second labels is the greater variance allowed in

TABLE 5.2--COMPARISON OF THE PRODUCT SPECIFICATIONS FOR A FIRST LABEL
AND A SECOND LABEL PRIVATE LABEL CLING PEACH HALVES

Product Characteristics	First Label Cling Peach Halves	Second Label Cling Peach Halves
20 oz. (No. 2 1/2) Yellow cling Peaches		
Grade	U.S. Grade "B" not less than 16.6 oz.	U.S. Grade "C" not less than 17.0 oz.
Drained Weight	Average 18.0 oz.	Average 18.4 oz.
Count	7-12 halves 8-11 preferred	6-15 halves
Syrup	Heavy	Light
All other provisions are identical for each label		

SOURCE: Actual product specifications of a current label program.
See Appendix Exhibits 5.1 and 5.2 for complete specs used
for compiling this Table.

the second label. Eight to eleven halves are the preferred number for first label, whereas fifteen halves are allowed in second label. What this really means is that the consumer will have varied sizes of peach halves in his bowl instead of consistent, uniform halves. The greater variance allowed across packages of the same product is highly significant. Many raw products which vary in size and maturity are usually lower priced.

Combined with lower sugar price and lower basic grade, the second labels are usually price-oriented (low price oriented) labels. They are used for that market segment which is price-sensitive and is willing to trade off some of the visual and taste characteristics of the product against unit price.

Some private label organizations, especially the buying groups, will label a third level of product. Third labels are usually one U.S. Grade lower and more variable than second labels. The firm whose specs are represented in Table 5.2 does not carry a third label because their second label is at the lowest commercially feasible quality grade. Notice also that this firm's first label is Grade B whereas many first label private labels are Grade A. This demonstrates that it is misleading to assume all products are the same.

The most frequent situation in which third labels are used is when a packer has excess inventory or odd lots which he wants to move. These off/on sales are made to the private label trade for use with third labels. This fits buyers' needs because they rarely "book" any third label products. An interesting observation is that sometimes the third label products may have quality almost or equal to first label. If the processor is dumping good lots, consumers can pick up excellent bargains.

In addition, if a large crop year also has above average quality, the third label will have good quality. The basic characteristic of third label merchandise is its unpredictability. Third labels are, however, useful coordination instruments as will be evident in Chapter 6.

5.4.3 The Design and Management of Labels and Packaging

If a retailer with a private label program has to create a series of labels, label development looms as a major topic. This situation became apparent during several interviews. Exhibit 5.3 is a list of a standard sequence of events leading to the creation of a retail private label. This list was taken directly from company documents and is still the sequence being used today. Therefore it is the complete list of procedures. If the product were being added to an existing line, the sequence would start at Item 6. Item 5 is interesting and highlights one of the important theoretical points about label design.

For this organization, the label is designed to copy as closely as legally possible the package design and colors of the leading national brand around which the product was created. This typifies the kind of planning that goes into the private label strategy for a competitive response. This strategy embodies the belief that you pack a product equal to or better than the brand, put it in a visually similar package, and place it next to the brand. Private labels are always placed to the right of the brand. Because most shoppers are right-handed, they would have to reach past the private label in order to get to the national brand. The hope is that the consumer will pick the private label by mistake the first time, but after trying it he will repeat the purchase because of the superior value. This strategy attempts to

EXHIBIT 5.3--SEQUENCE OF EVENTS LEADING TO THE CREATION OF LABELS FOR
DISTRIBUTOR BRANDS

1. Suggest brand names for the product replacement categories.
2. Test-panel selection of preferred brand names.
3. Submit top three choices in each product category to the lawyers for registration purposes.
4. Sketches were submitted by five (5) nationally-known lithographers.
5. Sketches were displayed next to the national brand item with which the new item would eventually compete.
6. After the general label format was finalized, detailed placement of net weight statements (ounces and metric), correct ingredient clauses, nutritional information, UPC symbols, and signature line were resolved.
7. The final art work was submitted to the printers with the instructions that all final film had to be approved by Chain X.
8. Facsimilies of the new labels were submitted to the lawyers so that they could be submitted for national and state registration.
9. Existing inventories of Chain X labels and packaging were being worked down to a minimum ending inventory figure.
10. The lithographers printed the new labels and sent them out to our selected suppliers.

SOURCE: Actual chronological sequence of events used to create private labels for a Midwest chain. Interviews with other private label directors confirm that these or a closely related set of similar procedures were used.

transfer some of the benefits from advertising and marketing force of brands to private labels. The main disadvantage of this strategy is that labels may be inconsistent across individual items. This leads to cluttered and visually confusing store shelves.

Another strategy for labels is to develop a separate coordinated set of labels for use in all products included in the private label program. This strategy usually incorporates the common color code and the corporate logo on every label which creates a unified and identifiable label scheme visible throughout the store. The theory behind this philosophy is that it helps build consumer loyalty (product differentiation) for the store's private label. This strategy is designed to help use the power of store brands to transfer to other and perhaps new store brand products. This strategy is usually adopted by corporate chains which have their own private label departments and programs. This common color-logo scheme is difficult to achieve for firms which get private labels from buying organizations.

In general, coordinated label approach produces more esthetically pleasing store merchandise displays which help build retailer-consumer loyalty. However, there are drawbacks to this approach. With common labels, the consumers will transfer ill will caused by a bad product experience to other store brand products more readily than with diverse labels. If, in addition, its label carries the retailer's name, any consumer resentment which exists will be fostered against the retailer.

This transfer phenomenon explains two often-observed facts about private label programs. First, retailers will not put their logos and names on anything but first label private label products. Second, those firms which commit their identities to their private label products will

usually have elaborate and/or strict quality control and buying offices. The commitment to use the firm's logo on the product is highly correlated with a high level of resources and a longer-run view of a private label program.

Once labels are printed, they are shipped to authorized suppliers who maintain the inventories of buyers' labels. Because grocery firms buy from many suppliers, chains have considerable expense tied up in label inventories. Again, a small chain may have \$50,000 in label inventory in one year. The most sophisticated buyers have computerized label inventory control programs for two reasons: they minimize costs, and since the retailers have proprietary interest and goodwill invested in the label names, they need to have some control system to prevent theft or inappropriate use of their labels. The practice of maintaining label inventories at suppliers' plants is a key element in private label markets.

5.5 Procedures for Monitoring Private Label Product Quality

Mechanisms must exist to monitor the flow of products to distributors to make sure they are in compliance with product specifications. In trade terminology, these mechanisms comprise the firm's quality control program. The interviews revealed quality control programs and commitments which vary across a continuum from very strict to superficial. Three typical examples are presented here because the programs analyzed in the interviews tended to center toward them. In addition, the three quality control programs discussed will highlight nearly all mechanisms or standard operating procedures discovered. For lack of any other appropriate designations, the three programs are referred to here as

distributor-run programs, distributor/supplier-run programs, and supplier-run programs.

5.5.1 Distributor-Run Quality Control Programs

In a typical distributor-run quality control program the buyer retains control over quality control. The buyer-distributor makes, monitors, and enforces quality rules. These programs have elaborate systems for checking and cross-checking compliance.

Distributor-run programs start with a fairly sophisticated quality control laboratory. It is here that the retailers' specs are developed. Quality control labs include all the equipment for testing for bacteria, color, and odors. Most quality control labs are supervised by a food technologist or microbiologist. These people, in turn, report to and/or work with the buyers.

The quality program is initiated with supplier plant inspections by the buyers quality control department. These usually occur on an annual basis although some firms may inspect more often. Basically, the quality control people inspect for the age, condition, and maintenance of the supplier facilities. They make sure standard industrial manufacturing practices are being used. They also reacquaint themselves with supplier personnel. Should a problem arise, the previous contacts between buyer and supplier personnel greatly helps to deal rapidly with problems. These inspections usually take place before processing starts.

While the quality control director is touring the plant, the buyers will be driving (by themselves or with supplier fieldmen) around getting a "feel" for the upcoming pack. They will do this at all plants and most growing regions. This type of information is invaluable to the

buyer. If weather factors affect the harvest, these knowledgeable buyers will be able to pinpoint damage and assess the market implications much better than other buyers.

The suppliers have the buyers' specs and are thus able to segregate products off the line for these organizations. Most often these buyers do not select specific lots of merchandise but rather rely on the supplier to make sure the product is up to spec. Here is where, however, the elaborate coding systems required in the specs come to bear. A top quality control department will pull product samples to check to see if they are up to prescribed specifications. Samples will be pulled from incoming trucks or railcars, from warehouse bins, and from store shelves. The total coverage is to prevent suppliers from finding out when samples are to be pulled and therefore biasing the results. All samples and correspondence is handled by product lot codes.

If there is a quality problem, the supplier is notified immediately. Often the packer will not be aware of a minor quality problem. Any consumer complaint letters are usually traced to the supplier whose product was sold in that store. Suppliers are provided with copies of the letters.

Buyers understand unusual quality aberrations in a supplier's product. However, the supplier had better not have frequent quality problems. The first time a processor supplies a product not up to the specs quality control department personnel are put on alert. The supplier is warned and his products sampling frequency is increased. Supplying less than spec quality twice usually terminates further business dealings.

Distributor-run quality control programs exist for three main reasons. First, is insurance, as it is usually cheaper to constantly

monitor and regulate quality than to respond to the bad consumer reaction or publicity which occurs when a bad product reaches the consumer.

Second is product consistency; to have a successful private label program, the products sold must be consistent within label specifications over time and across suppliers. Consistent quality, within specification limits, especially in commodity items, can only be achieved through careful and constant product selection and monitoring. It is no coincidence that the top private label distributors also have the top quality control departments. These departments are not cheap. Those firms who have a long-term commitment to private label recognize the absolute necessity of consistent quality.

The third reason is bureaucracy. Once a quality control system has been established it takes on a life of its own. Therefore, quality control programs tend to perpetuate themselves.

The basic characteristics of distributor-run quality control programs are their sophistication and thoroughness. Well-run private label organizations leave little for others to decide. They control the substance of product flow throughout. Many, in fact, most private label buyers talk about and highlight their quality control. However, only those firms with the above programs really do have full-fledged quality control. Many of these other firms in reality abdicate some of the quality control responsibility to suppliers.

5.5.2 Distributor-Supplier Run Quality Control Programs

Distributor-supplier run quality control programs have many of the trappings of distributor-run programs, the most noticeable difference being the lack of constant control throughout the product flow process.

Private label personnel only periodically visit the suppliers' plants for inspection purposes. However, the private label buyers will make annual buying runs to all producing regions to select lots of merchandise from which private label products may be shipped to their organization. The buyer will select or have the processor select samples from various uncommitted lots of products. A lot is a manufacturer term for a production run, and in the canning industry, usually refers to the product canned during a set specific time interval. Each lot is numbered. For example, Lot No. 1717C might stand for the product canned on June 20, 1977 from 12:00-6:00 p.m. There is no standard coding method, however, each processor has some bookkeeping system. What follows is a "cutting" when the cans in the sample are cut open. The buyer then inspects each product for compliance with his specs. He chooses those lots which meet his product specifications and authorizes those as suitable for shipment to his warehouse(s). These authorizations are not purchases. They only say, "If I buy from you, you may only send me products from these approved lots." Lots selection is sometimes used in the distributor-run program also. The author attended several cuttings and was impressed at how quickly the buyers and sellers were able to assess the quality characteristics of each can. What also was obvious (as deduced from suppliers' comments) after the "cutting" was how uniformed some buyers were about the products they were buying. In several instances the suppliers pointed out that buyers had picked products which did not meet their own specifications or had picked the lower quality end of the spectrum of their specs when better products were in the same sample. These buyers usually work for those distributors using supplier-run programs.

The difference between the distributor-run and the distributor-supplier run systems is what happens after lot approval. In the latter system the supplier is now responsible for the quality control. He must ship only from approved lots. Many private label buyers have only sporadic quality checks after the initial lot selection and do not systematically monitor quality as in the distributor-run system. Some buyers check to see if products are shipped from approved lots; others do not. However, a quality problem will result in an audit of the lots shipped.

In the distributor-supplier run system the rules are set down by the distributor but the daily execution is under the direction of the suppliers. The effectiveness of these types of quality control systems depends on the competence of the buyer and the business relationship and trust shared by the buyer and seller.

5.5.3 Supplier-Run Quality Control Programs

In the third type of quality control program, the supplier-run system, the supplier maintains most of the control over quality specification and execution. In fact, the supplier often develops the specs and supplies them to the buyers. Usually these specs will be very close to United States Government grade specifications. Buyer quality monitoring activities may be nonexistent and there is little formal communication between the buyer and seller. In fact the buyer may work through a broker. The great virtue of this program is that it is inexpensive to run; the overhead charge on the private label product is minimized. The great drawback is that this program can produce erratic results. Whether or not it does depends on the relationship between the buyer and his suppliers. There are two possible extremes in these relationships.

There can be a complete trust relationship between the buyer and supplier. When asked what his quality control program consisted of, one buyer responded "They know what kind of product I want. I don't even have specs forwarded to them." When asked what constituted his quality monitoring program he responded,

I read and keep track of the number of consumer complaint letters. My wife always buys our products. So I get to judge them at home. Only occasionally do we pull samples from the shelves. Pulling samples from the warehouse just screws up inventory control.⁴

This buyer will maintain the same suppliers over the years. This system will work as long as the supplier does not abuse the trust of the buyer. Accidental quality problems are forgiven if the supplier responds to correct them. However, if the supplier "shaves" quality, the trust relationship is strained. If the supplier persists, he is "fired." As long as the buyer has alternative sources of supplies. the threat of exit tends to regulate supplier behavior.

The other extreme of this type of quality control program is characterized by tenuous relationships between suppliers and buyers. Some private label buyers essentially purchase United States Government graded merchandise (where grades exist on an open market basis). Although these buyers may "book" products with many suppliers, they usually purchase wherever the product is available at the lowest price. Often they do not have the facilities or personnel to check quality. Some do not even use specifications. They are known in the trade as "in and out" buyers. They match up with suppliers who need to more uncommitted products in a hurry and usually at distressed prices. Typically these buyers work for firms which do not have a consistent or lasting commitment to private label programs. They have private label for price

competitive reasons. These buyers do extremely well in years with long crops but are out of the market during years with short crops. At most their quality control programs rest on the reliability and integrity of the United States Government's grading agents and system.

The level of quality control in private label programs varies from very strict formal bureaucratic regulation to very loose, almost non-existent quality regulations. If there were a typical program it would consist of lot selection with periodic monitoring by the buying firm. The standard operating procedures used include specification development, plant inspection, product sampling techniques, and lot selection. These quality defining procedures are critical, for they define the relevant product market. Each buyer can in theory be negotiating on a separate and distinct product. The procedures used in quality control are vital in the wholesale pricing procedures used by the industry. They are also crucial for explaining the pattern of supplier selection.

5.6 How Private Label Procurement Adjusts to Quality Variation

Thus far the discussion has been essentially static, that is, showing how the private label quality control system looks and operates, or would, if it were observed in a constant unchanging world. The quality of the raw product will vary between years and between growing locations. A major question is how does this seemingly formal specification system adapt to the quality variability? A great proportion of the interview time was spent on quality discussions to discover the dynamic adjustment mechanisms used. Some standard practices follow which seem to have become common methods for adjusting the system.

Are retail private label buyers willing to adjust or modify their specifications to more closely match the availability of various product qualities? They are not on a formal basis but will on an informal basis. The total transaction costs involved in changing specifications on an annual basis are high, because many people and organizations are involved. Probably more importantly, however, is the private label buyer's need or belief that the quality of their labels cannot vary. Most large private label organizations protect the integrity of their first label products as religiously as do brand manufacturers. It is an accepted marketing principle that to achieve and maintain consumer loyalty, the customer must have confidence in getting the same product every purchase. Under most circumstances buyers will not change the specs on their first label merchandise or allow substitute qualities to be used in their top lines.

While specs are not changed on second and third labels, buyers seem to have more tolerance for variation in those labels. If market conditions dictate, buyers will overlook minor deviations from specifications because second and third label buyers are more price-oriented. In order to get the lowest prices, buyers will tolerate more variation in quality on second and third labels. This seems to be an acceptable strategy because the consumers of second and third label merchandise are price-conscious and seem willing to accept more product variation.

When specs are changed, the changes are usually very minor. For example, if the fruits are small, the buyer may authorize a change in the count provision of the specs. There are very few changes beyond these superficial adjustments. Decisions on adjustments to varying quality are decisions made by individual firms. Different firms will have different

philosophies and these differences and the suppliers' knowledge of them are instrumental in the coordination process.

Thus far the discussed adjustments (or lack of) to quality variation have been firm-oriented. How does the entire subsector react? The answer to this depends on the extent of the quality variation in the raw product pool. The reaction of the suppliers and buyers is a function of the quality level and the crop size. To illustrate how firms adjust to changes in the quality pool a few hypothetical examples are presented.

Assume that a "normal" crop of a product has a quality score range or commercially available quantities from ninety-two to seventy-four with a weighted mean score of eighty-four. Given this kind of uniform shift in quality, the interviews suggest that all firms would maintain their relative procurement positions in the quality spectrum but would through conscious or unconscious means lower their quality expectations to be consistent with the available quality. Thus a firm which bought only ninety-two to eighty-nine score first label merchandise in the "normal" year would, for example, buy ninety to eighty-seven score merchandise in the low quality year. Other buyers would follow similar strategies. A similar process would take place if the quality of the product pool were better. Suppose for example the quality change was not uniform and instead the mean score dropped from eighty-seven to eighty-two. In other words, there was an overload of lower quality product, the same size of the total crop. In order to move this crop through the system, buyers will need to make some major changes in their buying behavior. Since they will not change the product specifications drastically, they will have to adjust in other ways. What usually happens is

that the relative prices between Fancy and Extra Standard merchandise will diverge from their historical or "normal" ratio. Fancy prices will rise as buyers try to fill first label needs and Extra Standard prices will fall because supply exceeds historical needs. Thus buyers should be induced to buy more Extra Standard. Consumers will have to buy more of the lower quality in order to balance the system.

To summarize thus far, if quality variations are uniform and not too severe, the product specification system seems to have enough "give" to accommodate the crop. This is accomplished by voluntary or involuntary changes in the specs. Involuntary changes refer to suppliers selling somewhat less than specification quality on products packed under existing specifications. The specs may call for ninety-six score but the product shipped may be ninety score. Some buying operations will pick up this switch and others will not. Those that do detect the switch may let it go because they understand the state of the market. Larger variations in quality which cannot be accommodated by the "give" in the system must be handled by changes in the procurement patterns of the buying organizations. For the system to balance during the current crop year these procurement changes must be matched by merchandising changes in the retail stores. The above scenarios assume a critical dimension of the dynamic operation of the private label system, i.e., variation in crop size. This dimension will be included in latter scenarios. Generally, however, the simultaneous occurrence of outlier quality and supply conditions creates turmoil in the commodity markets.

There are some interesting peripheral aspects about the nature of fruit and vegetable grading which affect quality control and adjustment. Many of the characteristics involved in product grading are subjective

including color, texture, taste, and general appearance. Whenever there are these types of characteristics, honest differences can arise. One principle about human perception seems to help dampen massive quality shifts from year to year--the principle of relativity. If the crop quality is poor the USDA inspectors tend to upgrade the product. If the product going over the conveyor is uniformly bad and a good field comes, the human reaction is to perceive that quality to be better than it is. For example the product may in reality grade out at eighty-eight score, but because the inspector has for the last six hours been seeing eighty-four score product, he may grade the lot out at ninety score. The reverse applies in long crop years with good to excellent quality. This phenomenon tends to spread the quality spectrum "out" somewhat more than would be expected in normal crop years. This leads to less congestion and therefore reduced coordination problems in the overloaded submarkets. It was not possible to determine how significant this "relative grading" process is from the interviews.

The use of relative perception also shows up in another area. Processors can use the principle of "relative appearance" to influence the lot selection process of private label buyers. Suppose a processor has a relatively long position in a certain score product and he needs to move this product through channels which might not usually take this grade. When a buyer is coming for a "cutting" he can select lots to "force" the buyer to pick the lots he wants to move. This is done by "loading" the lots. A typical cutting will check five lots. The lot of the merchandise he wants to move is placed in a cutting which consists of three "bad" lots and one excellent lot. This makes the targetted lot appear to be just below the best. The buyer will select it, being

confident that he got the best buy for the money. This strategy, of course, only works on some buyers. Those firms with extensive facilities and seasoned buyers usually will not buy on this basis.

What has just been reviewed may seem like a drawn out description of a relatively unimportant aspect of procurement. Quality control and specification is unimportant for some private label products, but not for processed fruit and vegetable products. The study of the supply and demand schedules only has meaning within an understandable and defined quality (product definition) space. The quantities and the qualities of these fruit and vegetable products vary year-to-year. Thus, properly functioning markets require that both aspects be coordinated. The above description attempts to identify the procedures used to affect quality coordination. However, a complete recognition of the role of these procedures requires an understanding of quantity procurement procedures.

5.7 The Private Label Booking System: Procedures Used to Obtain Private Label Merchandise

5.7.1 Economic Factors Responsible for the Evolution of a Booking System

How markets for private label products, particularly processed fruit and vegetable products, are defined in the previous section. Once the product identity has been established, procedures must be designed to ensure that adequate quantities of that product will flow to the retail stores.

The purchase of private label products by retailers from suppliers is in the realm of what business schools call industrial procurement. Basically, industrial procurement arrangements can range from spot-market purchases to long-term, specific contract purchases. There are elements

of all forms of procurement arrangements evident in the private label system. Specific exceptions to the general system are described below when appropriate to the topic being discussed.

For the most part, processed fruit and vegetable products are purchased by grocery distributors on a "booking system." While "bookings" are used in other industries (primarily entertainment and transportation) their use in the private label system is unique and only slightly analogous to other systems.

The booking system described below evolved for two reasons. The first is the need to have a system which is able to handle the large variations in the quantities of fruit and vegetables available from year to year. Some fruit yields may vary more than 100 percent from one year to the next. It is not uncommon for some crops to be left unharvested one year and the next year market demands to go unfilled. Clearly this type of variation makes long-term noncontingency contracts unacceptable if used by the entire industry. Also, spot purchasing would leave buyers very exposed in short crop years to being out of stock which is a very important factor to them. What was needed was a system that had enough flexibility to accommodate yearly quantity variation.

The magnitude of variation in supplies creates great uncertainty accompanied by costs of adjustment. The procurement system must either explicitly or implicitly distribute the costs generated by coping with uncertainty which gives rise to the second reason why the booking system evolved. It currently operates proficiently enough to shift the costs of supply and demand uncertainty to the processors. Since retailers have historically held and currently hold the advantageous bargaining position

in the procurement process, one would expect the booking system to operate in this manner.

5.7.2 The Definition and Organization of a Booking System

When a private label buyer "books" product he is in essence making the following statement: "During the upcoming marketing year, I will buy up to X thousand cases of product Y subject to my approval of price and quality at time of shipment." Basically this is a verbal agreement between the buyer and the supplier, in which the buyer maintains the option to take delivery of the product only if he finds the price being quoted at that time as meeting his expectations. There is no formal commitment of the buyer to a forward price or a set quantity. Thus a buyer may not "pull" all his bookings if the supplier's pricing is out of line with the market. The booking system is then in essence a system of gentleman's agreements with distinct advantages for the buyers.

Due dates are stacked to meet the harvest schedule of the products being processed. Normally processors want booking to be about two to three months before the beginning of pack and they will cover a whole year's product. Most processors will set up some form of shipping schedule. The normal rule of thumb is that one-fourth of the booking should be shipped during each quarter of the market year. Shipping is still at the discretion of the buyer but schedules are important in short crop years. Exhibit 5.4 is a copy of the terms and shipping schedules being used by a private label processor. These are fairly standard terms, however, there is one subtle difference to remember: shipping instructions and physical shipping are not synonymous. Buyers can issue

**EXHIBIT 5.4--SHIPPING SCHEDULES AND TERMS USED BY ONE PRIVATE
LABEL SUPPLIER**

SHIPPING SCHEDULES

	Asparagus and Spinach	Fruits	Tomatoes and Products
25%	as packed	prior to Sept. 30	prior to Oct. 30
50%	prior to Sept. 1	prior to Nov. 30	prior to Dec. 31
75%	prior to Jan. 1	prior to Feb. 28	prior to Feb. 28
100%	prior to March 1	prior to May 1	prior to May 31
	of current pack year	of current pack year	of current pack year

TERMS AND CONDITIONS

F.O.B. Cannery or Dock S.F.B.A.

Prices are subject to change or withdrawal without notice.

All sales are subject to confirmation and approval of assortments and subject to the terms and conditions of our canned foods contracts.

If buyer fails to ship according to schedule, the unshipped portion will carry over to following period, but that portion will be subject to being available when ordered.

instructions to ship but shipments can be lagged. The specific meaning and implications of these standard terms are explained later.

A dual record-keeping system is used to monitor the booking system. The suppliers have one set of records; the buyers have another: Exhibits 5.5 and 5.6 show examples of each. Exhibit 5.5 is a copy of a status report sent by a supplier to a retail buyer. These reports are sent at various time intervals (monthly or quarterly) depending on the supplier's sophistication and predilections. Exhibit 5.5 is for the beginning of a pack year for frozen cauliflower and the last half of the year for frozen broccoli. The report gives the buyer, at a glance, the status of his account. Included in Exhibit 5.5 are the bookings for these products. Bookings are nearly always nice even numbers reflecting the informal nature of booking contracts. The exhibit also shows movement to date, the plant inventory, the balance of the booking to be packed, and the inventory of buyer's labels on hand at the plant. Thus buyers are reminded about their booking commitments periodically by suppliers.

The buyers' record-keeping system, observed during the interviewing process, were all very similar. The technology used to handle the data differs with the level of sophistication of the firm. Some firms have their booking information computerized and programs may include transportation coefficients and invoice printing ability. For the most part, however, the records kept are similar to the reconstructed example shown in Exhibit 5.6. Booking information and label information have not been coordinated in most private label record-keeping systems. However, some firms are developing computerized label control programs.

EXHIBIT 5.6--RECONSTRUCTED SAMPLE PAGE OF A PRIVATE LABEL BUYER'S
BOOKING RECORD

	First Label Golden Whole Kernel Corn 24 16 303	Jonesville Canning Co.	Smithville Canning Co.	Williamsville Canning Co.	Wholesome Products Co.
1					
2	4/30/77 1977 Booking	6000	6000	3000	3000
3					
4	9/25	900(4.5)	900(4.5)	450(4.5)	450(4.5)
5	9/20	900(4.7)			
6	10/10		900(4.75)		
7	10/15	1800(4.6)			
8	11/16			900(4.75)	
9	12/3				1350(4.75)
10	12/15	900(4.75)			
11					
12	12/15	3000			
13	12/20		900(4.75)		
14	1/9	900(4.7)			
15	1/24		900(4.7)		
16	2/19	900(4.7)			
17	2/27		900(4.7)		
18	3/18	900(4.7)			
19	4/18			1440(4.6)	
20	5/20		900(4.7)		
21	6/9	900(4.7)			
22	7/14		450(4.7)		
23					
24	Book for '78	10000	7000	3000	2000
25					
26					
27					
28					
29					
30					
31					
32					
33					
34					
35					
36					
37					
38					
39					
40					

5.7.3 An Example of the Operation of a Booking Procedure

Exhibit 5.6 is presented to demonstrate the operation of the booking/shipping system during the crop year. A retail booking record had to be reconstructed from memory. Although several interviewed buyers were willing to allow the author to view their booking records, none allowed or volunteered to permit copying of these records. If there are trade secrets perceived by private label buyers, they are their supplier lists and the buying strategies revealed in the bookings records.

This exhibit was reconstructed under some restrictive assumptions. The first is that orders shown on this page were made independently of the shipping instructions for other commodities booked with the same suppliers. Most processors will pack several products. When buyers order they may want several products shipped together. Therefore the buying decision is often made over a set of commodity prices. The numbers generated in Exhibit 5.6 are based on the assumption that shipments of whole kernel corn are ordered independently of prices and shipments of related products. In reality, the need to minimize transportation costs induces buyers to have mixed loads shipped.

A second assumption embodied in the design of Exhibit 5.6 is that there is only one principal distribution center. Booking records of private label buyers for large chains and buying organizations are more complex mainly because they will have more suppliers. Large buyers will carry more suppliers in order to minimize shipping costs to their various divisions. For example, an Eastern division will be supplied from Eastern or nearby Midwestern processors whereas a Great Plains division might be supplied from Midwestern and Pacific Northwestern processors.

The ordering pattern among processors is influenced by the needs of the various divisions.

The private label buyer illustrated here has four suppliers of first label whole kernel corn. The booking page starts with the booking for each processor. Shipments pulled from each processor are recorded in their respective columns. The buyer in this Exhibit enters the negotiated prices (in parentheses) at time of shipment for all orders shipped which helps reconstruct the dynamics of the bookings for the upcoming crop year. Some buyers do not enter prices here. Others will use different colored inks to designate different types of deals and events. Rarely, however, will the buyer make any cryptic notes about supplier performance on the booking page. Those booking records seen during the interview process were fairly "clean." Yet, the author observed that buyers remembered the little controversies and problems which arose during the market year. The private label buyers are so specialized that they need to remember details which many other buyers and retail personnel would forget. Even though the bookings page is devoid of a great deal of explanatory information, an experienced private label buyer will be able to reconstruct the details of a marketing year fairly quickly.

The basic standard operating procedure used to buy private label, with the exception of special sales or circumstances, is that buyers purchase products from the next supplier in line for an order if and only if that supplier is shipping at prices consistent with the prevailing market prices. In Exhibit 5.6 orders placed August 25, October 15, and April 18 are special cases and will be explained. The other order dates follow the general procedure enumerated above. On September 20, the buyer purchases from Jonesville Canning Company. When it comes time to

order again, he approaches Smithville Canning Company. Since Smithville Canning is "on the market," he will place an order with that supplier. The next regular order is placed with Williamsville Canning Company. This procedure will normally proceed unabated as long as the suppliers are willing to ship at the buyer's perceived market price. However, the buyer will vary that procedure if the suppliers will not "help the buyer out" on a price change. In Exhibit 5.6 for example, the market was holding fairly steady at \$4.75 a case through Christmas, and the buyer followed the normal pattern. However, in the new year the market exhibited some signs of weakness and prices went down. The Williamsville Canning Company was approached for the order. The management of that company perceived that the market was at \$4.75 and refused to ship for less than that. Standard procedure would be to go to Wholesome Products Company. They also held fast on price. Thus the buyer went to the next supplier, Jonesville Canning Company. They agreed to ship for \$4.70. The January 24 order then went to Smithville Canning Company. These two firms ride the year out at the \$4.70 price. In the spring (April 18), Williamsville management "sees the handwriting on the wall." Unless they move product by lowering the price, they will have to carry inventory into the next pack year. Given this and perhaps other financial considerations, Williamsville decides to dump. The buyer is able to make a large purchase at below market prices (\$4.60 versus \$4.70).

Notice the buyer actually shipped all of his booked supplies with Jonesville early in the market year. This was because of the larger order shipped on October 15 which probably arose because the buyer had to get merchandise for an unexpected sale. Perhaps the firm had celebrated a new store opening or perhaps the buyer just forgot about the sale. In

any event, the buyer was in a bind. Jonesville Canning Company "bailed him out" by selling him a large share of his booking at a "good" price. In return, the buyer on December 15 booked additional product with Jonesville. The buyer will read this page and look at that October 15 entry and will remember the whole sequence of events.

Near April 1, the buyer must start developing bookings for the next year. Actually the large sophisticated private label buyers will be monitoring the winters in the growing areas, reading the grower intention reports, surveying the processors' inventory situations, etc. Nevertheless, bookings for many crops are not due until late spring.

One standard operating procedure seems to set the base of next year's booking. Buyers will usually book in direct proportion to the supplier's shipment during the current marketing year. In other words, if the supplier is able to ship his bookings for this crop year, at least that minimum amount of booking will be assured for next year.

This was not always the rule used. In fact, there was no standard rule for bookings in the past according to New York trade observers. An individual buyer for a large chain started using this rule years ago. He let the suppliers know he was using this rule. They were thus more inclined to give this buyer the best price they could to cultivate that retail account. Since this was a prestigious and presumably profitable account, the buyer always received the product at favorable prices. Because this approach worked, other buyers adopted it. The better buyers in the private label system now use this basic rule or variation of this rule in their booking decisions which forms the basis of the supplier selection process.

In Exhibit 5.6 the buyer has more or less booked according to the above rule. Jonesville Canning Company got a large increased booking, whereas Williamsville Canning Company got the same booking as this year and Wholesome Products Company was actually cut back. The process of booking on this year's shipments is somewhat imprecise because the bookings have to be made before the end of the shipping year.

The operation of the booking system fulfills the needs of private label buyers. They are able to reserve quantities of products without having to take a forward commitment on price or specific quantities. The system as it operates allows the buyer great flexibility. The only obligation incurred are gentlemen's agreements to try to use the booked quantity. As with quality determining procedures, the system functions until a significant aberration in the quantity available for sale is generated by conditions in nature. The booking system needs to have mechanisms to adjust for variations in quantities produced.

5.7.4 Booking System Operation Under Variable Supply Conditions

Theoretically, buyers would book for their anticipated needs. If the crop is very large (a long crop year) prices will drop and buyers will still ship according to the above rules. In this case, the buyers may exceed their bookings. This works as long as all suppliers have a proportionate increase to one another in yield or quantity. However, if the quantity increase is unevenly distributed across producing regions or across supplier firms within the same region, the standard rule for buying will hurt some suppliers. Since the buyer is not obligated to take his bookings, he will pull products from those firms with excess product (i.e., those with the lowest price) and let his bookings sit at

the other suppliers. In long years, the buyers may not adjust their bookings enough to compensate for the excess quantities which are in the subsector. In this case, the excess inventories cause depressed prices into the next crop year. This is the essence of coordination, and this dynamic aspect of market adjustment will be explored in detail in Chapter 7.

In short crop years, suppliers invoke a prorating system, the standard operating procedure of which is that the processor calculates this year's pack as a percentage of some normal year's pack. The packer then prorates all buyers' bookings by that percentage factor. For example, if the pack is half of the usual, all bookings will be cut back by 50 percent. Therefore each buyer would have his bookings cut in half.

The prorating rules are one reason inducing buyers to overbook. The buyer reasons that if his booking is twice what he needs and the processor prorates 50 percent, his prorated booking will be what he really needs. The buyer has thus protected himself from the short crop year. This would work if prorates were in reality equal for all buyers. In practice short crops are not allocated equally. This is because prorates are based on bookings which may not be the same as shipments.

Not to publically prorate buyers equally would lead to strained relationships with buyers. Differential treatment could lead to losing customers and business in the future. The equality of treatment means that all buyers play by the same rules. Buyers are different in their ability and in their access to information. Smart buyers are able to get additional product in short crop years because they know the market conditions. These buyers are able to ship products and get products committed before the supply situation is generally recognized by the

majority of the other buyers. These informal contacts complement the formal procedures established by processors for shipping additional supplies to buyers. Therefore in practice buyers are differentially prorated.

The formal rules leading to differential prorating are somewhat complicated. Refer back to Exhibit 5.4. The fourth condition of sale for that private label processor hints at the method of prorating allocation being used by processors. The condition states that buyers must ship according to schedule. The schedule is nearly always that one-quarter of the booking be shipped in each quarter of the pack year. If the buyer fails to ship all of the 25 percent of his booking in the first quarter, the remaining proportion of the booking carries into the next quarter. Conceivably a buyer could go into the fourth quarter with 100 percent of his product to be shipped. This procedure is only applicable to normal and long crop years. In short crop years the last phase "but that portion will be subject to being available when ordered" becomes the key. In short years, all buyers are prorated. However, buyers are able to bid on products over their prorated bookings. The product on which they bid is a pool consisting of the products taken from other buyers because they did not keep pace with shipping instructions. If a buyer does not ship 25 percent of his bookings, the excess is carried over into the second quarter and put in a pool. Buyers are then permitted to bid on that product. Therefore even though a buyer's booking carries over into the next quarter, it is up for bid and the tardy buyer is out of that much product.

At this point, a number of forms of allocation systems can arise. Some packers will change a buyer's prorate percentage from the standard

percent to the percent of that buyer's bookings shipped in the previous quarter. Suppose the standard prorate is 50 percent but buyer A ships only 30 percent of his bookings in the first quarter. In the second quarter, buyer A is only allowed to pull 30 percent of his bookings. Other packers will establish bidding priority lists for buyers desiring to get more of that product from the pool. The priority list might be arranged on the basis of the extent to and the speed with which the various buyers shipped their bookings in the most recent shipping quarter. Still other processors take the reserve pool and sell it to whomever they wish. This strategy allows the processor to "reward" good buyers, develop new customers, and penetrate new markets.

After prorating and formation of excess booking pools, the standard rules or procedures for dealing with short crop years do not follow clear-cut patterns. Every processor may have a different practice. Although the prorating procedures seem rather rigid, processors always seem to find methods to provide products to buyers in varying and unequal amounts. Some buyers get all they want while others get very little. It is this discretionary power that accrues to suppliers in short crop years which helps temper the power buyers obtain through the normal operation of the booking system. During short crop years suppliers use their own criteria for selecting buyers or accounts.

All of these SOPs operate within the price system. Because the supply and demand schedules of processed products tend to be inelastic, prices rise dramatically during short crop years. Nonetheless, most buyers are constrained by having to have the product on the shelf. In some short years, retailers may have to cross subsidize some products because of the relative pricing patterns observed for main product groups.

That is, peas, sweet corn, and snap beans all have price relationships. Processors recognize the consumer demand response to price increases. Rather than price to clear markets in the short run, they use these prorating SOPs to develop customer lists and markets over the longer term.

5.7.5 Overbooking and Its Implications

The booking system is ripe for abuse by the buyers. They can "overbook"; that is, they can tell their supplier that they are willing to buy more in the upcoming year than they really need. Suppliers will then commit the product to the buyer. If each supplier capitulates, the buyer will be at a strategic advantage during each exchange throughout the year. If all buyers overbook, false demand signals will be sent to the processing sector and possibly to the growing sector. Because of the impact overbooking can have on system coordination, the interviews tried to establish the types and extent of overbooking within the fruit and vegetable subsectors.

Ascertaining the sum and substance of overbooking through the interview process was difficult. Buyers are very sensitive to even admitting that they might consider an overbooking strategy and tended to downplay it. Suppliers, on the other hand, naturally tended to overemphasize the use of overbooking. The mirror-image interview process, though, did eventually produce what appears to be a fairly accurate assessment of the overbooking phenomenon.

The two types of overbooking are termed natural and strategic. Some overbooking is inevitable because of the nature of economic behavior. Every buyer will increase his booking to reflect his firm's anticipated growth in the upcoming year. Firms tend to be optimistic especially if

someone else carries the risk of their overoptimism. Each firm will anticipate that it can grow at the expense of its competitors. Thus each firm will increase its bookings on that assumption. Since all firms cannot grow at the expense of others, the result is overbooking. Notice, for example, in Exhibit 5.6, the buyer did not ship all his bookings for 1977. When the 1977 shipments are totaled, the 1978 bookings were generated using a set growth factor generated from historical experience and goals of the firm. The growth factor is applied to and calculated from the past year's actual shipments, not the past year's bookings.

The second natural force leading to overbooking is the industry practice of thinking in terms of volume or quantity rather than price. The growth factor is applied to the quantity shipped without much regard for the prices at which the booked products will sell for in the upcoming year. Presumably if every buyer books more (assuming constant supply) the commodity prices will rise, quantity demanded will decrease, shipping orders will slow, and products will be overbooked. Buyers do attempt to adjust bookings for the anticipated conditions in competing or substitute crops. But the author's observations indicate that they tend to think in terms of thousands of cases, rather than price. The composite effect seems to be to produce an overbooking tendency. Exhibit 5.6 exhibits this natural tendency to overbook. The overbooking is not severe because this firm did grow by about 8 percent (1977 bookings versus 1977 shipments). However, when firms fail to meet their growth objectives and buyers think in quantity terms, the "natural" overbooking can be a problem.

The second type of overbooking, booking for strategic advantage, in which buyers overbook trying to get suppliers to commit stocks in

excess of the buyer's needs. If successful, the buyer will enjoy an advantage in the bargaining process. Getting an indication of this type of overbooking was difficult. The interview process indicated that strategic overbooking exists; its use is declining; and its incidence is systematic.

Certain buyers overbook. They do so for bargaining advantage and for insurance. The probability is very high that these buyers ran out of products in the most recent short crop year and/or paid prices for their products which were significantly higher than their competitors'. They will overbook believing that this will assure them of the quantities they need at the prices they believe they deserve. These buyers tend to be short-sighted and usually find out that in the next short crop year, they again lack the product and/or pay higher prices. The reasons are that overbooking results in problems of credibility. Suppliers know which buyers overbook and are able to discount their bookings. Firms learn by experience and trade gossip which buyers overbook. The decline in the use of strategic overbooking as a strategy parallels the decline in the number of processors. Overbooking buyers need to change suppliers frequently in order to perpetuate the effectiveness of an overbooking strategy. With fewer firms and fewer entrants, the number of processors available for overbooking is diminished. Many will avoid business with these buyers, if possible, or will discount booking from these buyers. If the buyer represents a major account, processors may be unable to avoid his business. The best estimates developed from the interviews indicate about 10 to 15 percent of the private label accounts use strategic overbooking. This percentage has been declining rapidly. Chronic overbooking seems to be becoming anachronistic behavior.

When a buyer overbooks, processors indicate that they usually do so systematically. That is, if they overbook peas by 50 percent they will overbook carrots by 50 percent. Systematic overbooking is easily discounted. Processors also note an increase in overbooking following a short crop year in a given product. If, for example, corn is short this year, buyers will tend to overbook next year. (Even those who normally do not overbook.) Again, processors indicated that they usually were able to discount these overbookings.

The planning process of suppliers is called pack budgeting. Processors "budget" their pack to various markets (retail, hotel and restaurants, institutions, etc.) and then to the buyers in those markets. The suppliers make most of their initial pack decisions for annual crops in the upcoming year in the fall of the current year. Thus 1979 annual crop plantings and packs are being planned in September and October of 1978. The contracts with growers must be executed in late winter and early spring. Private label buyers' bookings made a few months before processing sessions are of no use in making annual vegetable planting decisions. Bookings are useful, though, to suppliers to help them make packing decisions: 1) how much raw product should go into 303s and No. 2s; 2) within retail packs, how much should go to various product forms (regular versus french cut beans); and 3) how much marginal production needs to be packed. The third aspect involves the infamous "passed acreage clause." Most annual vegetable contracts have provisions which allow processors to "pass" (see below) a grower's crop from harvest. Passed acreage provisions are instituted to deal with supply variation and to pass the risk from this back to the growers. In the past, processors could use passed acreage clauses as strategic bargaining weapons similar

to buyers' use of overbooking. Through grower bargaining, blatant misuse of passed acreage provisions has mostly been eliminated. Processors still have the option, however. In some crop years and under some specific conditions, processors must decide whether or not to invoke the provision. Private label bookings give some indication of the market demand for individual items. Thus the supplier gains some information useful for making this year's packing decisions.

Overbooking will, for the most part, affect coordination in the next marketing year. If the suppliers respond to overbooking they will pack more than demand warrants which would lead to depressed prices for that product in the upcoming year. If the extra product does not sell, it must be carried over as inventory into the next year causing a large reduction in the pack of that product in the following year. This leads to higher-than-needed prices. The cycle continues. In other words, if overbooking has a coordinating consequence it manifests itself in increased commodity market instability. When passed acreage clauses allowed processors to reduce pack at will, some of the impact of overbooking was transferred to growers.

The booking system allows the buyer a great deal of flexibility. In the past blatant overbooking was one option in the system, but as a long-term strategy, chronic overbooking no longer works. Buyers still can overbook products on a smaller scale. Suppliers indicate that the uncertainty about demand caused by current levels of overbooking are no real concern. The pervasive uncertainty which affects coordination is supply variation.

Thus far the booking system seems to unilaterally favor the buyer which holds true for normal and long crop years (usually three out of

four crop years). However, when yields fall and supplies tighten, bargaining power shifts to the suppliers. It is the possibility of these unpredictable but periodic short crop years which discipline the buyers in this system. In other words, the constant threat of a short crop year prohibits the smart buyers from exercising all their potential strategic advantages from the booking system during normal and long crop years. If a buyer abuses the booking system regularly, the packers will retaliate when they get the opportunity during a short crop year. Because short crops do occur, the booking system has some standard procedures used to deal with short supplies.

5.7.6 The Booking System in Perspective

The booking system described above is unique to the processed fruits and vegetable markets because of the uncertainty arising from yield variation during and between crop years. The operation of the system has evolved to provide maximum flexibility for the private label buyers. In short crop years, the flexibility reverts to the suppliers. The booking system permits the distortion of demand information caused by buyer overbooking. Transmission of faulty demand signals can cause some increased system instability. However, overbooking only affects annual crops. Effective elimination of passed acreage provisions and supplier reaction to overbooking buyers has further diminished the importance of overbooking in coordination failures. Supply variation is of much greater concern. Suppliers are much more concerned about retail buyers' actions after the pack than with buyers' overbooking before the pack. Buyer response to supply variation thus determines the level of coordination in commodity subsectors. Clearly there is nothing in the operation of the booking system which dampens instability.

5.8 Private Label Wholesale Pricing Practices

In this section the standard practices and methods used to price private label products are described in detail. Discussion here deals exclusively with the wholesale pricing schemes which take place between private label buyers and their suppliers. Excluded is any detailed description of retail pricing of private label products by buyers to final consumers. Also excluded from discussion is any specific analysis of the dynamics of private label pricing. Private label wholesale pricing simultaneously takes place with bookings and shippings, quality determination, and pricing behavior of the brand products manufacturers. A description of the dynamics of fruit and vegetable markets is contained in Chapter 7.

It is the dynamic interaction of all the elements of the private label system which determine the substance of coordination within the processed fruit and vegetable subsectors. Finally, the procedures enumerated below are only important or directly applicable to processed fruit and vegetable markets although some of the procedures are used in all private label transactions.

5.8.1 The Availability and Form of Price Information

Private label wholesale pricing is similar to any other industrial procurement process. Nearly all transactions are private treaties negotiated between individual buyers and sellers. Consequently, there are no open or terminal market institutions used. Thus, daily price and movement information is not readily available to the public. To generate such market information requires a concerted effort to identify industry

participants and a willingness of those participants to share their privately generated information.

In the processed fruit and vegetable markets, the information gathering effort and resources are provided by a private rather than public market reporting system. The American Institute of Food Distribution, Inc. (AIFD) publishes a weekly Report on Food Markets which contains market prices for nearly all processed commodity food products. The reporters for AIFD sample a set of buyers and sellers on a weekly basis to obtain price quotes on the most recent market transactions. All prices are quoted in ranges: i.e., Fancy Whole Kernel Corn \$5.25 - \$5.50. The price range is used to protect market information sources while at the same time providing some indication of the general level of prices. Ranges also prevent the trade from using a specific quoted price as the market price which saves the reporting firm legal problems and prevents alienation of the trade. In other words, quoting price ranges isolates the reporting firm from being accused of "setting" the market. In addition to market prices, the Report publishes summaries of market, weather, and field conditions; government inventory and planting intentions reports; and any other information which might be useful to the trade. Thus buyers and sellers have a compact, timely, and fairly accurate source of market information. In interviews with private label participants, copies of the Report were visible in every office. In fact, many of the people interviewed have been or are trade firms surveyed for the Report.

The Report has been in use for many years. Most people in the industries seem to be happy with its performance. It has never had any major scandals or been involved in public questioning as have private market

news report of other food industries. The Report reports the industry prices. An understanding of the determination of industry prices requires an understanding of the pricing process which takes place on the level of individual firms.

5.8.2 Private Label Pricing Practices Compared with Brand Pricing Procedures

A. Some Similarities

Wholesale pricing of private label products has some similarities and some dissimilarities with brand product pricing. The two are similar in their basic terms. The standard terms for private label are 2 percent discount if paid in ten days or net due in thirty days. If products are shipped from the West Coast, the terms are 2 percent, twenty-five days. Discount days are calculated from date of invoice not date of shipment. If the private label firm takes several days to process an invoice internally, the buyer gets extra time for applying the discount. Buyers recognize this and use it as a factor in determining suppliers. For example, some firms will take a week or more to process an invoice. This in essence gives the buyer 2 percent, seventeen or more days.

Here is where the similarity of terms end. Private label pricing does not usually include promotional pricing and advertising allowances. It is nearly always F.O.B. plant instead of delivered (See Exhibit 5.4). Also private label prices are not formally protected against price rises or declines. Finally, Robinson-Patman price regulation does not impinge on private label pricing as much as in brand product pricing (See Section 5.8.2-E).

B. Lack of Promotion Pricing

Private label manufacturers do not use extensive promotional pricing because the marketing of their products is controlled by the retail firms. Retailers make the pricing, advertising, and merchandising decisions.

Exhibit 5.7 is an example of the kind of price list manufacturers release. Basically, price lists state the product description and the F.O.B. price. Price lists can be issued whenever the processor desires. Some firms issue them frequently; others rarely. Since the wage and price controls of 1972-74, processors have tended to issue fewer price lists, especially for declines in prices. The standard practice seems to be to issue new price lists on price rises but to trade "off list" for price declines. This way, should price controls be reinstituted on list prices, the firm will not have its prices frozen at low levels. If there is a systematic price listing schedule it would tend to follow marketing year quarters.

Because brand manufacturers quote promotions and allowances as off-list prices, private label price reductions might appear to be promotion prices. Some private label processors call their price reductions promotional prices, however, they are not promotions because the retail buyer is usually not under obligation to do anything for the product in return for the "promotion" price. Some processors have tried and others will try again to tie performance requirements to private label price reductions. Retailers in nearly all cases ignore the performance criteria and just take the price decrease. This is a key difference between private label and brand product pricing. It is also a key element explaining the level of coordination in the subsector. As long as private

**EXHIBIT 5.7--PRIVATE LABEL PRODUCT PRICE LIST ISSUED BY A
PRIVATE LABEL PACKER**

PRICE LIST

NO. 110A-15ROUND TOMATOES--STEWED TOMATOES**JUL 26 1977**

SIZE	GRADE		PRICE PER CASE	CHANGE PER CS.	SHIP WGT
	<u>OZ.</u>				<u>LBS.</u>
24/8	8	Cho Whole Pld in Juice	\$ 4.50		16
24/8	8	Fancy Stewed Tomatoes	4.35		16
24/303	16	Cho Whole Pld in Juice	6.50		30
24/303	16	Std Whole Pld in Juice	6.00		30
24/303	16	Fancy Stewed Tomatoes	7.00		30
24/303	16	Diet Tomatoes	6.75		29
24/2 $\frac{1}{2}$	29	Cho Whole Pld in Juice	9.25		51
24/2 $\frac{1}{2}$	29	Std Whole Pld in Juice	8.50		51
6/10	102	Cho Whole Pld in Juice	9.75		44
6/10	102	Std Whole Pld in Juice	8.75		44
<u>OPENING PRICES</u> <u>1977-78 CROP</u> THIS CANCELS AND SUPERSEDED PRICE LIST 110A-14 DATED APRIL 15, 1977. SUBJECT TO CHANGE OR WITHDRAWAL WITHOUT NOTICE. SEE REVERSE SIDE FOR SHIPPING SCHEDULE					

A—Price Advance

D—Price Decline

☐—Item Withdrawn

See Reverse Side for Terms, Conditions and Shipping Schedule.
All Orders Subject to Our Confirmation.

label buyers continue to view private label processors' promotions as mere price reductions, they will remain simply price reductions.

C. F.O.B. Pricing

Private label prices are quoted F.O.B. plant instead of delivered. This difference is critical. Brand products manufacturers have their own distribution centers and price products on a zone basis to all retailers in that zone. Therefore, each retail buyer in the market region will get the same price quote. Manufacturers are also able to control price cuts and promotions by market area. Thus they can implement marketing strategies by market area. Private label products are priced at point of shipment. All retailers in a given market will have identical private label costs (assuming identical specs) if and only if they have equal transportation costs. If one retail firm has lower transportation costs than its competitors, it will theoretically have products which cost less. The combined effect of transportation factors on private label product prices and on inventory costs creates a need for a detailed section on transportation. The private label sector of the food industries have developed unique and interesting institutional arrangements to facilitate transportation (See Section 5.9).

D. Formal vs. Informal Price Protection

A third difference between private label and brand product pricing is the degree of formal price protection afforded the buyer. Recall that brand food buyers were protected from price declines via stock protection clauses. They were protected against price rises through provisions for buy-ins and sometime back-ins. With the exception of back-ins, all these other protection mechanisms are formal; i.e., they are explicitly stated

and documented. There are no comparable formal mechanisms available to private label buyers for most products. While there are no formal mechanisms, the everyday operation of the private label systems acts to provide buyers with informal protection. It is more complicated to provide formal protection in the private label sector because the identity of the supplier is less obvious since his product is labeled with the retailer's brand and all other suppliers' products are similarly labeled. As products are shipped, it is difficult to determine which processor's product was in inventory at the time of the price decline. Retail buyers would claim all processors products and each processor would say only someone else's product was in inventory. Nevertheless, buyers usually get some price protection.

Price protection for declining prices between shipment and payment originates from the buyers' information system and superior bargaining position. Buyers get wind of impending price declines. They can then adjust their inventory levels to reflect the possibility of a price decline. Buyers carry a minimum of inventory anyway. When there is a trade rumor of an impending decrease, buyers will order minimal quantities. The buyers are always in a superior position relative to suppliers to get market information. Buyers can get price quotes from all suppliers. Suppliers can only get reactions from buyers. The brokers have the incentive to communicate pending price decreases to buyers even if this is detrimental to their principal's interests. By warning a buyer, the broker gets IOUs which he can translate into future business.

Should prices fall, however, buyers can resort to several buying strategies. The transportation arrangements which have evolved in the private label system act to buffer the buyer from price declines which

will be explored in detail in the next section. The other device used by buyers is to pay only current market price irrespective of what the negotiated invoiced price is. Some buyers will call the supplier and ask to be allowed to pay the lower current price. One buyer explained this phenomenon by saying "My good suppliers won't let me hang. They'll go down to keep me competitive."⁵ Other buyers will cross out the invoiced price and pencil in the new lower price and pay only that amount calculated with the lower price. The supplier has few options. Usually, the difference is not large enough to make litigation financially feasible. The only recourse the supplier has is to decline future business with that buyer.

In isolated circumstances, buyers will use a ploy calling the product of inferior quality. If the price drops during shipment, the load(s) will be inspected and "found" to be in violation of the buyers' specifications. The buyers might then offer to take delivery and "try to sell the junk" for a lower price. Again the processor has several options. He can capitulate by taking his loss and deciding whether he should deal with that buyer in the future; or he can pull the product back which entails double transportation, carton expense, and label and labeling expense. The processor could also call for a government inspector to check compliance. As these latter two options are expensive and usually cost more than the price reduction, most processors will take the loss and decide later whether to adjust their future dealings.

Buyers can protect themselves against price rises by buying-in just as brand buyers do. However, buying-in is more difficult in private label because there are no formal deals or deal periods. Brand buyers know exactly when the price is going to rise. They can and have computerized

their buy-in procedures. Private label prices can change without notice (See Exhibit 5.7). The private label buyer thus has no formal notice of a price change. Again, the buyer's superior information system permits them to protect themselves from price rises. Since they are in touch with the market on a daily basis, buyers can usually get hints about when and how much the market will advance.

In the processed fruit and vegetable markets, suppliers will often "withdraw" from the market, a practice whereby a processor refuses to ship product. A buyer will not be able to get any merchandise during the withdrawal. Processors use withdrawals to take note of inventories of various packs of various products, to compare shipment records with bookings and/or intended shipments, and to study the market conditions to see what the general conditions are. After a withdrawal period, processors will enter with prices which reflect their observations about their position in the market. Usually withdrawals conclude with a price rise.

Buyers "read" withdrawals in attempts to ascertain future market trends. One withdrawal attracts notice while several processor withdrawals spur action. Since withdrawals are more often associated with price rises, buyers tend to buy-in. However, because processors know that buyers behave this way, they will use withdrawals to achieve their marketing objectives. For example, a processor might withdraw and then come back with a minimal or no price increase. The buyer suspecting that prices might rise might increase his shipments. The use of withdrawals can become an exercise in gamesmanship.

Even if the buyer misses a buy-in opportunity, he can usually get covered via opportunities for a back-in (a back-in is a buy-in after the

fact). Thus the buyer gets the benefits of a price decrease even though the deal has expired or prices have risen. Back-ins are always privately negotiated. Whether or not a buyer's allowed to back-in is the decision of the processor. Buyers logically favor those suppliers who have allowed them this form of price protection. Since all private label suppliers do not raise prices at the same time, buyers can delay the impact of a general industry price rise for some time by backing-in with several suppliers.

Although there are no formal price protection mechanisms built into private label markets, these informal standard procedures in reality provide price protection. Much of the protection is on the business relationship between buyers and sellers. Nearly all of the protection afforded buyers is at the discretion of the supplier. In practice the relative bargaining positions of buyers and sellers heavily favors the buyers; suppliers will usually protect the buyers.

E. Robinson-Patman Act Considerations

The fourth significant difference between brand and private label products pricing is the role played by the Robinson-Patman Act (R-P Act) which is responsible for certain standard practices used in brand product pricing. All prices must be available to all competitors on a cost-adjusted equal basis. This leads to the formal deal sheets used as pricing mechanisms. The application of the R-P Act to private labels is not as clear-cut. A brand product is identical to all buyers. Given that retailers have developed their own product specifications for private label products, it is theoretically possible for each retailer in the market to be getting a different product. Thus, wholesale prices can

theoretically be different for each retailer. Thus to prove a price difference between competitors is illegal, the government would have to prove that the difference was not cost justified and that the products sold were identical. This added qualification makes the cost of litigation higher and the probability of successfully proving a R-P violation lower. As a result few if any R-P cases have been brought in the private label product markets.

Throughout the interview process an attempt to assess the extent of price discrimination, if any, present in private label pricing was made. This was difficult because many suppliers do not sell to more than one buyer in one market at the same time. Thus there are fewer exchange loci present which can possibly lead to an R-P violation. Some buyers indicated that different customers pay different prices, but in many instances these buyers were in different markets and there could be justified cost differences. Suppliers indicated that it is good business practice to always charge the same prices to all buyers. Since most prices are F.O.B. variable prices would be detectable and would cause hard feelings. This does not preclude supplier-granted discounts for special considerations given by buyers. Buyer complaints of R-P violations are always more numerous during short crop years when product is prorated. Those buyers who have not had reliable shipping records and are thus short of product will end up paying higher prices because they have to buy from the spot market. The general conclusion reached is that there are isolated price differences quoted different buyers for similar products but whether these differences could be projected as offenses is questionable.

The real differences between supplier treatment of buyers are not prices but differences in the order and speed with which they are

offered "hot" deals. All buyers may get a shot at a "hot" deal, but favored buyers may get a crack at the deal weeks before an unfavored buyer does. This process gives the unfavored buyers the impression that they are getting higher prices. If the deal merchandise runs out before the supplier gets to all the buyers, the lower priority buyers do get higher prices. This type of behavior does not violate R-P.

By way of summary, some significant differences between brand and private label prices need highlighting. Brand product pricing is more stable. Prices are set by manufacturers at list in the fall of the year or at pack time. The correctness of the price is determined by how that price matches other similarly competing brand products and how consumers buy. The only price movement is effectuated by manufacturer deals. There are relatively few of these deals for one firm's product during the year. In contrast, private label product prices vary more frequently. The price is greatly influenced by what level the buyer wishes to pay. Processors bid against each other for the buyer's attention. Buyers almost never quote actual prices to suppliers. As one buyer said, "Buyers don't make prices." However, the author did run across one case in which a large buyer had copies of the supplier's invoices. The buyer would fill out the invoice as to desired quantity and price and then send the invoices to the processor to sign. If the processor did not like the deal, he could always throw the invoice away.

Buyers typically use cryptic statements to indicate the relative position of that supplier's quote to the market. One does not find that kind of haggling in the brand products business. The operation of the R-P Act acts as a logical defense against individualized bargaining in brand products. Finally, both brand and private label buyers are

protected by suppliers against price changes. The protection only breaks down in short crop years.

5.8.3 Pricing Behavior During the Marketing Year

The above description may give the impression that the private label business is one continuous bargaining process in which prices are being established on a frequent if not daily basis. This is not true. A private label buyer may buy several hundred individual products. It would be humanly impossible to negotiate all prices on a continuous basis; the pricing of private label processed fruits and vegetables has settled into a fairly standard cycle of pricing behavior.

There are four major peaks of pricing activity. After each of these, price negotiations are minor and the private label trade settles into routine shipping patterns. This calm is interrupted by the next pricing point. It must be remembered that this is a simplification of reality. There are exceptions to the rule. The relative size of the crop will disrupt the patterns. Some commodities will receive a lot of pricing attention one year and much less the next. However, for most processed fruits and vegetables in normal years, the following pattern holds.

The first major pricing point in the crop year is the announcement of opening prices. Openings are posted just as the new crop is ready for sale. The prices quoted in Exhibit 5.7 are opening prices. Processors hesitate a great deal in "posting" opening prices. No processor wants to set the market too low or be embarrassed by having to repost openings if his prices are too high. At this time processors will be pumping the buyers for information trying to get some feel for what price level they are expecting. Rumors about who is selling what at what price abound.

Many telephone calls are made. On the last possible day one or two major processors will issue openings. Other processors will fall in line with those prices or possibly come out somewhat higher or lower. Shipping orders will then start. Gradually the market activity will find its early season level and prices will adjust accordingly. Usually adjustments made to openings will be via off-list pricing or price rises. In any event, once established at some acceptable level, pricing activity settles into a comfortable, less frantic pace.

During this time the distribution pipelines which were emptied during the last spring and summer are being filled. Consumption patterns change drastically during the summer months as more fresh fruit and vegetable products are consumed and meals are not eaten at traditional times. Those on vacation alter their eating patterns. This time is used to sell out odd lots of last crop year's products. Starting in August, the pipelines must be refilled to accommodate the return of school and work schedules to normal patterns.

The next pricing point comes in late September through most of October. This is the peak of merchandising activity for canned fruits and vegetables. Nearly every retailer runs a "Fall Harvest of Value Sale." The major brand manufacturers run big sales at this time and nearly all major private label merchandisers also run some kind of promotion. Exhibit 5.8 is an example of one kind of private label promotion used at this time of year. The exact timing will vary from year-to-year but nearly all fruit and vegetable sellers will push products at this time.

There are both historical and economic reasons for this pricing point. The standard operating procedures for merchandisers are that they copy last year's merchandising schedule and calendar; they continue to

EXHIBIT 5.8--EXAMPLE OF SPECIAL FALL PROMOTION OF PRIVATE
LABEL PRODUCTS



CASE ORDER FORM #1

Prices EFFECTIVE Monday, Oct. 17th THRU Saturday, Oct 22nd

# CASE	DESCRIPTION	CASE PACK	RETAIL	CASE PRICE	\$ TOTAL
	Spartan Sweet Peas	24/16oz	6/\$1	\$4.00	
	Spartan Whole Kernel Corn	24/17oz	5/\$1	\$4.80	
	Spartan Cream Style Corn	24/17oz	5/\$1	\$4.80	
	Shurfine Whole Potatoes	24/16oz	5/\$1	\$4.80	
	Shurfine Sliced Potatoes	24/16oz	5/\$1	\$4.80	
	Shurfine Macaroni Cheese Dinner	24/7½oz	5/\$1	\$4.80	
	Watermaid Rice	30/1 lb	4/\$1	\$7.50	
	Shurfine Cut Green Beans	24/16oz	4/\$1	\$6.00	
	Shurfine Cut Wax Beans	24/16oz	4/\$1	\$6.00	
	Shurfine Spinach	24/15oz	4/\$1	\$6.00	
	Shurfine Mixed Vegetables	24/16oz	4/\$1	\$6.00	
	Shurfine Applesauce	24/16oz	4/\$1	\$6.00	
NAME: _____				\$ TOTAL	
ADDRESS: _____					
TELEPHONE: _____					

Turn this order in at your Favorite Shop-Rite Store.
Please allow 24 hours before you pick-up.
1ST WEEK CASE ORDER ONLY

program processed fruit and vegetable promotions every year. The economic reasons relate to the processor's needs to generate cash flow. Toward the end of the packing season all the bills are coming due including payments to growers, electricity bills, cans, and labor. Most processors need to generate money to pay these bills and are often willing to cut prices to move product. The combined effect of retailers looking for lower prices to create a favorable price image and processors needing cash results in another round of furious price negotiations. New price levels will either be set and/or buyers will be able to make large one shot purchases at very low prices. The October 15 transaction in Exhibit 5.6 typifies the type of pricing activity which is taking place. In this case, the buyer was probably in a bind because the merchandisers scheduled a promotion without telling him. The buyer needed to get a large quantity of product at a good price. In this example, Jonesville Canning Company came to his rescue. Jonesville was later rewarded with additional bookings for this year and increased booking for next year.

After this flurry of fall sales activity the market settles down again and is caused first by market saturation. Consumers have stocked up with sale merchandise. Next, the season changes into the Thanksgiving to New Year's period. During this time consumption patterns change and is the season of specialty products: cranberry sauce, spiced apples, canned yams, potato and bread stuffings, ripple cut carrots, baby peas and onions and french cut beans are in greater demand. The holiday mood results in expenditures on more expensive, unusual foods. These two factors combine to create a slack market for the typical peas, corn, and snapbean products. In addition, both buyers and suppliers are involved with relatives, Christmas parties, and holiday activities and there is

not much interest in anything but routine transactions. The slump in activity continues through the first several weeks of January when consumer demand is slack because everyone is eating leftovers and has decided to diet. The suppliers are waiting for some key information before initiating a new pricing point.

The end of January and the month of February is the next major pricing point. On the demand side, consumers are receptive to good food bargains; their credit card bills for Christmas are coming due. They are strapped for cash and will be searching for food bargains. In addition, eating patterns are beginning to settle back into the normal preholiday pattern. Children are back in school and normal routines of preparing meals resume.

On the supply side, processors are now at a critical point in the marketing year. They now have checked their inventory situation because of tax accounting needs. They know their inventory situation relative to their shipping and booking records. They thus know what they have to do to get their movements adjusted to end the pack year with desired carry-over levels. The triggering mechanism that starts price negotiation are the government inventory reports published at this time. This gives everyone in the private label trade an idea about what size inventory is available for the rest of the marketing year. If the inventory appears short, buyers start maneuvering to get their need supplies locked-in at lower prices. If the pack inventory is long, processors start to maneuver to move more inventory. The pricing activity crescendos at the annual National Food Processors Association Convention (formerly the National Cannery Association).

Aside from plant inspection and lot selection tours, this is often the only face-to-face meeting buyers have with suppliers. The buyers rent hotel suites and suppliers make appointments to talk to all their buyers and any new ones they would like to cultivate. At these meetings buyers give processors their "report cards" and review pricing, shipping, and quality control problems with each one. In the words of one buyer, "We encourage a frank and candid discussion of a supplier's performance."⁶ Processors have other words to describe the nature of these discussions.

This series of circumstances opens up the negotiating of market prices which are more variable from this time on until the end of the pack year. Deals are negotiated with individual packers attempting to get their inventories pushed through the system. Many of the deals are negotiated privately and participants try to keep the terms quiet. Rumors abound which leads to an interesting phenomenon.

Buyers can get price quotes from many sources of supply, but they hesitate to quote actual prices to processors. Therefore the only apparent source of market information for suppliers is that published in The Report on Food Markets. However, suppliers have another avenue for "feeling out the market." They pursue intercanner trades, transactions in which one processor buys a product from another. These are legitimate market transactions. Brand processors buy from private label processors and vice versa; private label processors trade with each other. These intercanner trades generate market price information for each party and thus become valuable sources of price information for processors. During times of price fluctuation, processors can call each other with offers to buy or sell product. Many of these calls are probably designed to get market information and since processors understand this

approach, they may attempt to mislead each other. In any event, the intercanner trade price quotation is one additional source of market information available to the packer.

If there is any additional cyclical pricing behavior in the pack year, it will usually occur after Easter and before Memorial Day. There is a slight shift in consumption patterns during Easter and its associated religious observances, but it is not nearly as significant as the Thanksgiving to Christmas shift. Generally, packers try to get the bulk of products shipped before schools let out in June since consumption patterns shift and people tend to eat more fresh (as opposed to processed) products. Thus there tends to be a flurry of pricing activity in late April or early May. After that the market settles down to "clean-up" sales. This is all based on the assumption that this is a normal crop year. The tail end of a short or a long crop year exhibits entirely different behavior (See Chapter 7).

The National Food Processors Association convention is probably the key event in the processed fruit and vegetable industries. Not only does market information get circulated but processors develop their expectations about the upcoming crop year. Processors of annual crops develop their ideas about how much acreage to contract and what prices they should bargain for. Processors of perennial crops start considering pack size distributions. This convention is the key information generating event in the whole marketing year.

The pricing behavior described above is evident in the movement figures in Exhibit 5.6. All the canners participated in off-line sales (see below) at the beginning of the year. Jonesville Canning Company "helped out" with a special deal for a fall harvest sale. Williamsville

Canning and Wholesome Foods seemed to want to hold out for prices around \$4.75. Williamsville finally decided to lower its price in mid-April. Wholesome Products Company never reduced its price. In response to standard booking rules, its booking for next year was cut. This market stayed fairly steady through the February marketing period. Jonesville and Smithville appeared to have stayed with the buyer's perception of the market level and thus continued shipping.

5.8.4 Some Specialized Buying Procedures

Special kinds of buying activity sometimes appear in the private label system. A complete understanding of the pricing process requires an acquaintance with these practices.

The first special kind of buying behavior is the use of off-line sales, a process whereby products are processed, labeled, cased, and shipped in one continuous operation. On some off-line sales, the product is loaded right into the buyer's trucks which are parked at the processor's plant. Off-line sales take place only during the packing period. By using off-line sales, processors can increase the throughput in their plants; thereby reducing the overall costs of their production. Significant savings can be gained because there are no storage charges. The ability to case and label at the end of the canning line saves substantial amounts of money. In flush crop years, it allows the canning firm to process more raw products before having to pass acreage of available products. Finally, off-line sales generate cash flow when processors need it the most.

Off-line sales seem to be Pareto better exchanges. The processor benefits from increased cash flow, improved throughput, and reduced

inventory costs, in return the buyer gets significant price concessions. Most processors would like the opportunity to participate in off-line sales. Some buyers do not have the ability to coordinate transportation, warehouse space, and payment requirements within their firms and are thus unable to put off-line sales together. As a result, off-line sales are usually the jurisdiction of the larger, more organized private label buying organizations.

Another, although rarely used, procurement method is cash buying. Very few large private label buyers will purchase products for cash. In doing so, they take title to the inventory and bear the storage and transportation costs. With cash buying, the buyer is taking all the risks. It is not, therefore, surprising to find that the organizations these buyers work for are also some of the most sophisticated private label merchandisers. In return, the cash buyer gets very special prices. There are no firms the author knows of that buy all their products with cash. Usually they buy only a proportion of their needs with cash and that is usually early in the marketing year.

Other times when cash purchases are made are when a buyer's credit is so bad that processors will only take cash. Sometimes in short crop years buyers who have been cut off will have to pay cash in order to get spot supplies; another time is when the firm is speculating. Buyers who speculate can be large buyers with superior information or private label brokers who will speculate on their own accounts. Some of the "street" buyers for large private label buying organizations will actually have fruit trees in their backyards. If a frost kills or damages a crop, they may know it immediately. If they have good working relationships with corporate headquarters, they can get authorizations

to buy existing stocks for cash before the general trade realizes the extent of the damage. This kind of information is one of the real advantages of a sophisticated buying structure.

The last special kind of buying is program buying which was discussed in a previous section. Program buyers buy in smaller lots and want mixed cars or trailers shipped on a fairly regular basis. Program buying reduces transaction costs by making buying more routine or "programmed." In return for the supplier's efforts in loading, record-keeping, and management, program buyers pay higher prices.

The basic discussion above of the pricing practices and cycles evident in private label processed fruit and vegetable markets is general and predicated on the assumption that this was a normal year. The standard practices described are used in nearly every commodity at some time or another during the market year. Abnormal years result as a result of the use of a different mix of pricing practices.

5.9 Transportation and Its Impact on Private Label Procurement

5.9.1 Relationships between Private Label Wholesale Prices and Transportation

Transportation plays a much more important role in private label products than it does in brand products. The brand products buyer merely establishes a lead time, places an order (based on quoted delivered prices), and leaves the details and job of delivering the merchandise to the manufacturer. The manufacturer's traffic department contacts the retailer's warehouse to make delivery appointments. The brand manufacturer either provides delivery with his equipment or hires common

carriers. Brand buyers only enter the picture when delivery performance results in stocking problems for the buyer.

Private label buyers are totally responsible for getting the product to their distribution centers. Private label prices are all F.O.B. Thus, a good private label buyer needs to be familiar with transportation rates, regulations, and practices. A successful private label buying program includes the integration of buying with transportation.

Transportation impinges on private label costs in two related but distinct ways. First, transportation costs can be a significant portion of the cost of a case of product and is especially true for products grown on the West Coast. Effectively organized transportation programs will result in a lower cost of goods bought. Thus the private label buyer will gain a competitive advantage over less effectively organized buyers. Second, effective transportation planning helps to reduce inventory costs, improves turnover rates, and therefore increases return of capital investment. Private label buyers went through the same inventory cost squeeze in the early 1970s as did brand buyers. They now select suppliers on their abilities to service distribution centers in ways which minimize the retailers' inventory costs. Because buyers are responsible for transportation programs, they have the incentive to search for and implement arrangements which reduce their costs. As a result, some unique transportation programs have evolved in the private label system. As with many innovations in the modern food system, the transportation programs developed by private label buyers have both efficiency and power (bargaining) implications.

One note of warning: transportation is a highly regulated sector. The incentives around which buyers develop their policies are rates and

rules. The rate and rule making structure of transportation is beyond the expertise and comprehension of the author. Thus the discussion below describes the institutions developed without going into the complete logic behind the developments. Suffice it to say that significant regulatory changes in transportation rules and rates will change the incentive structure facing buyers and will probably result in different transportation arrangements.

The cost of transportation services to the buyer is affected in three ways. The level of transportation costs is affected by the mode of transportation. Buyers are nearly unanimous in their preferences for trucks over rail. Irrespective of the rates, the real cost of rail transportation when adjusted for variance in delivery time, speed, and damage is nearly always more expensive than truck transportation. Only long hauls of large units of nonperishable products are shipped by rail. Most buyers will shift to truck at every opportunity. This factor would not result in differential prices were it not for the second factor affecting cost.

Not all buyers have comparable truck services available to them. Many private label buyers have access to their firms' truck fleet. A properly managed transportation department results in lower transportation costs. Firms with fleets can backhaul private label products, cross ship various commodities between divisions, and ship private label products directly to stores. Buyers without access to in-house fleets must rely on hired carriers with all their inherent disadvantages. Therefore private label buyers with access to their own trucks can lower their transportation costs and gain advantages in cost of goods over their non-integrated competitors. Chains, however, are not the only retail

distributors with truck fleets. Many wholesalers and cooperatives have very sophisticated distribution and transportation programs.

The third factor which can affect transportation costs involves trade-offs between inventory and transportation costs. Many food products (including private label) do not have movement sufficiently through the stores to justify ordering full truck or carloads. To minimize transportation costs, products must be shipped in full loads. If a product is less than a truckload (LTL), the receiver must pay a "stop" charge for having the product dropped at the distribution center. Thus the transportation cost per unit of a product brought in on LTL is higher than that shipped in a full truck. Yet ordering slow moving items on a full load basis ties up warehouse space and that increases inventory costs.⁷ Thus buyers are faced with a trade-off.

They typically solve this trade-off by shifting the problem to the processing sector. Buyers do this by only buying slow moving items from multiple product processors since multiple product shipments meet both cost constraints. The buyer can order minimal quantities so as to minimize inventory costs. He can also have the full load rate by mixing a group of slow moving products in one trailer or car or by shipping a minor product as part of a load of a large volume item. These factors combine to make it imperative that processors pack and sell several commodities. Buyers will seek these kinds of firms. Processors specializing in only one or two products must pack major items which have sufficient movement so as to avoid the LTL problem. Otherwise these specialized processors will be relegated to being spot sources of supply.

5.9.2 Storage-in-Transit Programs

Storage-in-transit programs are mechanisms to merge the needs of inventory management with transportation rates. Products are shipped in full load lots (trailer or rail car) at a through rate between two cities even though the product stops and is reloaded at an intermediate point. Suppose the 100,000-pound rail rate for shipment between San Francisco and Cleveland is \$3.25 per cwt., with an in-transit rate, the inbound product in full car lots can be stopped at an intermediate point; Kansas City for example. At this location it can be combined with other products in mixed lot cars and shipped forward to the final destination without a freight disadvantage. In other words, the in-transit rate preserves the direct freight rate while allowing for product mixing. A full car coming East loaded with one product is usually too much of that product for one distribution center. By stopping, unloading, mixing and reassembling with other products at a forward warehouse, the retail distribution centers can order from the storage-in-transit warehouses a full carload of mixed products. The multiproduct cars get in-transit rates as long as they are full and shipped by the same mode, which brought the product East.

The storage-in-transit warehouses serve to minimize the inventory which needs to be carried at the retail distribution centers. The safety stock needed at the in-transit warehouse is less than the composite stock which would occur if every distribution center had to carry its own safety stock. This increases the distributors' rate of return at all their distribution centers which is why private label buyers were instrumental in conceiving and implementing these programs.

The cost savings to the distribution centers must be weighted against the cost of operating an in-storage transit program. Most of these programs are conducted in public warehouses. Charges for the service must cover the costs of unloading, storing, assembling, and reloading the product. Confidential information given the author indicates that these tasks cost approximately \$.55/cwt. and are constantly rising. However, even though the rapid rise in interest rates has increased the cost of holding inventory even faster, distributors still find storage-in-transit programs profitable.

Figure 5.1 is a simple diagram of a storage-in-transit system. This one uses two warehouses. One is for canned private label, the other is for frozen products. Products are shipped from each major production area in full truck and trailer lots. The product is put in storage and shipped later as full mixed truck or trailer loads to each retail distribution center (represented by dots in Figure 5.1) on their request. These requests are, of course, collated and executed by the central private label buying organization. The products placed in the storage-in-transit programs are typically slower moving items. Many major items have enough volume at each distribution center to be shipped in full loads to each division without incurring excessive inventory costs at the distribution center.

These forward mixing warehouses produce other unique benefits for the private label buyer. First, private label buying departments do not directly bear the costs of the storage-in-transit programs. The warehouses used are public and are rented by the processors and the processors maintain title to the product in storage. Original purchases are made F.O.B. The processor bills the private label buyer at headquarters for

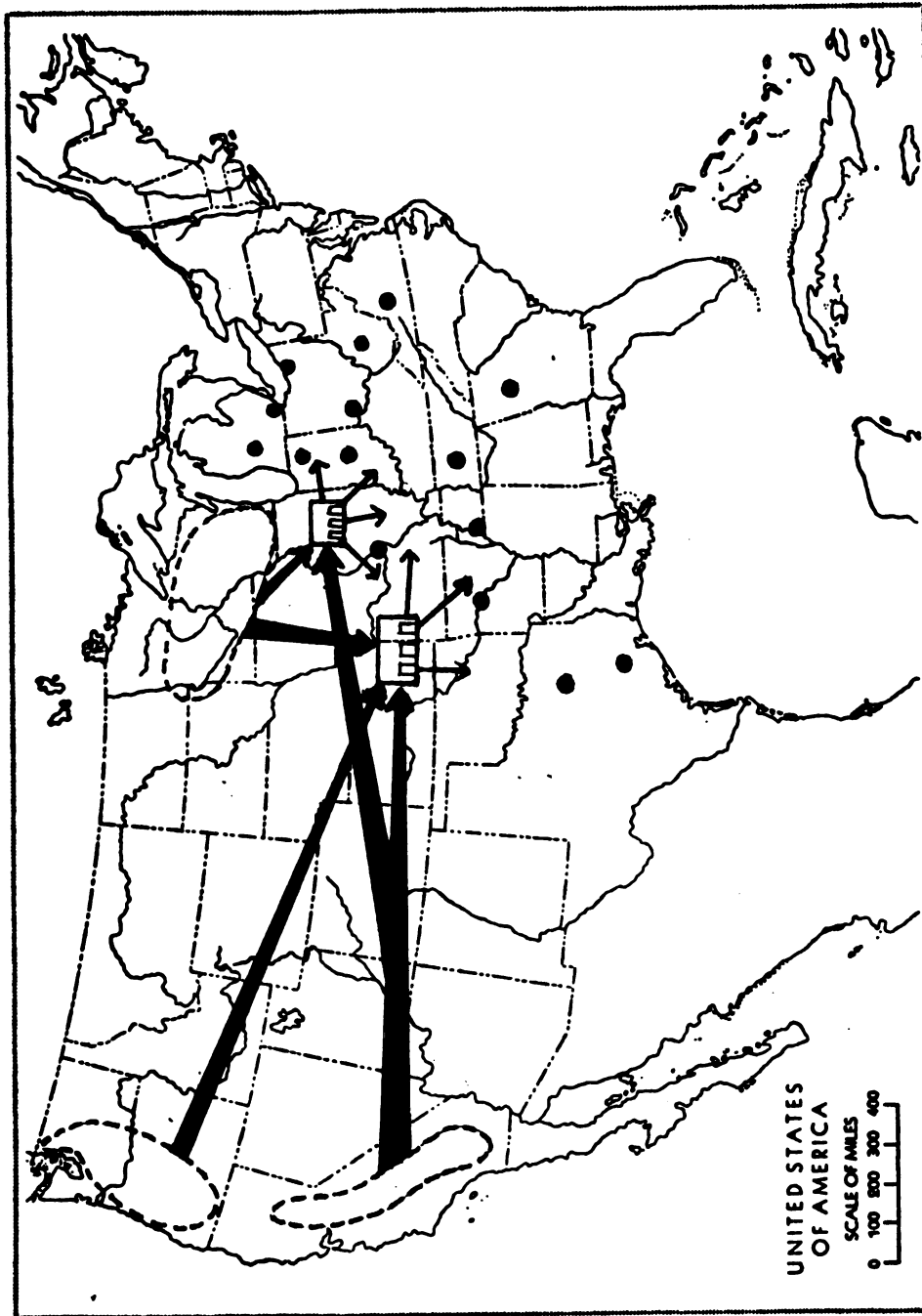


FIGURE 5.1--A Simple Diagram of a Storage-In-Transit Warehouse Program for Processed Fruits and Vegetables

F.O.B. price plus inbound freight plus storage-in-transit fees. When the buyers order the products shipped, they are charged this price plus outbound freight.

Whether the processor recovers all his storage-in-transit costs depends on how long his products have been in storage. If they turned over quickly, the processor may have actually made some money on storage. However, if the processor has had his products in storage longer than the average time on which the fee is based, he make take a loss. Several processors queried about this indicated that they recovered most of their storage charges, but usually incurred some loss which have to be made up somewhere. A reasonable hypothesis is that unrecovered storage costs are built into prices quoted to other outlets. Thus buyers with forward storage systems may be subsidized by other buyers.

5.9.3 Strategic Use of Storage-in-Transit Programs

The forward distribution system gives a strategic bargaining advantage to the buyer. This is the second benefit of these programs which accrues to the buyers. The buyer orders products brought forward from the processing plants which are usually labeled with the buyer's label and are in cases. They now sit in storage at the processor's expense until the buyer orders them shipped to the distribution center(s). The processor is now in a very vulnerable position. Suppose the buyer indicates to the processor that he believes the market has fallen. The processor says "No, it hasn't!" The buyer responds saying, "I can't ship at your price," and shipping orders are not issued. With every passing day, the storage costs increase and the price needed for the processor to break even rises. If market prices are falling or if buyers insist they

are falling, the price gap widens everyday. Thus the longer the supplier waits, the lower the probability of obtaining a break-even price. The inability to agree with the buyer's price is known in the trade as being "hung in-transit."

If this situation arises, the processor has few options. Since the product is cased and labeled with the buyer's labels, it is expensive to sell elsewhere. The processor would have to pay transportation and labor to move the product to a place where the product could be repacked and labeled. Repacking doubles the packaging and label cost. Thus usually the only viable alternative the packer has is to agree to the buyer's price and take his losses.

Notice the forward delivery system as it currently operates provides private label buyers with price protection. If the market moves down while the product is in storage, the buyer will only offer the current market price. If the price rises, the buyer will argue that the merchandise in the warehouse was shipped with the expectation of the old prices and that he cannot sell it for the new prices. Since most in-transit warehouses carry anywhere from a forty-five to sixty day supply, the private label buyer can get price protection for that amount of time.

Why would private label processors agree to these conditions? They have little choice, especially processors of a limited product line. Because they suffer a transportation disadvantage (LTLs), they need a system which can accommodate their slower moving items. If they do not hold the inventory for the retailers, the buyers will turn to the large processors who have extensive product lines since these firms can provide the product mixing (small lot shipments) needed for cost contain inventory. Thus in order for smaller processors to maintain their markets,

they must use in-transit warehouses. The only choice they have is how much of their business should they put in those warehouses. Those processors willing to talk about this problem indicate they go slowly when entering a recently established in-transit system until they can discern whether the buyer is honorable. Those buyers who blatantly "hang" processors have recourse over time to shorter and shorter supplier lists. Even though most buyers are very careful not to get that reputation, the threat of suppliers being "hung" pervades the market bargaining atmosphere. Unfortunately the bargaining power which accrues to buyers is a simultaneous product of the improved distributional efficiency arising from the in-transit systems.

5.9.4 Processor-Owned Distribution Systems

Processors have been searching for ways to generate the distributional benefits of forward warehousing without being put at a bargaining disadvantage. Program buying discussed above accomplishes the same results. Canned goods are more complicated and production is more dispersed. Therefore, program buying has not yet developed in canned products. The author discovered one case in which a buyer and seller were working together to set up a "mixed car on demand" program. This may be a future distributional model. Only time will tell.

Currently a few large private label processors have integrated forward into distribution setting up forward warehouses which accomplish the same thing as storage-in-transit operations. The two main characteristics of these processor-run operations is that the products are shipped to the forward warehouse in brights (cans without labels); and the warehouse contains case and labeling equipment. These characteristics

eliminate the strategic advantage that buyers have with in-transit warehouses. The processor has not committed his product to any single buyer. The product is labeled only when the buyers' shipment orders have been processed. With processor-run systems, the supplier maintains control over the product. He does not have to deal with quasi-monopolists.

The author knows of only two private label processor-run forward delivery programs. California Cannery and Growers ships products to their Midwestern plant. Their mixed shipments of California fruits and Midwestern vegetables can be put together. California Cannery and Growers also have a forward warehouse on the East Coast where they case and label brights. Tri-Valley Growers, the other large grower-owned processing cooperative, has recently formed a joint venture with a large Midwestern private label vegetable processor. In this agreement, Tri-Valley ships its products to a Midwestern plant where it is mixed with vegetable products. Therefore buyers procuring from either processor can more readily get full loads of mixed products.

Finally, it is not uncommon for brand processors to share warehouse space at forward locations. There is nothing preventing a group of private label processors from getting together and forming a joint venture forward warehouse system where they could share case and label equipment. The author does not know of any such operations. Perhaps competitive pressures among private label processors prevent this arrangement. One would expect buyers not to look favorably on such new arrangements.

Transportation is a critical factor in private label procurement. Because the buyer has to coordinate the transportation of private label products, it receives a lot of attention. The performance of the transportation system impinges on the buyer's performance as seen by

their superiors. Suppliers who recognize this and adjust to the buyers' needs are favored suppliers in the buyers' eyes.

5.10 The Pattern and Logic for the Account Selections of Buyers and Sellers

5.10.1 Criteria Used by Buyers to Select Suppliers

A review of the performance criteria used by buyers to select suppliers is central to the private label system. Although most of the factors in the operation of the private label system important to the buyers have been identified, this section highlights those aspects which are critical to the buyer. The trinity or performance criteria is composed of quality control, price, and service levels to the buyer.

The level of quality control exercised by the supplier is probably the most important long-term determinant of supplier account selection. The retail firm has committed its reputation to the products which carry its name. Any consumer dissatisfaction with the quality is attributed by the consumer to the retailer. Therefore private label buyers are very conscious of the quality of the various packers. The criteria of quality most mentioned by buyers during the interviews involved helpfulness, honesty, and consistency. Control of quality involves such questions as; Is the packer receptive to inspections? Will the packer be responsible for quality problems? Is the packer packing according to specifications? Is the packer's quality consistent over the pack year and between years?

All packers have to sign guarantees of quality. The packer takes legal responsibility for harmful quality and the out-of-pocket costs involved in product recalls which is an expensive risk to carry. Product liability insurance premiums are one of the most expensive and rapidly

rising of all insurance premiums. Packers are able to spread quality risk to a broader base by insuring through their trade association (National Food Processors Association). The packers bear all the financial risk of a bad private label product. However, because many private label products bear the retailer's name and logo, any quality problem will 1) be transferred to all other private label items under the same label, and 2) create ill will toward the retailer. Retailers who have a great deal invested in their labels and program need reliable quality packers. Consequently, they will choose those processors who will maintain specified quality over time.

A good deal of lip service is given to quality control by retail buyers. In many instances, however, the suppliers are the ones given the responsibility of making sure quality is controlled on a daily basis. The buyer has to have confidence in the suppliers.

Because the private label market is so sensitive to price and some buyers are always looking for the lowest price, processors may ship product below specification in order to make a profit. If the buyer leaves quality control to the packer and then squeezes him for the lowest possible price, the processor has a great temptation to ship product a "little" below specs. If the packer gets away with it once, he may try it again. Over time, the buyer may be receiving significantly lower quality. Most buyers want packers who will not succumb to this temptation. They enforce quality control with exit.

Buyers also want suppliers to rectify any problem with a minimum of hassles and cost to the buyer. If a problem with quality arises, buyers expect processors to take the product back and replace it with products up to specs while compensating the buyer for the lost labels and

transportation charges. This kind of quality protection is given by the brand manufacturers and it is expected for private label products.

There are thus two time dimensions to quality control performance. The short-term problem of quality is usually solved quickly by the application of buyer voice with threat to exit. The long-term problem of consistency and adherence to specifications are handled by the buyer's selection of suppliers. In time buyers and suppliers will evolve verbal and nonverbal understandings vis-a-vis what is expected of each party.

The price performance of a private label supplier as viewed by buyers considers whether the supplier keeps them competitive, and whether the supplier keeps them supplied. Since there is little formal price protection in the private label market, buyers need to rely on the supplier for informal price protection. As stated previously, suppliers who change invoices after a price decline or allow buyers to back into a deal are given preference. If a few suppliers provide this protection all suppliers must. The euphemism for this criteria in the trade is, "Does the processor help me out when the prices turn against me?" Again, buyers are primarily concerned with not paying more than their competitors and is the motivating factor behind the buyer's desires for price protection.

Price protection is the buyer's chief concern in normal and long crop years, while during short crop years the main concern is having enough of the product to keep the shelves filled. They are concerned with price in that they do not want to pay more than their competitors, but most importantly they must have the product. During short crop years the relative bargaining power often shifts to the suppliers. Through the elaborate prorating rules, suppliers are able to help certain buyers. How a

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supplier treats a buyer in short crop years determines how that buyer establishes his priorities for supplier selection in normal and long crop years. A supplier who keeps a buyer "in product" during short crop years and is consistent on price, quality, and service in the other years is given high priority. This high priority by buyers translates into continued and usually increasing business and sometimes higher average prices for the product during normal and long crop marketing years.

The supplier's "service level," the third key performance dimension used by buyers to select suppliers, is a catch-all phrase to describe how well the processor takes care of the buyer's needs on a daily basis. Criteria for service levels usually revolve around shipping and delivery performance. Is the product at the right division at the right time in the right quantity and of the specified quality? Buyers consider a "properly serviced" account one that does not cause any problems. They are under such time pressures that late deliveries and wrong products hit raw nerves. They make mental notes when they have too many service problems with a particular account and will usually discuss this with the processor. If service performance does not improve, buyers typically begin phasing that supplier out.

A primary element of service as viewed by the buyer is the processor's product line. Buyers will purposely select suppliers who can ship several products at one time in order to minimize inventory and transportation costs. Buyers will only buy from specialized processors if they pack a major commodity. In very rare circumstances buyers will take less than truckloads (LTLs) from small packers, but this only occurs when the buyer is out of the product. In these cases, the buyer will usually go first to his regular suppliers who have given him the fastest service in the past.

Buyers were asked to list the priorities placed on each of these three dimensions of performance. How they ranked the three depended on the length of time of which they were thinking. In the short run, buyers ranked service, price, and quality in that order. This is quite logical because of the contingencies of reinforcement faced by the buyers. Buyers are corporate or organizational bureaucrats. Their superiors (beyond immediate supervisors) probably could not tell a Grade A and Grade B product apart. One thing they do see is empty space in the store shelves. If a product is out-of-stock they call the buyer and ask why. In the short run, the cause of out-of-stocks is usually erratic service. Since inventories are to be kept at a minimum a delayed shipment can cause out-of-stocks. Since this is the quickest way for a buyer "to get in trouble" with his boss, buyers are particularly cognizant of service levels.

Retail executives are the most avid readers of competitor's food ads. The firm's private label retail prices may be higher than the competition one week and the buyer may get away with this. However, should the executives notice a pattern of higher prices for their own private label they request buyers to explain. Thus "out-of-line" prices are the second way a buyer generates negative reinforcement. This is why in the short run they rank supplier pricing performance second to service level.

The only concern most retailer executives have about quality surfaces when consumer complaint letters become excessive. These problems are usually short-run and special cases. Some buyers even classify these as service problems rather than quality. In the short run, quality ranks lowest in performance criteria.

In the long run this order is reversed. If the retail firm's quality slides, it will gradually lose customers and market share. It is difficult to develop a long-run private label program without consistent, fairly high quality merchandise. Thus when viewed over a long period, the quality performance of the buyer's suppliers determines the success of the buyer's private label program.

Pricing is important also, but not nearly as critical. The reason for this rests in consumer behavior. The buyer can correct a price mistake but finds it extremely difficult to correct a quality mistake. If the consumer gets one or two "bad" packages or products and alternative products exist, the consumer will shift to another and probably not return to the private label product for years. One estimate given during the interviews was that it takes five to ten years to overcome an experience with poor quality. In addition, the consumer will shift that hostility to other private label products of the retailer. The buyer can correct a price mistake by advertising and promotion. If the buyer's products are overpriced when the consumer makes several purchasing decisions, he can run a special and change the consumer's image of the product.

In the longer run service criteria seem to all fade out of consciousness. All suppliers will have ups and downs. The buyers and suppliers must be able to reconcile most of the short run service problems. Those supplying firms that are chronic service problems do not survive long enough to be of concern. If their service is perpetually bad, their quality and pricing performance also usually suffers.

Some other criteria are cited by some buyers interviewed. Several buyers select processors on the basis of their financial stability and strength. They know they are into private label products for a long haul

and want the suppliers they select to be around a long time also. They will usually only buy from the largest private label suppliers who tend to have multiple product lines and are able to service accounts in a more orderly fashion. Other buyers will select small suppliers in order to maintain an adequate number of sources in the future.

5.10.2 Dual-Branding and Cooperatives: Organizational Form and Supplier Selection

Many private label buyers are very adamant about buying from processors who are predominately private label firms and will not rely on a dual-brand manufacturer to be a major supplier. In a short crop year, the dual-brand supplier will protect suppliers for its brand first. This means that private label buyers will be out of product in short crop years. As described above, that is the fastest way for a buyer to loose his job.

When a brand manufacturer is a major private label supplier, one or more of the following conditions is present. The brand and private label business of the manufacturer is about of equal volume or the two have separate personnel and divisions. The brand products are strong in one market while the private label products are sold in other markets. The brand manufacturer holds some patent or trademark rights which precludes other manufacturers entering to supply private label.

Manufacturers are also hesitant to enter dual-branding situations. Because the retailers control shelf-space for all items, dual-branding would place the manufacturer in a vulnerable position whereby the retailer could put pressure on one area of the business in order to get concessions in the other area. The author heard of several instances

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where dual-manufacturers were put in this position. Given a choice, the brand manufacturer will steer away from the private label markets.

Aside from a decided preference not to deal with brand products manufacturers, private label buyers have few other prejudices for or against any other processor organizational forms. Most private label processors are either closely held and/or family controlled corporations or grower-owned processing cooperative. Most processing cooperatives are former proprietary firms which have been purchased by growers. The proportion of the private label processing capacity controlled by cooperatives is greatest in California and least in the upper Midwest, except for Michigan. The Pacific Northwest is somewhere inbetween these two.

Buyers' accounts will usually contain a mixture of cooperatives and proprietary firms. Buyers choose among them based on the criteria discussed above. However, there is a tendency for buyers to buy from proprietary firms and cooperatives on a slightly different basis because of the economics of processing conditioned by the organizational activities of growers. A key to survival in the processing industry is cash flow. Grower bargaining with proprietary processors has often included a provision that growers be paid cash at time of harvest which process when many other bills of the processor are due. Processors are typically caught in a financial squeeze. Since proprietary firms, especially those with limited access to credit, need to generate cash quickly, they are very susceptible to buyer overtures for off-line sales. Thus a buyer will go to proprietary firms first because they are under the most pressure to make quick low-priced sales. Cooperatives are not under as much cash flow pressure at pack time and are less susceptible to buyer pressure

for "speical" off-line deals because most grower-owned cooperatives defer part of the grower payments until later in the year.

If there are any particular biases toward one kind of a supplier by the buyers, they would tend to favor proprietary firms for two reasons. Buyers say proprietary private label firms tend to react "quicker" to market changes and buyers' special service needs. The very large cooperatives tend to be sluggish, just as any large organization will be. Buyers state they do not react fast enough.

The second reason is the level of management. Ceteris paribus cooperative managers according to buyers tend to be lower paid when compared to managers with comparable responsibilities in proprietary firms. Thus the best cooperative managers would have incentives to leave or work less deligently. This difference in managerial ability perceived by buyers was mentioned by several of them.

All in all, this prejudice for proprietary firms against cooperative processors is not nearly as strong as the buyers prejudice against dealing with dual-brand manufacturers. In a few cases, buyers did acknowledge that they strategically favored a few proprietary processors in an attempt to try to keep them as independent suppliers. This behavior not only reflects a buyer preference for independent firms but also buyer conjern for the number of potential suppliers in the future.

5.10.3 Determinants of the Number of Suppliers Used by Buyers

The number of suppliers a private label buyer has is a function of the size of the firm, the importance of the product, the uncertainty associated with the product, and the number of available suppliers. The larger the private label buying organization the more suppliers it will

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need for each product. Having the same number of suppliers as a smaller firm would mean that the big buyer would be heavily reliant on each of these suppliers exposing the buyer to more risk. This includes quality risk in addition to putting the buyer in a bilateral oligopolistic situation.

There are also transportation considerations. Certain products (green beans, peas, corn, tomatoes) are packed in several regions. Large national private label buyers book the product in all regions so as to minimize the transportation costs of getting the product to various distribution centers. Buyers will cross ship products (from one producing area into the market area serviced by a different market area) if the prices in the various regions get out of line with transportation differentials. Buyers can also cross ship for strategic reasons. They might attempt to "convince" processor in Region B that his prices are too high because the buyer is able to buy and ship product from Region A for less money. This may or may not be the case. Independent of the real economics of the ploy, it is one significant advantage a large private label buyer has. For the most part, however, the reason large buyers have more suppliers is to minimize risk and transportation costs.

Ceteris paribus, the larger the product sales the more suppliers the buyer will carry for that product. Again this is a risk reduction strategy on the buyer's part. An important product which the buyer cannot do without is also usually a price competitive item. Thus risks tend to be covered by having many suppliers. Minor products are often afterthoughts in a buyer's consciousness. Thus a great deal of time is not spent on those products. Because of the inventory cost/transportation

cost trade-off, buyers will usually pick the major multiline suppliers for these minor products.

Ceteris paribus, commodity private label products will have more suppliers than manufactured ones. The level of risk associated with the manufacturing process is much less than with the biological production process of the commodity items.

If there are few suppliers, buyers may try to develop new suppliers if possible. In the cases where there are few processors, the buyers will violate their no dual-brand rule. In fact they will "encourage" brand manufacturers to start private label products.⁸ There are enough of these products with few suppliers to raise the buyers' interest in maintaining competition and viable suppliers.

There does seem to be some pattern to the actual number of suppliers buyers carry on account. There is almost never one supplier per product for a buyer--the minimum is two or three. Regional chains or wholesalers will normally have four to six suppliers for these same products while national organizations carry twenty or more suppliers on major items. The major proportion of product will have to be booked with only about one-half of these suppliers.

The impression given to the author during the interview process was that the number of suppliers used and available is declining significantly. Many are going out of business. Buyers are shifting to multiple-line suppliers. The trend to fewer and fewer processors is very disturbing to some of the more foresighted buyers. They recognize that buyers shift risk to the processors through the standard procurement practices described above and by having a sufficient number of suppliers to disperse quality and quantity risk. Buyers know that their ability to get

these provisions in the future depends on there being sufficiently large numbers of processors available for negotiation. These insightful buyers say they give preference to procurement patterns which develop new and/or small suppliers into viable competitors. One private label buyer pointed to one firm on his booking records and said "This firm is my future."⁹ He went on to explain that he brings this firm along every year by increasing its bookings and giving it a little better than average price. Other buyers expressed similar fears about supplier concentration and hinted at similar procurement strategies. Several buyers expressed the fear that they would someday have to buy private label products from the major national brand manufacturers.

Concentration on the power relationship between the parties under-values the role played by the long-term personal relationships which exist in the private label system. Over time buyers and sellers get to know and understand each other. These trade relationships reduce transaction costs significantly. As the number of suppliers decreases buyers find exit a less viable and more expensive method of obtaining the mix of pricing, quantity, and quality services they need. Thus performance of the system relies more on regulation by voice under the threat of exit.

Changing suppliers requires moving label inventories. The buyer and seller joust over specifications until the supplier knows what this buyer wants. This takes time and is expensive for both sides. When a buyer decides to change suppliers it usually is a gradual process. This is illustrated by the Wholesome Products Company in Exhibit 5.6. The processor decided he was not going to sell for under \$4.75 a case. Rather than drop the supplier, the buyer reduced his booking for the next

year. Along with this reduction, the buyer probably suggested that performance (in this case price) would have to improve or the supplier would be dropped. The buyer will use this strategy for several years until the supplier changes his ways or is dropped. Probably the buyer will start developing a new supplier next year if Wholesome Foods continues its present policies. The buyer will use the same strategy (partial exit combined with voice) to change the suppliers' performance in quality and service. It would take the buyer about five to six years to totally turn over his current set of suppliers for a different set. Should buyers turn their suppliers lists over on an annual basis, their reputation would spread in the processing trade. As a result, they would be given a low priority by the sellers and would be unable to get the product during short crop years.

5.10.4 Criteria Used by Suppliers to Select Buyers

Adding weight to the importance of trade relationships in the system were the responses of the processors to questions about what performance criteria they observed buyers using. The processors' responses were in close harmony with those of buyers'. On a daily basis, service problems were the most pressing: the lost car of a product, a bad labeling job, and unglued cartons were the pressing problems.

The suppliers, however, did identify pricing as being more important to them than to buyers. Individual processors perceive pricing as more important because that is the foremost factor in many buyers' minds. Recall that the processors make the initial price quotes. They must make decisions about price protection and back-ins. Thus every time a buyer calls, or a broker for that matter, it is usually either for a problem or a price negotiation.

Processors rarely mentioned quality as a performance dimension. First, they would be reluctant to admit that they have quality problems. A few processors did volunteer the statement "I've heard rumors that some people shave quality." Second, quality is a long run issue. If the packer's quality is bad, most likely his price and service levels are also bad. Accounts lost will be because of these things even though deterioration in quality was also a factor.

Both buyers and sellers thus generally agree on the relevant performance dimensions used by buyers to determine supplier lists. Suppliers do have a choice of who they sell to. What criteria do suppliers use to select buyers for their products? Even though sellers have fewer choices, they still can, to some degree, choose their accounts.

Sellers rank buyers on their effectiveness and personal characteristics. Sellers recognize quite quickly which buyers are knowledgeable and which are not. Processors give knowledgeable buyers preference. When the processor has to move a product or adjust prices he wants a buyer who recognizes the move and acts on it. Sellers will favor buyers who are effective operatives in the bureaucracy who can get the retail firms to respond in a way consistent with the needs of the seller. Sellers generally favor buyers from large private label organizations, primarily because the competence of the buyer is highly correlated with the size of the organization. They also want buyers who can make independent decisions. If the retail firm's buyers are glorified bookkeepers and have to check every decision with someone else in the firm, that private label organization may not be able to respond fast enough to solve a supplier's problem. Thus suppliers prefer technically competent, strong, independent buyers.

The second major dimension for suppliers' account selection has to do with personality traits. Is the buyer honest? Does he promise one thing and renege? Does he misquote prices? Does he spread false trade rumors to help himself? Is he fair to all suppliers? Or is he arbitrary and capricious? Suppliers are always lacking information relative to the buyer and misinformation can be costly. Suppliers prefer buyers who are credible. Another personality trait is personal decency. Suppliers are human beings and expect to be treated as human beings. Public and private berating, cursing and belittling are out of place in any business context according to suppliers. Yet, this kind of behavior exists and will probably exist in the future. Most suppliers must take some verbal abuse but will avoid that individual wherever possible. However, one processor related that this kind of abuse does not bother him. In fact he will seek out this type of buyer. When asked why, he shuckled "I don't have many competitors ahead of me in the waiting room."¹⁰

When asked to characterize the type of buyer they would like to face, most private label suppliers responded "a tough but fair buyer." Fairness is obvious. Toughness refers to the buyer's gamesmanship. After many years in the business through ups and downs in the cycle, buying and selling takes on a routine nature. The real professionals, both buyers and sellers, take enjoyment in the bargaining and gamesmanship which takes place. Attempts to "best" one's opponent lends excitement to the procurement process. Through the years, the professional buyers and sellers develop a respect for each other and some actually become casual friends.¹¹ A sense of community starts to develop around the private label system and its participants. This is especially true on the West Coast industries. Unwritten group morality develops which acts as a

policing force. With the exception of some brokerage activities, the private label procurement system is very honest. Dishonest buyers or sellers do not survive according to the private label trade. They are isolated and gradually are eliminated, usually by their own firm's management.

While there are some objective criteria for selecting accounts, interpersonal relationships have a major role in the selection process. Buyers have priority suppliers. They help these suppliers out in long crop years. Suppliers have priority buyers. These buyers are taken care of during short crop years. Unprofessional buyers find unprofessional suppliers and vice versa. The lists are always in a state of change as managements change as processors and as buyers move on to other firms. There is always some crisis confronting the participants. All of this is part of dynamic market interaction.

5.11 Private Label Philosophies

The basic elements of a private label program are available to all firms. Yet there are perceivable differences in the private label programs of various retailers. These differences trace back to the basic purpose or philosophy applied by high level management to their private label programs. For the purposes of exposition private label programs are distributed along a continuum between two basic philosophies. This will be very useful later for understanding the level of vertical coordination in the processed fruit and vegetable industries.

5.11.1 Franchise Development Philosophy

The author has arbitrarily called the first private label philosophy the "Franchise Development" approach. As the name implies, the retail firms adopting this philosophy or approach to private label are primarily concerned about developing a long-term consumer franchise for their brands. This commitment leads to certain behavior which influences the whole operation of the private label program.

The franchise development approach to private label recognizes the importance of consistent quality over time. Veteran industry observers indicated that the reason early private label programs did not displace the brands as they were predicted to do was because retailers did not recognize the importance of consistent quality. Instead they emphasized the price. Gradually, many consumers attracted to private label by price drifted back to brand products. Those retailers who desired to develop franchises for their brands recognized this. Consequently rigid specifications were developed and quality control programs were implemented. Buyers selected sellers on their ability to pack consistent quality.

A second characteristic of franchise developers is their commitment to hire the best private label people to run their departments. Since they are in private label business for the long run they want the top professionals available. They need people who understand the nuances of the private label system. Their private label staffs are usually more stable. Their buyers are most often the most highly regarded in the trade. These professional people in turn recognize the importance of the organization's reputation and will try to maintain that reputation in face of externally or internally generated pressure.

A third characteristic of franchise developing firms is they are committed to having the product at all times. The battle is the relative market share between brand and private label items. Brands will nearly always have the product on the shelf. If the retailer's private label is unavailable, consumers will have to shift to a brand. Getting them back to a private label may be an expensive and lengthy process. Thus franchise builders are very sensitive to variations in quantity. They thus tend to develop strategies to assure that they have supplies.

As was explained above, there are ways buyers can assure that they have the product by overbooking, threatening, or cursing; or they can be a priority customer of the packers. Processors protect their priority buyers during short crop years. In most cases, buyers do not become priority buyers by adopting the first strategy. Franchise developing organizations have buyers who recognize that they are in the business for the long haul. These buyers gradually establish themselves as priority buyers or they do not survive the trauma of a short crop year.

Finally, franchise developers have the total firm's commitment to private label. They tend to use their own corporate names and logos on their private labels. When committing their names, the performance of the private label department reflects on the whole organization since alienation caused by poor private label products transfers to the whole organization. The performance of private label is usually part of package of images that the retailer is trying to project. Because it is a part of the attempt to differentiate this store from its competitors, retailers will have more commitment to private label. Private label departments are given equal corporate status with other departments and directors are included in corporate planning and decision making.

Retailers adopt strategies to advertise and merchandise their private labels so as to develop a loyal consumer following. Since private label departments have status, they can be more effective. When the private label system has to respond to a changing supply condition, these firms tend to be able to "move" faster. They are able to internally coordinate the factors necessary to get the entire firm to respond. In other words, these private label organizations have the "bureaucrats" who can get things done.

This description of the franchise development approach says nothing about the marketing approach used to develop these franchises. There are many strategies. Some firms use the approach of "better quality at a better price." Other use the approach of "super prices for acceptable quality products." What differentiates private label philosophies is not the image being projected but the fact that the firm has made a commitment to developing a particular image.

5.11.2 Competitive Response Philosophy

The second basic private label philosophy is the "Competitive Response" approach. As the name implies these are private label programs put together to match or meet competitors private label programs. In many ways, the competitive response approach is the opposite of the franchise development approach.

The competitive response firm often appears more price conscious. Since these firms are followers rather than leaders, they usually try to differentiate their private label programs by beating the competitor with price. Most often these firms will stress their quality; however, it is often not consistent. Because they are not as well established, they

do not tend to have steady, reliable sources of supply. When given the choice of either higher wholesale prices or no product on the shelves, these firms will most likely compromise quality. The willingness to compromise quality leads to product inconsistency over time. This inconsistency in quality coupled with other factors makes it difficult to develop a loyal consumer following.

Because competitive response programs are afterthoughts to a firm's management, a great deal of planning or time is not put into developing a professional private label department. Personnel used to conduct the private label program are pirated from other divisions in the organization or hired from what is available in the labor market. Serious professional private label people tend to stay away from these firms' offers because they can sense that the management does not have a well-planned, long-run program. Thus on the average these types of private label organizations have less committed private label personnel who tend to turn over more. This kind of labor pool tends to lead to chaotic, uncoordinated programs which run on a daily basis rather than by some directed plan.

Since the competitive response program has less experienced personnel, the buyers for these programs tend to use the short-cut routes for trying to get more product; i.e., overbooking, supplier switching, and spot market purchases. Buyers for many of these firms are not around long enough to become established as priority buyers. This is a vicious circle. Since these buyers are short-run oriented, they tend to do things in long and normal crop years which make them unpopular with the suppliers. When a short crop year comes, these buyers either pay substantially higher prices and/or are unable to obtain the product.

Higher management often fires the buyer after a short crop year. The new buyer sees why his predecessor was fired as he adopts the short-run strategies which he thinks will "ensure" that he has the product at low prices. He alienates the suppliers who then prorate him out of product in the next short crop year. This buyer is often fired and the cycle starts again.

It takes a concerted effort on the part of the retail firm to break this cycle which requires a change in its private label philosophy. Changing the behavior of the private label personnel is difficult because after several cycles of this type of buying behavior, the suppliers "mark" that retail firm as troublesome. The higher management will always tell the suppliers that they are sorry. They did not know the buyer was that way. But things do not change. When high-level management does actually adopt a different private label philosophy, the suppliers are bound to be skeptical. They will probably treat the new buyers in the same way they were conditioned to treat the old buyers.

The retailer whose private label program is a competitive response is much less likely to have an organization-wide commitment to the private label program. The tendency is for the private label department personnel to be second-rate corporate citizens and to be excluded from real decision-making authority on a daily basis. Thus, the private label department cannot shape advertising and merchandising strategy. When suppliers want to move product, the buyers cannot guarantee a price or advertising change at the retail level. Therefore, the suppliers will tend to pass these buyers by when good deals are available. Again, once a retail organization gets the reputation of having the characteristics of a competitive response program, it is difficult to break the cycle.

When private label brands first hit the supermarkets, most firms adopted the "competitive response" approach. Over the years, more and more firms have seen the virtues of the consumer franchise approach. While there are all gradations of private label philosophies, the majority of private label volume is sold by firms with a commitment to private label programs in the long run. However, there are still many firms who view private label as a competitive necessity. These firms will continue to hire unskilled buyers, sell inconsistent quality, and angle for the lowest wholesale prices. Only the demise of many more private label suppliers will make this approach impractical.

The phrases "good" and "bad" buyers have been used several times in the above text. These terms are meant to be descriptive rather than normative. Unfortunately one cannot talk about private label buying styles without making at least implicit normative conclusions. An unprofessional buyer is one who uses most or all of the strategic short advantages buyers have as a matter of course. These would include overbooking, strategically misinterpreting the facts (lying), hanging-in-transit, and rejecting loads because of "quality" problems. All buyers may periodically use one or more of these tactics while the unprofessional buyer uses them routinely. The worst of these buyers are those who combine this buying style with obnoxious and/or degrading personalities coupled with the same treatment of suppliers.

Suppliers know that buyers hold the upper hand. They understand (though they will never admit it) that most buyers will be forced by superiors and/or competition to apply some of these strategic leverage mechanisms occasionally. Even though buyers may have a personal policy against this type of behavior, they may be forced to "hang" someone

in-transit because of circumstances in the retail firm. For example, a high executive in the retail firm may change and he expects the buyer to use these mechanisms. The buyer must either leave or capitulate to his superior. Under these conditions, suppliers want the buyer to be consistent with all suppliers. That is, be fair. A professional buyer is one who does not economically or personally abuse his suppliers.

5.11.3 Retailer Organizational Form and Private Label Philosophy

There is some relationship between the organizational form of the private label buying organization and the private label philosophy adopted. The largest chains, with a few exceptions, have adopted a franchise development strategy. This makes sense. Most managements of large chains strive for national exposure. The probability of building an economically harvestable consumer franchise increases as the firm gets larger. In addition, some regional chains have adopted this philosophy of private label. These firms recognize the value of a sound private label program for differentiating their stores from those of their competitors.

The retailer commitment to private label is not as important for the private label buying organization as is the basic philosophy adopted by the managers of these buying organizations. The independent retailer buying from a buying group cannot be expected to have a long-range view of private label. After all, the products are probably not in labels with the store's name nor is there any direct investment in the structure of the private label buying department, or any leverage in decisions. Basically the independent retailer orders private label from the warehouse just as brand products are ordered. The private label philosophy adopted

by buying organizations really reflects the philosophy of its current and past management. For the most part, those large specialized private label buying organizations are the most forward-looking and professional private organizations in the country. Since this is their only business, they tend to be more responsive to innovation and changes. The retailers who they buy for may come and go, but the buying organization expects to be around for a long time.

Voluntary and cooperative wholesalers who establish private label programs to supply their affiliates vary in philosophy as do chains. Some take private label products quite seriously, others view it as a competitive necessity.

5.11.4 Private Label Program Brokers

One type of private label organization tends to defy classification--private label program brokers. They are brokers who deal exclusively with private label. They are traditional brokers in that they represent several packers to private label buyers. The buyers then place orders through these brokers. The program brokers are unique in that they represent many competing private label processors (sometimes twenty to thirty) to one retail account in any given market. Most brokers consciously avoid having two principals (processors) who compete because there are inherent conflicts of interest. These brokers set up private label programs for the retailer including all the requisites of a full-fledged private label program. In return, the retailer is committed to buy all their private label needs through the broker. The revenue for running the program comes from the brokerage fees paid by the processors for the product the broker gets placed into the program private labels.

In essence, the retailer gets a sophisticated private label program, paid for by the processors. These brokers are very careful to charge retailers for custom services they buy which do not directly involve increased processor sales because of strict rules set down to define and restrict "buyers brokers." Buyers' brokers were one of the chief targets of the Robinson-Patman Act and numerous examples were cited in the Congressional testimony on the act, one of the most noted being A&Ps use of a wholly-owned subsidiary brokerage firm.

Some of these brokers "custom design" a private label program for the retail client. Other larger brokers have sets of labels which they will give to a retailer, i.e., a packaged private label program. Since some brokers have several "packages," they can provide exclusive private label services for several retailers in one market. This is rare because the broker is legally exposed if both retailers do not get the same deals.

As with all brokerage firms, these firms do not take title to the merchandise. Rather they "suggest" shipping instructions to their processors. The processors case, label, and ship the product directly to the retailer's distribution center. For the retailer the brokerage firm provides quality control, service monitoring, and label inventory control.

There should, in theory, be no conflict between the buyers (essentially the broker) and the sellers. After all, the brokers work for the processors. In reality, the retail buyer makes the decision whether and how much to buy. The processor can either say yes or no. Thus private label program brokerage arrangements present the processors with the same choices they have under any other buying/selling arrangement

described above. The only difference with these arrangements is that the processors end up paying for a large proportion of the costs of operating a private label program. All other private label organizational forms have the retailer paying all the costs whether directly or through upcharge.

5.12 Food Retailer Vertical Integration into Food Manufacturing

In addition to the SOPs described above, food retailers get private label products by manufacturing items in-house. Food retailers have made significant inroads into the manufacture of certain food products--the most notable products are bread and fluid milk. The reasons for retailer integration into processing are well documented. The best exposition on the subject and the last set of comprehensive numbers on integration is contained in pages 75-95 in Technical Study No. 7, of the National Commission on Food Marketing.¹² This section does not intend to revisit this whole subject, rather it tells why integration has been very limited in the processed fruit and vegetable products. The chapter also relates three integration "traps" that retailers can encounter which are probably one of the major reasons why retailer integration is not more widespread.

5.12.1 Some Factors Retailers Consider before Vertically Integrating

During the interview process, the author came across an example of the decision-making process used by retailers to decide whether or not to integrate into manufacturing. An example of the decision process used by a major food distributor follows.

The distributor currently had a private label program for this product (not a fruit or vegetable product). The management asked "should we integrate into the processing of this product or continue to buy private label?" In order to answer this question top executives delegated several tasks. First, they instructed the marketing department to project their firm's sales of this product line for the next ten years. Given that projection, a copy was sent to the private label buying department and to the engineering department. The private label buying department was instructed to construct a report estimating how much it would cost to buy these products in the next ten years. The engineering department was charged with doing a study estimating how much it would cost to manufacture these products. This, of course, involved constructing the hypothetical plant(s) of the proper size and location. The results were given to the executives.

The findings showed that after including all the costs the planning department considered relevant, the retailer could, over the projected life of the plant, produce the product at lower prices than if purchased through private label sources. However, the plants were not built because the projected profit rate of the item was insufficient to give the retailer a rate of return on investment equal to or exceeding the company's target rate of return. For this product, the current private label processing system was receiving less return on their investment than was acceptable to this potential entrant.

This does not necessarily mean that the private label processors are receiving subnormal or only economically justifiable profits. Depending on the target rate of return set by the retailer, processors could receive excess profits and still not induce entry by integrators.

Target rates of return are often set higher than prevailing interest rates to compensate for mistakes in estimates and uncertainty.

The relative degree of risk of a project is very critical in retailers' decision making. For the most part, they seek relatively risk-free enterprises and/or institutional mechanisms to shift risk they incur to someone else. Risk raises costs and complicates managers' jobs. Given the retail trade's general aversion to risk, products with significant actual and/or perceived risk will not normally induce retailer integration. Retailers generally process products which have high volume and are capable of being produced on a constant flow basis.

It is easy to see why milk and bread are highly integrated since they are high volume items throughout the year. There was never risk of much market price fluctuation associated with baking bread. Retailers could buy flour and all other necessary ingredients on contract and there are usually no major shortages or price problems. Massive retail integration into fluid milk processing did not occur until raw milk prices were stable as a result of the Federal Milk Market Order system and the price support programs for dairy. However, this stability did not prevent seasonal supply variation. In order to process fluid milk, retail distributors had to develop methods to dispose of surplus fluid milk which would arise during most of the year. The conventional way of doing this is to build milk manufacturing capacity. This meant investments in operations that did not have the volume and flow characteristics needed.

With the development of large producer cooperatives with facilities for managing surplus milk, the quantity variation in supply could be regulated. Cooperatives could provide full supply contracts for fluid

milk and deliveries to retailers' plants could be scheduled within set quantities. So farmer co-ops solved both price uncertainty and quantity (no inventory cost) uncertainty. Consequently the amount of distributor-owned fluid milk processing capacity increased dramatically in the mid-to-late 1960s.

Some retailers are integrated into some grocery items. For example, some firms process baked beans, peanut butter, and vegetable oil salad dressing. Baked beans are a dry pack item. This means that beans, tomato sauce, and spices are added to the can and the product is cooked and ready to sell. There is no inventory, other than for the ingredients. All these ingredients can be bought on contract or stored in another set of firms. Retailers can hedge all their supplies of soybean oil for salad oil on the futures markets. Likewise, peanut butter can be processed as needed.

Thus the lack of price and supply uncertainty of major inputs is a critical determinant of whether retail distributors will integrate backward into food processing. Yet industry analysts often do not recognize its importance. Successful attempts to stabilize prices and fluctuating supplies in major commodity products will make retailer integration more practical and worth investigation. To the author's knowledge, there have been only three distributor-owned canneries for fruit and vegetables since World War II. Empirical observations suggest where inventory risk is significant and when it can be shifted, and competitive processors exist, it is usually not profitable to integrate. Even in the absence of a competitive processing sector, the presence of risk and the ability to shift it will often inhibit integration strategies.

5.12.2 Vertical Integration Traps

There are questions as to whether retailer integration is an appropriate long-run strategy. Modern retailers might easily fall into several "integration traps." Those discussed here have happened or are actually happening to integrated retailers and can actually cause integrated retailers irreparable harm.

The first integration trap might be called the "Capacity Utilization Trap." After appropriate economic analysis, the management decides to go ahead with the integration into a product line. Everything works fine as long as demand projections hold. If the retailer loses market share, sales will start to decline. As sales decline, the quantity produced at the plant goes down and as quantity declines the cost per unit produced increases. If the cost rises, the retailer must either reduce retail margins or increase retail prices to reflect increased costs. As was explained earlier, retailers tend to use constant add-on margins. Thus prices rise at the store. As prices rise, quantity demanded falls off further. Integrated product price again rises and the cycle continues.

The way to break this cycle is to reverse the decline in market share and sales or cross subsidize the integrated products with profits from other items. The integrated distributor has a difficult time selling excess production from its plants. First, other buyers of the product have formal or informal commitments to traditional suppliers. Other retailers in the market are not about to help their competitors out unless the deal is really good. Specialized manufacturers in the industry will fight hard to keep their accounts. Second, most potential accounts would view integrators' plants as unreliable sources of supply. As soon

as the plant production was needed in the retailer's stores, other accounts would be terminated. Thus integrated distributors who get into a declining capacity utilization trap will normally only be able to sell on the spot market and these prices will usually be low because retailers rarely integrate via acquisition. Rather, they build new plants customized to their product line and distribution needs. These new plants usually cause an overcapacity problem in the processing industry. The overcapacity burdens the market and its price for years.

The salvage value of the plant will normally be low. In addition, retail managers usually have to go out on a limb to get the stockholders to approve the money for integrated plants in the first place. Selling of the manufacturing plants is a public admission of an error in decision making. These two factors usually result in the firms hanging on to their plants. Thus the capacity utilization problem continues.

The second integration trap is called the "Transfer Price Trap." Many integraters will set up separate organizations to run their retail and manufacturing operations. The question then becomes "how much should the manufacturing arm charge the retail arm?" Depending on the reward and incentive structure, the two arms may be pulling against one another. Again an actual case example is used to illustrate this point.

A major retail chain built a canning factory to process canned fruits and vegetables for the chain's private label. The chain's buying department and manufacturing management met with top management to arrive at a transfer pricing solution. The management told the manufacturing people they could only charge the cost of production including the costs of cans, sugar, energy, raw product, and overhead expense. Of all the expenses only raw product prices were not fixed and/or predictable.

The manufacturing personnel suggested that the high price paid to growers for the canning product as reported to the USDA should be used to calculate raw product costs. All sides agreed and everyone went about their business.

The manufacturing personnel then became a cooperating firm for the USDA unit that published the figures. They would buy a small percentage of their raw product needs at a fairly high price and report that price to the USDA. They would then buy the rest of their needs, say 90 percent, at market prices or the lowest prices they could get. Recall the cost to the buyers is calculated using the USDA high price quote.

For years the manufacturing division was honored for outstanding service and efficiency at the company banquets. Meanwhile the private label buyers would be trying to explain why canned goods sales kept falling off. Eventually, the loss of canned goods sales helped precipitate financial woes for the retailers. With proper monitoring and better rule specification at the onset of the integration, the transfer price trap could have been avoided. As things go, however, these are not the types of concerns of top level executives.

A third kind of integration trap is the "Preferential Treatment Trap." This is a problem of structuring short-term incentives within the firm so that the long-run consequences are not actually detrimental to the firm. Again an actual case example illustrates this problem.

A firm has integrated into manufacturing several product lines. The firm management recognizes that integrated products are special; i.e., they are "double profit" items. If the integrated plants are well managed they should be able to produce products at a profit as do the non-integrated manufacturers. The retailer could elect to forego profits

at the manufacturing level and price the product at cost of production (plus overhead) and thereby have lower shelf prices. However, if the retailer's competitors are not integrated, the integrated competitor can charge prices similar to his competitor's and take profits on the manufacturing operations.

The firm has an incentive to give these items special attention in the distribution network. One firm may establish positions in each division for a person whose sole job it is to promote these items. This person is given a sales quota. These quotas are established by the firm's manufacturing units and higher management. Another firm may use less formal structures to show preferential treatment. Some firms allow the manufacturing arm to lobby the selling arm. No matter how it gets done, these private label products produced by integrated divisions get preference.

This preference is not harmful in and of itself, however, it can easily get out of hand. Because the firm makes double profits it eyes production in more and more products. If these products are all given special treatment, the proportion of shelf and ad space given to private label expands. Thus integration tends to lead to more and more private label share relative to brands by the retailer. If the space devoted to private label is fixed, the integrated firm will have a distorted array of private label products.

Trade sources believe there is a limit to the proportion of a retailer's sales which can be devoted to private label products. Private label is imitative business which relies on brand comparison to give meaning to the products. Overemphasis of private label works in the short-run because the products develop a consumer franchise with the

firm's current customers. However, you need brands to pull new customers into the stores. If too much energy goes into private label products, the firm loses its competitive edge over its less integrated competitors. Gradually, its market share could shrink. To get more customers back it would have to change policy. Changing private label policy would alienate the existing customers who have a preference for the private label product array. Likewise, if the firm limits private label share to remain competitive in market image with other retailers, then the private label product mix will be skewed toward manufactured items. This would mitigate against developing a good sound group of consumers who like the firm's products. Thus the dynamics of integration into manufacturing are a form of a corporate trap. What is profitable in the short run evolves into a long run consequence which is detrimental to the financial viability of the integrating firm.

The above examples, all real world cases, point out the extremely delicate balance needed by retail distributors considering integration into the manufacturing and processing of private label. These dangers, recognized by forward-thinking retail executives coupled with the exacting conditions needed for retailer entry into a given product line and capital needs for new store formats, scanning equipment, and energy saving technology, make further retail distributor integration into private label manufacturing less likely.

5.13 Procurement of Private Label Manufactured Products: Some Observations

Generally, manufactured private label items refer to nonfood grocery items which nearly all major private label organizations sell, the most common items including paper products, household cleaning products and

pet foods. However, the author includes noncommodity food items in this category, such as powdered drink mixes, hamburger extenders, pasta products, and dried beans. These items have a common bond with nonfood grocery items in that their manufacturing or processing function is continuous and not dependent on season or region of production. In other words, the order for a manufactured product can be processed at the time or just slightly before the buyer's order is received. There is no need for someone in the system to take an inventory position in the product for an entire production year.

Inherently less risk is involved in producing and marketing these products. There may also be less need for forward planning for other sectors selling to these private label manufacturers. The inputs needed for these products are either bought on contract or on large worldwide markets where futures markets or some other institution is available to the manufacturer to shift his procurement risk. This greatly reduced risk exposure results in some markedly different standard procurement procedures being used. When compared to the private label procurement procedures described above (Section 4.3), private label manufactured products procurement will usually have the following characteristics:

- Fewer supplying firms on buyers' lists
- No formal booking system
- Supplier-developed specifications
- Formal policies for supplier terminations, and
- Less volatile pricing

One of the ways buyers deal with risk and fluctuating prices is to cultivate more suppliers. If risk levels are lower for some products, one could hypothesize that buyers would carry fewer suppliers for those

manufactured products. However, this does in fact appear to be the case. For many of these products, the average regional chain private label buyer will most likely have two (sometimes three) suppliers for these products. Larger private label organizations will tend to have more suppliers because of the need to minimize transportation costs.

Some of these products also tend to be slower moving items. Thus the manufacturers usually are multiple product firms. Because of this, there is usually a smaller population of firms from which buyers can choose. This is also partially responsible for the observed fact that buyers have fewer suppliers. Although the author had few observations, these suppliers were all specialized private label firms. Most of these firms at one time had had a weak brand. However, being unable and/or unwilling to compete in the brand market, they settled into a pattern of supplying private label retail products and commercial institutional/industrial needs. Still other suppliers have evolved from being industrial suppliers and have been willing to take on private label accounts. Whenever a national brand manufacturer was observed supplying the private label market, it was in a product line in which it did not have a brand franchise.

Not only are there fewer suppliers of these products, but buyers do not use a booking system to assure themselves of product. Again, this reflects the paucity of risk in these product markets. The buyer places a label inventory in the manufacturer's plant and places orders as needed. The manufacturer will, if he has a long-term relationship with the buyer, know the buyer's approximate demand schedule for his products. His forward planning is on this historic knowledge. To the extent that there is communication about demand it will usually be in an annual

account review. For the most part, these are open-ended, noncontractual arrangements between the buyer and seller. The buyer or seller can terminate business at will. However, unless there is performance deterioration, these procurement relationships are usually of long duration.

The manufactured products also tend to have more supplier participation in the instigation of the private label line. Suppliers are largely responsible for developing the specifications for these products. Many of these products are complex. The detergents, for example, will have various chemical combinations coupled with dyes and perfumes. Few private label buying organizations have the in-house expertise to develop the item specs from scratch which places buyers at a disadvantage. If buyers exert too much price and service pressure, the manufacturer will start shaving quality. Many buyers do not have ready access to quality control departments equipped to monitor nonfood's quality performance. Only the very sophisticated private label buying organizations have the facilities to monitor all private label products' quality. Those that do use approximately the same sampling procedures used to monitor processed fruits and vegetables.

Buyers still maintain control over label designs and inventories; however, on some manufactured products labels may be manufactured by the supplier because for some products the labeling process is part of manufacturing. In addition since there are fewer suppliers, the buyers might allow the manufacturer to do the ordering and maintain the inventory of the supplier's labels. This difference in labeling procedures is critical in the decision on changing suppliers.

The one unwritten rule in the entire private label system observed by all but the most unprofessional buyers is, "If the product is in your

labels, it is yours." In other words, if a private label product has been packed in the buyer's labels, the buyer has a moral obligation to take that product as it has near zero salvage value for the manufacturer. Most products cannot be repacked economically since most canned products are stored in "brights" and only the very minimum of inventory is in the buyer's labels, label and inventory issues do not complicate decisions to change suppliers. However, manufactured products often must be packed in the label at time of manufacture. Also, the manufacturer must pack some of this product ahead of time in order to meet the buyer's orders in the shortest period possible. So at any given time, there is usually some inventory of manufactured products in buyer's labels. In order for buyers to change suppliers and fulfill their moral obligations, they would have to buy all those products. Buyers will nearly always take all of the packed product when they are changing suppliers.

But, what happens to the manufacturer's label inventory and expense? Again, the buyers have developed a standard operating procedure for dealing with this problem. When the buyer wants to change suppliers, it is standard practice for the new supplier to buy out the existing label inventory of the old supplier. Thus as a condition for obtaining the buyer's account a new supplier must cover the buyer's label expense with the discontinued manufacturer. The use of this standard practice reduces the buyer's transaction costs for changing private label manufacturers. While there is not the total flexibility as with processed fruits and vegetables, the buyer still finds it relatively painless to shift manufactured product suppliers.

Wholesale pricing of manufactured products tends to be much less volatile because of the steady nature of the manufacturing process.

Inputs are much less variable. Prices do not have to adjust to coordinate inventory levels between production years. The pricing pattern at the retail level tends to take on the character of brand product pricing. Prices are basically stable except for programmed specials on the products. For example, paper plates are always on sale for major summer holidays. The retail pricing activity, and as a result the wholesale pricing activity, takes on a nonurgent routine basis. The general lack of instability in prices probably reflects the lack of uncertainty and the lack of need to coordinate supply and demand on a short-term basis. The lack of price volatility also probably reflects the fact that there are relatively fewer suppliers jockeying for position with buyers.

In the final analysis, these characteristics are probably the most significant for explaining the significantly different procurement procedures observed in the manufactured products versus the commodity based items.

5.14 Procurement of Frozen Private Label Products

It was clear from the preliminary research investigations that the procurement of frozen food products differed from that of conventional grocery items. There are different buyers, warehouses, and suppliers for frozen food products. Because separate systems exist, it could be hypothesized that significantly different procurement procedures could evolve. The interview process did reveal some significant differences between the two types of products explored in some detail below. This material is directly applicable to frozen fruit and vegetable products. Other private label products in the frozen food case probably have procurement patterns more closely related to manufactured items discussed above.

5.14.1 Various Types of Frozen Private Label Product Procurement Organizations

One noticeable difference between canned and frozen private label procurement is how these products are bought. Canned goods are always bought through an in-house private label organization or from a separate private label buying organization. Private label frozen products are bought in several different ways.

The first is through in-house buyers. Closely related to in-house buyers are the buyers for private label buying organizations. These buyers operate similarly to in-house buyers and buy in the same markets. The author is most familiar with these types of buyers. The information generated below came from interviews with these buyers and suppliers of private label frozen products.

The second type of "buyers" are specialized frozen food brokers who represent suppliers. These brokers manage frozen food cases and will provide the retailer with stocking and service. These brokers will often be program buyers who have set carloads of mixed products sent routinely to accounts. In-house and buying organization buyers will use storage-in-transit warehouses to achieve the same effects of program buying. Brokerage-run operations free the retailer from having to oversee a very management intensive department.

Still other buyers will buy custom pack private label services. These operations are run by frozen vegetable and fruit processors who have a line of brand products to sell. The retailer will guarantee the processor freezer space in return for the processor's willingness to pack and ship the retailer's private label products. The first private label frozen vegetables were started under customer pack. Today two or

three major frozen processors specialize in this kind of frozen supply arrangement.

The one major consequence of the varied supplying arrangements in the frozen vegetable products is that it is more difficult and dangerous to generalize standard operating procedures. There are many more actors and consequently many more sets of reinforcement patterns evident in frozen food products than in canned goods.

5.14.2 Some Marketing Differences between Frozen and Canned Private Label Products

Another major difference between the canned and frozen market involves the definition of the market. Private label vegetables are much more important in frozen products. In canned products, anywhere from 30 to 50 percent of sales are private label. Most private label frozen vegetables have market share of around 60 percent. Thus when studying frozen vegetable procurement, the private label market predominates. This is not the case with frozen fruit products, however. Aside from a few berry products and orange juice, the sales of fruit in frozen form are small volume or nonexistent. Thus most of the ensuing discussion centers on frozen vegetables.

Canned products have similar crop and market year cycles and are embodied by similar marketing characteristics. Frozen vegetables vary significantly. For example, some frozen vegetables have processing periods 8 to 10 months long. This is especially true for vegetables produced in a warm climate (California) such as broccoli, cauliflower, and brussel sprouts. These are primarily fresh market products and their processing acts as a buffer or balancing mechanisms for the fresh market. Thus these products will be priced and coordinated entirely differently

than the peas, corn, and snapbean products produced in the Pacific Northwest (cold weather crops) which behave more like their canned counterparts. In addition, with the exception of asparagus, these crops are all annuals. As will be shown in Chapter 7, the annual crops have different coordinating approaches and consequences.

There are two other frozen products which are unique, frozen potatoes and concentrated orange juice and need to be studied separately. Frozen potatoes are the one vegetable in which the brand factor predominates in the market. Thus private label frozen potato pricing is dominated by the brands. Also, frozen potatoes are sold predominantly through institutional and industrial markets. Therefore, the coordination of potatoes in the retail store is secondary and subservient to what happens in the institutional markets. Since potatoes are unique, their coordination problems must be studied independently.

Orange juice is also unique because of its singular importance as the most rapid selling item in the frozen food case. Thus it is also the item most frequently promoted and put on "special." Orange juice also has a significant brand component and is watched over by a large sophisticated grower-marketing effort. Thus the pricing and coordinating behavior witnessed in orange juice is clearly atypical compared to other frozen commodity items. The coordination of the orange juice market is a study in and of itself. The marked variability in the basic economic forces underlying frozen vegetable products again raise questions about the propriety of making generalized statements about procurement and coordination.

5.14.3 Consequences of Quality Specifications for Frozen Products

The next major difference in frozen products is the nature of product demand. With a few exceptions, there is no retail consumer market for Grade B frozen products. Nearly all frozen vegetables sold through retail private label outlets is Grade A for several reasons. The first is the cost of retail freezer cabinet space which is the most expensive shelfspace in a retail store. Thus the opportunity cost in terms of excluded items is very high. There is no room for typically lower margin/lower quality merchandise. This is closely related to the second factor about frozen foods. They are more closely linked to the fresh market than canned products..

Consumers seem to consumer either frozen vegetables or canned vegetables. The cross-elasticity between the canned and frozen form is probably very low. Although there are no specific figures, interviews with processors of both canned and frozen products said that there is very little relationship between the consumption levels of individual products in canned and frozen forms. Many households have decided preferences on product forms. Some people will never eat canned peas but will also never eat frozen corn. Since frozen form is associated with the fresh form, the consumer is typically more quality conscious. Fresh vegetable consumers tend to be higher income, better educated, and have smaller families than canned vegetable eaters. These characteristics are also applicable to frozen food consumers in general. A consumer of frozen food generally has an inelastic price demand, but an elastic quality demand. Thus a Grade B product at a bargain price is not that attractive to these consumers.

The lack of market for anything other than Grade A products has a significant effect on vertical coordination. As was shown in Section 5.6, quality variation is an important "give" point in system coordination. If the final market does not have a tolerance for varying quality, arrangements must be made to assure that raw product supplies are of very high quality. One packer told the author that any crop with less than 80 percent Grade A was "real trouble." An interesting project would be to investigate the extent to which the grower contracts for canned and frozen product differ and how the system accounts for this need. One reason crops for freezing are grown in the Pacific Northwest may be that quality variation is not as great.

About the only market for Grade B product in private label retail packs is to mix it with Grade A product in the larger size polybags. The twenty and thirty ounce polybags seem to be able to absorb some Grade B product without much consumer awareness. If the same proportion of Grade B (say 10 percent) were mixed in a ten-ounce retail pack, the consumer, it has been observed, notices the addition. This may be a reflection of fact that more price-conscious consumers buy the larger sizes and may not be as sensitive to quality. In any event, the only quality coordinating mechanism evident in frozen vegetables is this blending technique. Again, different private label buyers have different tolerances for varying quality. And as with canned goods what is acceptable quality in a good year may not be the same in a poor quality year.

5.14.4 The Importance of the Institutional/Industrial Markets for Private Label Frozen Vegetables

Frozen and canned products have different "driving" or dominant markets. With canned goods, the retail market is the largest outlet for

product. With frozen vegetables, the dominant market is the industrial and institutional markets. The author tried to construct tables to demonstrate this difference. The problem is that the publically available data are not refined enough to make the table meaningful. A best estimate is that retail accounts for about 75 to 80 percent of the canned products and only 45 to 55 for frozen products' processed volume. Industrial markets are composed of those firms which buy the product as an ingredient for a final consumer product--an example being a frozen dinner or meat pie manufacturer. Institutional buyers are those who buy for large cafeteria and restaurant use. These two markets are characterized by two entirely different coordinating mechanisms than those evident in the retail market.

The industrial buyers buy on contract. Thus the processor knows his demand and at least has a pricing formula to calculate expected prices. Institutional buyers use both bookings and contracts. The significant difference between these markets and retail outlets is the concept of "portion control." The institution and industrial buyer can somewhat change the unit sold dependent on the price. If peas are expensive, for example, the frozen dinner manufacturer can use a quarter ounce less in each unit. If they use mixed vegetables, they can change the mix. And if prices are out of line they can change the menu.¹³ In other words, the industrial and institutional markets have the "candy bar" method of price change. Since retail packs are not as readily adjustable, changes in supplies must be compensated for in product price.

The pricing behavior of secondary markets follows the behavior in the primary market. Since the industrial and institutional markets for frozen are more stable than retail markets, the pricing behavior of the

retail market for frozen products is much less volatile. The processors of frozen products are used to having solid orders ahead of time and tend to "expect" this kind of behavior from retail buyers. Since these products are fairly minor compared to canned sales, the buyers seem to be less price oriented.¹⁴

5.14.5 Packaging Characteristics of Frozen Vegetables

A significant difference between canned and frozen vegetables is the flexibility in packaging in both product forms. Once a canned product is packed in retail and institutional size packs, it cannot be changed. Thus an inventory adjustment must come through the respective market. This is not necessarily the case for frozen products. Frozen commodities can be processed IQF (Individual Quick Frozen) in bulk. Each pea, bean, or kernel is individually frozen and then stored in large tote bins (totes). Whenever an order comes in, a tote is pulled from a warehouse and an order is packed. With IQF, frozen product can go to any market at any time. Thus, if there is a supply imbalance the processor has opportunities to reduce the inventory problem through three (industrial, institutional or retail) markets rather than one. The result is there is notably less pressure on retail prices. The frozen processor has less difficulty balancing inventory.

However, odd shaped products like spinach, broccoli, cauliflower and asparagus cannot be processed IQF. They are packed in ten-ounce cardboard packs known in the trade as "wet packs." In other words the product goes off the line wet (blanched) and is frozen in its wrapped container. The wet packs have less flexibility than canned products. Whereas cans are in brights until sale, wet packs have the buyer's label

on them and once frozen, bulge and frost. It is nearly impossible to label or relabel a wet pack item once it has been frozen. Thus frozen wet pack items take on the same label characteristics as described in the manufacturing products section above. The buyer is morally committed to take the product when it is in his labels. The only question is when he takes it. If the packer is not "on the market price" the buyer might let it sit over the market year. Frozen products are very expensive to store. After an extended storage period, the processor will find it impossible to recover all the costs. New crops will be cheaper. Thus the wet pack frozen supplier faces even more difficult bargaining situations than a canned packer. Fortunately, wet pack items have long processing seasons. Thus the processor does not have to take as long a forward inventory position. The volatility in frozen prices seems to concentrate in the wet pack items. These technological differences in processing are important determinants in explaining some of the observed stability in the frozen vegetable markets.

5.14.6 Merchandising Private Label Frozen Vegetables

Frozen products need to be treated differently by merchandisers which is another significant difference between canned and frozen products. The methods used to sell grocery items are not as readily available to the frozen food merchandiser. For example, the picturesque and end-aisle display does not work quite as well for frozen foods since they need to be refrigerated and much of the existing store equipment does not include frozen end-aisle capacity. Newer stores are starting to include frozen end-aisle equipment.

Since the regular case does not have the impulse power of end-aisle displays, retailers must implement several strategies to get the consumer to the sale product in the case. Banners must be hung above the item. The newspaper ad must feature the item to make the consumer aware of the sale. Finally, the consumer must be given an incentive (usually a coupon) to travel to the case to find the item. A frozen food promotion must be more coordinated and elaborate than a grocery promotion which means that fewer frozen food promotions can be run for the same money. In addition, frozen food manufacturers are some of the most prolific new-item introducers and product promoters. If there is a limit to how many frozen ads are to be run, brand products get the great share. Private label items are hard pressed to compete effectively for promotions.

One overlooked but very important fact about frozen foods is that home storage of frozen food specials is usually limited to the top section of a refrigerator. Consumers who have separate home freezers to save money on specials will use it for meat specials and home-prepared foods. These price-conscious consumers more often than not are canned goods buyers. Thus private label frozen food sales do not generate the massive quantity of movements that canned goods sales do. After all, cases of canned goods can be stored in more places. To get the same quantity of frozen product moved, more sales and promotions on a more or less continual basis are needed. Generally, frozen vegetables need less coordinating promotion than canned goods.

Probably the most appreciated difference between canned and frozen markets for the processors is the relative stability and profitability of frozen vegetables. Prices tend to be more stable for the reasons enumerated above. Profits tend to be higher because products are not

promoted as frequently. The retailer margins for frozen vegetables usually range between 28 to 30 percent. Of course frozen products are more expensive to handle and sell. Still the impression left by the trade is that frozen vegetables are more profitable than their canned counterparts. Retailers seem not to be concerned about adjusting private label frozen prices very much. This can lead to coordination problems in adjusting to changes in grower supplies.

The profitability of frozen vegetables to both retailers and processors probably results from several facts. First, there are relatively fewer freezer suppliers for retail than there are canners for retail products and many also tend to be geographically concentrated. Therefore they usually all experience similar growing conditions. The fact that there are relatively fewer firms (than in canning) producing similar products in close proximity and experiencing similar exogenous market factors might result in tacit collusion. Second, freezing plants tend to be newer and more advanced than canning facilities. The canned products market has a much greater variance in capital age and depreciation so that competing firms can have drastically different cost structures which can lead to price volatility. The variance in cost structures among freezers is not that great. The interviews indicated less pricing-below-cost behavior than with canners. Third, the management of freezing firms often comes from the frozen food departments of brand manufacturers. Managers "brought up" in the brand business tend to have brand marketing experience. They would therefore tend to avoid "price oriented" commodity strategies.

All of these factors combine to make frozen vegetable products more price stable and generally more profitable to the retailer and

manufacturer. As would be expected, the freezing industry is experiencing entry by new firms and expanded capacity. To date most of the new firm entry has been in the California frozen vegetable products. There has, however, been some expansion of plant capacity elsewhere. Whether this new capacity will precipitate price volatility and below-cost pricing evident in the canning industry is yet to be seen.

5.14.7 A Summary of the Differences between Canned and Frozen Private Label Products

In summary, the private label frozen vegetable and fruit sectors differ from the canned sectors in the following ways:

- Food store sales are not the dominant market for frozen vegetable sales

- There is basically only demand for top grade frozen products

- Private label frozen products are sold to retail store by a variety of methods

- Private label dominates the frozen vegetable retail sales

- There are technological factors which make packaging and labeling of frozen food significantly different from canned products

- Adjusting supplies of frozen foods via merchandising requires different techniques and retailer commitments

- Private label frozen products have more price stability and greater profits than canned

All of the above combine to make the vertical coordination process distinctively different for the frozen fruit and vegetable products. Frozen products are not as significant in terms of retail sales as are canned. The retail sector is not as cognizant of the market conditions of frozen vegetable products as they are of canned products. One manifestation of this is that private label prices do not fall in long crop years. Thus retail margins increase and the supply situation at the

processor level often does not get reflected to the consumer. This is the claim of the processing sector. The freezer processors have other options for their product however. Many of the same forces that affect coordination in the canned products operate in the frozen markets also. However, differences noted above tend to delude the coordinating forces so that they are not traceable through the system. Of the frozen vegetables, the cold crops (peas, beans, and sweet corn) seem to have the closest correlation to the coordination processes at work in the canned goods markets. These crops are all annuals and would coordinate the same as canned annual crops. Because of their relative importance, frozen vegetable adjustments are less dramatic.

The coordination process described below is written with canned goods as the base. The study of vertical coordination in the frozen fruit and vegetable markets is probably best handled in a study of the procurement practices of the industrial and institutional buyers.

5.15 Generic or "No Brand" Products

Recently "generic" or "no brand" label products have burst upon the food retailing scene, a concept which has created an inordinate amount of interest among trade participants and consumer activists. The Economics, Statistics, and Cooperative Service of USDA received a request from an Assistant Secretary of Agriculture for an assessment of the trend; Consumer's Report ran a special feature; and every consumer reporter in the country is reporting and pushing the trend. This section attempts to put the generic products development in perspective through an examination of the history, theory, and current adoption of the generic concept. The section concludes with an analysis of the trend and assessment of its future potential.

5.15.1 The History of Generic Food Products

Generic products are food and nonfood items which are packaged and labeled with their generic description rather than with a brand name (either manufacturer or retailer). For example, canned peas will be labeled Sweet Peas and toilet tissue, Toilet Tissue.

The generic, no brand, or plain wrap concept was first introduced in 1976 by a large French supermarket firm, Carrefour. It began by claiming its products were equal to brand name products. The limited line of products was an immediate success, because up to this time European consumers did not have any private label products. The European generic label was thus comparable to American first label private labels.

In 1977, Jewel Company launched its version of generic labels and was primarily a competitive response to the success of limited assortment stores (Aldi-Banner, a German firm) in Jewel's base markets. After a few month's delay, retailers all over the country started introducing generic lines. The first part of 1978 saw many firms either create generic lines or react to the trend.

To date, the generic movement has reached a significant number of firms and sales volume. However, the author, from monitoring the trade press, suspects these numbers do not exceed one-third of the firms or volume. Major chains such as Safeway and Krogers have decided against generic programs. The press attention given the generic trend and the heavy promotions given by adopting retailers tends to create the impression that generic programs are more widespread than they really are. The author expects generic activity to slow and perhaps even decline. The reasons for this will be explored below.

5.15.2 The Theory and Reality of Generic Merchandising

The theory of generics is that the product is brought out in a simple, plain package without extensive advertising and the savings from this strategy can be passed on to the consumer. However, the cost savings in current generic programs arises not from less expensive packaging and less advertising, but from other factors. While the analysis which follows was done by the author, it has been verified with conversations with, and documents supplied by, industry participants who are currently active in generic branding programs. Knowledgeable observers of the retail trade tend to have similar conclusions about the real nature and prospects for generic programs.

The early publicity of Jewel and the articles of the consumer reporters perpetuated the belief that cost savings to the consumer were the result of lower packaging costs. With the exception of a few products (crackers, boxed pet food, etc.) the package cost savings of generic products are insignificant. For example, a can of generic corn will have the same labor, energy, overhead, can, and transportation costs as the brand and private label products against which it competes. The cost difference between a plain black-and-white label and a color label is negligible. Where, then, do the cost savings originate?

The first and foremost cost savings comes from the lower quality of commodity or material used in the product. Commodity items are usually USDA Standard or low Extra Standard grade product. Processors often process these products only to make better utilization of their plants or because there are contract or grower requirements that they process all the product grown. Historically, these poor quality supplies could be purchased at bargain prices.

A comparable process takes place in the manufactured nonfood items. Specifications are written so that the product produced is relatively inexpensive. Toilet tissue will usually be single-ply, rougher grain, white, unscented, and packed in an unperforated plastic bag. As these products have distinctly different characteristics, the issues arise about the definition of quality. Consumer activists point out that the generic products are nutritionally comparable to brand and private label products and that generic programs provide the customer with a choice. The grade differences, they claim, reflect cosmetic differences in size, shape, and maturity and that these characteristics do not impinge on nutrition. This is true. However, a nutritionally complete product is worthless to a seller if the appearance of the product causes the potential consumer to forego its consumption.

The second major factor producing the lower costs for generic products is the willingness of distributors to take a lower gross margin on the overall line of the products. What evidence is available indicates that the average margin for generics is between 12 to 14 percent. This compares to the 17 to 20 percent normally charged for private label. Some of the lower margins are justified by low operating costs for generics. Generics are limited to only those items which are fast-moving and purchased by a high percentage of consumers on every shopping trip. None of the items are perishable. Thus they are capable of being handled by the most efficient distribution techniques. However, the low gross margin also represents the distributors' beliefs that a generic product line will move so fast as to break even and will draw new customers into their stores to buy other higher margin products. This, of course, is the concept of a loss leader and/or traffic builder item. Instead of

using one item, the program uses a whole line of products. Thus, in general, generic products are cheaper, but not because of packaging and advertising cost savings.

In many respects, consumers have had generic products for years. The marketing vice president of California Cannery and Growers (one of the largest private label suppliers) recently stated

Generics are simply the culls from the canners' attempts to pack to fancy and choice grades, and are a normal and natural result of the fruit and vegetable canning operations. There are numerous examples of private label programs which cover the entire grade spectrum. Therefore there always has been a market for Grade C or standard grade merchandise.¹⁵

Generic products for the most part are the same products which used to be available to the consumer through second and/or third labels. Recall that these labels were of varying quality and moved in and out of distribution in response to supply and cost conditions. This is precisely the way generic products are managed. The only difference now is that the consumer franchise attached to the product is for Firm X "No Brand" instead of Firm X "Third Label."

From the distributor's perspective, however, one thing has changed: the margins on these products. Normally, most second and third label programs are retailed at margin levels comparable to first label products. During promotions the margins on second and third labels will often drop as low as those used on generics. However, after promotions the margins return to the normal, higher levels. Thus the only significant difference between current generic programs and second-third label private label programs is the fact that generic margins are always low.

Generic labeling will also affect the labeling practice of packer brands used in the canned fruit and vegetable subsector, making them

diminish in importance. Packer labels are labels used by processors who pack mainly for private label to market odd lots of merchandise they have in inventory. Packer labels often are the labels which these processors had at one time used or are still trying to use to develop consumer franchises. With formal private label programs, processors sometimes had products that would not meet private label specifications or that exceeded their private label booking needs. In order to move this merchandise, processors would put their labels on the product and sell it to retailers on the spot market. Retailers would buy this product at a low price, put on a respectable margin, and promote and merchandise the product on an in-and-out basis. Of course, packer labels are very variable in quality.

The generic label trend may do away with packer labels for two reasons. First, generic products are those that used to be packed under packer labels. Second, the display space for generic items comes from the floating space used to sell packer labels. The result is that the generics will act to coordinate in a way similar to packer brands. The label will be a retailer generic not a processor brand. Thus any hope of private label processors developing a differentiated label to the consumers are severely lessened. Small processors will now find it nearly impossible to ever develop a brand through retail outlets.

The generic development provided some good evidence of the nature of the supplier-buyer selection process. Many retail managements decided for competitive reasons to launch generic programs in the middle of the marketing year. Buyers were given orders. The suppliers of generic grade products were soon allocated. Those retail organizations with good professional buyers who had developed sound supplier relationships were

able to establish generic programs. Buyers who did not have these relationships were in trouble. All the buyers were put under inordinate pressure. They could not succeed without the cooperation of the processors. Those buyers with good trade relationships were bailed out and thus still have their jobs.

The final point in the analysis of generics focuses on profitability. Two simultaneous forces work against the profitability of generic lines. The first was described above. Retailer margins on generics are too low for every firm to make a profit. The 12 percent margin was profitable for the first retail mover. As other firms entered the volume decline was such that no firm could make money at low margins. The second force is that supply prices, especially for commodity items, were bid up quickly. The whole growing and processing sector is reinforced for growing and packing the top quality products. The costs of production are similar for growing and packing Fancy and Standard products. The price for the products is significantly different and growers strive to produce the highest quality product. Should the generic trend reduce this price spread, processors and growers can probably, over time, generate larger supplies of standard grade. Whatever supplies of lower quality are available has often been a function of nature. These products were "given away" before the advent of generics. Thus the first firm investigating the feasibility of generics saw a very profitable business. These supplies were rapidly exhausted and prices of Standard merchandise rose to levels equal to Fancy prices. Some retailers had to resort to buying Extra Standard and Fancy products to meet the generic commitments they made through advertising. Some retailers were reported to be suffering out-of-pocket losses on every can of generic product sold.

The lower margin and higher product prices have significantly reduced the attractiveness of generic product lines. The price problem is not as severe with the manufactured items but the retailer margin problem still exists.

5.15.3 The Probable Future of Generic Foods

By way of summary, the following is the author's assessment about the concept and future of generic label programs. Generics will remain for the time being because the retail trade has backed itself into a corner. They promoted and created such a general following of generics, that they cannot readily back off without considerable corporate embarrassment and the possibility of alienating consumers. Many retailer firms have not committed themselves to generics for the long run, evident in their unwillingness to "cut" generics into the shelving pattern. Currently, generics are treated as special displays and departments. This allows the number and facings of items to be readily adjusted. After some time, the sales pattern on generics will settle down. Those firms who decide to continue the program will put the items into regular shelf and distribution patterns.

Certain products will be more likely to survive in generic form than others. Manufactured items lend themselves to generic labeling because they have more constant supplies, control quality levels with minimum variance, and are generally more profitable to the retailer. The number of generic items offered will probably settle down to around 100 to 150 items per store.

The generic programs concept flies in the face of historical evidence about what is needed for a successful labeling program no matter

what kind it is. Products must be consistent over time. The average quality may be lower, but it has to be consistently low. If quality varies between high and low, consumers will resent returning to lower quality after having high quality at the same price the previous period. Retailers are beginning to recognize this element is necessary for generics. The trade reports that buyers are already becoming more selective in what quality variance they will permit for their generic lines.¹⁶

Retailers also quickly realized that "No Brands" take just as much or more retail ad promotion, and merchandising support, as any private label. Yet they feel they are not "developing" anything for that investment. That is why most generic labels, although plain, are distinctly different enough so that consumers will recognize "their" generic products. Also, some of the largest retail distributors (both chains and wholesalers) have either not introduced generic lines or have responded by stressing their second labels. Other firms have revamped their second and third labels across divisions to have one brand name to respond to generics. These firms have one thing in common: their response to the generic brands is a similar strategy but with a differentiated label.¹⁷

The general level of generic quality and the variance in quality will probably result in many consumers shifting back to the higher margin private and brand label products which they abandoned to try generic labels. Confidential information provided to the author indicates that generic product sales drew customers from national brands and retailer private label brands about equally. Also, the first wave of customers to buy generics were the relatively affluent, college-educated consumers.

This group is most influenced by consumer product reporting. They are also some of the most sensitive to quality variation. Informed industry observers believe two things will happen to generic labeling. First, sales will settle down to about 10 to 15 percent of grocery sales. Sales will be to buyers who are particularly price conscious by choice or necessity. Second, the market for generics will be primarily through warehouse or box stores. These limited assortment stores appeal to the price sensitive buyer. A marriage between generics and limited assortment box stores would seem likely.¹⁸

5.16 Distributor Label Procurement in Perspective

Distributor or private labels are food retailers' attempts to provide another product choice to consumers. Private labels are differentiated consumer products. What makes them unique is that retailers and distributors add the marketing services which create the differentiation. Because of this added responsibility, procurement SOPs for distributor labels have become highly specialized and elaborate over time and has resulted in a procurement system which is basically separate and distinct from brand product procurement. It is normally at the retail merchandising function that brand and private label products merge (See Chapter 6).

Private label buyers are different from brand buyers because of the additional areas of expertise they need to evolve: develop labels, specify product characteristics, order product, coordinate transportation, and bargain for price results in specialized private label buyer career paths. They thus become familiar with both suppliers and their product's market conditions.

Pervading the private label procurement system is the interpersonal relationships between buyers and sellers. Since there are many product characteristics and distribution factors involved in private label procurement, frequent contact between buyers and sellers is necessary for longer term effective market coordination.

Food distributors can obtain private label in three basic ways:

1) They can establish their own private label program with sole ownership and responsibility for the operation; 2) They can be part of a cooperative program where they have part ownership but shared commitment and responsibility; or 3) They can choose a controlled label program where they have no ownership and very little commitment and responsibility. The varying levels of commitment to private label programs results in multiple types of labels, quality control programs, and product booking and transportation tactics.

The interrelationships between the various types of buying practices and behavior are best understood within the context of overall private label philosophies. In the franchise development philosophy, distributors attempt to maintain consistency within the label strategies and business practices they adapt. The ultimate goal is to create a consumer franchise for their products. In a competitive response philosophy, private label programs are used to respond to market conditions. The effect of this tends to reduce the overall consistency within private label programs.

For the most part, the supply network for distributor fruit and vegetable products is independent of the brand product supply system. Generally, buyers have greater bargaining strength than the competitive small and medium size suppliers of private label products. In commodity

products, this bargaining strength often results in system risk and uncertainty being shifted from the retail sector to the processing sector.

Should suppliers develop countervailing power, retailers always have the option of vertically integrating back into processing. This option is, however, affected by commodity risk factors and can often lead to longer term difficulties for the retail firm.

The interviews revealed that private label manufactured items and frozen fruit and vegetables had some special characteristics which result in unique procurement SOPs. These characteristics affect the number of private label suppliers needed, the price volatility of the items, and the need for retailer provided marketing inputs.

The brief examination of generic or "no brand" private label programs presented served as a useful review of the dynamics and breadth of private label procurement arrangements. In the final analysis, however, generic products are a reformulation of existing principles of private label products.

APPENDIX EXHIBIT 5.1--ACTURAL PRODUCT SPECIFICATIONS FOR FIRST
LEVEL CLING PEACHES29 oz. UPC
16 oz. UPCSPECIFICATIONS FOR ChainX YELLOW CLING PEACH HALVES

Manufacturer guarantees to ChainX that ChainX Yellow Cling Peach Halves shall be packed in accordance with good commercial practices and shall conform with the specifications set forth herein and shall comply with all provisions of the Food, Drug, and Cosmetic Act and all regulations promulgated thereunder, particularly those regulations governing nutritional labeling, artificial flavoring, imitation foods, dietary foods, and the food label information panel, as applicable. Chain X Yellow Cling Peach Halves shall be produced from top-quality ingredients only, which ingredients shall be clean and free from contamination or infestation of any type. All ingredients used must be free from Salmonella and any other pathogenic organisms.

Net Weight: The average net weight of any lot of production must at least be equal to the stated net weight. Weight control must be maintained to assure compliance with National Bureau Standards Handbook 67 regarding prepackaged commodities.

Grade: Chain X Yellow Cling Peach Halves shall grade U.S. Grade B when scored according to the U.S. Standards for Grades of Canned Clingstone Peaches and in addition shall conform to the following requirements.

Drained Weight: The minimum drained weight of any 16 ounce size container shall be not less than 9.3 ounces, while the average drained weight of any lot must be equal to the recommended U.S.D.A. weight of 10.2 ounces. The minimum drained weight of any 29 ounce size container shall be not less than 16.6 ounces, while the average drained weight of any lot must be equal to the recommended U.S.D.A. weight of 18.0 ounces.

Count: The count range for the 16 ounce size shall be 5 to 10 units per container with 7 to 9 the preferred count. The count range for the 29 ounce size shall be 7 to 12 units per container with 8 to 11 the preferred count.

Syrup: Chain X Yellow Cling Peach Halves shall be packed in a heavy syrup.

Flavor: The peaches must possess a normal flavor and odor.

Package Code: Each package shall be legibly and indelibly coded to designate a) production date; b) batch, or production time interval (this should be based on the quantity determined by a review based on Good Food Manufacturing Practices and Hazard Analysis Critical Control Points for the specific product); c) production plant; d) filling line if appropriate; e) product identity if needed for your internal use prior to labeling; f) and any additional information required by current regulations.

APPENDIX EXHIBIT 5.1--(cont'd)

Chain X Yellow Cling Peach Halves

In order to accommodate your coding equipment, we will not specify the nature of the code. We prefer the use of the Julian system, i.e., first three digits for day of year and fourth digit for last digit of year, June 20, 1977 = 1717, plus other appropriate symbols to meet the above package code requirements. Chain X must be kept informed of your current system at all times.

Case Code: The exterior of shipping case or outer wrapping shall have the same legible code information and UPC numbers as the retail package plus any other appropriate identification as required by ChainX procurement.

Record Keeping: In addition to quality control reports requested below, it is essential that the processor maintain production and "in-process" quality control reports that when coupled with the finished product quality assurance reports will facilitate specific product identification for any necessary follow-up. The reports should document identification of raw material, ingredients, separate component parts, packaging materials, and their related quality inspection or analysis reports, process records, weight or fill records and other specific quality evaluations (sensory as well as analytical) for the finished product.

Nutritional analysis data, in addition to appropriate quality control records, to document compliance with regulations on nutritional labeling are required.

The records must be kept on file for sufficient time to allow for the normal expected life of the product as it moves through the distribution and sales system and be made available for ChainX personnel as requested.

Shipping Records: Bills of Lading and invoices will show all codes included on shipment.

Quality Assurance: Quality Assurance certificates or quality grade sheets shall be sent to

for each day's production of ChainX private labeled product. These reports shall include: code, color, net weight, defects and texture.

Supersedes spec dated:

May 14, 1976

Reason for change:

General Update

Originator:

Approval

APPENDIX EXHIBIT 5.2--ACTUAL PRODUCT SPECIFICATIONS FOR SECOND
LABEL CLING PEACHES

29 oz. UPC

SPECIFICATIONS FOR No.2 YELLOW CLING PEACH HALVES

Manufacturer guarantees to ChainX that No.2 Yellow Cling Peach Halves shall be packed in accordance with good commercial practices and shall conform with the specifications set forth herein and shall comply with all provisions of the Food, Drug, and Cosmetic Act and all regulations promulgated thereunder, particularly those regulations governing nutritional labeling, artificial flavoring, imitation foods, dietary foods, and the food label information panel, as applicable. No. 2 Yellow Cling Peach Halves shall be produced from top-quality ingredients only, which ingredients shall be clean and free from contamination or infestation of any type. All ingredients used must be free from Salmonella and any other pathogenic organisms.

Net Weight: The average net weight of any lot of production must at least be equal to the stated net weight. Weight control must be maintained to assure compliance with National Bureau Standards Handbook 67 regarding prepackaged commodities.

Grade: No. 2 Yellow Cling Peach Halves shall grade U.S. Grade "C" when scored according to the U.S. Standard for Grades of Canned Clingstone Peaches and in addition shall conform to the following requirements.

Drained Weight: The minimum drained weight of any 29 ounce size container shall be 17 ounces while the average drained weight of any lot must be equal to the U.S.D.A. weight of the 18.4 ounces.

Count: The count range for the 29 oz. size shall be 6 to 15.

Syrup: No. 2 Yellow Cling Peach Halves shall be packed in a light syrup.

Flavor: The peaches must possess a normal flavor and odor.

Package Code: Each package shall be legibly and indelibly coded to designate a) production date; b) batch, or production time interval (this should be based on the quantity determined by a review based on Good Food Manufacturing Practices and Hazard Analysis Critical Control Points for the specific product); c) production plant; d) filling line if appropriate; e) product identity if needed for your internal use prior to labeling; f) and any additional information required by current regulations.

APPENDIX EXHIBIT 5.2--(cont'd)

No. 2 Yellow Cling Peach Halves

In order to accommodate your coding equipment, we will not specify the nature of the code. We prefer the use of the Julian system, i.e., first three digits for day of year and fourth digit for last digit of year, June 20, 1977 = 1717, plus other appropriate symbols to meet the above package code requirements. ChainX must be kept informed of your current system at all times.

Case Code: The exterior of shipping case or outer wrapping shall have the same legible code information and UPC numbers as the retail package plus any other appropriate identification as required by ChainX procurement.

Record Keeping: In addition to quality control reports requested below, it is essential that the processor maintain production and "in-process" quality control reports that when coupled with the finished product quality assurance reports will facilitate specific product identification for any necessary follow-up. The reports should document identification of raw material, ingredients, separate component parts, packaging materials, and their related quality inspection or analysis reports, process records, weight or fill records and other specific quality evaluations (sensory as well as analytical) for the finished product.

Nutritional analysis data, in addition to appropriate quality control records, to document compliance with regulations on nutritional labeling are required.

The records must be kept on file for sufficient time to allow for the normal expected life of the product as it moves through the distribution and sales system and be made available for Kroger personnel as requested.

Shipping Records: Bills of Lading and invoices will show all codes included on shipment.

Quality Assurance: Quality Assurance certificates or quality grade sheets shall be sent to

for each day's production of Kroger private labeled product. These reports shall include: code, color, net weight, defects, texture.

Supersedes spec dated:

June 3, 1976

Reason for change:

General UPdate

Originator:

Approval: _____

CHAPTER 5

FOOTNOTES

¹Much of the following brief explanation comes primarily from reading trade source materials.

²For a more complete discussion see "Brand Power Study," Progressive Grocer, October 1976, pp. 47-51.

³Confidential interview with Director of Private Label Programs for a Midwest chain.

⁴Confidential interview with Head Buyer and Director of Private Label Procurement Program.

⁵Confidential interview with a Midwestern private label buyer.

⁶An executive of a Midwestern based private label buying organization.

⁷Inventory costs here refer to not only out-of-pocket costs but opportunity costs as well.

⁸A good example here is the private label pineapple market.

⁹Confidential interview with a Midwestern private label buyer.

¹⁰Confidential interview with a Midwestern based marketing director of a large private label processor.

¹¹The United States Antitrust laws as viewed by the retail and processing trade preclude anything other than the most casual friendships.

¹²National Commission on Food Marketing, Organization and Competition in Food Retailing, Technical Study No. 7, (Washington, D.C.: Government Printing Office, June 1966) pp. 75-95.

¹³This is akin to retailers changing facings on a supply basis. Retailers normally do not change shelf facings. Rather they use off-shelf methods.

¹⁴The frequency of price changes is easily documented by following commodity prices (both canned and frozen) for one year in The Report on Food Markets. The problem is that these data do not present movement data at the same time. Thus, even if prices change infrequently, the majority of the sales could be made at price points.

¹⁵"Private Labels 'Holding Their Own Despite Generics'", Supermarket News, August 20, 1979, p. 31.

¹⁶"Packers See Shortage of Generics' Supplies," Supermarket News, October 2, 1978, p. 4.

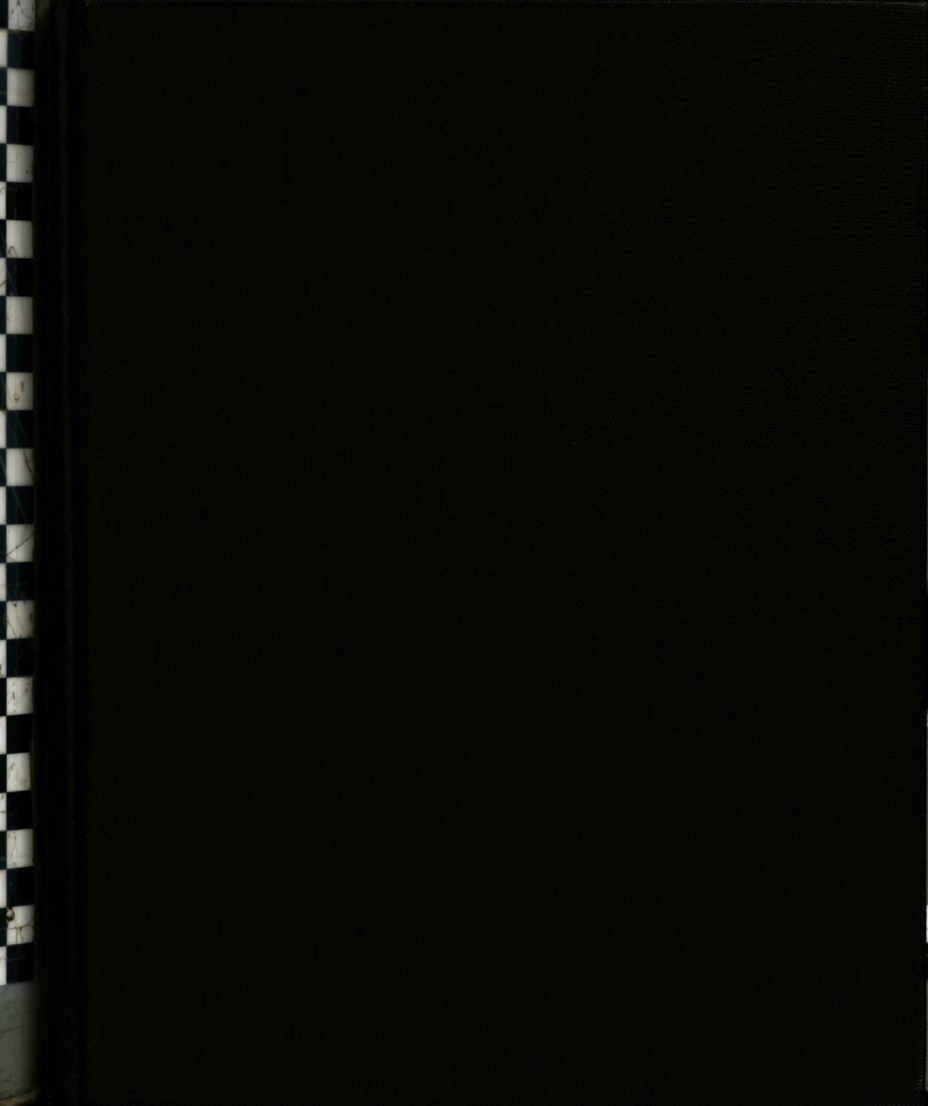
¹⁷Examples include Safeway's Scotch Bay, IGA's Much-More Brand, and Kroger's emphasis on Avondale.

¹⁸These basic conclusions are beginning to be realized. See, "Effects of Generics Held Not Extensive," Supermarket News, April 2, 1979, p. 2.

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FOOD DISTRIBUTOR PROCUREMENT PRACTICES: THEIR
IMPLICATIONS FOR FOOD SYSTEM STRUCTURE AND COORDINATION

VOLUME II

By

Larry G. Hamm

A DISSERTATION

Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of

DOCTOR OF PHILOSOPHY

Department of Agricultural Economics

1981

9/15/94

CHAPTER 6

FOOD RETAILER MERCHANDISING AND BRAND PRODUCT MARKETING STANDARD OPERATING PROCEDURES

6.1 A Few Missing Links and Definitions

The two preceding chapters explain how grocery products are procured and distributed. The procedures enumerated thus far are responsible for getting the individual items to the grocery stores. Where the items are placed on the shelf and/or within the store and the level and type of advertising support given to the products are instrumental to system coordination. Grocery buyers are the supply agents for food distributors. They often have little control over the merchandising of the products they buy. Yet coordination involves the meshing of demand with supply. This chapter addresses the methods used to affect consumer demand for individual food products.

Many of the basic factors involved in the merchandising and marketing process have been identified in earlier chapters. This chapter provides a theoretical framework into which these factors can be classified and their relationships discussed. Evidence about the effectiveness of merchandising techniques is presented. Special attention is given to the logic of how retail merchandisers decide which products, especially brand versus private label, to feature.

Part of the retailer merchandising decision process flows directly from the brand manufacturers' marketing activities. Because the retail

distributors must manage all aspects of private label product development, Chapter 5 included discussions about retailer planning and how the private label system adjusts to variable product quality in commodity items. Brand commodity based items also vary in quality and manufacturers must make marketing and production plans. How these functions are performed by the brand segment of the market are covered here. They are addressed here rather than in Chapter 4 because they are more closely related to marketing strategies of manufacturers than to procurement procedures of retailers.

The two terms, merchandising and marketing, might appear confusing. In this report, they address different phenomena. Food retailers compete against one another by trying to create different store images. They try to differentiate their firms by embodying certain characteristics in their stores (low prices, product variety, convenience, cleanliness, pleasant surroundings, etc.) to which consumers respond. Retail merchandising is the process by which the images of price, quality, and variety are created in an attempt to generate the profit goals of the retail firm. Merchandising as discussed here is retailer manipulation of the prices, selections, and advertising of many individual products in order to create a competitive consumer image.

Marketing is used here to mean the process by which a manufacturer attempts to sell his product(s) at the expense of competing products to consumers. Marketing today has come to include activities such as market segmentation, image making advertising, and pricing strategies. The basic distinction is that marketing refers to a manufacturer's attempt to sell his product(s) to consumers. The ultimate goal is to best his rival

manufacturer. To be a successful marketer requires an understanding of an ability to affect retailer merchandising.

During the interviews, attempts to follow the coordination flow of individual commodities invariably led to discussion about the role of retail merchandisers and brand marketers. In order to have a total picture of vertical coordination, the questioning in some of the latter interviews was shifted to merchandising questions. Also some of the trade literature was re-examined for examples and evidence about retailer merchandising.

The merchandising and marketing SOPs identified below are not as detailed as the procurement SOPs described above. This is because the importance of merchandising strategies are difficult to uncover. To the extent that there are competitive secrets in food retailing, they involve the formulation, execution, and detail of merchandising actions of retail distributors. Retail merchandisers are the mystery people of retail organizations. No merchandisers were interviewed because it was not possible to gain access to them. The material presented below comes from 1) interviews with several buyer-merchandisers; 2) merchandising information supplied by buyer-interviewers; and 3) trade literature.

6.2 Demand for Individual Food Items and the Role of Merchandising

When asked, nearly all suppliers and many buyers agreed that retail price reductions on individual fruit and vegetable products do not result in significant increases in product sales in the short run. Therefore relying on price reductions or increases at the wholesale and retail levels to obtain subsector coordination is essentially futile. These statements seemed at first to be too radical and were dismissed by the

author as being statements made by people who recently had a bad marketing experience. These statements, however, were made consistently by the trade people interviewed.

Industry personnel explained the process like this: The average supermarket shopping trip takes thirty minutes. Seven of those minutes are spent in the checkout line. Therefore consumers have twenty-three minutes of shopping during which they are confronted by 8-12,000 individual items. No human mind is capable of consciously recognizing all these items, let alone remembering individual prices from the last shopping trip. Thus the price of an individual item may change during a week and the vast majority of shoppers will not realize the price has changed.

Most shoppers develop routine shopping patterns. They travel down the same aisle in the same direction every time they go shopping. In fact, familiarity with one store's layout is a strong deterrent to changing stores. Many consumers will tolerate some poor performance in their customary store rather than shop in a store "where I don't know where everything is." In addition, for many consumers, their meal menus are semi-fixed. They reach for products as they go down an aisle week after week. Only occasionally do they consciously make price the deciding factor on the majority of the food items they pick.

6.2.1 Theory of Consumer Demand for Individual Food Items

Contemporary shopping behavior described above does have a basis in economic theory.¹ Figure 6.1 presents a hypothetical demand curve of an individual consumer for a relatively low cost, nondurable grocery product. Within a critical range, the individual demand curve is perfectly inelastic. That is, as prices change (either from P_1 to P_2 or P_2 to P_1)

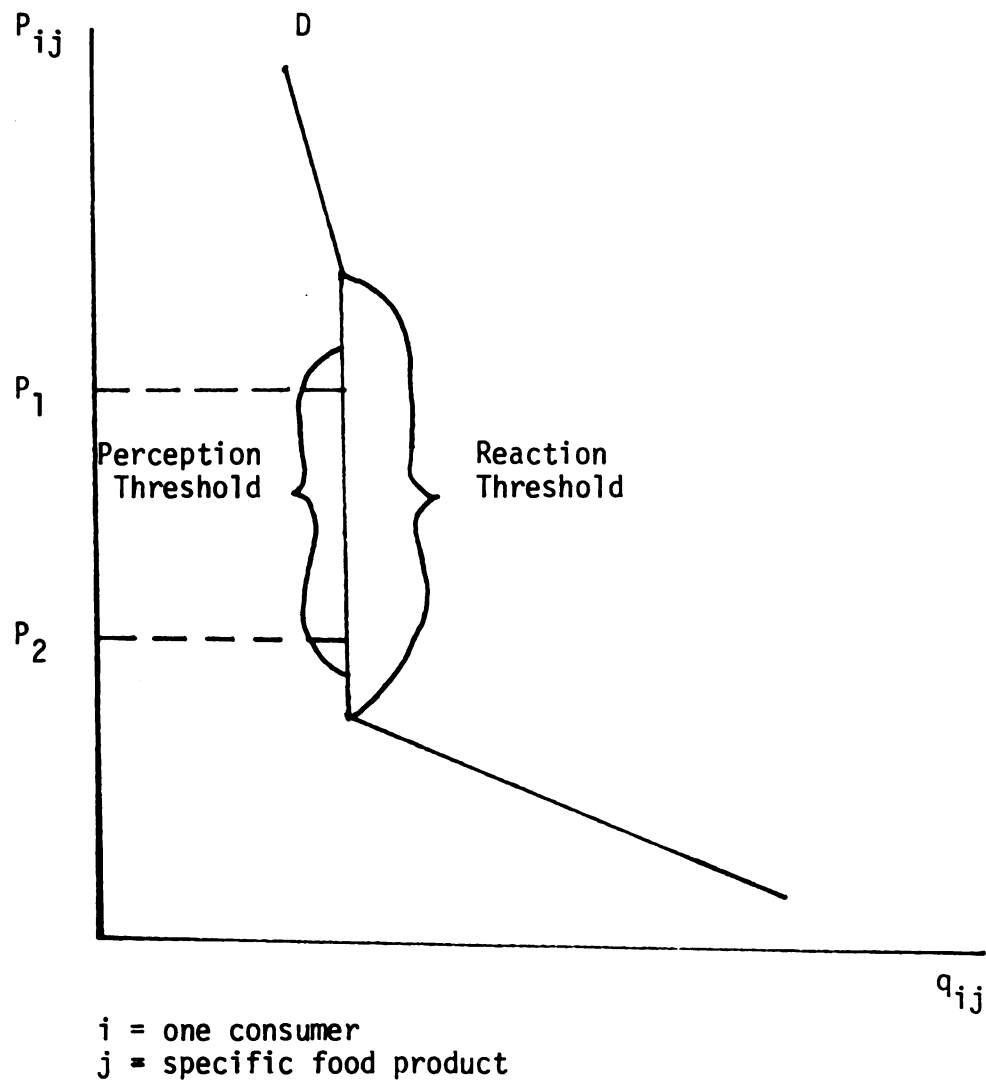


FIGURE 6.1--Hypothetical Individual Demand Curve for Low Cost, Nondurable Food Products

there is no corresponding increase or decrease in product movement. This inelastic portion of the demand curve is composed of two different behavioral components. First, prices may change and consumers do not perceive that there is a change. The perception threshold identifies at which point the consumer finally recognized there is a price change. The perception portion of the inelastic segment arises because the capacity of human consciousness is limited.

Even when consumers do realize that prices have changed, they still may not change consumption. In other words, after the perception threshold has been reached, there might still be a reaction lag. This failure to react is essentially a transaction cost argument. Even if the price has changed, the relative size of that change may not be large enough to induce the consumer to go through a search procedure (i.e., the utility maximization process) to find an alternative product. The inducement to enter a search process is the size of the expected gain. Thus the reaction threshold will be relatively low for higher value, and/or durable products. But for small purchases (under one dollar), and non-durable products, the potential gain (savings) from search for another item is relatively small. Therefore even though the consumer may recognize a price change the same purchase may still be made.

The size of the inelastic segment will of course vary by product and consumer. The implications for market demand schedules are ambiguous and it is impossible to say a priori what shape demand curves take. If the product sells for nearly the same price in all markets, probably most consumers would have similar perception and reaction thresholds. It would therefore be reasonable to assume that the market demand schedule around these thresholds would be very inelastic. The demand schedules in

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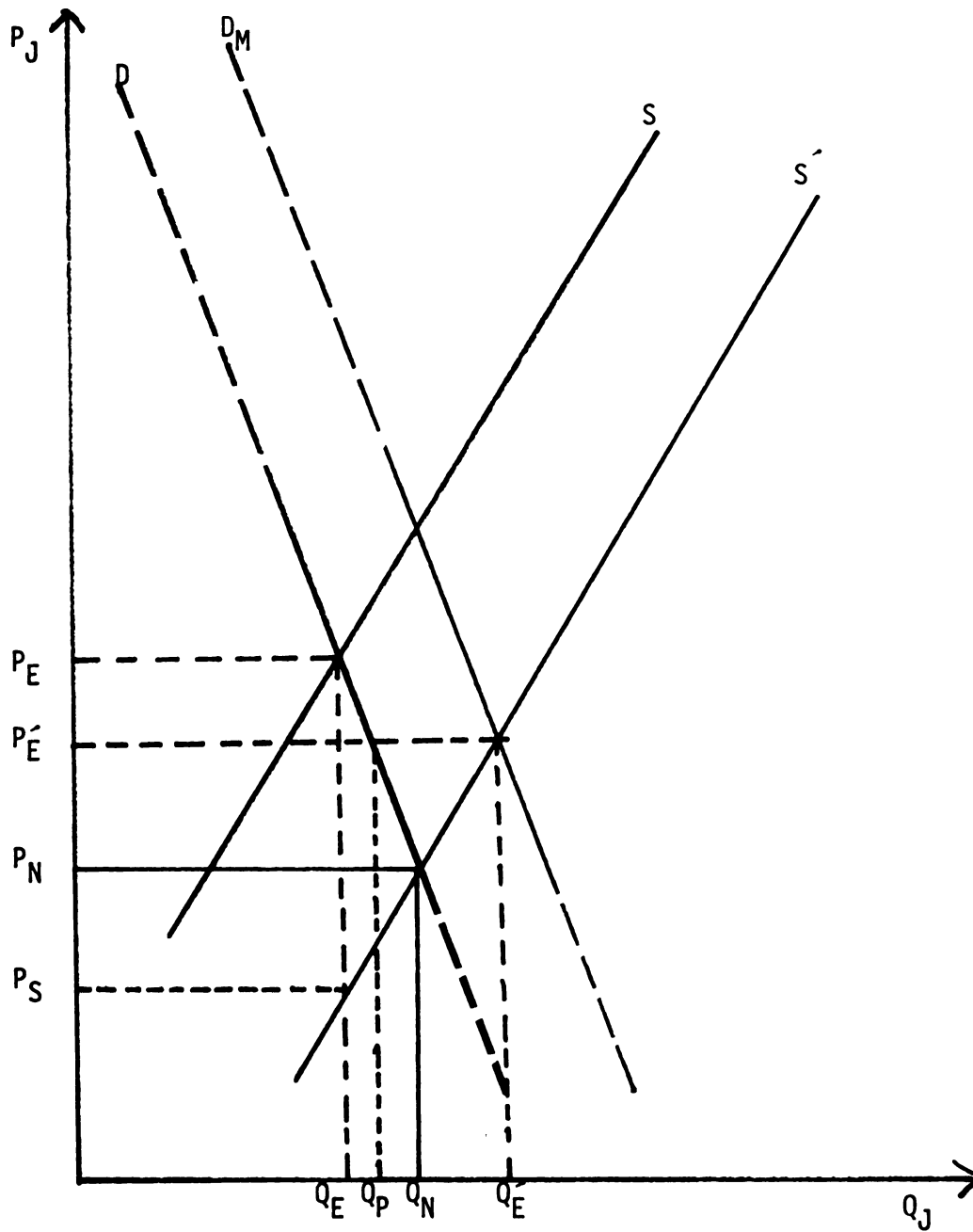
Figures 6.2 and 6.3 are drawn with this assumption.

The theoretical implications for vertical coordination are very clear. It would be economically irrational for a retailer to reflect a wholesale price decrease on the shelf price to the consumer. If demand in the relevant range is nearly perfectly inelastic, all that would accomplish would be to reduce total sales and profit. Likewise, price increases would be passed on immediately. If the demand situation depicted in Figure 6.1 is representative of most consumer grocery products, the often observed and criticized retailer behavior of passing price increases forward while refraining from forwarding price decreases is theoretically rational for the retailer. This phenomenon combined with the similar bias caused by computerized data handling systems and informational lags by retail personnel makes coordination of the subsectors solely with price changes very difficult.

6.2.2 The Role of Merchandising

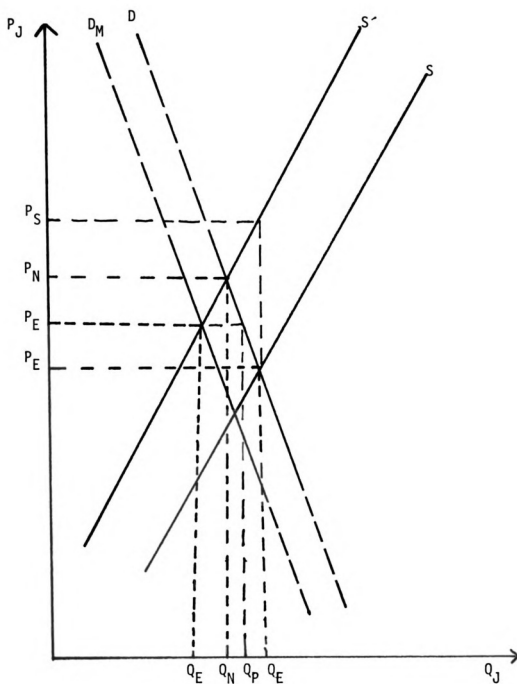
Referring back to Figure 6.1, one way to make the system more responsive to price changes is to reduce the size of the perfectly inelastic section. Merchandising does just that. Merchandising techniques and/or SOPs are designed to eliminate the perception and reaction gaps. Advertising, displays, and signs can call attention to a product thus eliminating or greatly reducing perception thresholds. Various other methods induce impulse shopping. When merchandisers entice a consumer to buy on impulse, they have eliminated perception and reaction thresholds.

For example, a major canned vegetable product may be selling for \$5.75 a case of 24 No. 303s. Suppose the wholesale price (price from seller to retail buyer) falls \$.75 to \$5.00. This is a significant price



J = Specific Food Product

FIGURE 6.2--Price and Product Movement Implications of Retail Merchandising for Wholesale Product Market with a Supply Increase



J = Specific Food Product

FIGURE 6.3--Price and Product Movement Implications of Retail Merchandising for Wholesale Product Market with a Supply Decrease

decrease given the basic price level of the commodity. This decrease, however, amounts to only \$.03 a can for the consumer price (assuming the same gross margin). Nearly all executives interviewed said that a small price change like this would not significantly increase product movement. In other words, a few cents change in the price per can falls within the perception and reaction thresholds. The important fact is that processors can have substantial (10 to 20 percent) price changes without the consumers' demand adjusting.

Retailer merchandising activities will increase quantities purchased in two ways. First, if they remove or reduce perception thresholds, consumers will respond by moving along the market demand. In other words they will respond in the conventionally observed manner. Second, merchandising techniques may also increase (decrease) the demand schedule for individual commodities. This increase (decrease) in demand arises from sales to current nonbuying consumers. This latter effect is usually caused by 1) a shift away from similar or supplementary items and 2) sheer impulse reactions of consumers. There is some question as to whether impulse sales increase product consumption or just increase household inventories which replace future sales. A complete discussion of this is deferred until Section 6.5.3 below.

Figure 6.2 illustrates this by use of conventional supply and demand diagrams. Assume that D , DM , S , and S' are annual market schedules for a single food item at the wholesale level. D and DM are drawn with dotted lines to reflect the previously discussed fact that there is no a priori way of knowing what the shapes of the market demand schedules are beyond some small price range. However, this formulation does not inherently violate conventional economic wisdom about the continuity and slope

of demand schedules. S and S' as depicted in Figure 6.2 are not perfectly inelastic as might be expected. The reasons for this are explained in Section 6.5.4 below. It is possible to show the relationship between wholesale and retail prices on one diagram by using separate supply and demand schedules for the retail market and the wholesale market. Dual or triple market diagrams are extremely cluttered and difficult to follow. This discussion assumes that there is a fixed, constant relationship between wholesale and retail supply and demand schedules. Consequently, annual price and quantity movements in the two markets will parallel one another. Thus following the impact in one market is sufficient.

In a typical year, supply and demand are represented by D and S . Market equilibrium is at P_E and Q_E . Suppose crop conditions are good and supply shifts to S' . Without merchandising actions by retailers and/or brand marketers, the following sequence of events would theoretically take place. Retailers would in the short run (several weeks perhaps) maintain retail price as if wholesale price was still P_E . Consumers would not increase consumption in the face of larger wholesale supplies. Thus there is considerable pressure built up on the market. In competitive commodity based products such as canned fruits and vegetables, suppliers start cutting prices in an attempt to sell their inventories. Wholesale prices could fall as low as P_S as suppliers try to increase sales. Over the marketing year (the assumed time period of Figure 6.2), the eventual market solution without merchandising will be P_N , Q_N . As wholesale prices approach P_S , some retail prices will fall (perhaps not by the full amount of the wholesale drop) and thus there is a slight increase in wholesale movement.

Suppose retailers are somehow induced to activate their merchandising powers for this product. In doing so, market demand is shifted to DM. The market equilibrium for the merchandised product is P'_E , Q'_E . Notice that merchandising has the impact of raising market price and increasing market sales. In the absence of merchandising, suppliers would receive lower prices and sell fewer units. In fact, the quantity $Q'_E - Q_N$ is a surplus inventory which must be carried forward into the next production-marketing year. Since this is a one-year market assumption, the supply schedules would include that portion of the individual suppliers marginal cost curves between the minimum points on their average variable and average total cost curves. Even without a heterogeneous supplying firm assumption, it is theoretically possible that at the nonmerchandising solution P_N , Q_N , a substantial number of suppliers could be selling at a short-run loss. Thus without merchandising activity by retailers, competitive bidding by commodity suppliers in long crop years may result in market sales below cost. This may be the reason that nearly all suppliers interviewed insisted that retailer merchandising was the key to market coordination.

Figure 6.2 also illustrates the two components of the merchandising sales effect. As a result of merchandising activities, sales of the product increased $Q'_E - Q_E$ amount. By observing where P'_E intersects D (the premerchandising demand) it is possible to decompose $Q'_E - Q_E$ into segments $Q_P - Q_E$ and $Q'_E - Q_P$. The former segment indicates the proportion of the sales increase resulting from the consumers being made aware of the price decrease. This is the price effect. The merchandising effect increase, $Q'_E - Q_P$, results from new consumers buying this item.

The relative proportions of increased sales accruing to the price and merchandising effects depends on the relative elasticities of the products' demand and supply schedules. Generally speaking the more inelastic the demand of an individual product, the greater the merchandising effect. This is because products with highly inelastic demand schedules are purchased by consumers who buy out of necessity or have very strong preferences for the product. Only by inducing new consumers to purchase the product can sales be increased substantially. Table salt is an example of a highly demand inelastic product, but since nearly every consumer purchases this product routinely, there is no payoff to merchandising. Thus the characteristics of individual food products determine which merchandising tool or mix of tools is more effective in improving the product's movement through the stores. The ability to match merchandising tools to individual products is what determines the success of brand marketing executives and retail merchandisers.

The theoretical implications of retail merchandising are symmetrical; that is, merchandising activity is needed when supplies are short. Figure 6.3 illustrates the need for merchandising. Suppose the supply curve shifts to S' . In the absence of merchandising, the market price would rise to P_N and Q_N would be sold. This would result from the fact that even though wholesale prices raise retail shelf prices, consumers may continue to purchase quantities approximately equal to those purchased in normal crop years, because they do not perceive a price rise. To prevent this consumer behavior, retailers would have to use "counter merchandising" which most often includes featuring close substitutes and pointing out that the price of this product has risen. Slogans like "Eat cheese, your sensible alternative to meat" are used to adjust market

demand for short products. In Figure 6.3, such retailer action would shift D to D_M . The equilibrium market solution with counter merchandising would be P'_E , Q'_E . Less product would be sold at a lower price.

In commodity type products, short crop years are often bonanzas for suppliers. If retailers do not counter merchandise, buyers bid product prices very high. Suppliers usually sell off of this year's crop and any carryover product from other years. There are substantial profits to be made by suppliers. Consequently, the suppliers rarely complain if retailers do not "merchandise" their products in short crop years.

Likewise, retailers probably do not have the incentive to institute counter merchandising on their own. If the product demand schedule is inelastic within the relevant range, as many individual grocery items are suspected to be, a price rise will increase total revenue and most likely retailer profits. The impetus for counter merchandising usually comes from the suppliers of close substitute products whose products are now relatively less expensive.

These suppliers will attempt to persuade merchandisers that increased emphasis on their products will produce a greater revenue effect than obtained by not counter merchandising. If substitute suppliers are successful, the market solution would approximate P'_E , Q'_E .

In the longer run, retailer merchandising activity or lack thereof can have significant influences on the demand schedules of individual products. The most probable impact is to change the elasticity of demand for the item. If an individual item is frequently merchandised and exposed to consumers, consumers will be more responsive to price changes (perception and reaction thresholds are reduced) and more consumers will become regular users. These products will become relatively price

elastic. These are the 400 or so items with which most consumers are most familiar. Perhaps frozen concentrated orange juice is a good example of this process. On the other hand, lack of merchandising does the opposite to a product. The consumer base of the product erodes as fewer people are exposed to the product. The remaining consumers become increasingly hardcore users who have decided preferences for the product. Over time unmerchandised products would tend to diminish in importance and become highly price inelastic.

6.2.3 The Dynamic Implications of Merchandising

The theoretical role of merchandising can be extended through time. For simplicity in exposition let us assume that the supply function of the typical product analyzed in the preceeding figures systematically varies between proportionally equal short and long crop periods (i.e., one year short--one year long, etc.). Market prices could be recorded and plotted under two assumptions. First, crop size varies but retailers do not adjust demand through merchandising behavior. In other words, the wholesale market equilibrium solution would be P_N , Q_N in Figures 6.2 and 6.3. Second, retailers do respond to changing supply conditions with either active or counter merchandising tactics. In this case, the market equilibrium solution would be P'_E , Q'_E in Figures 6.2 and 6.3. Figure 6.4 is a plot of equilibrium prices through time. The solid line tracks unmerchandised prices and the dotted line tracks merchandised prices. The important difference between the two functions is the size of the amplitude.

These cyclical wave functions are typical for many agricultural commodity items. Economists have studied dynamic market behavior

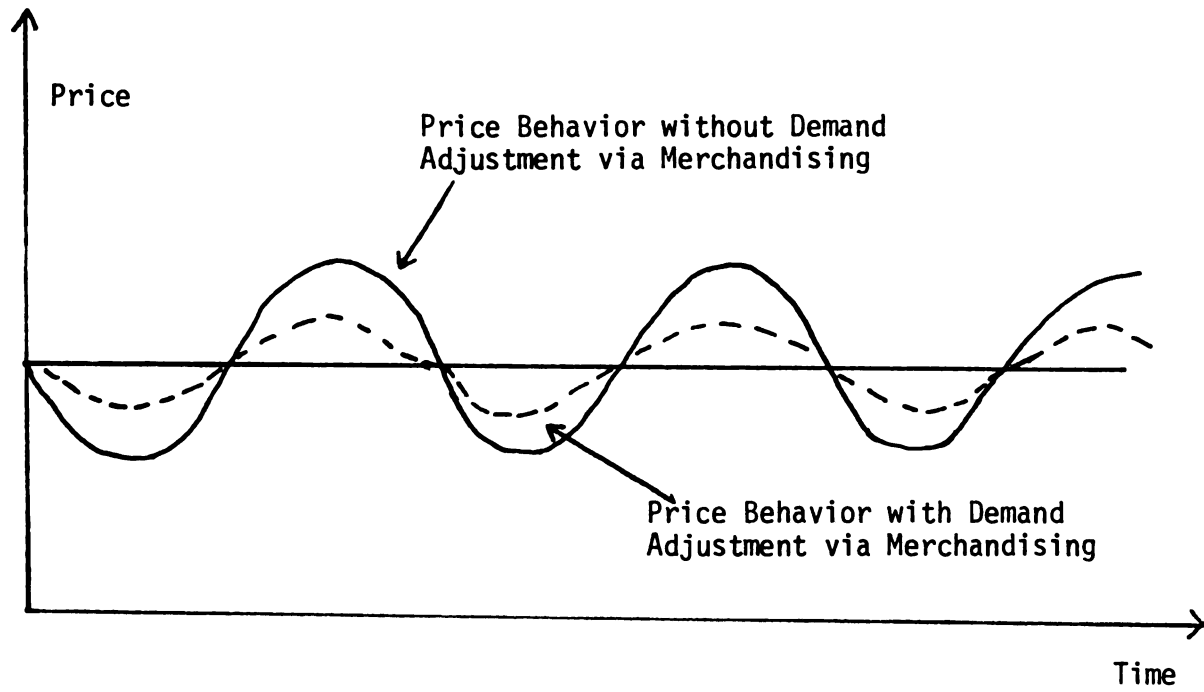


FIGURE 6.4--Hypothetical Price Movements With and Without Merchandising Adjusted Demand

functions like these many times. Their prime concern is normally the dynamic stability and convergence tendencies of these functions. There is little or no concern as to whether or not this behavior is necessary at all. It is presumed that if they exist, they are somehow ordained by the market. Commodity item supply variation will necessarily result in adjustment paths over time. However, the magnitude of the price and quantity variation observed may be much greater than need be if retailers systematically applied merchandising tactics to products with large supplies. Inasmuch as larger than needed price and quantity adjustment are made in the system, resources are expended which might not be required if retailer merchandising was vertically coordinated with product supply conditions.

To summarize thus far, if consumers do have significant perception and reaction thresholds for grocery product price changes, retailer merchandising actions are necessary to minimize food system resources used to adjust to agricultural supply variation. The gains in system efficiency are theoretically identifiable because of the simplifying assumptions made about the regular nature of supply variations and about the homogeneity of retail merchandisers and buyers and product supplying firms.

The real world implications of merchandising-induced coordination failure are more complicated than the theoretical implications. First from an overall perspective, commodity supply cycles are not as regular or predictable as the one assumed above. Most often there are more long years than short years because of the effect of overinvestment caused by the high prices in short years. Rarely can cycles be predicted with great accuracy because of the stochastic behavior of nature. All that

can be concluded is that irrespective of shape, size, or cause of commodity price cycles, theory suggests that the fluctuation effects can be dampened with appropriate retailer merchandising.

A second complicating factor is that not all firms are homogeneous. Resources must be expanded to adjust to cyclical behavior. Different firms will have different resource bases and have different capabilities to adapt to cyclical behavior. Thus coordination practices will have differential impacts on different groups of firms. Adjustment over time will cause certain economic institutions to survive and others to perish. Finally, different food products have different reactions to retail merchandising. Thus it is difficult to generalize about merchandising across many commodities.

The remaining parts of this chapter and the first part of the next chapter attempt to identify some of the "real world" consequences of retailer merchandising behavior. Some of the dynamic implications of merchandising-induced coordination practices are having profound impacts on food system organizations.

6.3 Merchandising SOPs and Their Effectiveness

6.3.1 The Need for Merchandising SOPs

While the buyers are the supply agents of food distribution organizations, merchandisers are the demand agents. Merchandisers in essence decide which products, of the thousands carried, are highlighted to the consumer.

Merchandisers are the image makers of the retailing trade. Their first job is to create a store image to possible consumers so that they choose to shop in their store rather than those of their competitors.

Thus they use the organization's marketing resources (advertising, stocking and pricing policies, etc.) to create a differentiated service mix to create loyal consumers and entice new consumers to their stores. Their second job is to have internal store formats and stocking patterns which result in the highest possible sales per customer visit. Simply put, the merchandisers must be successful in getting consumers to the store and once in the store induce them to buy the highest sales mix of products.

Merchandisers work within financial and physical constraints. Retail firms budget only so much money and personnel for merchandising. Merchandisers must work within these budgets or obtain monies from outside the firm. Most of the outside money comes from suppliers. Nearly all of supplier monies are provided by brand manufacturers.

As will be shown below, merchandising requires certain store locations and shelf activity. These physical constraints limit the number and/or size of retailer instituted promotions. Only a small proportion of the items stocked can be promoted at one time. Effective merchandising also requires joint use of advertising. Advertising space and access is limited. Coordinating all the parts of a successful merchandising plan for a product takes managerial time. The merchandisers can only manage a limited number of promotions a week.

The composite effect of all these constraints to merchandising is that there are fewer products merchandised than their suppliers would like. Merchandisers thus become pivotal agents in the food system. Merchandising decisions and techniques used have also evolved into standard operating procedures. Just as with procurement, these merchandising

SOPs are documentable, transferred among firms with personnel movements, and fairly standard within the industry.

6.3.2 Some General Merchandising Rules

Recall that a merchandiser's first task is to bring as many customers into the store as possible. Merchandisers thus have the incentive to promote those items which have the most potential consumer drawing power. Because of this, the trade literature and interviews revealed that merchandisers tend to favor 1) heavily used products and 2) brand products.

One interviewee stated that merchandisers will rarely special an item which does not have a 75 percent or more customer use rate. This means that of all the consumers entering the store, on the average 75 percent of them use the product at some time and are therefore familiar with it. These consumers may not purchase the product during their visit. What is important is that they recognize the product in the advertising and are able to relate it to similar or identical products in competitors stores and retail ads.

The 75 percent use rate figure is no doubt arbitrary. Different merchandisers will probably have different cut off levels. The principle is however the same; promote those items which provide the consumers with proper product price and selection images. Normally only the top 400 to 500 basic grocery items fall into this high use category. Thus retailers will tend to promote the same basic items continually. This reinforces the observation made earlier that consumers are only operationally aware of the pricing structure of about 400 to 500 food items. This basic merchandising rule also is partially responsible for the observation that most retail food ads are essentially the same or appear to be very similar.

At times, merchandisers can and will violate the heavy use rule. Joint promotion of two or more items with lower individual movements may produce the same drawing power as a single item. Also not all items in an advertising flyer must be high use items. The only point is that there is a systematic bias by merchandisers to promote basic food items of a high use rate with which consumers are most familiar. Only the top selling processed fruit and vegetable products fall within this elite group.

The second broad rule is "to promote and advertise brands." The logic behind this rule is that brands provide a common denominator for consumers to compare the merchandiser's stores with those of the competitors. Private label specials inform the existing customers about the values in the merchandiser's stores. Unfortunately, a consumer unfamiliar with the merchandiser's stores cannot make value comparisons with other stores. Chains X, Y, and Zs private labels may all have the same prices in newspaper ads. There may be, and often are, real and perceived quality differences between private labels. Thus consumers cannot easily reach a "value" comparison by using private labels. If, however, Del Monte peas are 3 for \$.79 in Chain X, and 4 for \$1.00 in Chain Y, the consumer can easily recognize that Chain Y has the better price deal and value. National brands with their consistent quality provide the common denominator needed by consumers for identifying special deals.

Table 6.1 and Appendix Table 6.1 are presented in an attempt to illustrate these points. Table 6.1 illustrates the relative consumer drawing between brand and private label products. When full merchandising efforts are used (advertising and display), brand products generally have a greater percentage increase in their incidence of purchase than

TABLE 6.1--THE IMPACTS OF ADVERTISING AND DISPLAY MERCHANDISING
TECHNIQUES ON THE INCIDENCE OF PURCHASE FOR SELECTED
CANNED FRUIT AND VEGETABLE PRODUCTS

Product	Average Incidence of Purchase ^a	Percent Change From Average When Product Receives:			
		No Advertising		Advertising	
		no displays	displays	no displays	displays
Applesauce					
Brand	1.35	-15.6	81.5	50.4	314.1
Private label	0.85	- 3.5	N/A	105.9	312.9
Cranberry Sauce					
Brand	1.45	-31.7	-11.0	91.0	409.0
Private label	0.67	-47.8	134.3	217.9	276.1
Fruit Cocktail					
Brand	1.25	-17.9	67.2	28.8	277.6
Private label	1.00	-16.0	82.0	75.0	251.0
Peaches					
Brand	1.74	-20.1	32.2	122.4	28.7
Private label	1.18	-15.3	129.7	120.3	11.9
Pears					
Brand	0.98	-30.6	93.9	250.0	249.0
Private label	0.49	-42.9	40.8	855.1	N/A
Pineapple					
Brand	1.87	-24.0	114.4	59.4	8.6
Private label	0.64	-26.6	453.0	269.8	N/A
Corn					
Brand	1.18	-26.3	72.0	205.9	323.7
Private label	2.42	-13.2	19.0	88.4	18.2
Green Beans					
Brand	1.00	-16.0	119.0	217.0	369.0
Private label	2.37	-13.9	43.5	139.2	9.7
Peas					
Brand	0.94	-28.7	120.2	137.2	555.3
Private label	1.67	-19.2	134.1	43.1	170.1
Mushrooms					
Brand	0.39	-15.4	279.5	797.4	1248.7
Private label	0.33	-21.2	N/A	697.0	3090.9

N/A means not available

^aIncidence of purchase is the number of customers out of every 100 customers which purchase that particular item. Incidence should not be confused with volume of product moved. The one customer in a hundred purchasing brand canned green beans, for example, may be purchasing four cans in that single purchase.

SOURCE: "POPAI/Dupont Consumer Buying Habits Study," Chain Store Age/Supermarket, December 1978, pp. 41-145. The data is based on 4,000 consumer interviews conducted in 200 representative supermarkets in the U.S. between October and November in 1976.

do private labels. The results in Table 6.1 vary considerably because of the nature of the data and sampling techniques. Incidence of purchase only indicates the number of customers selecting the item and does not represent volume. Data do not exist publically to see whether brands had greater volume movements as a result of merchandising.

Appendix Table 6.1 attempts to indicate the effects of promotion activity of the volume movement of brands and private label products. In all cases, promotion increased the volume of brand products more than that of private label products. Although these data are very limited, they do tend to show the inherent power of brands to draw additional sales. This, combined with the fact that brand manufacturers pay for the promotion of their products while retailers have to pay for private label merchandising, it is easy to see why merchandisers tend to favor brand products in advertising. Thus a general SOP for food merchandising is to advertise and promote brands with out-of-store techniques but try to switch the consumer to private label (higher margin products) once they enter the store. Private label merchandising tends to be accomplished with in-store techniques.

6.3.3 Some Specific Merchandising SOPs

Food shoppers will quickly recognize many of the fairly standard merchandising techniques. Almost all food retailers use these or variations of these techniques to sell food. What food shoppers often do not realize is how instrumental these techniques are in influencing their behavior.

Perhaps the most basic factors influencing a product's ultimate fate is its location and exposure on grocery shelves. Product exposure

is measured by the number of facings it gets. A facing is one row of a given product, i.e., the number of label exposures "facing" the customer. The products location refers to its relative height on the gondola (shelf unit) and its relative position in the grocery aisle.

Retail merchandisers make periodic plan-o-grams or shelf plans to reflect current product sales. Generally, the higher the product's shelf and the greater its facings, the greater its sales potential (See Table 6.2). Exhibits 6.1 and 6.2 are examples of plan-o-grams for canned vegetables and canned fruit sections, respectively. The small numbers to the left of each product indicate the number of facings allocated to that product.

The construction of plan-o-grams is a painstaking and complicated job. Merchandisers design plan-o-grams to increase sales in the long run. Thus retailers will almost never make facing or location changes to serve the current market supply conditions of one or a few items. Plan-o-grams are changed only after product group reviews. The space given to product group sections is decided by chief merchandising executives. Changes are normally made only after a store-wide sales review or a fundamental change in the image the retail organization is attempting to project.

There is a circular logic to the placement of products on grocery shelves. Products which are the best sellers are put in positions for the best sales. Product locations are not static however. Exogenous events which cause sales changes may put the product in a self-defeating location cycle. A product's sales can decline because consumer demand changes, a newer slightly different product by another manufacturer is introduced, and/or there is a supply decrease and product price rises

1 TP SICK 100	4 BUTTERFLIED SIX 1/2	4 T.P. POT SIX 1/2	4 BUTTERFLIED SIX 1/2
2 TP WICK 100	2 T.P. SUCED POT 1/2	6 T.P. DIED POT 1/2	3 CORN CRACKS
2 NAT. P.K. WICK 100	2 NAT. P.K. SUCED POT 1/2		3 CORN CRACKS
2 BUTTERFLIED WICK 100	2 BUTTERFLIED SUCED POT 1/2		
2 BRUCE YAMS 400	2 ROYAL PRINCE YAMS 400	3 KEY MARK CR. SICK 1/2	4 KEY MARK CR. SICK 1/2
3 PRINCE YAMS 400	3 NAT. P.K. YAMS 400	3 KEY MARK CR. SICK 1/2	4 KEY MARK CR. SICK 1/2
3 LIBBY SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
3 T.P. SUC. BEETS 100	3 T.P. SUCED BEETS 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
2 SICKLY DIED 100	2 NAT. SUCED BEETS 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
2 THICK Y. WICK 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
2 VEG. ALL 100	2 T.P. WICK 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
2 LIBBY P.K. WICK 100	2 T.P. P.K. WICK 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
3 D.M. SUC. BEETS 100	3 BUTTERFLIED SUC. BEETS 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
4 T.P. TURNIP 100	5 T.P. TURNIP 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
3 NAT. P.K. TURNIP 100	4 NAT. P.K. TURNIP 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
3 CANTONIA TURNIP 100	4 CANTONIA TURNIP 100	2 NAT. P.K. WICK 100	2 NAT. P.K. WICK 100
5 D.M. PEAS 100	5 FRESH LIKE PEAS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
5 T.P. SUC. PEAS 100	5 T.J. SUCED PEAS 100	2 C.G. PEAS 100	2 C.G. PEAS 100
5 EATMORE PEAS 100	5 THIRTY FIVE PEAS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
6 T.P. SUC. CORN 100	6 F.J. SUC. CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
5 LIBBY SUC. CORN 100	5 STERILE SUC. CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
6 C.G. SUC. CORN 100	6 JELLY CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
6 T.P. SUC. CORN 100	6 F.J. SUC. CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
6 THIRTY FIVE CORN 100	3 HARTS WICK CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 T.P. KIDNEY 100	5 T.P. KIDNEY 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 SILVER FLOSS 100	5 T.P. KIDNEY 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 T.P. TURNIP 100	2 T.P. TURNIP 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
3 NAT. P.K. TURNIP 100	4 NAT. P.K. TURNIP 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
3 T.P. CUT ASH 100	3 NAT. P.K. CUT ASH 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 T.P. CUT ASH 100	5 T.P. CUT ASH 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
6 PULPY P.K. 100	6 F.J. CUT ASH 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 STERILE CUT ASH 100	4 D.M. CUT ASH 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 C.G. CUT ASH 100	4 LIBBY CUT ASH 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 T.P. WAX 100	4 D.M. WAX 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 THIRTY FIVE WAX 100	4 NAT. WAX 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 T.P. FC CORN 100	4 NAT. FC CORN 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 T.P. WHITE BEETS 100	3 T.P. GREAT BEETS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
3 D.M. LIMA BEETS 100	3 LIBBY LIMA BEETS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 SEN SHOE BEETS 100	2 SEN SHOE BEETS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 T.P. KIDNEY BEETS 100	5 T.P. KIDNEY BEETS 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
4 T.P. KIDNEY BEETS 100	4 BROCK'S CHILI 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
3 T.P. CHILI 100	4 BROCK'S CHILI 100	3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100
2 T.P. WHITE BEETS		3 NAT. P.K. SUC. BEETS 100	3 NAT. P.K. SUC. BEETS 100

High Profile 40'

HIGH LOW 47

EXHIBIT 6.2--PLAN-O-GRAM FOR THE CANNED FRUIT SECTION IN A RETAIL GROCERY STORE

16 1/2"	16"	12"	12"	700
4-WILD APPLE 20oz 2-TYOU CHERRY 20oz 2-TYOU PINE 20oz 2-TYOU STRAW 20oz 2-LIBBY PINE 20oz	4-TYOU APPLE 20oz 3-WILD CHERRY 20oz 2-TYOU PINE 20oz 2-TYOU BLUE CHERRY 20oz 2-D.M. PINE 20oz	2-WILD APPLE 20oz 2-TYOU APPLE 20oz 3-T.P. THET CHERRIES 2-TYOU LEMON 20oz 2-WILD B. BERRY 2-LIBBY PINE 16oz	2-TYOU PINE 20oz 2-LIBBY PINE 20oz 2-JOHNSON GRAVING CRUSTS LG 1-JOHNSON CRUSTS SMILE	2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz
2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE	2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE	2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE 2-D.M. CRUSH JUICE 2-TYOU CRUSH JUICE	2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE	2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE 2-TYOU CRUSH JUICE
3-Roseale Apple 20oz 2-TYOU PINE 20oz 4-WILD APPLE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz	3-T.P. Apple 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz	4-FRT VALLEY Apple 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz	2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz	2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz 2-TYOU PINE 20oz
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reduce sales. Lower sales cause a movement to a lower shelf and/or facing reduction which causes a further sales drop inducing retailers to lower the shelf and facings again in the next plan-o-grams. This continues until the product reaches the bottom shelf and has only one or two facings left. The bottom shelf at the end of an aisle is known in the trade as the "coffin corner." Once there, products stand little chance of survival. They are in danger of being discontinued at any time to make room for the next product in a down cycle.

As with other "social trap" situations, once a product gets into this kind of cycle (irrespective of the reason) it is difficult to break out. Impetus to increase sales and therefore to break the cycle must come from someone other than the retailer. Retailers' attitude is that this is the suppliers worry and responsibility.

Table 6.2 presents, in ascending order of complexity, some empirical evidence about the power of various standard merchandising techniques. Techniques 1 and 2 show the sales impact of moving product shelf locations and changing the number of product facings. This movement power cannot, however, be used to improve demand and supply coordination within one marketing year. Retailers very rarely adjust plan-o-grams just to alter the movements of a few items. That is just too costly. However, product location and facing issues are so critical to products survival that brand marketers do attempt to get their products at desirable locations.

The most spectacular produce movement increases come from moving products off the shelves onto special displays. Building an end-aisle display can increase sales by 400 percent (No. 3, Table 6.2). Adding a colorful, three-dimensional sign can increase sales another 100 percent.

TABLE 6.2--EFFECTS OF MERCHANDISING TECHNIQUES ON PRODUCT MOVEMENT

The results reported below are from a special study conducted by Progressive Grocer during 1970. The study consisted of testing various merchandising techniques in sets of one company's stores matched for volume, design, size, and demographics. These figures represent averages of several products over several time periods.

<u>Technique</u>	<u>Description</u>	<u>Impact On Sales</u>
1. Change in shelf location with no price or facing change	a. Movement from top shelf to bottom shelf	-80%
	b. Movement from next to top (eye level) shelf to bottom shelf	-45%
	c. Movement from bottom shelf to middle (waist level) shelf	+43%
	d. Movement from next to bottom shelf to middle shelf	+10%
2. Change in number of product facings with no price or shelf location change	a. Reduce facings from 4 to 2 units	-48%
	b. Reduce facings from 3 to 1	-58%
3. Use of off-shelf (special) displays	a. End-aisle display with special price compared to shelf location with same special price. No advertising.	+420%
	b. Same as (a) above but with the addition of more elaborate, colorful signs	+542%
	c. Display of two related items together versus display of each item separately. Total sales increase:	+170%

TABLE 6.2--(cont'd)

<u>Technique</u>	<u>Description</u>	<u>Impact On Sales</u>
4. Use of shelf-signs	a. Use of a simple "as advertised" sign to point out advertised product on shelf compared to same product without a sign. No special price.	+124%
	b. Use of simple sign with no advertising, no price reduction, and no product name identification	+ 5%
	c. Same as (b) above but with a product name identification on the sign (i.e. Budget Saver--Joe's Salad Dressing)	+ 18%
	d. Same as (c) above but with the addition of a price on the sign. This price is the normal price (i.e. Joe's Salad Dressing 39¢)	+ 39%
5. Combinations of various techniques	a. Product advertised in newspaper with special price combined with a simple shelf sign "as advertised at xx¢"	+194%
	b. Same as (a) above with the addition of an end-aisle display	+629%
	c. Same as (b) above but with manufacturer "theme sale" making use of store-wide banners, P-O-P, etc.	+782%

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The power of joint displays is also evident. The single most important merchandising technique for canned fruits and vegetable products coordination is getting off-shelf display in the retail stores. Off-shelf displays can quickly help increase movement of products to help balance inventories.

There are limits to store display space and to the number of individual items which can be given display priority. Therefore only the major fruit and vegetable commodities get this space. Although minor commodities have great difficulty because of consumer use SOPs, some minor products will reach end-aisle via joint displays. Brand marketers often are able to get display space for their minor items. But in general the most effective coordinating merchandising mechanism is foreclosed from many canned fruit and vegetable products. The nature of frozen foods also precludes its use with frozen commodity products.

The use of shelf signs (P-O-P materials) is also effective in increasing sales. Thus using shelf signs can help coordinate minor commodities which tend not to get promoted off the shelf. However, for shelf signs to be significantly effective requires that they be tied with advertising (Table 6.2). This means that someone, (either retailer or manufacturer), has to take the responsibility for implementing and coordinating P-O-P and advertising. Retailers are unlikely to do this except for those private label products which they decide to promote.

A true marketing miracle occurs when all of these techniques are combined at one point in time. In Table 6.2, the last group shows the tremendous impact on coordination merchandising programs can make. The use of advertising and display techniques to increase incidence of product purchases is also dramatically illustrated in Table 6.1. The

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pay-offs are high but so are the costs. These programs, called "theme sales" or "store-wide events" are in the domain of only the largest food manufacturers because only these firms have the financial, personal, and informational resources to produce a successful theme sale. A very few of the largest private label distributors can also induce retailers to produce store-wide sales for private label but these tend to be on a smaller scale. Since these store-wide sales feature a whole line of products, they are useful for coordinating individual fruit and vegetable products.² The merchandising techniques presented in Table 6.2 are generally applicable to all grocery products.

Canned fruits and vegetables have some very critical pricing SOPs associated with them. These pricing SOPs or guidelines are used elsewhere in the store but in few other product groups do they dominate merchandising behavior as they do in these products.

First, retailers prefer that grocery products not exceed \$1.00 per unit. The retailers believe there is a significant consumer price perception break at \$.99. The vast majority of individual items in a grocery department are less than a dollar. However, inflation and the changing nature of some products are changing this. Many frozen products which are full-meals embodying a good deal of customer convenience, have prices well over \$1.00.

Second, fruit and vegetable products must be priced in multiples. Price multiples are, for example, 3 for \$.69, 4 for \$.89, and 5 for \$.99. This is the number one rule merchandisers use when pricing canned fruits and vegetables. If the buyer is to get the merchandiser to promote canned (and to a lesser extent frozen) products, he has to get the suppliers to sell product at wholesale prices which, when the constant retailer margin

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The logic behind the use of price multiples is that the consumer buys more. One merchandiser said that when products are priced at 5 for \$1.00 instead of 4 for \$.79 product sales will increase by 20 percent. Thus price multiples get consumers to buy in multiple units.

Some of the California canned fruit products are encountering coordination problems because they lost their price multiples. When prices rose rapidly in 1973-74, the price of a No. 2½ can of fruit at retail went above 50 cents. Therefore, retailers could no longer feature canned peaches at 2 for \$1.00. This started the shift toward the sales of No. 303 cans. Now even 303s are beginning to lose their multiples. When a product loses its traditional price multiples, the merchandisers are at a loss for ideas. They tend to forget these products and put others on special. Again inflation seems to be altering this pricing SOP. It is increasingly difficult to get attractive price multiples as inflation continues. Whether multiples over \$1.00 will be effective as historical multiples remains to be seen.

Price multiples are a direct recognition of consumer perception thresholds. Price multiples have been used for many decades and they still work. Price multiples are but a subset of price points. Price points are prices which for some reason are recognizable to consumers. Knowledge of price points and multiples are some of the most basic skills food merchandisers need.

There are many other merchandising techniques and SOPs which are the trade secrets of the individual merchandisers. Many of these

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techniques involve the effectiveness of joint promotions, various types of advertising, seasonal stocking patterns, and uniqueness of certain products in certain stores. The ones given above, however, are the very basic merchandising techniques. Their power is undisputed. Coordination of the subsector depends on the merchandising effects on demand. Without this demand adjustment, vertical coordination is very difficult.

6.3.4 Merchandising SOPs in Perspective

The preceeding discussion of merchandising SOPs is much less precise than previous discussions of buying SOPs. No merchandisers were interviewed. Most interview material was received from buyers who related experiences and perceptions generated through their interactions with merchandisers. A considerable amount of merchandising information was obtained through the literature search. Although the conclusions reached above should generally hold, much of the merchandising story was left undocumented.

Outside observers have not gotten access to the quantitative data sets needed to judge the true effectiveness of merchandising techniques. Some industry observers doubt that such data even exists within the firm. The general use of the Universal Product Code (UPC) with computerized scanning will greatly enhance the level of evidence needed to test the power of various merchandising techniques. Until then, retailer merchandising still remains a nebulous "art" to most industry observers. Yet nearly all observers agree, retailer merchandising is the single most important force linking individual product demand to product supply.

6.4 Brand Manufacturers' Marketing and Coordination Strategies

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6.4.1 Introduction

A brand manufacturer marketing executive attempts to differentiate his output to the consumer as a retailer attempts to differentiate his store. The manufacturer's output is individual products rather than a store's shopping services and ambiance. A retail merchandiser's focus is other retail competitors. Likewise, a brand manufacturer's focus is other manufacturer's producing similar products. One big difference is that for a brand manufacturer to succeed in his goals he must deal through retail food distributors. Successfully besting one's competitors requires that the strategies needed for that task be sifted through the retail buying and merchandising process. Thus, successful brand product management is a very complicated job requiring an ability to outmaneuver one's competitors and understand and manage retail buyers and merchandisers. This must all be accomplished within the framework established by the basic product's supply conditions.

This section attempts to describe how the brand manufacturers accomplish this job for commodity-based fruit and vegetable products. Manufacturer planning processes, marketing logic, and use of sales force make up the elements of demand side management. The supply side of the process details how manufacturers manage raw product quality and quantity variation in general, for major products, and for minor products. The section concludes with a brief summary of the current trends in brand manufacturer commodity marketing.

Material in this section was obtained primarily from interviews with brand marketing executives and former manufacturer personnel who are now in the private label sector. Again this section was not a primary part of the research. It is presented because some understanding of

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brand manufacturer behavior is necessary to make inferences about vertical coordination. The results should, however, be used somewhat more carefully than those in Chapters 4 and 5.

6.4.2 Brand Manufacturer Planning Processes

Processors have to make two basic planning decisions: supply plans and demand plans. In trade terminology, these are referred to as pack plans and marketing plans. A pack plan is the document used to execute contract and/or planting decisions and to determine the allocation of harvested crops to the various retail and institutional packs. Pack plans for the upcoming year are started after the packing period of the current year. Serious pack budgeting is done in the early fall or winter. Processors must line up their cans, seed, and acreages for the next year. Pack planning process is equally valid for annual and perennial crops, although the factors planned and coordinated are likely to be different depending on the type of crop. It is the author's observation that this pack planning process is very similar for both brand and private label firms. To the extent that brand manufacturers are larger and often operate multiple plants in multiple states, their pack planning is much more complicated. The real difference in the pack planning process between the two lies in what forces determine the composition of the pack plan. In private label firms it is highly influenced by the level of inventory held by the firm. In brand firms, the marketing plan determines the pack plan.

The market plan of a brand processor attempts to direct how much of which product is sold where. Market plans are made over three dimensions: product, geographic market area, and time. A typical market plan for a

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manufacturer would be the desired sales of Product X in Market Region 12, for the next marketing year. Market region or area divisions are determined by the manufacturer. The marketing regions established by manufacturers are usually based on the geographic location of the manufacturers' production plants and distribution centers. Within these areas are divisions. Within divisions are zones. The division definitions are currently determined by the market organization of food retailers.

Because of Robinson-Patman requirements, manufacturers must give promotions and price cuts to all retail competitors. Thus if one retailer buys in SMSA A (Standard Market Statistical Areas) but sells in SMSAs A, B, and C and another retailer is located in SMSA C but sells in SMSAs C, D, and E, the manufacturer wishing to promote his products would have to make the same offer in SMSAs A, B, C, D, and E. Therefore, the broad geographic area would encompass one manufacturer market area. Note this division is made on retailer buying location not by retailer market location. For example, one chain may sell in SMSAs A, B, C, D, E, and F but has buying centers in B (servicing A, B, and C) and E (servicing D, E, and F). The manufacturers would not have to offer the same deal to both distribution centers if they did not have overlapping competitors. As retail firms expand service areas or merger and consolidate distribution points, the size of the market divisions to be covered by a manufacturer's marketing plan also expands. The expanding size of market divisions increases the cost of a promotion and price cuts by the manufacturer. Also, the manufacturer has fewer market areas in which to "fine tune" demand to match supply.

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The above discussion has implications for industrial organization researchers. An SMSA may be the appropriate market delineation for measuring food retailing concentration. However, the appropriate "market" for manufacturers is these retailer-defined market divisions. Only if the firm 1) sells in a national market and 2) has a brand franchise can the national market be considered the appropriate market definition for food manufacturers for research and policy purposes.

Most marketing plans are one, three and five year planning documents and are under constant revision. One-year market plans tend to become goals to be achieved during the upcoming year. That is, the final marketing plan adopted during the packing season becomes the target against which the individual product manager's performance is measured at the end of the year. The market goal is nearly always measured in terms of brand market share. The one-year plan states specific market shares to be obtained by each product in each market. These figures are the product line managers' goals. Longer term market plans formulate desired strategies for enlarging, holding, or regaining market share in various individual markets.

This behavior is fairly consistent with the theory developed in Chapter 2 above. Market share goals are easy to understand and provide a common denominator to compare across products. Brand manufacturers use market share because they have some discretionary power over their products' prices and are able to set markups for their products. These markups cover their costs and desired profits. Increased market share obtained over goals increases profits. Margins on products are only altered either because of competitive pressure or by deliberate design

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to increase market share in a given area. At any particular time, the manufacturer may have lower margins for both reasons.

Pack plans are designed primarily to plan the efficient use of processing plants. Properly executed pack plans result in full canning lines; proper quality distribution of raw products; and synchronized product procurement of the various commodities so that plants can run with minimum interruption for a longer period. Pack plans are goal oriented to minimize cost.

Recall the discussion on the private label booking system. Bookings are only useful in the latter stages of the pack planning strategies. Sales or market plans also have a different meaning for private label processors. The marketing of private label products is controlled by private label distributors. Sales plans usually attempt to predict sales to retail, institutional, government, and export segments. Processors can do little to affect the sales to individual firms within these market segments except to lower price.

Marketing plans by contrast are documents to maximize and dictate the promotion and pricing strategies used to try to obtain the highest sales for the firm. Ability to partially manage demand for individual products implies that brand manufacturers have some degree of market power and in that way they differ from private label processors. These firms would logically like to maximize the return to their marketing resources. Market plans are an attempt to do so. As will be discussed below, commodity based food products make the revenue-maximization process much more complicated than for products with manageable and/or predictable supplies.

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6.4.3 Brand Marketing Logic

Brand manufacturers use their marketing power to alter the quantity of product which flows through the food distribution system to the consumer. The manufacturer has two principal vehicles to achieve needed quantity adjustments. These are systematic application of 1) direct-to consumer advertising and promotion and 2) price and promotion activity geared to food retailers. The former strategy involves advertising; the latter involves price and other concessions to retailers. The following public statement by a marketing vice president of Del Monte Corporation probably best summarizes the way national brand manufacturers view product movement adjustment:

Del Monte traditionally had run four major promotional allowance programs annually, building four peaks--and four valleys into the distribution curve. In an effort to smooth out the curve, we are running eight promotions yearly, but the number of items affected in the promotions will not be as large, according to Mr. Gumucio. In addition, the country has been broken down into 17 minimarkets with a separate campaign for each region. Media budgets will be maintained--even during periods of shortages--but sales and trade promotion budgets will vary according to the availability of product.³

Advertising levels are maintained irrespective of crop size. The quantity of product sold is adjusted by varying sales and promotions to the retailers. Adjustment can be made by adjusting trade promotion across all markets or by making adjustments in any number of specific markets. These same adjustments can be used to counteract or initiate strategies to improve or maintain market share. Market share development seems, however, to be the job of media advertising. In unusual circumstances advertising can be shifted among products and between markets (while still maintaining budgeted levels) to help increase or decrease the movement of any particular product so as to coordinate movement with availability.

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The number of promotions run by a company usually does not vary from year to year. As reported in Chapter 4, the retail trade tends to program the various promotion strategies of manufacturers into their operations. If a manufacturer fails to promote in the same historical pattern, the buyers will alert him to that fact and possibly institute various "reminders" to help the manufacturer realize that the schedule is off. This programming of promotions has some important coordination and organizational implications. Since there are limited promotion and merchandising resources at the retail level, systematic promotion strategies by manufacturers can result in promotion foreclosure to other manufacturers. This is similar to the foreclosure that many firms face when trying to get prime time television advertising slots.

The above adjustable promotion and trade allowance system would appear to be a rather simple, straightforward response to variable product supply, however, there are some significant difficulties with this process. The biggest problem is the possible number of individual strategies needed to have an acceptable level of supply-demand coordination for all products. A firm the size of Del Monte has a hundred or more products. It is impossible for them to fine tune all products. As a result the large national brand manufacturers must develop some systematic process to decide which products to promote and how those selected products should be promoted.

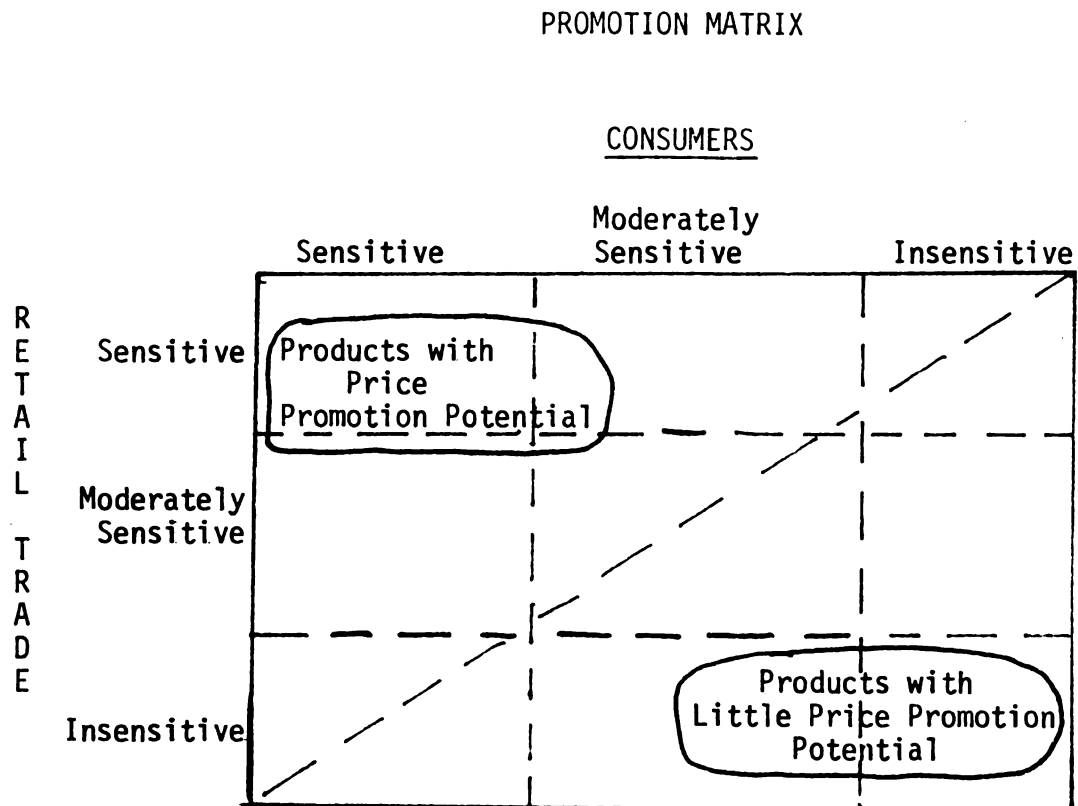
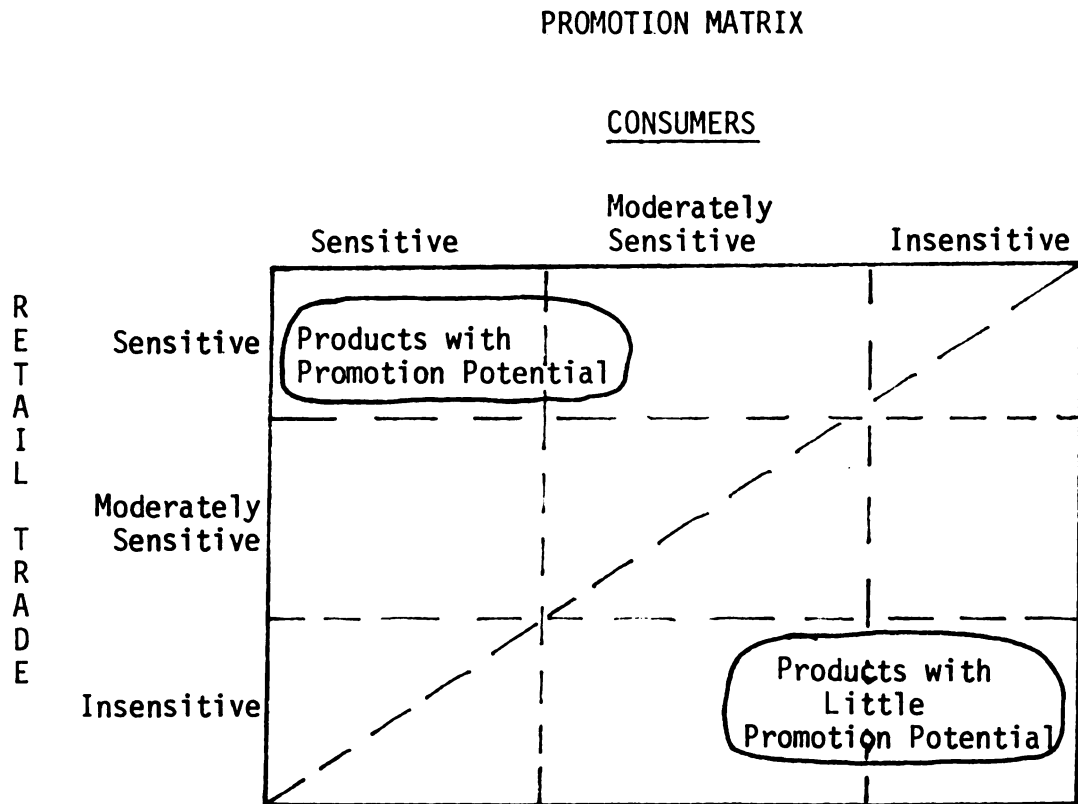
Exhibit 6.3 recreates some marketing matrices presented to the author by executives of a national brand manufacturer. The manufacturer arrays all products from the most sensitive to the least sensitive with respect to retail trade and consumer promotion and to retail trade and consumer price promotion. Promotion activity usually includes advertising

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and display considerations. Price promotion refers to the use of coupons and price reductions to the consumer and trade allowances (price reductions) to the retailers. By arraying the products in this way, the matrices have cells which indicate the probable success of applying a certain adjustment variable (promotion or price tactic) to a given product. Those products which fall below the diagonal lines in Exhibit 6.3 have a very low probability of eliciting the desired movement by applying various marketing techniques. Basically, those products which fall below the diagonal lines are not given much or any marketing effort by brand manufacturers. Those products which are above but close to the diagonal lines are only given brand marketing support in unusual circumstances.

The general impression left with the author was that these matrices are developed with national, aggregate movement figures. While it would be possible for a matrix of this type to be developed for each market area, the national marketing directors did not deal at this level of detail. Individual product line managers no doubt know their product's relative local market strengths and weaknesses.

The construction of these matrices is implicitly based on the theoretical observation made in Figure 6.2. The impact of merchandising (in this case brand marketing) could be divided into a price effect and a merchandising effect. Brand marketing executives have come to observe over the years that different products have different responses to price and marketing changes. Factors like use rates, frequency of purchase, and coupon redemption rates all affect the relative responsiveness of various products to different manufacturer actions. In some respects products have their own sets of consumer promotion, trade promotion, retail price, and wholesale price elasticities. Manufacturers may not

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Chapter 4

know whether these are continuous or discrete or quantitative or qualitative. They do however have some understanding how various products react in the food system and therefore act accordingly.

These matrices also highlight another point often overlooked by food system observers; that is, manufacturers explicitly acknowledge the role of food distributors (retail trade) in the sales of individual food products. In fact, these matrices imply that retail buyer-merchandiser activity is relatively more important to the success of some food products than are individual consumer actions.

A summary of the material to this point indicates that national brand manufacturers use a set number of programmed full-blown promotions per year. The products promoted during these campaigns are chosen for 1) market share or development strategies, and 2) the need to adjust consumer movement to supply contingencies. Type of promotion, to who it is aimed at, and which product are determined by referring to an explicit or implicit marketing matrix. Products which fall below the diagonals in marketing matrices do not receive marketing effort by brand processors. If these products had variable supply situation, coordinating actions fall on someone else in the food system.

6.4.4 Brand Sales Forces' Roles in Market Coordination

Buying allowances, merchandising allowances, advertising allowances, coupon drops, network TV, spot TV, performance contracts, stock protection clauses, etc. are the tools identified and explained in Chapter 4 which brand manufacturers weave together to implement their marketing plans. The very careful construction of the promotions discussed in Chapter 4 are designed to elicit the desired behavioral responses from

consumers and retail buyers and merchandisers. Brands give financial allowances contingent on the retailer providing the merchandising support desired by the manufacturer. Recall performance clauses usually require that retailers use some of the most powerful combinations of merchandising techniques available. Since merchandisers usually have several hundred manufacturer deals available on a weekly basis, there is a tendency for merchandisers to take the allowances without performing the stipulated merchandising tasks. Manufacturers sales forces provide the link between distribution of marketing resources and proper implementation and application of those resources at the store level.

Manufacturers hire and maintain a field force (either employees or brokers) to monitor retailer compliance of promotional deals and to perform other functions. In years past, the manufacturer's field forces performed nearly all the merchandising chores for the retailer. For years, this included stocking the shelves, building the displays, posting P-O-P material, answering consumer complaints, and even placing the orders for their products. Today retail labor union regulations have shifted some of these jobs back to retailers. Table 6.3 is a list of the services and their importance to chains and independents that manufacturers' representatives provide to retail stores. Notice merchandising and buying functions rank among the highest of all the services provided. These manufacturer representatives influence merchandising control two ways. One is to gain retailer compliance. Another is that the retailer gets an allowance for merchandising procedures which are done with the manufacturers' labor force.

The work done by manufacturers' representatives is significant. Table 6.4 gives the author's estimate of the labor transfer from

TABLE 6.3--SERVICES PROVIDED BY MANUFACTURER'S SALESPeOPLE OR BROKERS
TO RETAIL CHAINS AND INDEPENDENT STORES

	% Performing In Chain Stores		% Performing In Independent Stores	
	%	Rank	%	Rank
Check or correct out-of-stock conditions	98%	1	98%	1
Check correct accuracy	95	2	95	5
Suggest shelf arrangement for their product category	92	3	95	4
Recommend order to store personnel	92	4	93	9
Ask for special display	91	5	97	2
Pick up or compensate for damaged merchandise	90	6	92	10
Adjust facings	89	7	96	3
Set up their department in new stores	89	8	90	12
Provide display materials	87	9	94	8
Offer special merchandising ideas	87	10	94	7
Offer information on sales trends in their product category	83	11	88	13
Discuss or show consumer advertising	82	12	87	14
Present new items	82	13	95	6
Discuss their products' quality (ingredients, attributes, etc.)	82	14	88	15
Build or help build special display	80	15	90	11
Offer plans or formulas for maintaining well-stocked department	79	16	86	16
Advise about seasonal sales changes	78	17	81	18
Describe their product's appeal to consumers in store's neighborhood	75	18	81	19
Check on freshness/outdated merchandise	74	19	74	21
Report sales ideas from other stores	62	20	77	20
Discuss their company's progress and policies	60	21	69	23
Inventory their items	60	22	67	24
Stock shelves	51	23	64	25
Report retail prices found in other stores	48	24	72	22
Suggest retail prices	43	25	82	17
Ascertain store performance on merchandise contracts	36	26	56	28
Offer or pay display allowance	29	27	58	26
Offer or pay advertising allowance	27	28	56	27
Redeem company coupons	25	29	48	29

SOURCE: "Brand Power Study," Progressive Grocer, November, 1976,
p. 48.

TABLE 6.4--LABOR COST SAVINGS ACCRUING TO FOOD RETAILERS FROM THE
ACTIVITIES OF FOOD MANUFACTURERS' REPRESENTATIVES IN
RETAIL STORES

Assumptions:

35,000 manufacturer and broker salespersons call on stores. Each salesperson makes 1200 calls a year. The average call is 1 hour duration with half of the salesperson's time spent performing key retail functions (shelf improvement and resets, building displays, correcting out-of-stocks, and selling new items).

*1200 calls @ \$4.00 per call equals
\$4800 annual retail savings per
salesperson.

*35,000 salespersons @ \$4800 savings
results in:

168 MILLION DOLLARS A YEAR LABOR SAVINGS TO RETAIL STORES

SOURCE: Basic numbers and methodology are taken from "Brand Power Study," Progressive Grocer, November 1976, p. 48. The wage rate was adjusted by the author to more accurately reflect today's wage structures.

manufacturers to retailers. There are approximately 35,000 manufacturers representatives. A conservative estimate of their worth to retailers is \$168 million a year.

Retailers still maintain the active control over which promotional programs and merchandising packages they choose. They still may have a hundred different manufacturers' offers per week from which to choose. Which ones get chosen at this level is largely a function of the manufacturers' level of consumer advertising for this product in this retail market. Merchandisers have learned that it will be to their benefit to take the deal and do the necessary merchandising procedures if the consumer in his market is going to be exposed to extensive media and/or print (coupon) advertising by the manufacturer. Referring again to Chapter 4, the third element to most brand promotions is consumer advertising. The three basic elements--cash allowances to the retailer, effective field forces to monitor and implement merchandising procedures, and consumer advertising (which in part helps the retailer choose among alternative promotions)--result in many of the retail merchandising decisions being orchestrated by manufacturers. Thus strong, effective manufacturers can, to a large extent, control their products' destiny in the retail food stores because they influence consumer demand through advertising and because they direct retail merchandising efforts through their field forces and promotions.

6.4.5 General Strategies Used by Brands to Deal with Variable Quantities and Qualities of Raw Product

The crops contracted to brand processors suffer the same weather induced quality and quantity variation as those fields grown by private label suppliers. Brand manufacturers who operate nationally are usually

able to counteract some of this variation by planting in several growing regions. However, brand manufacturers must have some mechanisms for coordinating quality variation within their fruit and vegetable packs. These mechanisms are explored briefly below.

Private label processors use a series of labels to sell varying quality merchandise. Brand manufacturers do the same. Nearly all national brand packers have second labels. For example, Green Giant's is Kountry Kist and Del Monte's is Argo. In normal production years, a given percentage of the pack is below "commercial fancy" grade. Brand processors have developed these second labels to merchandise this lower grade product. The second brand has been positioned as the leading brand in several geographic market areas. The national brand manufacturers have also positioned these second brands along with their first brands in several markets. When quality distribution of the pack varies because of growing conditions, brand manufacturers have two options. They can cut back or increase distribution and promotion in the swing markets. If this adjustment is not sufficient, they can adjust promotion in those markets where the second label is the leading label. They would implement this second option only in drastic cases because it would affect the brand's market share in that market. This quality adjustment is essentially the same one adopted by private label firms except that first and second private labels are sold in the same stores.

Brand manufacturers have another method for adjusting quality. Brands have developed their own grading systems independent of the USDA's grading system. It is also an attempt to try to develop differentiated products. Trade sources indicated that brand grading systems try to develop a "commercial fancy" product. They take products for their

number one brands which encompass the entire USDA Fancy category and the very top of the Extra Standard categories. This product is numbered with their own grading scale. Trade sources indicate (although brand manufacturers would not comment) that brands sell different score levels in different markets. In other words, the contents of a national brand product in one market is not exactly the same as in another market area. Consumers in some markets have decided preferences for certain types of product characteristics. If quality varies in one year, the brand can market more heavily in market regions where consumers have a preference for the "long product quality." All trade sources indicate that the Southeastern United States will tolerate lower quality vegetable and fruit products which other geographic areas would reject. In fact, the Southern way of cooking vegetables tends to prefer a distinctly different grade of products. Thus while brand manufacturers will take a public posture that "every can of Brand X is the same high quality," quality is alleged to vary across market areas.

The combined use of second labels and flexible quality standards in first labels usually permits the brands to have enough flexibility so they are able to balance product sales with any given year's quality distribution. When the pack's quality is significantly skewed in any one direction, the brand manufacturer must invoke considerable marketing effort to balance consumer movement to supply availability.

The above description details the adjustment variables available to a brand manufacturer to coordinate supply and demand of any specific product under various quantity and quality pack conditions. The adjustment process basically involves altering the manufacturer's promotion and advertising behavior. At this point two things may happen. Brand

manufacturers may choose not to exercise their marketing options or they may implement the needed marketing operations but the retail sector, especially buyers, can short circuit the efforts. Buyers may, for example, agree to a promotion and take the manufacturer's allowances but not display the product and/or reflect any price decrease to the consumer. If retailers do this, the manufacturer normally evokes the previously discussed power of his field force.

6.4.6 Market Year Adjustments for Major Commodities

Briefly reviewing how brand manufacturers react under various supply conditions will help set the stage for further analysis of vertical coordination. What follows is a chronological description of how brand manufacturers adjust strategies to deal with normal, long, and short crop years.

Assume a normal crop year for any specific major product sold by brand manufacturers. Under a normal crop year the product pack comes up to expectations and is consistent with marketing plans for the crop. The manufacturer will have its standard marketing plan put in place. This plan includes a set number of programmed promotions (eight for Del Monte). These promotions will not be of the same magnitude or structure. Some, perhaps two or at most three of these promotions, will be store-wide extravaganzas. These promotions, known as "theme sales" by the trade, combine many aspects of marketing. The firm will coordinate national advertising with local advertising placed by retailers with coupon drops, with in-store merchandising procedures, and with price promotions to the retail trade. Normally brand manufacturers will hold one of these theme sales in the fall and spring. A specific product can be

singled out for promotion in many given ways (i.e., advertising, coupons, trade allowances, etc.).

Other promotions are much less elaborate. They include certain elements of all merchandising tools but are not nearly as elaborate as "theme sales." Again, in normal years, a product's projected movement includes a calculation of movement of that product under various promotions. In normal crop years, the response of the private label sector is predictable. Therefore, a brand product's movement is predictable. Supply and demand will usually balance at the brand level.

All brand manufacturers will use similar strategies. Some will be more spectacular and more effective as long as the supply of a processed fruit or vegetable product is not out of line with a reasonably normal figure.

The brand manufacturer adjustment process during long crop years differs from that in a normal crop year. In a long year, the market prices quoted by the private label processors will tend to be lower than in normal years as these firms bid against one another for retailers' off-line business. The generally lower price for private label puts pressure on brand producers to lower their products' prices in order to maintain the retail price gap between brand and private label product. This acts as a signal to the brand manufacturers to assess their supply situations. The result is that brand manufacturers will adjust their marketing plans to reflect the market conditions. The adjustment process has two dimensions. First, they offer more "attractive" trade and promotion allowances on long crop products which induces retailers to 1) place larger orders for and 2) "special" or promote these products more often. Second, the brand manufacturers will include these

long products in more of the programmed, routine promotions. If a manufacturer has eight yearly promotions, the long crop products might show up in six or eight of them.

The above adjustment process also can be used when the quality of the product varies between crop years. The promotions can be varied on different labels and in different markets to help balance the pack. The manufacturers do not, however, seem to be inclined to adjust their consumer oriented media advertising and promotion tactics. As stated previously, these tactics are designed for market planning and strategies to increase, maintain, or develop market share statistics for the manufacturer's products in various region. Therefore, if adjusting promotions to retailers and increasing the number of times a product is put on sale do not sufficiently move enough product to balance inventory, manufacturers must develop alternative strategies to dispose of the remaining inventories.

According to the trade, the national brand manufacturers used to "dump" the excess product on the market in their own labels. This dumping just meant that they simply cut the price so far that retailers were inclined to buy more product. This strategy would upset the longer run marketing plans of the manufacturers. National brand manufacturers now tend to sell these excess inventories as "brights." The manufacturers are said to let the word out that they have the product. Prospective buyers are invited to come to the warehouses and make bids on the product lots. This process of dumping brights versus their own labels has some interesting implications.

The product will usually be sold to the private label market. In long crop years, private label consumers may, in isolated markets, be

buying identical products in their brand and private label purchases. Since private label buyers realize that these "bright" supplies from brand producers are sporadic, they are not willing to buy substantial quantities without a significant discount from current private label market prices because most private label buyers want to keep a set of regular suppliers. During long crop years, the normal private label suppliers are also likely to be long on product. Buyers are thus normally pressed to be able to move all of their "regular" suppliers' products. Thus private label buyers will buy surplus brand products only at a very good price. This dumping at below market prices puts pressure on the private label processors to lower their prices to match the brand producers' prices.

There was some indication during the interviews that the very largest private label buyers usually get the first option to bid on surplus products. When brands liquidate surplus products, they want to do it as quickly as possible so that they do not upset the brand-private label retail pricing ratio. Larger private label buyers are more likely to buy and move larger quantities of product faster than small distributors. Under rare circumstances, other manufacturers and processors will bid on this merchandise.

When crops are large, brand manufacturers can adjust product movement through market pricing strategies aimed at retailers. If these adjustments do not result in sufficient movement to balance the manufacturer's inventories, the firm will sell excess product on the open market. Brand manufacturers do not seem to be willing to carry inventories into the next pack year. If they incur losses on their surplus sales, they seem to be able to bear these losses through their normal

margin structures. Thus in long crop years, brand manufacturers for the most part are able to coordinate their suppliers with market demands.

During short crop years, brand manufacturers take an opposite strategy to the one described above. The first thing they will do is to eliminate some or all of the promotion and trade allowances granted to grocery buyers. They may include the short products in some of their regular promotion schemes but do not highlight or feature those products in any way which makes them attractive to grocery buyers. In severe short crop years the brand manufacturers may even eliminate those products from their regular promotion schemes. When the supplies of any given product are critically short, the brand manufacturers may be uncertain about the industry supply situation. In order to assess the situation, brand manufacturers may temporarily "withdraw" for a short time from the market. A withdrawal is when the manufacturer stops taking orders for products from the retail buyers. This signals to the retail trade that the level of market supplies is short.

The primary reason for a withdrawal by a brand manufacturer is to assure that their supplies of the short products will be sufficient to cover their shelf space needs for the entire marketing year. Nothing is more harmful to the marketing plans of a brand seller than to have insufficient amounts of products to keep its allocated (by retailers) shelf space occupied. If the manufacturer does not have enough of the product, other competing manufacturers and retail private labels will usurp the vacant space. Lost shelf exposure is extremely expensive to recapture. Thus manufacturers will "withdraw" rather than risk making a marketing mistake that will result in insufficient product later in the marketing year.

If during a withdrawal or any other systematic review of the short products the manufacturers discover that they have insufficient inventories of their own products, they will go onto the open market and purchase additional products to cover their anticipated shortfall. Normally the brand manufacturers will go to private label suppliers to buy the product. Since they have critical quality dimensions for their products, they will normally select the best quality private label packers. Rarely will they purchase supplies from their brand competitors.

Brand manufacturers entering the open market will usually cause a tremendous stir in the industry. Brand factors will have to pay higher than market prices to entice suppliers to forsake their normal customers. Suppliers also know that brand manufacturers are willing to pay higher prices because of the severe consequences of losing shelf access. Because of this, brand manufacturers attempt to hide their identities from prospective suppliers. They will do this by attempting to use surrogate purchasing agents. The interviews indicated that this strategy usually does not work. The rumors that a major brand manufacturer is purchasing in the open market travels very quickly. This rumor usually causes the market prices for these products to move up quickly.

6.4.7 Adjustment Procedures for Minor Fruit and Vegetable Products

The brand manufacturers' strategies explained above work equally well for all processed fruit and vegetable products irrespective of their volume of sales. A manufacturer could balance inventories of cling peaches and apricots by using all the techniques described above. However, manufacturers tend not to try to adjust demand to supplies for all products. The reason is simply that doing so requires the systematic

application of marketing and sales department personnel and resources. A large manufacturer may pack over a hundred different products. Balancing inventories on all of these products could conceivably use all of the firm's marketing resources. Therefore, the manufacturer would not have the ability to implement desired marketing strategies designed to best rival manufacturers. Thus manufacturers have developed an alternative method for dealing with the uncertainty of fruit and vegetable commodity items. They simply avoid it.

For minor products, some brand manufacturers are willing to buy their products from other processors. This research did not investigate the procurement arrangements between a brand manufacturer and a commodity processor. The author suspects that the manufacturer will use standard industrial contracting procedures for buying these products. Most of these contracts are probably for one year or less and the manufacturer will usually contract with several packers. This reduces the manufacturer's risk in the event that any individual supplier defaults on contract provisions.

This contracting procedure essentially eliminates the manufacturer's need to use its marketing options to balance the product's demand with existing inventories. The problem is shifted to the processors from whom the manufacturer buy. This frees the manufacturer's marketing and sales personnel to concentrate on developing and implementing strategies for increasing the firm's market share. In addition, the manufacturer no longer has to bear the cost of running processing plants, and negotiating grower contracts.

Even though this strategy seems to have significant advantages for the brand manufacturer, it is normally only used for minor fruit and

vegetable products. The interviews explored the question why this strategy was not employed for all processed fruit and vegetable products. Both brand manufacturer and private label processors answered with essentially the same logic. Procuring processed product is risky. Should there be a crop failure or a quality breakdown in processing, consumer access and franchise to brand products might be damaged. Brand products are very susceptible to quality errors. A batch of less-than-normal product can cause irreparable harm to a brand item and that damage can be transferred to other products. Given this risk, most brand manufacturers seem only to be willing to accept that risk on relatively minor products which could be dropped from the line without any undue harm to profits. Many manufacturers do not, however, seem willing to take such risks with major items in their lines. One manufacturer did, however, imply that it would adopt this strategy at such as time as 1) there were three or four processors large enough to handle such a large account, and 2) that these firms have the expertise and control to maintain and assure a prescribed quality level. Should such an economic environment arise, this manufacturer felt risks of damage to the brand franchise would be sufficiently low that the firm would be willing to disintegrate its processing operations.

In summary, there seems to be a trend toward processing disintegration for minor fruit and vegetable products marketed by brand manufacturers. This trend has progressed further with some manufacturers than with others. The total disintegration process will not occur until certain economic structures evolve.

6.4.8 Trends in Brand Marketing

The above description may tend to leave the reader with an impression that brand manufacturers are omnipotent, calculating institutions which achieve the results they plan for with impunity. This is, however, not an accurate portrayal of reality. The best laid plans go awry. Just as retail firms are complex bureaucratic institutions, so are food manufacturers. Marketing, sales, procurement, and processing divisions and personnel often have conflicting goals. Internal communications within a firm can easily break down. Marketing strategies do not always succeed. Sometimes their numbers are just wrong.

Large manufacturers can and do make mistakes. One story related in the interviews explained how the marketing division of one national manufacturer was not informed that the current crop was significantly smaller than last year's. Consequently, they implemented the previous year's standard marketing plans and promotions and sold the entire current year's pack in the first half of the marketing year. The firm in question is still trying to regain the shelf space and profits it lost that one year.

A main point of this section is that given these kinds of impediments, large brand franchise manufacturers of processed fruit and vegetable products have the financial and personnel resources needed to manage their products through the food system. There are trends, however, which seem to indicate that manufacturers are increasingly willing to forego their traditional marketing behavior patterns. First, large manufacturers are less likely today to use their marketing resources to adjust demand to meet current supply conditions. Rather they seem to be willing to alter supply by either buying to make up deficits or selling

surpluses in the private label market. Second, for minor commodities and an increasing number of major commodities some manufacturers are willing to disintegrate their processing and marketing operations by buying needed products from other processors and only selling their marketing abilities. Third, major manufacturers have not developed many new products using commodity items (See Table 4.2). Thus consumer exposure to commodity products is diminishing over time. These three factors all result in an increased reliance on the private label-institutional market processing sector to provide the impetus for supply adjustment in the processed fruit and vegetable subsectors.

Re-examining Figure 6.2 helps explain why these current trends are a logical economic strategy. Manufacturers have the financial and personnel resources to affect retail demand schedules. Given that ability, why should they use that marketing power to shift demand to meet variable supply contingencies. If the product being sold is a noncommodity, fabricated food product with a manageable supply schedule, systematic application of marketing resources would increase product movement and price. Thus, the economic return to manufacturer's marketing resources is much more certain and most probably much more profitable with sales of noncommodity grocery products. The current shift away from commodities by brand manufacturers is a logical behavior response for them. Given the fact that most of the major brand producers of processed fruit and vegetable products are now parts of large conglomerate organizations, the trends away from commodities will probably accelerate as the traditional commodity-oriented personnel of the brand manufacturers are reorganized out of existence.

6.5 Some Related Issues Which Affect Coordination Behavior

Some aspects of merchandising, retail, and processing organization have thus far been overlooked but do have some bearing on the coordination of the food system. This section reviews some of these factors.

6.5.1 Implications of Food Distributor Organizational Structures

The organizational structure of food distributors can have a profound influence on system coordination. Organizational factors may be intrafirm and interfirm in origin. An intrafirm factor deals with how the firm organizes its buying and merchandising tasks. Within a retail food distribution organization the buyers are the supply agents and merchandisers are the demand agents. Some firms have buyers and merchandisers; others have buyer-merchandisers. This distinction is very important. For if coordination depends on responsive, systematic action by merchandisers based on information generated during the buying function, the buyer-merchandiser organizational form is transactionally more efficient. Whenever information needs to be communicated between two people (bureaucracies) a time lag and perhaps information distortion occurs. The buyer-merchandiser can be expected to have more relevant information and the discretionary power to act on that information. Under an organization with separate buying and merchandising decisions, intrafirm political and personality characteristics affect coordination behavior. Thus for a buyer to do an effective job of helping to coordinate a product's sales requires that he know the likes/dislikes, idiosyncrasies, and reinforcement patterns of the merchandisers who have control over his products.

How many chain retailers have buyer-merchandiser systems is not known. The author would estimate that less than half do. The procurement and merchandising functions are organizationally separate in the independent retail sector. The individual store owners or their employees do the merchandising function. They only order products from the buying organization. How much influence buying organizations (affiliated and cooperative wholesalers) and brand manufacturer salespeople have over independent retailer merchandising decisions is critical to coordination. Further research is needed to address this specific issue.

The intrafirm separation of buying and merchandising of brands is also the case for the private label system. With rare exceptions, private label products are bought and sold under separate buyers and merchandisers. Few retail chains which have buyer-merchandiser systems have the buyer-merchandisers buy private label products since private label procurement is just too specialized and time consuming. In addition, a very substantial portion of private label sales are made by retailers who are affiliated with private label buying organizations. The buying and merchandising function is not only separate but in different organizations. Thus the level of communication and understanding between buyers and merchandisers is even more critical for coordination.

Some private label buying organizations recognize how difficult it is to deal with suppliers when they have little or no control over the retail merchandisers. Most of the largest private label buying organizations have implemented programs to try to influence the merchandisers. Some require that member retailers give a firm commitment to purchase a set (say 80) percent of their last year's sales. Other private label buying organizations use theme sales, and TV specials to try to influence

product movement in their affiliated retail store market areas. They may also develop promotion/merchandising funds using these monies to "sweeten" a private label price reduction in hopes of getting the retailers to merchandise the private label products. These are all attempts by the buying organizations to exercise some influence over the retail merchandising decisions of their affiliates.

Thus in nearly all private label marketing and most of brand label sales the buying and merchandising functions are done by different people very often in different organizations. If better coordination is desired, the interaction between buyers and merchandisers is a key adjustment point. In the modern food system, only the most sophisticated brand manufacturers seem to have successfully managed around this organizational impediment.

6.5.2 Brand-Private Label Conflict with Retail Organizations

The fact that brand manufacturers are able to "direct" merchandising activity but simultaneously are tending toward leaving those food product areas with greatest merchandising need fosters a basic dilemma for food retailers. More of the coordinating problem is being put on the private label sector. Yet, retailers desiring to promote private label products at the expense of brand products are faced with a quantifiable (lost brand allowances, merchandising support, etc.) opportunity cost. How retailers resolve this dilemma is critical to the performance of the food system.

In order to overcome the inherent financial advantages of promoting brands, retail distributors, to be successful, need to make a long-term commitment to their private label programs. This means allocating

organization resources to private label (i.e., out of pocket expenditures to replace essentially "free" to retailers resources supplied by brand manufacturers). Retailers who adapt a "Franchise Development" approach to their private label products are much more likely to be willing to make this trade-off.

Brand manufacturers often assert that retail distributors do not accurately reflect brand allowances and private label costs in their pricing structure for brands and private labels. In other words, private labels were being cross-subsidized by brand products. A retailer, however, who does attempt to market his private label program will have to allocate resources and recognize the cost of those resources in his private label margin structure. Therefore the more emphasis on private label products and the higher proportion of sales that are private label, the smaller will be the price spread between brand and private label products. In the longer run, the more coordination responsibility taken by private label products via retailer provided merchandising, the smaller will become the current price advantage held by private label over brand label.

6.5.3 Empirical Evidence Concerning the Effectiveness of Retail Merchandising

The evidence presented in Section 6.3.3 details all that is publicly available about the effectiveness of various merchandising techniques. There may be many studies specific to a given product in a given market in a given time period which may be held privately. The whole area of the specification of demand schedules for individual products; the elasticity coefficients of various product demand schedules; and the movements along and shifts in individual product demand curves does not exist

either privately or publicly to the author's knowledge. Clearly, much of this chapter is based on the assumptions made in Section 6.2. As to the appropriateness of those assumptions, the author can only infer that they are in fact valid, because the whole procurement system for grocery products (both private label and brand label) seems to operate as if they are the way the consumer behaves. With the advent of laser scanning and UPC coding these assumptions will be more readily testable.

There is little doubt that merchandising increases product movement dramatically. But does this movement result in increased consumption of the product or does it merely temporarily shift product inventory from suppliers through distributors to the consumer's cupboard shelves? This question was asked of many trade people interviewed during the research. The vast number of responses were "we don't care." The main concern an individual supplier has is to convert his inventory into dollars. As long as the merchandising effort moves his product, coordination of his supply with demand is achieved. This merchandising process can take place, however, without an industry-wide balance of supply and demand. What is needed is for the merchandising effort to increase (decrease) consumption of the individual product(s).

Some of the people interviewed did volunteer their observations about consumption behavior. They tended to agree that if consumers bought more of a product, they consumed more of that product. The extent of the increase in consumption is dependent on the nature of the product. A perishable or refrigerated product tended to increase consumption more. A good example is a soft drink. If a soft drink is bought and refrigerated, more of that product is consumed. That is because of impulse every time the door is opened as the person looks for

a cold drink. The normal person will pick the product of which they have the greatest quantity.

This is also true of canned fruits and vegetables. If there are five cans of corn and one or two of all the other vegetables, the typical homemaker will usually choose a can of corn. In addition, if that product is plentiful (scarce) the average size of the serving presented to the consumer will be larger (smaller). This is especially true in institutional and industrial markets. The merchandised product may also find its way into different dishes and menu items. There is a tendency to make relishes, salads, and casseroles. In fact suggested recipes are one of the favorite merchandising techniques of brand manufacturers when running theme sales and promotions. These three behavioral responses tend to result in the increased consumption of products which merchandisers have induced consumers to buy. This increase in consumption is a function of the number of visual exposures the consumer has with that product after its purchase. Therefore merchandising probably has a two-fold effect of 1) increasing consumption of that product and 2) temporarily shifting inventory to consumer's shelves.

The next logical question was what is the general equilibrium impact of merchandising? James Shaffer, in a 1960 article on consumer buying patterns, documented that impulse buying or in-the-store purchasing decision do not significantly alter total food expenditures and the allocation of expenditures among particular food groups for the population as a whole.⁴ The research showed that merchandising techniques did not significantly alter the overall consumption pattern for fruits and vegetables. Thus, any increase in the consumption of an individual processed fruit and vegetable item must be correspondingly offset by a

decrease in the consumption of other processed fruit and vegetable products. Again, this factor is relatively unimportant to the individual seller. The only thing that matters is that his supply and demand are coordinated.

Retailers recognize that the ultimate constraint to merchandising is the size of the human stomach. If consumers are eating more corn, they are eating fewer peas. To some extent this is true. One could hypothesize that the reason Americans are overweight and are larger in stature with every succeeding generation is the fact that our food merchandising SOPs are effective in getting consumers to buy more and therefore eat more than is physiologically needed. The relatively low cost of food to Americans only serves to reinforce this pattern of development.

There was no interviewee who would make a definitive statement on the general equilibrium impact of merchandising. The consumption and movement data needed to examine these substitution effects are not available. Certainly if merchandising is effective, there must be a corresponding decrease in food purchases somewhere. Where and to what that decrease occurs is not known. Thus the remaining coordination discussion is of a partial equilibrium nature. Only the impacts on one commodity will be examined.

6.5.4 Supply Schedules for Individual Processed Fruit and Vegetable Products

Rarely in fact do researchers have empirical demand functions with which to work. More often supply functions can be constructed. None have been for this project. However, some reflection on the probable form of supply schedules for individual products will be helpful for the analysis in the next two chapters.

One could argue that supply functions for processed products are totally inelastic once pack has been completed. Because the product is no longer perishable, suppliers have the option of storage. Thus as prices fall, a few suppliers are often willing to store the product in anticipation of better prices next year. As prices rise, products come out of storage. Processors have some flexibility if the price is right for moving product from one market to another. For example, retail sales could be transferred to government, export, and perhaps even institutional markets.

The supply curves used in Figures 6.2 and 6.3 were constructed on the assumption for one year for one product of a specified quality. Within a period of a few years, suppliers will continue processing as long as product price is above average variable cost curves by financing their actions out of depreciation accounts. Their willingness to do this stems from the historical pattern of cyclical price movements and the knowledge that they will likely recoup losses in a short crop year. Since suppliers are not homogeneous, the supply schedule will begin to curve toward the origin as lowering prices forces more firms out of business. Given the competitive nature of many processed fruit and vegetable commodity markets and the lack of complete effective retailer merchandising, market equilibrium solutions are often close to or in this part of the supply schedule. Thus some supplying firms must exit the industry. If the existing suppliers are in one or two segments of the subsector, then lack of effective merchandising will have a restructuring influence on the processing industries. Chapter 7 analyzes the extent to which this phenomenon is occurring.

6.6 Merchandising in Perspective

Consumers are not very attuned to the absolute prices of most individual grocery items. Relatively small changes in the package price of an item go unnoticed and therefore in the short run retail demand does not adjust to the supply conditions which precipitated a price change. In contrast, in competitive wholesale markets small retail price changes per unit often result in wholesale price changes which move some firms from profits to losses. Consequently suppliers are acutely aware of actions taken by retailers to alter consumer demand.

Merchandising often includes actions by which retail distributors attempt to point out product price changes to consumers. While the general equilibrium implications of merchandising are not clear, all publicly available evidence indicates that merchandising tactics dramatically affect the sales of individual products. Brand product manufacturers, fully aware of this power, structure their marketing programs in a way so that they elicit the needed merchandising behavior from the retail distributors. The techniques they use to do this are fully documented in Chapter 4 above.

Private label suppliers, while aware of the merchandising power, must rely on the private label sellers to merchandise their products. Given the operation of the current food system, private label merchandising is not automatically forthcoming. In fact, given that brand manufacturers "pay" for retailer merchandising and that buying and merchandising are most often organizationally separated, there are tremendous impediments to private label merchandising.

APPENDIX TABLE 6.1--COMPARISON OF THE IMPACTS OF ADVERTISEMENTS ON
NATIONAL BRAND AND PRIVATE LABEL PRODUCTS^a

<u>Product</u>	<u>Normal Case Movement</u>	<u>Case Movement During Three Week Promotion^b</u>	<u>Added Sales Case Volume</u>	<u>% of Normal Movement</u>
16 oz. Canned Green Beans				
National Brand 4/\$1.00	206	3516	3310	1607%
Private Label 4/\$1.00	842	2908	2066	245%
24 oz. Cooking Oil				
National Brand 85¢	176	1521	1345	764%
Private Label 79¢	136	883	747	549%
6.5 oz. Canned Tuna				
National Brand 44¢	138	1943	1805	1308%
Private Label 44¢	140	1556	1416	1011%
3 lb. Regular Coffee				
National Brand \$2.97	80	1683	1603	2004%
Private Label \$2.79	98	534	436	445%
5 lb. Flour				
National Brand 66¢	138	3500	3362	2436%
Private Label 59¢	260	2357	2097	807%
13½ oz. Frozen Sausage Pizza				
National Brand 68¢	98	1958	1860	1898%
Private Label 66¢	184	1368	1184	643%
49 oz. Heavy Duty Detergent				
National Brand 98¢	336	1908	1572	468%
Private Label 79¢	86	352	266	309%
Jumbo Paper Towels				
National Brands 39¢	122	1905	1783	1461%
Private Labels 39¢	108	1641	1533	1419%

^aIt is impossible to tell from the data available whether or not the advertisements were controlled for media and size for both types of products. National brand advertisements in newspapers are often coordinated with T.V., radio, and coupon activity. Private label products are usually only featured in newspapers and only occasionally with retailer sponsored coupons.

^bAll promotions were for three weeks duration although they occurred during different three week periods. Although the data are not clear on this point, the numbers probably represent case movement from the warehouse of one retail account.

SOURCE: Majers Market Research Corp. as reported in "Brand Power Study," Progressive Grocer, January 1977, pp. 50-52.

CHAPTER 6

FOOTNOTES

¹Adapted from class notes of Professor James D. Shaffer. Agricultural Economics 809, Institutions Behavior and Performance, Michigan State University Fall 1976.

²See section 6.4 below.

³"New Marketing Approach at Del Monte," American Institute of Food Distribution: Weekly Digest, December 14, 1974, p. 6.

⁴James D. Shaffer, "The Influence of 'Impulse Buying' or In-The-Store Decisions on Consumer Food Purchases," Journal of Farm Economics 42 (May 1960): pp. 317-24.

CHAPTER 7

AN ANALYSIS OF THE COORDINATION AND STRUCTURAL IMPACTS AND POLICY IMPLICATIONS OF FOOD DISTRIBUTOR PROCUREMENT PRACTICES

7.1 A Strategy for Analysis

Most of the effects of retailer procurement and merchandising standard operating procedures (SOPs) are evolutionary. The SOPs result in benefits and costs to food system participants which are sequential and dynamic. The goal of this chapter is to provide an understanding of the dynamic operation and some of the performance consequences for the United States food system.

Because of the dynamic nature of the research, scenarios are a primary analysis tool. Scenarios are very useful in describing how the various types of procurement practices act upon one another. They provide a vehicle for joining brand and private label procurement practices with retailer merchandising SOPs within a multiyear setting.

Scenarios can be rather nondescript if used within an overall food system setting. In an attempt to more precisely demonstrate the flow of consequences for procurement SOPs, scenarios are presented for the processed fruit and vegetable subsectors. By using processed fruit and vegetable examples, the general status of most commodity type items in the food system can be better understood. Many of the organizational consequences of procurement and merchandising practices are applicable to all food (commodity and noncommodity) items.

To accomplish the analysis, the chapter proceeds as follows. The flows of information and control in the food system are examined using the general framework developed in Chapter 2 above. Three scenarios depicting the dynamic operation of selected processed fruit and vegetable markets under different supply conditions are presented to demonstrate the interaction of brand and private label subsector behavior. The vertical coordination consequences to commodity subsectors of the present distribution of benefits and costs are described in several sections. Structural dynamics of procurement practices are examined in the last several sections. The final section summarizes in list form the consequences of the current set of procurement practices on the United States food system.

Policy implications of distributor procurement practices are handled simultaneously with the coordination and structural analyses. There are few straightforward policy recommendations which flow directly from retailer buying behavior. However, when many existing policy institutions and some current policy proposals are evaluated in light of retailer buying behavior, some important policy considerations develop. Particularly important are institutions dealing with producer-first handler interaction and proposals which attempt to regular consumer product contents, labels, and advertising.

7.2 The Distribution of Information and Control in the Food System

7.2.1 Integrating the Various Components of the Food Distribution System

Coordination is a dynamic process involving the assignment and transfer of control and information among participants in a system. Procurement

and distribution practices (Chapters 4 and 5) and merchandising SOPs (Chapter 6) are interwoven into flows of decisions and information which direct food from supplier plants to final users. In the grocery segment of the food system, these flows involve brand manufacturers, private label suppliers, brand buyers, private label buyers, and retail merchandisers. This section analyzes how each of these groups interacts with the flows of control and information in the system.

7.2.2 The Distribution and Flow of Control in the Food System

The process of moving food from supplier to consumer involves costs and rewards. The assignment of the tasks and responsibilities determines who bears these costs and who reaps the rewards. Control or power is the ability to affect the flow of costs and benefits within this system. As developed in Chapter 2 above, control can be active or passive. Active control is the ability to direct the distribution of rewards and costs; passive control is the ability to refuse to accept the costs which are being generated in the system, especially those resulting from uncertainty. Both active and passive control are applied in merchandising, procurement, and distribution. Each of these functions and the control exercised by various system participants is analyzed below.

A. Merchandising

Merchandising in its simplest economic context is a conscious attempt to change consumer purchases. In terms of rights assignment, food retailers control the merchandising efforts and direction of their stores. The key elements of shelf assignment, off-shelf assignment, price and margin determination, in-store advertising, and retailer print and media

advertising are under the merchandisers' direct control. Attempts to adjust consumer purchases to supply contingencies requires the approval of merchandisers. The merchandisers have active control over the merchandising variables. However, the amount of effective control retailers retain in brand versus private label merchandising is very different.

Brand manufacturers have the ability to substantially influence retail merchandisers in many of the merchandising decisions which arises from two factors. One is the structure of their promotional offers to the retail trade. The examples and explanations given in Section 4.4 demonstrate how this manufacturer influence is effectuated. Retailers receive monetary and non-monetary support in return for their commitments to various types of merchandising support. The use of direct consumer advertising by food manufacturers helps assure that merchandisers select those manufacturer's products for special merchandising treatment.

Since merchandisers often have several hundred manufacturer deals available on a weekly basis, there is a great tendency for merchandisers to take the allowances without performing the manufacturers' stipulated merchandising tasks. This is one of the more frequent points of contention arising between distributors and manufacturers. Herein arises the second factor which brand manufacturers can use to influence merchandiser behavior.

Field forces brokered or owned by manufacturers provide the manufacturer with store-level monitoring and enforcement potential. In addition, many of these field forces provide the labor necessary for implementing the promotion activity (See Section 6.4.4). Thus some brand manufacturers are able to 1) use consumer advertising to induce retailers to select their promotions; 2) structure promotions to compensate the

merchandisers with payments in money and kind; and 3) implement their promotions because of the store-level control exercised through field forces. Not all brand manufacturers have the financial or personnel resources to effectively mount and/or coordinate this kind of promotional effort. Those that do, to a large extent, have managed to gain active control over the merchandising function.

The retailer maintains nearly complete control over private label merchandising. A brand product has an identity throughout the distribution process. Thus manufacturers of these brand products have a strong incentive to try to control the merchandising process. A private label supplier's product loses what little identity it does have when the retailer's label is attached. Even if the private label firm had the resources to go directly to the consumer to affect the merchandising process, it would be irrational for him to do so. Most likely the other suppliers and the retailer would benefit more than the paying supplier. The private label processor has no merchandising power. The only way a private label supplier can try to influence a retail merchandiser is by lowering his price to the buyer.

Not only does the private label supplier not have any way of affecting merchandiser behavior, he usually cannot communicate directly with the merchandiser. As stated previously, nearly all private label products are bought by specialized buyers. The existence of buyer-merchandisers for private label is extremely rare. Thus a private label processor who wishes to get merchandising support to increase his demand ~~needs~~ to have the retail buyer act as his agent. Only the buyer can ~~sent~~ the price decrease to the merchandiser and provide the jawboning necessary to get the desired merchandising support.

Private label supplier influence on merchandising is made even more difficult because of the frequent separation of buying and merchandising into different organizations (See Section 6.5.1). Thus to the extent that merchandising activity is needed for effective coordination, there are very different coordination solutions for brand and private label products.

While it seems that retailers maintain absolute control over private label merchandising, this is not the case. Given the facts that 1) merchandising resources are limited (end-aisle displays, newspaper ads, etc.); 2) certain brand manufacturers can control merchandising decisions; and 3) brand merchandising tends to draw more customers, brand products tend to be favored. Thus private label product merchandising is heavily influenced by the brand segment. Only a retailer corporate commitment to develop private labels as a major marketing element of the retail organization will overcome the inherent brand merchandising advantages. This is why the basic philosophies used by private label firms has been highlighted in the research. A retail organization with a long-term commitment to private label transmits that priority to its employees.

Firms with a private label commitment will have a different impact on subsector coordination. Normally, these firms will merchandise private label before brands develop their promotions (See Section 7.3). Also these firms are more receptive to private label supplier price changes. Thus some private label movement is exposed to merchandising (demand modification) techniques.

Merchandising control can be summarized as follows. Retailers own the merchandising rights. They may abdicate some of those rights to brand product manufacturers in return for allowances, labor support, and

advertising for consumers. Manufacturers who are effective in their marketing techniques can manage the merchandising function to achieve their coordination needs. Private label suppliers face significant barriers to obtaining needed coordinating activity from retailers. Consequently if merchandising action to coordinate the system is not forthcoming, the consequences of coordination failure fall most heavily on 1) private label suppliers and 2) brand manufacturers who do not have the financial and/or human resources necessary to manage the merchandising of their products at retail.

B. Procurement

Brand manufacturers are able to wrestle some control of the procurement process away from retail distributors. The control obtained is gained concurrently with manufacturers' attempts to direct the merchandising function. Buying allowances are often offered along with merchandising allowances and these are all coordinated with the consumer advertising and promotion activity. This most often takes place during the new product introduction process. Exhibit 4.4 documents how a manufacturer structures payments to retailers in order to gain their agreement to stock the new item(s). Buyers do however maintain some of their authority. For example, in the case documented in Exhibit 4.4, some buyers only stock a few of the items in the new line rather than all eight. Again, the procurement power usurped by brand manufacturers is directly a result of the manufacturers' consumer advertising and merchandising activity.

With the above exception, retail distributor buyers retain nearly complete control over the rest of the grocery procurement decisions.

This control comes from the grocery buyers' right to decide which items and in what quantity are stocked on the grocer shelves. Through the explicit or implicit use of stocking decisions, buyers have been able to substantially insulate themselves from most risk and uncertainty. The SOPs used to accomplish this differ somewhat for brand and private label products.

Brand manufacturers are more or less required to grant buy-in (or perhaps back-in) privileges, provide stock protection clauses, slot charges, and damaged goods clauses. All of these "concessions" have the effect of isolating the buyer from nearly all downside and upside price risk on any of the brand products they stock. The Robinson-Patman Act, requiring that manufacturers assure all retailers in a market get the same products at cost adjusted equal prices, partially protects retail buyers from discriminatory retribution from suppliers who the buyers may have "disciplined" for not providing all of their requirements. Most brand procurement SOPs result in the distributor having the lowest wholesale prices. These will, for the most part, be equal to those of his competitors. Whether those wholesale prices are reflected to the consumer is dependent on many other factors.

Buyers maintain control over private label procurement obtained by the threat that a private label supplier will be denied access to the distributor's label. The operation of the booking system and the use by some buyers of storage-in-transit programs gives buyers downside price protection. Many suppliers, because of their generally weak bargaining positions, will allow modified buy-ins or back-ins. Thus the buyer gains some protection for price rises.

The private label procurement system for commodity items, with their inherent quality and supply risks, tends to be more complex than brand product procurement. Gentlemen's agreements and general business reputations tend to regulate private label buying. Some private label buyers with a longer run perspective although maintaining near total control over procurement will not fully exercise that control in return for supplier restraint in poor crop years. There is, however, no disputing the fact that buyers control private label procurement.

C. Distribution

Implicit in the discussion of procurement SOPs in Chapter 4 is the conclusion that retailer distributors to a large extent control the distribution of food products. They demand and get delivery schedules to minimize their inventory costs. They demand and get compensation for their costs in slotting a new product in the warehouse. They demand and get compensation for goods that get damaged in their warehouses. There seems to be little distinction in their demands from brand manufacturers and private label suppliers. Their insistence on minimum inventory cycles, however, does systematically discriminate against certain types of suppliers. Perhaps their complete control over distribution variables is best summarized by reviewing the use of in-transit storage programs. In these programs, the retail distributor has the private label supplier put his labels on the product, orders it shipped into a warehouse hundreds or thousands of miles away, orders it stored at manufacturer expense on call until the retailer needs it, at which time payment is not due until thirty days later.

Retailers also have control over other distributional aspects. Manufacturers, of course, are liable for their brand name products and for any recall. Although retailers use their own labels on private label products, they do not accept any product liability. The private label packer bears this responsibility through various explicit legal agreements and implicit understandings.

From the above discussion and that in Chapters 4, 5, and 6, it is clear that food retailers have control over many aspects of the food distribution system. This power arises because there are more products produced than there is shelf space. This power arises independently from any horizontal market power the retailer has. Food distributors have over time parlayed this control into SOPs and other institutional relationships which minimize the retailers' exposure to risk. Brand manufacturers by virtue of their consumer franchises have been able to "go around" the retailers to achieve their desired goals. Private label processors and packers have no such options. The destiny of their undifferentiated products is primarily in the hands of the retail food distributors.

7.2.3 The Distribution and Flow of Information in the Food System

The actions of firms and individuals in the food system are influenced in part by what information they receive and there are important differences regarding the flow of information. More information exists in the system than is transmitted through the system and some information transmitted may be inaccurate. These factors can affect vertical coordination practices.

A. Demand Information

Consumer purchase decisions initiate certain flows of information. Individual retailer organizations collect the demand information for all products sold in their stores. At this point in the system, retail organizations "own" the demand information. However, a break develops in the flow of demand information within the system at this point.

Retail organizations have no incentive to pass their demand observations on to the next stage which is local, regional, and national market demand summation. This is because they have no particular allegiance to any single product. As long as there are other products vying for shelf-space and consumer access, retailers will only judge products by comparing them with a relatively narrow set of alternative products. Recalling the discussion about discontinuing products in Chapter 4, individual product performance is judged by comparing the product's demand (and profitability) with those of closely related products now in distribution. Some retailers will check the product's standing in the local market (by using Selling Areas-Marketing, Inc. 'SAMI' data) but for the most part the product's fate is determined by its relative standing within the retail organization.

Retailers therefore do not see the need to collate and transmit demand statistics through the system. Thus individual product demand information is impacted with retail food distributors. In order to "free" this demand information, some individual or organization must have both the incentive and the ability to collect and transmit this information. Herein arises another difference between brand and private label suppliers. Private label suppliers have neither the incentive or ability to get individual product demand information. Since the retailer may

have six to ten suppliers of any particular private label product, an individual supplier would get only minimal value from knowing what that product's demand (movement) was. The supplier would not likely know what day, what market, or what store his product was finally sold under the retailers label. Given also that most private label suppliers are small to medium sized firms, many under capitalized, most do not have the ability to free impacted demand information.

Brand suppliers, on the other hand, have the incentive to know the demand for their product(s) relative to other competing products. Yet the cost of acquiring that information from the hundreds of retail organizations, using many different record-keeping systems, is sufficiently high that without some method to lower transaction costs, most manufacturers would not have the ability to get needed demand information. SAMI buys individual product movement figures from retailers. The data is collated and translated into reports for the brand manufacturers who purchase the information.

The A. C. Nielson Company provides a similar service. These demand transmitting organizations overcome the financial constraints to unlocking impacted demand information. These services also collect private label information primarily for brand clients. Because individual private label suppliers cannot ascertain where their products fit in that information, it is of little use to them for demand projections.

Currently these demand collecting agencies can get only quantity (movement) data. Thus brand manufacturers do not have a complete demand picture. Here again the use of manufacturer sales forces play a critical role. Field forces, especially in-house units, are able to augment movement data with price data. For example, some companies' field

persons, as part of their regular duties, include recording data during each store visit--the prices being charged for the manufacturer's products, their competitor's prices, and facings and locating promotion compliance. This information is sent to headquarters, summarized, and redistributed to regional offices all within a matter of a few days. This kind of information allows the manufacturer's representatives to interpret the quantity (movement) information they are receiving. The manufacturer can often discuss, for example, whether a demand change is a result of a competitor's coupon drop or caused by a change in retailer merchandising activity. This type of information is much more difficult to obtain with brokers because of the increased transaction costs associated with trying to communicate with many different sales organizations in different parts of the country. Brand manufacturers with their own field forces have significant information advantages over their brokered competitors.

The national implementation of computer scanning of Universal Product Code (UPC) symbols has the potential to merge price and quantity demand information together in a very timely fashion. However, again the retailers have no incentive to transmit the demand information through the system. Currently A. C. Nielson, National Advertising Bureau (NAB) and other firms are trying to develop the demand information marketing system to sell this data to manufacturers. Although much better than current information, UPC data will still need to be augmented with information which explains "why" a change in demand or quantity demanded for a given product occurred. Manufacturers with field forces will still hold some competitive advantages over rivals.

Quantity movement of private label products remains impacted in the system. No comparable data systems have evolved to give private label suppliers retail demand information. The best data available are the wholesale price ranges reported weekly by the American Institute of Food Distributors. These price data are combined with whatever information about quantity private label suppliers can glean from their historical sales patterns to retail buyers and the buyers bookings for the upcoming year. As was discussed at length in Chapter 5, booking information may be inaccurate, since buyers for their insurance from short-crop may prorate and for strategic bargaining purposes may "overbook" the product. In long crop years, overbooking may cause processors to pack more product than the market needs at prices which will return costs and some normal profit on investment. Bookings, however, come too late to cause packers to automatically inflate acreage in grower contracts. Overcontracting culpability must fall on the processor. However the general demand uncertainty caused by the operation of the booking system may be one incentive for processors to overcontract. This may shift risk to the grower who has little or no control over the situation.

Overbooking is strategic misrepresentation. The general sense of the interviews was that overbooking does occur, is not a serious problem, and as a strategy is declining. Buyers who overbook get known rapidly in the trade. Processors are able to "discount" overbooking firms by using their historical pattern of shipment. Overbooking is only a problem with new buyers. Once the buyer has established a track record, his bookings are discounted in favor of his historical shipments of products.

Overbooking has been hypothesized by some industry observers to impact on vertical coordination consequences. Findings of this research tend to show that retailer overbooking does have an impact on vertical coordination but the magnitude is rather minor. Retailer overbooking may be responsible for some of the exaggerated commodity cycles observed. Inflated demand estimates tend to cause some uncertainty among processors. Given that suppliers' future business is hurt most when they cut buyers off from supplies, processors tend to adjust to uncertainty by packing more rather than less. To this extent overbooking does tend to create supply-demand imbalance and therefore coordination difficulties. However, since bookings are often received too late to affect contracting and/or planting decisions, overbooking does not have a major impact on coordination. The problem is that of a missed opportunity to get reliable information into the system. Processors' overplanting or contracting is somehow based on their internal decision-making logic and is not, for the most part, a natural economic response to erroneous demand information from retail buyers.

In summary, consumer product decisions generate demand statistics which become the property of food retailers. Retailers sell these statistics to firms which process the information for client brand manufacturers. Some manufacturers are able to generate other types of demand information which give them superior information bases over their rivals. Demand information for private label products is much less available to suppliers and therefore they operate under greater conditions of uncertainty than do brand manufacturers.

B. Supply Information

The value of supply information about a food product varies in the food distribution system. For manufactured and/or formulated products supply variation is relatively minor because manufacturers are usually able to control the flow of products out of their plants and into the distribution networks. Supply variation for these products usually results from interruptions in transportation or regulatory action.

Supplies of commodity based food products vary because of acreage and yield changes between and during crop years. Where commodities constitute a significant portion of the final consumer product's price, supply variation causes price variation. Thus those agents in the food distribution system exposed to this price risk, often desire and seek supply information. The following discussion of the flow of supply information is limited to flows in commodity items.

The two most important supply variables for any product are 1) the size of inventory carryover from other years and 2) the size and condition of the upcoming crop. Publicly available information exists for both these variables. The government and private industry trade groups attempt to monitor inventory positions of various crops. Although these reports are often time lagged, they are generally well used by suppliers and some buyers. In the past the USDA and more recently trade organizations, have issued grower and processor planting intention reports and contracted acreage reports. These reports attempt to provide the market with supply information for the coming crop year and are generally available to firms in the trade.

Planting intentions and contracted acreage reports are often of limited value for planning and coordination purposes. Planting intentions

are particularly suspect. Many commodity markets are monopolistically competitive in which firms recognize that their actions affect their competitors but still act as if they were in an atomistically competitive market. The interviews revealed that processors may report that they are reducing acreage to meet market needs but will often not follow through on their stated intentions. They reason that if all other firms reduce acreage and they maintain their output, they will gain a profit advantage. It was reported that most processors would reduce acreage but attempt to increase yields by applying more fertilizer and eliminating only the poorest acres. In other words, the intention reports are unreliable because they influence the actions of all firms.

Acreage reports are only partially useful because they cannot predict yield variations which are influenced heavily by weather conditions during the growing season, and particularly close to harvest time. Even for perennials where supply is much more predictable, yield variations are very critical for industry supply. Also quality, which is a critical coordination component, is not really known until both annuals and perennials are completely harvested.

Thus even though there are attempts to increase the supply information to commodity subsectors, industry quality and quantity statistics are not available until after harvest. Each supplier recognizes the value of his own supply information and usually does not share that with other firms or buyers. Therefore all interested firms and buyers must develop, as best they can, some supply information networks. As with demand information not all the system participants are equally adept and/or equipped to gather supply information.

National brand manufacturers have some information gathering advantages over other sellers and buyers, most of them being a function of their size. Since they are large and therefore have a larger share of production, they may have a better idea about what the situation of the industry inventory and quality is. Besides owning inventories, they often have plants in several growing regions and therefore know the quality and yield factors for most of the country. Brand manufacturers will attempt to augment this information with whatever they can find out through trade publications and rumors.

The smaller and more regionally specialized private label processors often have less supply information because they have only their own experience to draw on which is usually in a localized geographic area. Therefore private label processors do not have first-hand knowledge of quality and yield conditions nationally. Most firms attempt to augment their limited supply information with the same published and unpublished trade information available to brand suppliers. Private label processors are less disadvantaged in their access to supply information than to demand information.

The concern for or even consciousness about supply issues varies dramatically with various grocery buyers. Private label buyers need to be more attuned to supply conditions because they are responsible for planning purchases for a whole year. As discussed in Chapter 5, some private label buyers are much more concerned. These buyers who take forward buying commitments seriously are always trying to get a handle on supply conditions. The best private label buyers will attempt to use their positions to pump supply information from their suppliers. If they have national operations, they can get national supply readings. The very

best private label buyers will have better supply information than most private label suppliers. However, for the most part private label buyers have only a limited concern for supply conditions. As long as they are able to have sufficient suppliers to provide needed supplies at market prices, the majority of private label buyers will continue to be only partially aware of market supply conditions.

Brand grocery buyers and merchandisers have almost no concern about product supply conditions. Because they are used to dealing with manufactured food items, they rarely encounter supply-induced problems. Brand manufacturers of commodity-based items, usually (if they want to maintain shelf space) shield buyers and merchandisers from variable supply conditions. Thus brand grocery buyers and merchandisers are unconcerned about subsector supply conditions and therefore they would be unlikely to initiate actions to alter vertical coordination.

In order for subsector supply conditions to be reflected to consumers, brand manufacturers must go around the retailers and go directly to consumers by using their merchandising power (Chapter 6). Private label suppliers must hope that the private label buyers are able to have access to and influence with the grocery merchandisers. Without the buyer-to-merchandiser link, the private label subsector must wait until brand actions alter private label-brand label price ratios and the retail sector begins to react.

In summary, in commodity-based grocery product markets supply information is incomplete. Brand manufacturers by virtue of their size usually have better information than private label suppliers. For the most part, supply information does not get transmitted through to consumers by the retail buyers and merchandisers. Transmission forward

requires action by suppliers. Only the sophisticated brand manufacturers have the incentive and ability to make consumers react to supply conditions. Private label suppliers must rely on someone else.

7.3 The Dynamic Operation of the Processed Fruit and Vegetable Markets

7.3.1 Some Definitions and Assumptions

This is the first of several sections which brings together in a dynamic context the behavior of various components of the food system. The purpose is to illustrate the longer term implications of current vertical coordination patterns in the food system. Processed fruit and vegetable products are used in the analysis because all of the basic units in the food distribution system operate within these subsectors.

Three scenarios depicting the operations of the processed fruit and vegetable markets are presented below which represent behavior under different supply conditions. To simplify scenario construction, certain assumptions have been made. First, the following scenarios are only directly applicable to canned products. Because of the factors enumerated in Section 5.14, behavior in the frozen market of the food retailing segment is different from behavior in the canned market. Second, the following scenarios are applicable for only the major canned fruit and vegetable products including peas, sweet corn, snapbeans, peaches, pears, fruit cocktail, and applesauce. Pineapple is a special case. The same market processes operate in the minor products but there a few other important factors are involved. Third, the scenarios assume that the distribution of crop quality is essentially proportional to historic market needs irrespective of the total crop size. System response to

varying quality has already been discussed in Section 5.5 and 6.4.5 above. Assuming quality variation would increase the number of scenarios which would have to be covered without adding any significant new insights into dynamic market behavior, there could be average, above average, and below average quality crops in each of the normal, long, and short crop years. This would result in nine scenarios rather than the three presented below. The final assumption is that the brand and private label segments of the market are linked by a very basic pricing rule used by the food retailing industry; private label products are priced as some relatively fixed level below the comparable brand products. Market experience has shown that if the price differential narrows, consumers will shift away from store brands to brand products. The converse is also true. Thus the basic assumption is that changes in relative prices between brands and private label products is a major driving force which induces market participants to alter their behavior.

To help keep the scenarios manageable, the behavior of five broadly defined system participant groups are analyzed. First are the national brand sellers consisting of firms which have consumer franchises and have shelf space on the retail shelves.

Second are firms defined as above average private label suppliers (AAPLSs) which have several general characteristics. They have some conscious marketing efforts. This may only be a director of marketing but at least this is some firm commitment for developing and maintaining a longer run marketing program. Also, these firms rank as a desirable supplier by most of their major buying accounts. In other words, these firms do pay and have in the past paid attention to the requests on price, quality, and service from private label buyers. Lastly, these

firms have market information systems which keep them accurately informed of market and trade conditions. Thus information is combined with a marketing perspective to produce a responsive and adjustable private label supplier.

A third group of participants is here defined as average private label suppliers (APLSs) which tend to have a production or processing orientation characterized by a "Let's pack it, we'll sell it later" philosophy. These firms are market followers rather than leaders. They are and have been relatively inattentive to retailers' needs for service and quality. They are in business because they do match market prices and are attentive enough so that they obtain enough business to perpetuate their existence.

The fourth group of participants used in the scenarios are above-average private label buyers (AAPLBs) sharing two basic characteristics. First, they are preferred accounts by many private label suppliers arising from their reliability, honesty, and professionalism over the years. Second, these are buyers who usually work for retail distributors who have a long-term commitment to developing their private label products as integral parts of their operations. In other words, AAPLBs tend to be the buyers for firms which have the franchise development philosophy described in Section 5.11.1.

Conversely, average private label buyers (APLBs) most often are buyers for firms which have adopted the competitive response philosophy of private label. These buyers tend to be more inexperienced, more overworked, more myopic, and sometimes less ethical than AAPLBs.

No doubt these definitions are gross generalizations. Real world buyers and sellers come in many categories of experience and expertise.

However, these categories do provide useful simplifications which help depict the general operation of canned fruit and vegetable markets during the course of a marketing year.

7.3.2 Market Behavior During a Normal Crop Year Scenario #1

Assume a crop yield consistent with the volume sold through retail outlets in the most recent years. Carry-in of product is at normal pipeline maintenance levels. Most packers are satisfied with their inventory levels and set out to sell their products with standard practices used over the years. The following scenario runs for one marketing year which is assumed to commence during pack time and end at the onset of pack next year.

Pack time brings subsurface activity and anxiety as processing firms wait for some other firm to announce "opening prices" for the new pack. Private label sellers are sensitive to any rumor and will call all their buyers hoping to get some indications of buyers' thoughts on what opening prices should and will be. AAPLSs will be spending more time studying their cost figures and analyzing market projections while many APLSs spend more time running down rumors. The brand manufacturers will be making adjustments to their marketing plans.

Opening prices will normally result from two events. First, the privately negotiated off-line, cash sale deals between AAPLBs will eventually become known to the trade. Second, major brand suppliers will post their initial list prices. These events combine to "break the dam" and all suppliers soon announce their opening prices with perhaps some adjustments up or down depending on competition and other market dynamics.

The next month to six weeks usually amounts to essentially a pipeline filling process. Buyers process orders to build up their inventories for the increased consumption which follows as schools open and families settle into routine meal patterns and as fresh produce starts to become scarce and higher priced. During this time most suppliers know what their inventories are but do not know exactly the supply situation of the total industry.

As pipelines are being filled AAPLBs are starting their buying for their annual fall harvest of value sales. They will be working on both AAPLSs and APLSs for price concessions and hot deals. While market share is the key determinant of the brand firms, cash flow considerations are a major factor influencing the actions of private label suppliers. The AAPLBs will have received information about the financial health of various suppliers. These buyers will be able to approach suppliers especially APLSs at a critical time and offer a lower price than current market for a large order. The supplier needing cash will often agree. These deals are privately negotiated and may or may not affect the market price immediately.

At the same time brand manufacturers are about to launch their first major promotions of the year. The AAPLBs can sometimes beat the brands to the punch on timing their fall specials if and only if they have a close working relationship with the retail merchandisers who set the advertising and display policies.

The launch of a major brand promotion is an early major upheaval on the market. The coordinated advertising, display, and promotional allowances usually cause retail prices of brand products to be lowered. This narrows the brand/private label price ratio which induces retailers to

seek to lower their retail prices on private label and, therefore, wholesale private label prices. At this point all buyers put pressure on private label suppliers to lower their wholesale prices. At this point APLSs become serious about moving large chunks of their inventories. Many AAPLBs already have their supplies committed and have beat the market. In normal years, some suppliers will lower prices--others will hold the line realizing that this is normal but temporary price activity. Whether this general lowering of private label prices increases sales to consumers depends on how successful the private label buyers were in influencing the merchandisers in their firms.

The market gradually drifts back up as promotional periods for the brands expire and retailers gradually move the inventories they acquired during the brand-induced price change. This usually brings the market into the Thanksgiving through Christmas period when most retailers and brand manufacturers turn their attention to the specialty products featured during the holidays. Procurement of major products takes on the routine order-reorder cycle of many food products. There will be a few isolated instances where APLSs will be trying to move inventory, but generally there is not much excitement in the market. During this period, AAPLSs and AAPLBs will be servicing their favored accounts. Buying/selling nearly stops except for computer ordering the two weeks before and after Christmas.

The time from the beginning of the New Year until Easter is probably the most turbulent time for the processed fruit and vegetable markets. Several important events occur during this period which serve as catalysts to move the market. The first is the release in early January of the USDA reports on the pack and the inventories of canned fruit and

vegetable products which is the first comprehensive data publicly available about crop size for the United States. Processors know what the normal sales of any product are in a given year and know from experience what effect various inventory reports have on the market. Thus, suppliers quickly begin assessing their inventory positions in light of possible price movements resulting from inventory reports.

At this time, retail buyers are also back in the market for deals. Consumers are 1) ready to return to normal meal patterns after the holidays, and 2) are very price conscious because budgets are being strained by incoming holiday bills. AAPLBs are shopping for deals to feed their firms' merchandisers. During this period, brand suppliers will also be running another set of promotions.

At the end of January or in early February another major event in the marketing process occurs when the National Food Processors Association (NFPA; formally the National Cannery Association) holds its annual convention. At this meeting, buyers and sellers have what is likely to be their only face-to-face meeting of the year. Buyers rent hotel suites and suppliers get appointments to receive their "report cards" (evaluation by buyers). During this convention, many, many deals and trades are made. The NFPA convention sets the private label market or at least starts the market into motion. Again AAPLSs and AAPLBs will arrive at the convention knowing what they need to do to achieve their goals. The APLSs and APLBs on the other hand, will go to the convention to find out what they should do.

Another important factor causing movement in product markets was a recently repealed state tax law in California. On March 1 of every year inventories were evaluated for taxation. Therefore, most of the

California-based processors would sell through pricing strategies designed to move as much inventory to out-of-state buyers as they can. California-based retail distributors would not take shipments in order to reduce their taxable inventories. This law provides the incentive to firms to change their current price offerings. One firm's price change may multiply quickly through the system.

In early spring, several major private label buying organizations will put on large multiproduct promotions. These private label events are designed to help the private label buying groups induce their member retailers to merchandise and promote private label products in such a way that the buying group can balance its booking commitments with actual movement. These promotions closely resemble the major brand promotions.

As spring wears on, pressure intensifies on suppliers to move their inventories before new pack. After schools are out for the summer, it is very difficult to sell processed fruit and vegetable products in volume. Thus, supplying firms try to get their warehouses in order before summer. Here again, AAPLSs will usually accomplish this before APLSs and often at higher prices. The closer it gets to the summer season, the more price pressure the private label market undergoes as recalcitrant suppliers bid against one another through lower prices to get buyer's and merchandiser's attention. Meanwhile, brand suppliers will be making similar adjustments. The main difference is that brand suppliers are using their own marketing effort rather than having to rely on retail distributors. As new pack approaches, inventories will usually be sold.

In normal years, product sales will usually be sufficient to create the desired carry-in situation for the industry. Brand factors will have

been able to implement their market share goals and still balance their inventories via their own marketing. AAPLBs were able to get their private label at market prices but when and with the service level they prefer. APLBs were able to obtain nearly all of the product they wanted from a variety of suppliers who were at or below market prices. APLSs were able to move all their inventories through the system when they lowered their prices. The AAPLSs also were able to move all their inventories through the system when they lowered their prices. Since they move slightly faster, they may have on the average received slightly higher prices for their product than did APLSs. Generally in a normal year everyone is slightly unhappy. Buyers think prices were too high. Suppliers think they were too low. Brand manufacturers think they could have sold more. All participants may complain, but not very vociferously, for all realize from past experience that things could be worse.

The above scenario depicts a rather routine annual market cycle. This cycle however approximates a "normal" year, but as many industry people volunteered, many years are not normal.

7.3.3 Market Behavior During a Long Crop Year Scenario #2

Assume significantly higher than normal yields and therefore increased pack size (10-15 percent) for the year over normal. Assume also that pack carry-over for these crops is also higher than normal. Thus near the end of the packing season most suppliers recognize that they have a long supply situation.

Under long crop conditions opening prices tend to get set by the private label sector. This is because AAPLSs realize that they need to move a lot of product, and therefore offer significant concessions on off-line

sale agreements. In long years, they will also try to entice buyers who have not previously participated into off-line or fall sale commitments. APLSs will still be packing product and will not be fully market-oriented yet. The AAPLBs will be getting the product at extremely attractive prices. These prices will be drifting down for APLBs also.

The general lowering of the private label prices puts pressure on brand suppliers to lower their opening prices. Brand manufacturers will tend to feature long products in their displays and ads and give deeper promotional allowances to the retail buyers. Prices after the initial flurry of activity do not draft back up as they would in a normal year. They stay at lower levels. This is because all suppliers now recognize their large inventory situations. Those SPLSs who did not get sufficient product movement will continue to quote low prices hoping to get buyers to order more of their products. By early November some APLSs usually become very distressed. They need cash to meet commitments but the market has been saturated. Thus these packers will exercise their only leverage, and lower prices even further.

The two groups of buyers respond differently. The APLBs will shift suppliers and go to the lowest priced supplier. The AAPLBs, on the other hand, will go to their regular suppliers and request a price concession from them. If these suppliers (usually AAPLSs) relent, AAPLBs will order products from them. If they do not, the AAPLBs will shift some, but not all of their needs to these other suppliers.

Prices of the long products will remain low. Movement at retail will depend on the merchandising actions of retailers. The market goes through its usual holiday slump. The normal events in January and February now take hold. The inventory report issued by the USDA confirms

all the trade rumors that inventories are significantly higher than normal. Suppliers now know they are going to have to really work on buyers if they hope to sell off their supplies. Again the brand manufacturers adjust their promotions to try and move more product. The AAPLs move rapidly to lower their prices and to get the buyers to bring their shipping instructions in line with their bookings. In addition, they try to entice the buyers into larger orders by giving special prices off the market. AAPLBs will usually respond positively.

By convention time the APLSs are in a real panic. They now see how bad the market is and are willing to cut the price further. The APLBs now start shopping around for the lowest price. The limited reneging on bookings observed in the system usually occurs during these periods. Suppliers bid against one another. Yet increased movement only can occur if the retailers follow through with merchandising activity at the store level.

Sometime during the year, the brand manufacturers may decide that they do not have the ability or corporate will to market their entire pack and make a trade announcement that they want to sell off their excess. As stated previously, the brand manufacturers will usually get bids at below market prices because most buyers know that they are not reliable suppliers. The APLBs will readily buy these supplies because of their low cost. Most AAPLBs will only buy these products if they can "fit them" into their operations without penalizing their preferred, normal private label sources. Some of the largest AAPLBs will have enough volume to slip a few carloads through. The effect of the brand sales into private label markets is, however, to lower market prices

even further as buyers now expect all private label suppliers to match the brand product suppliers' prices.

By mid-March and April, the private label market may be selling below costs in an attempt to get retailers to move the inventory through the system. Private label suppliers have only one course of action available to them to move supplies of product (i.e., to lower prices). As the market season moves on some packers (particularly AAPLSs) will have been able to get most of their product inventories moved. Other packers, especially the APLSs, will approach the new pack year with an excess carry-over of last year's crop. Inventoried product is almost guaranteed to be a losing proposition, for unless the forthcoming crop is significantly short, new crop priced product will not be high enough to cover inventory costs for twelve to fifteen months. This is especially true for frozen products. The consequences of a large carry-over are different for annual and perennial crops.

In retrospect, a long crop year is a traumatic experience both economically and psychologically for private label suppliers. The dynamics of the market often force product prices below costs of production. Nearly all private label suppliers will reach these lower prices. However, the AAPLSs will usually be able to move all or most products; some APLSs do not survive such a year. Brand suppliers are inconvenienced by long crop years. They need to adjust marketing and sales strategies. They are able, however, to balance their inventories simply by their willingness to dump "brights" (unlabeled cans) on the private label market.

Buyers, on the other hand, enjoy long crop years. Buying is easier. Distinctly different buying behavior is evident, however. The AAPLBs

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will have bought the product all along. They probably bought extra products and cajoled the merchandisers to move it. They, for the most part, pulled their bookings and lived up to their commitments to processors. In fact they may have paid slightly higher prices for their products in order to live up to their commitments.

The APLBs most often exploit the short run situation in the market fully. They will play one seller off against another to get the lowest possible price. The APLBs will neglect their bookings if they can get supplies cheaper elsewhere. Adopting this buying strategy will usually produce the lowest possible average price for the buyer for that year.

Long crop years will usually result in increased inventories to be carried over until the next year. Brand suppliers will manage their inventories. Private label suppliers will lower their prices to retailers in an attempt to sell more of the product. The amount of the product sold will increase somewhat but the amount of and the number of suppliers carrying inventory across market years will depend on how the retailers react to these supplier prices. In general, in long crop years the retail sector actions are insufficient to move enough product so that the private label processing sector has to carry extra inventory into the next year as well as selling at very low prices this year.

7.3.4 Market Behavior During a Short Crop Year Scenario #3

Assume yields are significantly below normal and that carry-in from the previous year is unusually low. Thus in the aggregate there is a shortage of product compared to the products' normal historical movement.

As under other scenarios, the individual processors know about what their supply situation is, but do not know exactly the supply status of

the industry. They know, however, that the crop is short. At the onset of short years, there is a general level of uncertainty. The AAPLSs will not be pushing off-line sales. The AAPLBs however are well aware of the crop situation for they will have cultivated a field location intelligence network which lets them know the supply situation very early in the season. On a national basis, they probably have better market information than any but the brand suppliers. They will be buying as much product as they can get the sellers to release.

For the most part, the APLBs are proceeding as normal. They are shopping and looking for the best price buys. Early in the market year, they may have some success. A few APLSs, not realizing the overall short situation, may ship the product, but in general, the prices will be firm. A key factor is that the AAPLBs are willing to take forward inventory (or at least purchase) positions.

Meanwhile the brand sellers are unsure as to what level their brand competitors will open prices. They all tend to hold their market price down somewhat. That is, their advances are not as great percentage wise as are those of the private label market. They may, however, downplay the short products in their first major promotions.

Retail merchandisers tend to follow their own normal crop SOPs and thus many firms (especially those with APLBs) will be featuring the short products as if there were no major supply change from last year. In order to get the product quantities needed for the promotions, the buyers have to bid up the market price. After the initial promotional pushes, usually the end of October or early November, the spread between brand and private label prices narrows because private label prices increase. This tend to shift sales away from private label to brand label products.

Brand sales gradually increase even if the brand is de-emphasizing the short products in their promotions. Thus brand sales start to move ahead of projections and inventories start to dwindle. At this point, one or more of the major brand factors will withdraw from the market to assess their supply and price situation. This now emphasizes to everyone the short situation and the market goes into turmoil. The holiday season tends to blunt anxiety for a while. After Christmas, the inventory report of the government verifies what the market has come to realize: supplies are quite short. At this point, the AAPLSs may begin to withdraw from the market. Market prices start going up to ration the short supplies.

Short years bring forth the suppliers' revenge for buyer treatment during normal or especially large supply years. In other words, suppliers are now in the position to discipline buyers for their past behavior. It is during short crop years that supplier-buyer relationships are tested. The AAPLSs will "take care of" favored buyers. The favored buyers are usually but not always AAPLBs. At a minimum, the AAPLS will keep his favored buyers "in product." At a maximum, he will give those buyers a break on the price. This is usually done by alerting buyers about impending price increases so that they can order ahead. Only the "most favored" buyers get this consideration. Most buyers are just thankful to have the product and are willing to pay the market price.

The NFPA Convention is a much more pleasant experience for the suppliers in short years. In short years, the AAPLBs are in a panic. Recall the only way an executive sees directly how his private label buyer is performing is whether or not there is product on the shelf. During short years suppliers use their limited supplies to build IOUs and expand into

other market areas and to discipline buyers who had mistreated them in the past.

In March and April several things may happen. First, some brand manufacturers may fear running out of product. They can under no circumstances run out of product or they will lose the all-important store shelf space. They go to the private label market to get fill-in supplies and are willing to pay top dollar for their needs. They are able to do this because 1) they have higher profit rates for their products and thus more pricing leverage and 2) they are willing to take a loss in the short run (this year) in order to maintain the shelf-position they developed over the years. This bids private label market price up even more. Private label buyers (APBLs) often cannot successfully bid against the brand manufacturers in this situation. Thus only brand manufacturers get the residue product volume and the private label market prices go even higher.

The second thing that may happen is that "holes" start showing up in the private label departments of retail stores. Some private label buyers are unable to obtain the product. Some suppliers thoroughly enjoy this rare opportunity of cutting a buyer off. The first buyers to get cut are those who have been unfair (used all their leverage) in earlier periods and have not been pleasant in their dealings and conversations with suppliers.

If the shortage of product is in several major items, private label buyers start "resigning." Top management, not understanding the nature of these commodity markets, will fire a buyer who cannot get product. These are, however, the same managers who would require their buyers "to get every last cent" during long crop years. These managers nearly

always have the competitive response philosophy of private label. What happens then is that they go to the employment market to hire another private label buyer. Often the only buyers in the employment pool are those buyers just fired from other firms because they did not get enough of the product. Thus there is a great deal of musical chairs by buyers during or just after a short crop period. The probability is that the firms with unethical buyers just turn around and hire a recently fired "bad" buyer from some other firm. Only if the retail distributor makes a conscious philosophy change and develops a private label department which fosters long term relationships with suppliers can this cycle of being out of product in short years be broken.

Compounding the product shortage may be the actions of retail merchandisers who do not communicate with their firm's buyers. Lack of retailer-merchandise communication is one characteristic of APLBs. The buyers are not closely linked to the merchandisers. Thus buyers cannot get the merchandisers to vary their merchandising activity in long or short crop years. The merchandisers following their own normal year SOPs tend to plan sales by looking at last year's sales plans. If the buyer cannot educate the merchandiser about supply conditions, the merchandiser may actually promote the short product instead of pulling promotions. This often happens at the front end of a market year because the buyer (APLBs) may be ignorant about the supply condition, but it may happen later in the year because the merchandiser does not believe the buyer. In any event, the needed retailer action to balance supply and demand may not be forthcoming. If this occurs it accentuates the short supply situation.

In summary, short crop years are what keeps many suppliers in business. Prices for private label products rise to fairly profitable levels. The APLSs use this rare opportunity to capture as much profit as possible. The AAPLSs will also do that but not at the expense of cutting off their favored buyers. Both APLSs and AAPLSs use short crop years to discipline unprofessional buyers. The AAPLBs will get through the year with enough of the product to keep the shelves filled at the higher prices. The APLBs will normally experience spot out-of-stocks of the short private label items. The worst buyers will suffer severe out-of-stocks and will be fired.

The brand manufacturers will nearly always cover their needs. Their prices will have risen during the year. They may or may not have higher profits proportionally comparable to those of private label processors. However, if they made marketing mistakes and had to buy the product on the open market, their product's cost could be significantly higher and therefore their profits might be lower than in a normal supply year.

7.3.5 Sensitivity Analysis of Assumptions Used to Construct Scenarios

The scenarios attempted to convey the simultaneity of the actions of the various industry participants. Each acts in his own interest within the bounds of the historical SOPs formed by past reinforcement patterns, the market information available, and their market power abilities. There does appear to be some regularity to participant behavior.

Processors and buyers take into account many factors. Brand price is just one. When industry participants were questioned, they indicated that private label prices were not adjusted to meet every brand price

change though. Only when the industry thought that the brand price change was permanent was private label prices adjusted. In other words, the private label trade seemed to be reconciled to the fact that temporary brand promotional prices and activities would result in consumer shifts to brand products irrespective of the attempts to maintain the brand/private label price ratio. However, if a brand product price reduction appears to be more than a temporary allowance, private label prices will be adjusted. Thus at any point in time the brand/private label price ratio rule might be violated. But if both brands and retail distributors want to maintain their relative market shares within a product category, they will maintain this consumer-generated price gap over time.

Since the brand/private label ratio is a driving force in the market, some observers might infer that brand manufacturers drive the behavior of the processing subsector. This is generally not the case. Often the progressive segment of the private label industry will assess supplies and make price changes before both the brand manufacturers and the remaining private label processors. Also the brand manufacturers have learned that certain market segments follow their lead. Thus some brand manufacturers in the past have sent out false signals and created confusion in the subsector. One way would be for a brand manufacturer to withdraw from the market (implying a short crop) and then come back on the market with lower prices. Executing this strategy too often destroys the manufacturer's credibility. However, periodic use of false signaling does provide the incentive to private label buyers and suppliers to develop their own pricing actions. Therefore, in summary, brand pricing

does in a general way condition the dynamic behavior of other participants but there can be, and are, exceptions to the process.

One assumption is that the above scenarios apply only to major canned fruit and vegetable products. The reason this assumption is made is because only the major commodities experience these basic scenarios in all markets. In other words, the scenarios presented represent what happens in the national market. Minor commodity products may experience the same type of market dynamics but not on a national scale. Merchandisers have different SOPs for handling major and minor products (See Section 6.4.7). Thus the market pricing dynamics in evidence for major commodities are usually not the same for minor commodities. The processors have learned that this kind of pricing behavior does not elicit the necessary merchandising activity for minor commodities. As discussed above, the brand manufacturers tend to buy these minor products from private label processors.

How then do minor commodities respond to varying crop size fluctuations? They act similarly to the way described in the above scenarios except that they do so in a limited number of markets. Many products with minor national status may be sufficiently popular in one market to warrant retailer merchandiser treatment as a major product. For example, canned carrots and beets may be major items in some markets. In these markets, the scenario behavior described above is applicable. Thus coordination of minor products depends on eliciting proper and sufficient actions from retail merchandisers in enough individual markets to coordinate supply and demand conditions for minor commodities. Should either condition not prevail, coordination of minor products breaks down. Coordinating changes in supply and demand are very difficult

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for minor commodities with no individual markets large enough to warrant major item merchandising SOPs. The only option for these products is to find individual merchandisers who will promote their products or to use nonretail markets to coordinate fluctuating supply and demand conditions.

Although the general scenarios apply for the marketing of both annual and perennial crops, the adjustment implications differ significantly and its discussion is deferred to the next section.

Although the assumed crop conditions for the previous scenarios are somewhat restricted, they illustrate some major behavior patterns. Rarely does the crop size juxtapose the assumed inventory carry-in. While some commodities have regular cycles, most crop yield variations are random events. Thus in reality there can be a large number of crop size/carry-in inventory situations. Irrespective of the crop size/carry-in situation, the industry behavior described in the above scenarios covers the basic adjustment mechanisms used by industry participants. Various crop size/carry-in situations may elicit reactions of different intensity and frequency.

The assumed participant classifications (AAPLBs, APLSs, etc.) are also somewhat oversimplified. In reality, buyers and suppliers fall in a continuum from highly skillful professionals to short-run oriented order clerks. Classifying firms was done to show some meaningful patterns influenced by personalities and abilities of the industry participants. The classification scheme also helps to partially illustrate how different private label philosophies impact on buyer behavior on a daily dynamic basis.

An important fact to recognize is that the impacts of vertical coordination outcomes do not fall on all participants equally. Continued

coordination difficulties have systematic, predictable implications for the survival of certain industry participants. Consequently, the future organization of the subsector is, to a large degree, being shaped by the current vertical coordination behavior. These aspects of vertical coordination behavior are examined in Section 7.4 below.

Perhaps the most critical aspect of the scenarios is the partial equilibrium nature of the analysis. The adjustment processes described ignore the market behavior of other processed products which can substitute for the affected products. For example, if peas are in short supply, and higher priced, consumers may eat more corn. The availability of substitutable products dampens some of the impacts of short and long crop years. Thus the above analysis may tend to overstate somewhat the needs for coordinating activity for a given commodity. Because some of the substitutable crops are grown in the same areas, weather-induced yield variation tends to hit these crops in the same way. However, this substitution requires that consumers be presented with higher pea prices and more corn facings (shelf exposure). Thus for the dampening effect of product substitution to be felt requires that retail buyers and merchandisers make the necessary adjustments. Again, market coordination depends on the actions of these retail personnel with their inclination to respond according to a substantially different set of decision criteria.

All of the above cautions aside, the three scenarios are reasonable proxies for how the market operates under different supply conditions. The scenarios are sensitive to some of the assumptions used but no single assumption is beyond a pragmatic test against reality.

7.4 The Dynamic Coordination Consequences of Procurement Practices on Various Types of Processed Fruit and Vegetable Subsectors

7.4.1 The Errosive Effects of Vertical Coordination Consequences

The previous section demonstrated that without appropriate retailer merchandising activity coordination of commodity demand and supply schedules is usually less than effective. Failure to match supplies with demands in one year often creates hardships for firms and disadvantages for certain products, but is not usually permanently damaging. However, continued coordination practice over an extended time period begins to take its toll on selective firms and products. This results in the dynamic evolution of the various subsectors. With a continuation of the behavior described in Section 7.3, this section abstracts the likely consequences to long-term demand for annual, perennial, and minor processed fruit and vegetable commodities. The next section (7.5) does the same for various types of firms.

7.4.2 Implications for Annual Processed Fruit and Vegetable Products

Annual commodity subsectors evolve from coordination practices fairly rapidly. If there is a long crop year, processors attempt to reduce contracted acreage of annuals the next crop year and vice versa after short crop years. The ease of this adjustment depends on several factors. One is the degree of specialization in the growing and processing of the product. If the product is a sideline for growers they may be willing to accept the variation in acreage without much protest. They can use their primary enterprises to pick up the slack or create more capacity to help adjust the subsector, e.g., corn, peas, beans in a

dairy area. However, if the commodity needing supply adjustments tends to be the major and/or only crop of the growers, they will logically resist attempts to use acreage changes for balancing the system unless there are price changes to partially balance these. Since the growers will bear the coordination costs via unstable incomes over time, under these conditions, they will often seek to develop institutions which will help blunt the impacts of coordination shortcoming on them. The two most often used institutions are grower bargaining and grower-owned cooperatives. These coordination consequences help explain the various stages of development of grower bargaining and processing cooperatives seen in the United States vegetable subsectors.

In the upper Midwest (Wisconsin, Minnesota) annual canning crops tend to be cash crops grown by dairy farmers. These growers were willing to make fairly large percentage acreage adjustments from year to year. Consequently these growers have less incentive to organize to shift coordination consequences. This is true only to the extent that processors did not use harmful and capricious tactics, such as passed acreage abuse, to make growers bear all the consequences of subsector variation. There is much less grower bargaining and/or processing cooperatives in this area than anywhere in the country. However, times are changing. New areas of canning crop production are opening in central Wisconsin with specialized growers who raise only canning crops. As they have expensive, specialized capital equipment which can be employed only on these canning crops, these growers are much less willing than the dairy farmers to make the acreage adjustments necessary to balance the system, especially reductions. Consequently, growers of annual crops are turning to group action to redress some coordination practices.

On the short term basis, certain existing coordination practices cause the entire subsector, from growers to retailers, to incur adjustment costs. Different coordination practices might result in product price-quality cycles with a much smaller amplitude. The aggregate amount of subsector resources needed for adjustment could be substantially less. In the long run, the effects of coordination impacts can be devastating to the given commodity.

Suppose yields are exceptionally high and the retail sector does not adjust its SOPs to help balance supplies. Prices will be depressed and inventory will be carried over into the next year. Suppose, in addition, that processors in an attempt to outsmart the market do not cut back packs to reflect market conditions. Therefore the pack is relatively (compared to a "normal" year) large in year $T+1$.

Since the inventory situation is beyond historical bounds, retailers may not be able to push the product through because customers are saturated with the product. Prices are at very low levels. Now the processor and grower sectors start to respond by adjusting acreage and packs. In year $T+2$, there are substantial production cutbacks. Specialized growers shift to other crops, often investing in new specialized capital equipment for the new crops. Some marginal processors are unable to survive these depressed prices and go bankrupt. Yet inventories are still so long that prices remain relatively unprofitable. So much so that in year $T+3$, more firms and acreage exit the subsector.

Suppose in $T+4$ there is a crop failure and yields fall dramatically. Past inventories would quickly go through the system. Although some retailers would adjust, those that do not and continue to oversell would put further upward pressure on prices. As product prices continue

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to rise and supplies become tighter, merchandisers would begin to cut the products from their advertising and promotion plans. Suppliers would not fully rebound to T+1 levels because 1) some growers would have switched to and invested in other specialized crops, 2) some processing capacity would have disappeared; and 3) some processors currently in business would not want to switch back because of past experience. With high prices, retailers and manufacturers would not promote this product. It would be dropped from the current year's promotion plans. Consumers would not be exposed to the product for the whole year. The result is they change their consumption and shopping pattern. Without merchandising, the product gradually loses its broad consumer base.

If this continues for several short years, the retailers will tend to ignore this product. Recall the merchandiser's SOP is to take ad plans from last year and copy them. This product is nowhere to be found in last year's merchandising formats. The only way the product can be resurrected during T+5 and subsequent years is for the manufacturers and processors to use their marketing and pricing strategies to induce the merchandiser to reintroduce the product through promotions. But this time, however, processor and manufacturer prejudiced against this product, and grower shifts to alternative crops, may have made a full quantity recovery impossible.

This scenario documents the serious decline of a major fruit and vegetable product. Coordination consequences set up incentives for processors and growers to shift away from the product. A rapid price increase alters the SOPs of merchandisers which may eventually lead a large number of consumers to lose their perception of the product's existence. When the percent of consumers buying a product drops,

various general merchandising rules of thumb for protection (See Section 6.3.2) come into play. Without promotion, the percent of consumers buying the product declines further. This process continues until the product becomes a specialty item or it disappears entirely from retail shelves.

Once a given product falls into this trap, it is difficult to break out. What is needed is marketing support from processors to get the product back into the consumer's buying routine and menu. If because of these coordination consequences the product falls below the diagonal on manufacturers' promotion matrices (See Exhibit 6.1), brand manufacturers will not provide this market support. Private label processors have no ability to do anything about it because retailers do their marketing. Thus once coordination practices start a product down the lost market path, it is very difficult to regain major market status.

7.4.3 Implications for Perennial Processed Fruit and Vegetable Products

Perennials basically follow the same scenario except that the adjustment time is much greater. Thus the consequences of incorrect actions caused by coordination impacts are not easily resolved. Suppose retailers do not get all the system's inventory moved; this depresses prices. Then if another good crop arises the next year, prices will remain depressed. After several years, growers will rationally seek to shift to crops with relatively higher returns. This shift has much greater implications in perennials than in annuals. Bulldozing one orchard and planting another crop represents a long-term commitment to the new crop. The nature of economic incentives is that many firms will disinvest at approximately the same time. The composite disinvestment may be greater

than that needed to balance the system. The result may be that in several years crops will be short. This will most likely enter that product into the high price no merchandising trap. By the time the growers get new production in place (at least five years on the average), the product may be well on its way to being a minor (nonmerchandised) specialty item.

When prices are high for several years, growers will tend to overinvest in orchards. The size of the overinvestment has two components. One is the amount that growers overinvest relative to historical movement. The other is the amount of overinvestment which can no longer be sold because the coordination practices have reduced consumer demand. This latter portion of overinvestment can be salvaged if some institution in the system will promote and advertise the product in order to win back lost consumers when the supply is again available. As with annual crops, the retailers do not consider it "their job." The private label processors do not have the ability. The brand manufacturers may or may not depending on their commitment to that given commodity item, but often will not since nonfluctuating manufactured products fit their market SOPs and profit goals better.

The inability of the perennial crop subsectors to vary acreage on an annual basis to help balance supply and demand results in there being significantly different grower and processor SOPs than in the annual crops. Suppose there is excess inventory in year T. In year T+1 most of the trees will still be producing. The only way a processor can balance inventories is to buy less from the growers. This would mean (assuming normal or above normal yields) that growers would not be able to sell their entire crop which often happens. Most often this portion

of the crop goes unharvested. This phenomenon causes growers great anguish and economic hardships because a very high percent of their costs are fixed. They also take pride in their products and hate to see them wasted. As a result, growers have adopted several institutional alternatives to get around this problem.

They have formed processing cooperatives, often with the philosophy or SOP that the cooperatives will take all the product and pack it. This can accentuate the coordination challenge. They also developed through the political system the legislation to establish marketing orders. Some of the state orders had provisions expressly intended to balance crop supplies with industry-wide demands. These marketing orders spread the burden of adjustment over all growers. Growers also undertook collective bargaining with processors. Bargaining was instituted because of real and grower-imagined processor malfeasance and capriciousness and because growers tried to shift some vertical coordination responsibility forward. One or some combination of the three are found in nearly every perennial fruit and vegetable subsector. To some extent that they have shifted incentives in the system and consequently the structural evolution of perennial crop subsectors has produced a more extensive array of institutional mechanisms to deal with coordination consequences.

7.4.4 Implications for Minor Processed Fruit and Vegetable Products

Minor products play an important role in the food system since these provide a large part of the profitability of many private label and small brand processors. The major commodity prices get adjusted frequently as the packers try to balance their inventories. Many merchandisers and buyers are constantly looking for deals in the major items. Minor items

are not frequently merchandised and promoted. Therefore their processor and retailer margins tend to stay at higher average levels.

The fundamental reason for the high margins is the basic demand structure for these commodities. Minor products are stocked by retailers because a select group of consumers buy them on a fairly regular basis. These consumers have a distinct preference for these products and are often not particularly price sensitive to these items. Lowering prices will not normally appreciably increase the amount that these consumers buy. In addition, minor products have lost general consumer appeal. Promotions will not normally increase the number of new consumers. Over time retailers realize these bounds. Thus they tend to keep these items stocked at fairly constant prices and margins. Retailers obtain profits. Processors have items on which they have a dependable profit throughout the year. For many processors, minor and/or specialty products provide the revenue which keeps them solvent.

It is usually more difficult to adjust subsector inventories for minor products as they have few processors and fewer buyers. In a long year, there are fewer buyers and merchandisers available to push the products through the system. Severe problems can also arise in short crop years. Minor crops have very inelastic demand schedules. Thus short crop years cause the price to rise dramatically. Retailers will pass on those prices to the group of loyal consumers. Thus the market base for the minor product continues to fall. On the other hand the growers' supply response to high prices from short crop years will induce new capacity. Since these products' supply bases are small, even a small absolute acreage increase often is a relatively large proportional increase in supply. In annual crops, the processors tend to dampen the

supply response because they will refuse to contract or process all of the forthcoming crop. Growers planting annuals will usually check market possibilities first. This is often not the case for perennials. In perennials the production commitment is now but the market is several years later.

Marketing the product may be several years in the future. Entrepreneurs may not consider distant marketing problems. Some observers may conclude that this behavior is irrational and the entrepreneur will fail. The problem is that the entrepreneur does not only take himself out but may mortally damage many of the more rational growers producing these crops. A cycle like this can further reduce the supply base for the commodity. The combined effects on longer run supply and demand schedules cause the product's consumer base to shrink further, resulting in the continued decline of the product.

In most respects, minor commodities respond to coordination practices in ways similar to major commodities. A major real difference is the volatility of the minor commodity markets. Because merchandising options are foreclosed and the supplier-buyer base is small, coordination practices tend to cause larger adjustment lags. These cycles tend to harm the long run survival of the products. Once a product enters the coordination failure trap, movement toward its demise accelerates.

As a product's sales slip to lower and lower volumes, an interesting shift occurs in its distribution pattern. The lower a product's sales, the greater the probability that it will be marketed by a national brand rather than a private label. Recall private labels are very important in canned fruit and vegetable markets, but successful private label products need to have volume in order to achieve the lowest possible

costs. As volume drops, a retailer's sales start dropping to the point where they cannot sell enough to generate processing plant economies of scale. Thus retailers lose their desired margins and they start to drop the items.

Brands, however, do not lose their profitability. Suppose there are forty grocery stores in one market area. Assume that four retailers each own ten stores which sell one-quarter case of Minor Product X under their private labels every week. Thus any one retailer will sell only two and one-half cases a week. A national brand selling in all stores would sell ten cases a week. Compound this over all markets and it is obvious that national marketers can still obtain economies not available to localized marketers. Thus as a commodity falls into a coordination failure trap, it may end up being sold as a high-margin specialty item by a national manufacturer. This is usually only the case if the product's remaining loyal consumers are relatively wealthy and the product has a "classy" image and is profitable to the brand firms. Canned asparagus spears are a good example. However, if the product is generally less desirable when compared to substitute products or has a bad image or is unprofitable to these firms, national brands will often abandon the product. Since the private label economies are also absent, the product is usually marketed under weak packer brands: canned sweet cherries, water pack tart cherries, and purple plums are good examples of this phenomenon. Minor commodities which have reached this point are in dire straits.

7.4.5 Words about Quantification and Causality

This section on the impacts of coordination practices on annual and perennial fruit and vegetable subsectors and concludes with some words

of caution. The above discussion of the roles played by coordination practices tends to ascribe causality to those practices. Many forces can cause a commodity to enter declining cycles. The fact is that once started, the structure of incentives in the commodity subsectors is such that necessary corrective action is not automatically forthcoming from anyone in the system. In that way, coordination practices help perpetuate ineffective and destructive markets. The scenarios implied that it was coordination practices induced price increases which were responsible for consumers shifting their consumption patterns. However, some of the price rise in many former major (nor minor) products may have been due to production cost increases. Thus some of the decline in consumer demand is permanent reflecting real relative cost changes and their impact on consumer tastes and buying patterns. The remaining part is a temporary maladjustment caused by coordination consequences. Separating the relative size of these components is difficult. But coordination practices are usually only partially responsible for the decline of commodity subsectors, because it occurs simultaneously with other factors.

The qualitative analyses above are derived by logically extending the SOPs found in Chapters 4, 5, and 6 through processed fruit and vegetable product subsectors. The resulting dynamic scenarios attempt to describe the evolutionary forces at work in vertical systems. The ones presented are generally consistent with the observations made by veteran industry observers. Most of these relationships await empirical testing.

More quantification would have been done were it not for the lack of necessary data to accomplish this task. To the author's knowledge no data exist (at least for publicly available sources) on 1) wholesale prices of individual brand products (adjusted for deals) and weighted

for movement; 2) wholesale prices for private label products adjusted for merchandising activity; 3) numbers of facings and brand composition for individual items over time; and 4) documented buyer and supplier gamesmanship during the bargaining process over time. Without this data and others it is nearly impossible to empirically document the dynamic processes beyond that obtained from knowledgeable observers and participants as used in this analysis.

The above admonishment also holds for the forthcoming (Section 7.5) structural analyses. Data on firm identification needs to be much more specific than that provided through the Census Department. Processors need to be segmented, counted, and monitored over time by market outlet rather than primary plant product definition.

7.5 Structural Implications of Vertical Coordination Practices

7.5.1 Subtle Structural Change

Procurement and merchandising practices set up incentives which result in certain sets of vertical coordination conditions. As processing and supply firms react and/or are differentially affected, the structure of these industries is also affected. This evolving structural change is subtle and may not be recognized as being associated with vertical coordination conditions. As before, care must be exercised when assigning causal direction to a flow of structural change. However, this evolving structural change can have profound impacts on the future organization of the United States food system and it is therefore useful to discuss them.

Vertical coordination practices impact on the supplying firms most directly. Three groups of fruit and vegetable suppliers, brand manufacturers, cooperative processors, and proprietary private label processing firms are analyzed below. A final section projects these current evolutionary trends into the near future.

7.5.2 Brand Fruit and Vegetable Manufacturers

Brand manufacturers have evolved in their commitment toward the growing and processing of fruit and vegetable products. In their early histories many of the major brands vertically integrated via land ownership into the growing of canning crops. As their markets grew, raw product procurement shifted to contractual arrangements with growers. Owned land was gradually relegated to research and development or sold off. Partially because the retail food distributors refused to accept many of the costs of commodity instability, the processing sector attempted to have the growing sector bear most of the adjustment costs. This resulted in the development of grower bargaining and processing cooperatives as growers attempted to shift uncertainty and coordination costs back to the processors.

Brand manufacturers seem to have gone through various stages in their approaches to handling this coordination task. First, they have used their marketing power and resources to balance their inventories. They accomplish this by adjusting advertising/promotion activities to alter consumer demand and they market their second labels in floating markets to help adjust their sales. These actions are expensive and tend to make long-term market development and strategies difficult. Thus the second brand coordination strategy arises. Instead of marketing the

variable supplies, brand manufacturers start selling (buying) surplus (deficit) supplies in the private label market. Since they are considered unreliable supply sources, the market would only deal with brand manufacturers on a significant discount/premium basis. Only those manufacturers with enough profit margins in their brand sales are able to use this open market coordination option.

The commodity based nature of fruit and vegetable processed products makes them generally less stable and less profitable than more fabricated products. The need to sell/buy commodities on the market results in lower profits. In addition, brand prices are linked to private label prices. Thus depressed conditions in the private label market will lower brand profit margins. Manufacturers see less need to even be in the "commodity" business. Thus they are initiating the disintegration process, which is the third option. As they sell-off or exhaust their investments in processing facilities, they will gradually discontinue selling commodity-based products. Some buyers and many suppliers interviewed indicated that they have observed this behavior. Several suppliers indicated that they have received overtures from the major brand manufacturers about custom packing arrangements. Nearly everyone observed that new product development by these companies will be directed away from commodity based products. Brand manufacturers will continue to market these products only if they receive returns greater than those available by selling high processed food. Continued market instability reduces these returns and will hasten processing/marketing disintegration.

All three types of coordinating behavior are currently present in the brand sector. The trend seems to be away from the first method of marketing and moving toward the third brand strategy. The ability to

balance the supply-demand situation in the brand sectors is not equal among all firms. Only those firms with strong consumer franchises which generate higher unit profits are able to maintain the retail sales forces and profit levels necessary to successfully implement any of the three strategies. Thus as more of the supply coordination burden is put on the brand manufacturers, fewer brand manufacturers will survive. Those manufacturers with weaker and/or regional brands will find it increasingly difficult to profitably balance variable processed inventories. Generally, these firms lose their brand franchises and revert to being commodity processors for the private label market. Continued coordination consequences will gradually result in fewer brand manufacturers of processed fruits and vegetables. Since disintegration of processing and marketing avoids the need for the brand to bear coordination costs, it seems logical that this strategy will become increasingly common in the near future. The increasing concentration of the private label processing sector resulting in large stable multiple product firms from which brand manufacturers can purchase processed product can reinforce this pattern.

Minor products tend to be marketed by national brands as high margin specialty items. Continuation of vertical coordination practices will probably in the future result in fewer processed fruit and vegetable choices at higher costs to the American consumer. In the future, the brand fruit and vegetable industry will probably evolve to be a very few (two or three) full-line national brands with a few additional regional and small national brands producing specialty products and providing service to small, special segments of the market which have been overlooked or passed up by the national firms.

As brand manufacturers increasingly adopt strategies downplaying commodity subsectors, the costs of ineffective coordination fall primarily on the private label processors. They cannot use any of the three methods used by brand processors to balance inventories and demand. The only way for private label firms to get balanced supply and demand is to bid against one another in price and service to get access to retail private labels. Private label buyers then determine which private label processors succeed and which ones do not. Again the procurement SOPs are not neutral to various types of private label organizations.

7.5.3 Cooperative Fruit and Vegetable Processors

As mentioned previously, grower-owned processing cooperatives are a significant and increasing institutional force in the processed fruit and vegetable subsectors. Supply-induced income variation of perennial crop producers has spurred development of cooperatives. Once established, processing cooperatives can provide strong economic competition for proprietary (private label) processors. This pressure is generated from three basic economic advantages possessed by cooperatives.

Perhaps the greatest contemporary advantage of cooperatives revolves around the payments to growers for raw product supplies. One typical provision of grower-bargained contracts is that proprietary processors pay for raw product at harvest in cash. This means that processors must have sufficient capital financing to pay all product costs (cans, electricity, harvesting and plant labor, and raw product) at packing time. Cooperative processors, because growers are willing to take deferred payments and/or because they own the inventory, usually do not pay cash for raw product at harvest. Since raw product cost is either the second

or third largest cost component, not having to finance all of these payments is a significant financial cost advantage of cooperatives. Nearly all proprietary private label processors who bought the product for cash identified this factor as the most significant cost advantage cooperatives have over proprietary processors.

Another financial advantage is the availability to cooperatives of publicly sponsored capital through the Bank for Cooperatives. Cooperatives are able to obtain as much as two percentage points lower (than available through commercial sources) through these financial institutions. This can be a significant advantage in an industry where inventory storage is such a large financial burden. As interest rates continue to increase, retailers will attempt to shift more of this inventory burden to suppliers. This financial advantage can be large enough that one proprietary-cooperative joint venture stated publicly that this was one important reason for its inception. The extent of interest advantage varies. Joint ventures also give processors access to grower resources and know-how. Joint ventures might also permit processors to monitor industry bargaining efforts and thereby provide the processor with differential competitive market information. It must be remembered that these advantages have been available for decades and have been used successfully and unsuccessfully for years. The recent rash of cooperative processing ventures cannot be solely attributed to the availability of financing options.

A third advantage of cooperatives over proprietary firms is their income tax exemption. Other things being equal, cooperatives have several tax advantages. These have been reduced in recent years. Since

the profit rates in the private label proprietary processing industry are fairly low, tax advantages may tend to be overemphasized.

7.5.4 Proprietary Private Label Fruit and Vegetable Processors

Because of the above advantages to cooperatives, processing cooperatives will take over the private label processing industry unless proprietary firms have some countervailing advantages over cooperative processors. Proprietary firms do have at least two advantages over their cooperative competitors. One involves the inherent flexibility of proprietary firms. Another is an advantage given to proprietary firms by retail buyers.

Proprietary processors tend to maintain more decision making freedom on raw product purchases than do cooperatives. If carry-in inventories are high, proprietary processors will vary contracts to cut back in this year's pack size. Cooperatives may do the same but are usually somewhat constrained in their actions. This is especially true for perennial crop cooperatives which were established by growers to have a home for all their product. The buyers interviewed indicated that cooperatives tend to have longer product inventory positions than proprietary firms.

This raw product procurement flexibility means that proprietary firms are not always forced sellers. They can pick and choose markets and deals which will maximize their revenues. Cooperatives on the other hand, will more often be long on supplies and will more likely in some years try to move product so that warehouses will be empty for next year's crop. Several managers of proprietary firms indicated that cooperatives were almost always responsible for downward price pressure

in the market. Interviews with buyers neither confirmed nor denied this observation.

While there were too few comments, on or off the record, to say unequivocally that buyers favored proprietary firms, many buyers hinted that they did prefer proprietary firms. The most frequently cited reason was that buyers received better service from proprietary firms: shipping was faster and on time; invoices and billings were handled faster; and they were more responsive to buyer complaints and needs. These factors may be a function of size in that the most visible processing fruit and vegetable cooperatives tend to be larger than proprietary private label processors. Part of the poor service buyers perceived may be because of bureaucratic inertia.

A second reason buyers tend to favor proprietary firms is that they prefer an effectively competitive supply network. The professional private label buyers realize that a subsector of all cooperative processors could legally form a marketing agency in common. Therefore, buyers would have to deal with oligopolists or at the extreme, a monopolist. The smart buyers attempt to keep some proprietary processors in business. Doing this may involve some short-run costs to the buyer, however some buyers have enough power in their firms' bureaucracies to be able to implement this strategy. Not surprisingly these buyers work for retailers with the franchise development private label philosophy.

Buyers will usually buy from proprietary packers first during the market year. This is not altruistic action but rather an economic phenomenon. Buyers know that proprietary processors have a greater need for cash flow because of the need to buy raw product for cash. Thus they know that proprietary processors are more vulnerable to hard bargaining

early in the season. This buying SOP does help the proprietary packer. One frozen vegetable packer stated that "Survival in this business means selling the pack out every year. Carrying inventory over into future pack years never pays." Since buyers make their initial purchases from proprietary firms, these processors are already ahead on balancing inventories for the pack year. Some cooperatives may not receive their first substantial orders until a month or two into the pack year.

The composite effect is that buyers' lists of priority suppliers tend to favor proprietary processors. This reflects the fact that proprietary packers often earn those slots (because of service levels) and some buyers want to maintain a viable proprietary processing sector. A favored supplier may benefit by getting a higher average price for his products because he sells before the market drops or at the minimum has his bookings pulled first. Thus he has lowered carrying costs. Generally, proprietary processors tend to be better able to balance their inventories with consumer demand. The composite observation, then, is that processing cooperatives tend to carry a disproportionate share of the carry-over year-end (inventory) of the given fruit and vegetable subsector.

7.5.5 Future Directions for Coordination Practices-- Induced Structural Change

In the past, coordination practices used to cause growers to bear the costs of system adjustment. Contracts were varied (voluntarily or involuntarily) year-to-year to balance current crops with carry-overs. Growers were generally unwilling to accept variable incomes. Grower-owned processing cooperatives were one solution. Current retail buying practices are such that the costs of coordination failures are borne via inventory carry-overs. These carry-overs tend to be carried by

processing cooperatives, so to a large extent, growers are still bearing the costs of inventory management. Now these costs may be taken out of their fixed assets in processing rather than their fixed assets in producing the raw product.

All indications are that the structural trends identified above will continue. Nearly all the national brand fruit and vegetable manufacturers are now part of general marketing-oriented conglomerates. Their natural inclination is to disinvest in commodity-based products. Continued development of more effective grower bargaining will probably hasten this disintegration process. Proprietary private label processors will be continually under more financial pressure. Given some of the factors identified in Section 7.6 below, their numbers will be fewer and they will be considerably larger. The trend toward cooperative processors will increase. Gradually, the weaker of these cooperatives will merge or dissolve. Current trends thus seem to indicate that private label processing of fruit and vegetable products in the future will be done by an increasingly oligopolistic core of processing cooperatives and large multimarket, multiproduct proprietary processors.

7.6 The Role of Present and Potential Public Market Institutions in Affecting Food System Evolution

7.6.1 A Recurring System Response

A common theme in most of the above scenarios is that system participants will attempt to avoid the consequences of variable commodity supplies. This is done by developing SOPs which shift costs associated with supply adjustment to other participants. Variable supplies arise from 1) weather-induced yield variation on existing plantings and

acreage; and 2) increased (decreased) acreage resulting from producers' reactions to market returns influenced by existing coordination conditions. The system response to the combined sources of supply variation helps lead to product stocking and structural trends which seem to be occurring in response to current coordination practices.

There are numerous public institutions which have been developed to influence commodity supplies and/or product flows to markets. Often these institutions or proposed institutions are evaluated without including analyses about their possible impacts on coordination practices induced system evolution. This section briefly examines these institutions in light of vertical coordination analyses.

7.6.2 Marketing Orders

A plethora of marketing orders and boards, have been designed over the years to insure "orderly marketing." Some groups question the performance of these institutions because they can influence the flow of products in the system. When evaluated in a static, short-run context their concern may seem justified. However the proper use of supply control mechanisms in these institutions can help smooth commodity price cycles. This can reduce the adjustment costs needed to balance the system and therefore reduce the amount of resources which would otherwise have to be committed to the sector. In the longer run some marketing orders could help prevent unnecessary vacillations in commodity supplies and prices.

Historically, it may be that the administration of supply control marketing institutions has not taken a sufficiently long-run view of this power. Multiple year programs require that a financial commitment

for carrying inventories (usually of processed product) be made by someone in the system. Thus marketing order programs have been hesitant to take forward positions in finished products. Where they have (tart cherries, for example), administrators have been hard pressed to keep from "cashing in" supplies within a one year period.

Another problem is that although forward supply management benefits the entire subsector, the costs are very often borne by one group of participants. Very often growers are charged with the bill. From a growers' perspectives and financial bases, the cost is often too great for the share of benefits that they get. Thus an institution which could have overall system benefits is not used because the mechanisms do not exist to distribute the costs throughout the subsector. Marketing orders and boards can be very valuable coordinating mechanisms. Properly structured and administered they can help commodity sectors match the stability and planning needs of the food distribution system. Over the long run this may keep more product selections of less processed commodities and products on the grocery shelves.

7.6.3 Exclusive Agency Bargaining

Grower bargaining is often viewed only as an institution to redistribute benefits whereby unorganized small firms (growers) can combine to more equitably bargain with more concentrated processors. One of the ancillary benefits of bargaining is that information is more economical to collect and disseminate to growers. Market demand and supply information is thus brought to bear in the marketing process between growers and processors. Most bargaining situations however do not involve determination of supply as part of the process.

Exclusive agency bargaining, properly instituted, allows quantities of supply to be explicitly considered in the bargaining process.¹ This form of bargaining thus has the potential to help commodity subsectors coordinate supply fluctuations in the system. Longer run supply planning is much more likely with this form of bargaining. This is primarily because of the better information obtained and the possibility of having staffs which can translate this information into growing decisions.

Thus exclusive agency bargaining can be very useful in helping "smooth" that portion of commodity cycles which arises from temporary and exaggerated economic signals. Exclusive agency bargaining will most likely have to be merged with other institutions in order to dampen weather-induced supply variation. As with marketing orders, growers appear to be responsible for a greater proportion of system adjustments.

7.6.4 Markets for Forward Deliverable Contingency Contracts

Marketing orders, marketing boards, and exclusive agency bargaining arrangements all deal with the exchange process at the grower-first handler level. This research indicated that while false demand signaling (overbooking) is not severe, a large part of the relevant demand information is not transmitted back through the food system. This impacted demand information could be useful to the coordination process. None of the above mentioned institutions however are able to affect this impacted information. Markets for forward deliverable contingency contracts if established for processed products could possibly "force" retail buyers to reveal their demand estimates for given crops. This more certain (known versus induced) demand information would probably make the coordination process more effective.

Another, more important barrier to coordination is the inability of a large portion (private label suppliers) of a commodity subsector to get retail merchandisers to adjust their behavior to changes in supply. Forcing buyers to make contractual commitments would "force" them to make the merchandising adjustments at store level in order to move products in accordance with their legal responsibilities. A national system of markets for forward deliverable contingency contract could therefore be very helpful in altering retailer behavior so as to improve food system coordination.

In the fruit and vegetable subsectors, markets for forward deliverable contingency contracts are probably technically feasible. Electronic systems are rapidly developing and the eventual adoption of UPC ordering will further enhance prospects. This research indicates that the product specifications used in the processed fruit and vegetable commodity subsectors are sufficiently standardized so that meaningful standard market product definitions could be established. The exceptions to standard government grades seem to be fairly minor and capable of being included in markets for forward deliverable contingency contracts. This is possible because the USDA grading system is well understood and used by all producing elements in the food system.

Should certain consumer interest groups succeed in changing the existing grading system to one which is "consumer" oriented, the private label sector would have to go through a period of adjustment during which new specifications are developed and commonly agreed to. There is always the possibility that the now voluntary grading standards would be abandoned in favor of supplier-determined grading. Any major changes

from the current system would likely make a system of such contracts more difficult to establish.

In the final analysis, there would seem to be much to be gained vis à vis vertical coordination by instituting a system of these markets. Conversations with processors and distributors made it quite clear that neither group will willingly accept such a set of markets. These types of markets alter the distribution of property rights now held by processors and most by retailers. The more important conclusion, however, is that retail distributors would probably not cooperate even if the system were established via public policy. Rather they would foster the evolution of another set of firms (brokers, booking agents, etc.) to take the responsibilities being shifted to the retail sector. Most likely the dominant national manufacturers would also abdicate their responsibilities by developing purchasing surrogates. The modern food system has a visceral dislike for commodity items. The only way the food distributors seem willing to deal with commodity subsectors is if the general level of supply variation induced uncertainty is greatly reduced.

7.6.5 Producer-Sponsored Commodity Promotions

In the absence of supply stability and with food system abdication, growers are often the only system participants willing to attempt to coordinate commodity flows. The most important key to system coordination is getting access to retail distributor merchandising actions. Some producer-sponsored commodity promotions have been able to accomplish this.

Raisins, western citrus, cranberries, grape juice and jellies, and English walnuts are some commodities with marketing institutions which are able to tie into the behavioral patterns of food distributors. The

common elements across all these commodities are 1) in national brand franchise and 2) some method of affecting the flow of product to market. The former permits the producers to go around the retail merchandisers directly to the consumers; the latter permits the flows to be "smoothed" so that the commodities fit in the system. The most frequent institution used by commodity groups is a cooperative. The cooperatives may perform many functions, but perhaps the most important is the managing of the brand franchise. These marketing cooperatives are often found in conjunction with state or federal marketing orders which help manage the flow of product to market.

There is little doubt in the minds of experienced food system observers that growers armed with these tools probably do the best job of any commodity subsectors in assuring that their subsectors survive in the long run. Unfortunately, the combination of brand franchises, dominant cooperatives, and marketing orders generates concern in many consumer and government quarters. Some believe that most of these promotionally effective producer groups are generating monopoly returns and are therefore not operating in the public interest. Most of the coordinating actions taken by promoting producers involve the expenditure of resources. Thus prices of these products will be higher than in the absence of these actions. The advocates of change assume that consumers will receive the same products but at lower costs by eliminating grower marketing systems with effective promotions. The above scenarios imply that in the short-run this result may arise but in the longer run consumers will probably have fewer relatively unprocessed commodities and products and at higher prices.

This is one area where there will probably be increasing debate in the coming years. Producers seem increasingly willing to attempt to affect consumer demand for their products. The number and size of promotional check-offs is increasing while an increasingly vocal group of consumers is advocating diminished advertising and promotion. This research indicates that generic commodity advertising alone will do little to match supply and demand. Only when this advertising is combined with a knowledge of and ability to manipulate the distribution process, can producers influence the long-run survival prospects for their commodities. Consumers would seem to have as much of an interest in this factor as they do in short-term price issues.

7.6.6 Supply Control Through Weather Modification

If the principal cause of coordination problems is supply uncertainty, elimination of variable weather would seem to be the basic solution. While programmable weather in a macro sense is still beyond technical and institutional possibility, weather modification in microenvironments is not only feasible but in place. One unforeseen consequence of the large government supported irrigation projects in Western United States was to develop fruit and vegetable growing areas where weather has much less impact on product quantities but especially product qualities. In this sense, irrigated crop subsectors are more easily coordinated and therefore enjoy a comparative economic advantage. For example, Washington State apples have been able to displace many Eastern state fresh apple markets because of their more stable appearance in quality. Similarly the Eastern citrus industry has largely converted to processed product sales while Western citrus has much of the fresh market.

If the costs of coordination practices are very high, whole new methods of production can be developed. Several large conglomerate food companies are operating completely controlled indoor, fresh-vegetable factories. These light controlled, hydroponic factories have the unique characteristics of producing constant and known quantities and qualities (albeit at a higher price) of vegetables on a consistent basis.

The dynamic implications of commodity supply uncertainty are clear; subsectors must develop institutions which allow their products to fit into the modern food system or they will eventually die. Nearly all the current and proposed institutions which can affect the coordination process require public policy decisions. To get these public decisions, there seems to be a need to re-orient much of the public debate to a more relevant time frame. Concern needs to be shifted from short-run price-cost issues to a longer run debate focused on the questions of longer run product mix and system effectiveness. Paramount to this shift is the development of analytical concepts and tools to deal with micro-system dynamics.

7.7 Procurement Practices Effects on Private Label Processing Industry Structure and Policy

7.7.1 Buyer Bias Toward Multiple Product Firms

In addition to the evolutionary forces set in motion by grocery buyers SOPs, their actions can directly alter the structure of the private label processing industry. The private label buyers' concern for inventory costs and the resulting distributional consequences are having the most immediate impact on the private label processing structure. Retail distributors want to maintain only those inventories needed to provide

specified service levels to the stores. Thus they want frequent, small shipments. To reduce their inventory costs buyers require packers who will provide frequent small shipments of product at specified times. With the exception of a few major commodities, food distributor orders are less than truck (car) load quantities. In order to achieve retailer inventory goals and minimum transportation costs, shipments must contain several commodities. Therefore buyers have decided preferences for multiple product suppliers. With current procurement SOPs, specialized, limited-line suppliers are becoming foreclosed from the private label retail market.

Having a multiple product line is needed for processor survival in another way. A Wisconsin pea and corn packer could probably meet the inventory-shipping requirements of buyers. However, those products nearly always have buyer-induced and packer-sustained downward price pressure. Therefore in the majority of pack years, these major commodities will not be profitable to the processors. In order to be profitable a private label packer needs to supply one or more of the minor processed fruit and vegetable items since these typically do not receive the same intense price procurement pressure and are usually profitable for the supplier. Buyer preference and processor profitability therefore are moving the industry more to require that private label processors diversify and pack a multiple line.

One way that specialized and/or smaller processors have survived is by availing themselves of retailer-sanctioned forward storage in-transit programs. However, these programs put processors at a strategic bargaining disadvantage. Abuse of storage-in-transit programs induces processors to develop their own transportation programs. Most brand manufacturers

have their own distribution networks which accomplish these same tasks. A few of the largest private label processors have, either through ownership or joint ventures, instituted forward distribution programs. Insofar as these programs provide a competitive advantage, more processors will need to invest in some form of a forward distribution system. This also tends to work against smaller processors and moves the system toward a structure of a few, large firms.

Thus the buyers' concerns for shifting inventory burdens and for minimal transportation costs culminate in the needs for processors to be multiple product packers and to have transportation arrangements which meet buyers needs. Both of these require large, well-financed packers. Consequently, there will probably be structural realignment in the private label processing sector. Most of the structural change will occur in those areas where the greatest numbers of smaller specialized processors exist.

7.7.2 Buyer Response to Source and Nutritional Labeling Proposals

Policy proposals for processed fruit and vegetable industries will impact on private label firms in ways determined partially by food distributor buyers. Consequently, during the interview process buyers were questioned about their possible reactions to two often proposed policy actions: source labeling and nutritional information labeling. Source labeling requires that all labels have the name of the manufacturer in addition to the distributor's name listed on the product. This proposal is often advocated by consumer groups who believe that most private label products are really manufactured (and consequently identical) to those made by the national brand companies.

Buyers nearly unanimously agreed that source labeling would induce them to drastically cut their supplier lists. Most indicated that they would go to less than half, probably a third, of their suppliers. Currently most private label departments run with inadequate staffs. The additional transaction costs created by such a requirement would overburden most buying departments. To overcome the additional labeling costs and record-keeping buyers indicated they would have no choice but to eliminate most of their smaller packers and buy only from a few of the largest suppliers.

A nutritional labeling requirement will likely have the same general impact. The largest private label buying groups and chains will be able to use their own quality control labs to determine characteristics. Smaller private organizations would attempt to transfer label compliance to the processors. Many smaller processors will be unable to invest in the needed equipment and personnel to meet labeling requirements. Consequently buyers will have to shift to large processors who have the resources to meet the labeling requirements. The buyers will choose fewer suppliers because of the transaction costs involved in keeping different label inventories. Small private label firms will be forced out of business even faster than now.

These two proposed regulatory actions are presented to illustrate the importance of understanding the standard operating procedures of economic decision makers. Both of these policy proposals would probably lead to wholesale structural changes in the private label processing sectors with the likely outcome being substantial increased concentration in that industry. Yet much of the advantages of private label programs to consumers stems from the competitive nature of private label

processing. Without explicit recognition of the roles played by grocery buyers, many well intentional public policy actions may actually reduce food system performance.

7.7.3 Some Policy Implications of Not Recognizing Heterogeneity in the Food System

Not recognizing that private label and brand products have different manufacturing and distribution channels may lead to consumer policy which can be counterproductive. Likewise, assuming that all processors are the same has significant consequences at the first-handler level also. Even within the private label sector types of firms differ significantly. Failing to recognize the heterogeneity of firms during policy formulation threatens the whole private label concept. The following two brief discussions attempt to illustrate these points.

A. Grower Bargaining

This research illustrates how brand and private label processors face different procurement procedures and therefore have different business conditions. If growers through their bargaining representatives push for contract provisions which are designed for large national brand processors, they may put the private label processors in severe economic circumstances; perhaps the most severe is the shifting of supply variation risk to processing firms. Brand manufacturers have the ability to deal with this risk. Private label processors do not. Consequently, the number and organizational form of these firms is changing rapidly.

B. Cooperative versus Proprietary Processors

Grower-owned processing cooperatives are becoming an important force in the fruit and vegetable subsectors. During the interviews conducted

for this research, it was clear that these cooperatives have a different pattern of behavior than do proprietary firms. As a result, cooperatives deal with different buying tactics from the food distributors. The consequences are not clear, but it seems that processing cooperatives will tend to bear a greater proportion of the coordination costs for commodity systems through larger and slower moving inventories. This will become even more pronounced as more brand manufacturers switch to buying products from the private label market.

If the financial advantages (lower financing costs, lower capital costs, etc.) cooperatives have over proprietary competitors are significant, the joint existence of cooperatives and proprietary firms in one commodity sector, will force remaining proprietary firms into either bankruptcy or conversion to cooperatives. This conversion process has already started and it is likely to progress very rapidly.

The conversion process may include instances where growers may purchase processing capacity to prevent losing their market outlets. Some of these conversions may not be in the growers' or the food consumers' best interests. A policy initiative might be to have public monitoring and debate on the desirability of particular proprietary-to-cooperative conversions.

Should processing cooperatives be saddled with the burden of system coordination, there would be a need to rethink fundamentally the conventional wisdom about coordinated group activities of firms. An industry of cooperatives would have 1) the incentive, 2) the economic ability, and 3) legal authority to initiate group actions to coordinate supply and demand of processed products. However, a marketing agency in common for processed fruits and vegetables would certainly be at odds with historic

antitrust orientation. With this set of circumstances, a policy debate concerning the benefits and costs of coordination versus cargel actions would emerge.

C. Survival of the Private Label Concept

Failure by policy makers to recognize the dichotomous nature of food distribution can lead to the elimination of the effectiveness of private label products. Private label products are produced by a specialized set of small to medium sized firms who continually strive to be as operationally efficient as possible. These firms operate under conditions similar to pure competition. The price differential observed between brand and private label products is largely a result of the existence of these competitive highly plant efficient firms. Continued regulation of these firms as if they were similar to national brand franchise owning firms will rapidly restructure the private label processing industry into a more concentrated segment. The emergence of oligopolistic private label supplying industries will probably greatly reduce much of the price advantage now gained by consumers. Likewise growers will probably have fewer marketing outlets.

7.8 Procurement Practices Effects on the Structure of Brand Food Manufacturers

7.8.1 The Cumulative Impact of Procurement Practices

No single grocery retailer SOP is so dominant that significant structural change can be attributed solely to its influence. Rather the structural impacts of grocery SOPs are cumulative in that the simultaneous interplay of many of the standard procurement and merchandising procedures

systematically reward different groups of food manufacturers. Merchandising, procurement, and distribution SOPs are reviewed with the goal of highlighting their interaction with food manufacturer behavior. The analysis leads to an observation that there are tiers of competition or competitive viability within food manufacturing. It is the responses of various types of food manufacturers to retailer buying pressure which set up the dynamic forces responsible for the probable future structure of food manufacturing. As with other analysis of brand food products in this report, this discussion is generally applicable to call brand grocery items and not restricted to only processed fruit and vegetable products.

7.8.2 Structural Implications of Merchandising SOPs

Some of the more critical merchandising variables are shelf space and facings, shelf location, special on-shelf and off-shelf display space, and retailer run advertising. Retailers attempt to manipulate these so as to produce an image which will develop loyal customers who will provide an acceptable flow of retailer profits over time. It is impossible systematically to plan and execute every merchandising, advertising, and pricing decision so as to achieve these goals. Therefore, retailer merchandising will most often make decisions by taking the most advantageous opportunity available for each product. They thus array the net costs of taking a particular manufacturers product. A manufacturer who is able to defray retailers costs of distributing an item, will most likely have his products chosen for distribution. So long as manufacturers compete for merchandisers' attention, retailers can continue to parcel out shelf space and merchandising support to the highest

bidder. Therefore over time, the manufacturers who understand these standard procedures gain differential advantage over their competitors who do not.

The two basic tools used by manufacturers to affect merchandising decisions are manufacturer field forces and conditioned wholesale product price concessions in the form of allowances and deals. These tools are necessary but not sufficient for a firm to be more successful than its rivals. Field forces and deals must be properly administered and their actions synchronized for best results. Administration is primarily a function of the competence of the manufacturer's management. Timing is a function of differential access to retail buyers and merchandisers.

Differential access is obtained by consistently giving the retail buyers extra support and concessions. Field sales forces are instrumental in this process. Retailers rely on manufacturers' representatives to provide in-store labor subsidies. Retailers rarely use their own labor to stock the shelves on new store (called "a store set") or to rearrange stock in accordance with new plan-o-grams (called "a store reset"), rather they "request" that the manufacturers' representatives be at a store at an appointed time to help with the task. Nearly all manufacturers representatives will show up, for the rule of the trade is "He who sets the shelves, gets the shelves." When plan-o-grams (shelf maps) are made in headquarters, it is impossible to have every bit of shelf in every store allocated just as planned. As it turns out, nearly all plan-o-grams miss some space. The manufacturers' representatives who are stocking the shelves are allowed to usurp the extra space for their products. The extra facings are, of course, very valuable. Manufacturers who do not have field representatives known to the retailers do not get invited.

The good will built up by these activities gives the manufacturers' representatives differential access to the merchandisers. This means that the manufacturer's representatives can "help" the retailers make their plan-o-grams and manage the departments where their products are stocked. Over time, with enough good will, manufacturers can actually make the plan-o-grams from their own computerized product flow statistics. In the extreme, retailers may hand over nearly complete control to the manufacturer as the following passage from Chain Store Age further demonstrates:

The chain's buyer-merchandisers use the custodian system for every department. The sales rep. for the major product in the department is responsible at store level for maintaining that department. He is in charge of that department at store level, helping the manager and reporting to the buyer-merchandiser on any problems. Moreover, once every year, the custodian meets with the buyer to help him update the department (emphasis mine)."²

Thus even though food retailers own the rights to make shelf and merchandising decisions, they are willing to "sell" them to manufacturers. Those manufacturers who are the highest bidders 1) get the merchandising support needed to make their products successful and 2) get more and longer access to buyers and merchandisers. Differential access is critical because product success (over rival manufacturers' products) depends on coordination of field force activity, price and allowance activity, and consumer advertising.

7.8.3 Structural Implications of Procurement SOPs

A. Discontinuing Product SOPs

Evidence suggests that retailers maintain absolute authority over discontinuing a product from distribution. No examples were found during

the research to indicate that manufacturers were able to directly veto a retailers decision. However, manufacturers with differential access to retailer product decision makers are usually able to pre-empt the discontinuance process. They are usually informed before one of their products are eliminated. Forewarned and armed with coordinated marketing resources, they can take steps to increase its volume through increased consumer advertising and/or trade and consumer price adjustments. Often these actions must be taken in a few weeks. Only those manufacturers with integrated financial and personnel marketing resources are able to forestall a product discontinuance decision.

B. Existing Product Procurement SOPs

The everyday procurement of products in distribution is routine, often accomplished with computers and clerks. However, the wholesale pricing process is very complicated because manufacturers use deals and promotions in attempts to elicit desired retail buyer actions. The dynamics of everyday buying of brand products is dominated by various manufacturing firms' attempts to increase their market share over those of their rivals. They structure deals and promotions with retailer performance clauses. Since retail buyers and merchandisers often have 200 to 400 deals a week to choose from, their inclination is to take all of them and to ignore the performance clauses. Without a field force to monitor and implement performance plans, manufacturer deals become much less effective in moving more quantity of that brand. Field forces, however, do not assure that the manufacturer's deals are taken. Manufacturers must coordinate consumer advertising with deal presentations. Both field forces and consumer advertising are necessary for success in everyday sales to grocery buyers.

Food distributors make no distinction between brand and private label products in the warehouse except that brand products are often billed for slot charges. Consequently, the same distribution factors (interest and transportation costs) are critical for both brand and private label processors. Brand manufacturers with multiple products and their own forward distribution and delivery systems are favored by the retailers. Specialized and/or small brand manufacturers who must rely on common carrier and/or LTL shipments have a difficult barrier to distribution to overcome. This probably explains why the largest manufacturers have elaborate distribution and transportation networks. These forward distribution systems thus provide a competitive advantage. This factor plus the investment in these facilities are several probable reasons for the proported opposition of large national manufacturers to the legalization of backhaul.

In the historically competitive food retailing industry, grocers have always looked for small concessions which reduced their costs and increased their competitive advantages. As one manufacturer would innovate with a new idea, retailers would then "request" a similar concession from that manufacturer's rivals. For example, it is reported that it is common practice that spice manufacturers have gotten themselves into an expensive behavior pattern. Retailers will usually authorize only one manufacturer (other than their private label) to sell spice in their stores because the different companies have different containers (cans vs. jars) and color combinations on their labels. The spice department would be a mess if retailers were only to stock each manufacturers' best selling items. Suppose a new firm wants to sell in that distributor's stores. Retailers suggest he do the following: first,

provide the display rack and labor to stock it; second, buy all of the old firm's existing stock from the retailer; third this must be done in all stores. This display-stock purchase is very common. However, one manufacturer added a twist. After he bought the existing stock from the retailer, he gave it back to the retailer to sell it at whatever price he wanted. In other words, the new entrant would have to allow the retailer to sell his existing stock twice in addition to the above conditions. What started out as a simple offer of a free display rack has grown into giant proportions. This is but one example of the type of process which takes place. These conditions are similar to an "industry trap" in which once manufacturers start with concessions, all firms must follow. The end result is a transfer of benefits to retailers with no differential advantage accruing to any manufacturer.

Over time, manufacturers began to recognize that some of these small concessions resulted in desirable behavior from retail distributors. The successful manufacturers were the "first movers" who initiated the concessions and had the personnel systems to benefit from retailer reactions. This illustrates how retailer procurement actions increase barriers to entry and success in grocery manufacturing. By using their power in the short run, retailers are helping to develop more concentrated, and therefore more powerful, manufacturers.

C. New Product Procurement SOPs

In many respects, the new product procurement decision process used by retailers is structured so as to reward only those manufacturers who have perfected the processes discussed in this section.

Today, the manufacturers who are able to control the destinies of their products through the distribution system are those who have learned to provide rewards for all the various special interests within a retail organization. Thus, a successful new product introduction will include a slot charge payment to reward the warehouse director, a buying allowance for the buyer, a promotion allowance for the merchandiser, and display allowance materials and store-level labor support for the store manager. Thus each segment of the retail distribution has a vested interest in seeing that this new product or existing product gets a hearing before the consumer. All of these payments and incentives are necessary in addition to consumer advertising.

The major national manufacturers' executives interviewed estimated that nationally about 70 percent of the grocery advertising and promotion budgets are expended on activities directed at the final food consumer. The remaining 30 percent goes into activities designed to satisfy the needs and/or requests of the retail trade. These same executives also indicated that some expenses involved in these activities are not included in the advertising and promotion accounts but are more or less hidden in the accounts of departments other than sales and marketing.

The ultimate success of any individual new food product is determined by how well it matches the real and/or perceived needs of consumers. Getting that market test requires that manufacturers 1) understand procurement SOPs; 2) have the financial and personnel resources to manipulate or manage around and within these SOPs; and 3) have the ability to gain access to effective consumer advertising. Access to effective consumer advertising and promotion is the critical factor leading to the development of different tiers of competition in food manufacturing.

7.8.4 Dynamic Implications of Brand Manufacturer Responses to Retail Buying Pressure

In the bargaining process between retailers and manufacturers there are two common denominators of power. Retailers obtain their power through their control over shelf-stocking decisions. Manufacturers cannot sell to the mass consumer market unless they are on the retailers' shelves. Manufacturers obtain much of their power through product differentiation attained through consumer (particularly television) advertising. If consumers enter a market intending to buy a product, the retailer must stock the item or risk consumer alienation. When all the techniques, tactics, and strategies observed in manufacturer-retailer interplay are analyzed, the common root of power usually entwines one of these two factors. Generally speaking, manufacturers gain by allocating most of their marketing dollars for developing consumer product differentiation. Retailers, on the other hand, will attempt to capture as much of these resources for their own uses (buying, promotion, and merchandising allowances) as possible. How effective retailers are depends on the market share position held by the manufacturer.

Brand food manufacturers can be divided into two tiers. The first group are those firms with the ability to control the destinies of their products in the food distribution system. These are the manufacturers with an understanding of standard procurement procedures; the field sales forces to manage within these procurement SOPs; and products with a substantial degree of product differentiation. Most often these are the firms with products consumers recognize and plan to buy before entering the store. Very often these large firms' products are market share

leaders in their respective categories although usually not all of their products are numbers one and two in a category.

The second tier of brand manufacturers also have a working knowledge of procurement and merchandising SOPs, field sales forces, and consumer franchises for their products. However their salesforces are not as likely to have the pinpoint timing to coordinate promotions, advertising, and deals. They are less likely to have differential access to retailer merchandising and buying personnel; likewise, their consumer franchises are also probably weaker. While their products have sufficient product differentiation so that consumers will recognize the label, this differentiation is often not strong enough to produce a preshopping buying decision. Normally products like this will sell in profitable volumes only if retailers apply their merchandising techniques.

Retailer SOPs are applied approximately equally to all products. What differs however is the way in which first and second tier manufacturers respond to retailer buying pressure. The differential response by manufacturers to retailer bargaining pressure within the constraints established by procurement and merchandising SOPs is a driving force leading to the structural evolution of food manufacturing.

To illustrate this process, a scenario of the behavioral responses of manufacturers is presented. Assume that a product category has sufficient volume to justify carrying five brands in a common size in the stores. Three of the brands are differentiated manufactured brands. The other two are a first label and a second (perhaps generic) label retailer private label. Assume that the top two national brands have about equal market shares, say 40 percent each of the brand sales. Thus the third brand has 20 percent of the brand sales.

Typically, retailers will use the third brand as a price brand. Because of its lower level of product differentiation it may be priced at a few cents per unit lower than the other national brands. The retailers will often give this third brand preferential treatment in an attempt to win concessions from the top brand. A typical strategy of retailers is to feature No. 3 by subsidizing it with promotion monies gathered from allowances and deals from other brand items in other product categories. Most likely the buyer has induced the No. 3 brand to give him a deal which he will match dollar for dollar. With in-store merchandising, volume will have increased dramatically. Most of the volume will come out of the sales of the top two brands. This is precisely what the buyer wants. He will then take the movement figures and call in the representative of the top brand. He will say something like,

Your volume is way off. Your product cannot justify all of the facings and prime shelf locations we have given it. Unless you give us some promotion money (deals) to get our margins and/or volume up, we are going to have to make some changes.

It is at this point the difference between being a first tier and second tier company comes into play. The second tier company will acquiesce to the buyer's wishes and institute trade deals because it does not have the ability to increase movement without retailer-controlled merchandising help. If the firm gives in, the buyer will do the same thing all over to the next firm and the scenario continues ad infinitum. The buyer will continue to play one supplier off against another.

The first tier manufacturers will behave differently. Their reaction is best summarized by the following quotation.

When you've got the leading market position you don't get a promotion contest at retail. You respond by increasing consumer marketing efforts. It is difficult because your sales people (those interacting with buyers) are pleading with you to let them match market conditions.³

First tier firms will thus answer the volume decline observed at retail by increasing their consumer advertising and promotion. Since their franchise is strong enough, the added advertising will usually increase volume enough to maintain shelf and facing locations. These first tier companies have learned that giving retailers price concessions is a short-run solution which can possibly lead to eventual erosion of their market share. The only way to maintain or increase market share (and therefore profits) is to use advertising resources for bolstering the products consumer franchise.

This response by first tier manufacturers leads to the often observed behavior that leading firms counter price competition with increased advertising expenditure. This behavior is largely motivated by the need to counteract retailers. Again those manufacturers with field sales representatives who have gained differential access to buyers and merchandisers have the ability to move faster and more effectively in this retailer induced crisis.

Short-run advertising shifts are not usually implemented to gain a competitive advantage on competing manufacturers. Rather it is just a rational ploy to help the firm avoid retailer-induced price competition which could lead to market share erosion. This behavioral response is also partially responsible for the frequently observed fact that a conglomerate buying an established product line will often immediately start massive consumer advertising of the product.⁴ These firms know that the only way to safeguard the market position they have just purchased (often the primary reason for the merger) is to make sure it is the leading or next-to-leading brand in the category. Only then will the product be immune from price competition. Often the acquired

company may already have fallen into the price promotion strategy and the acquiring company must immediately increase advertising in order to maintain its investment.

Retailers will get different behavioral responses to their bargaining tactics from first tier (those firms with leading market positions and effective, fast-moving field representatives) and second tier firms. Since first tier firms usually do not capitulate to retailer-induced price competition, buyers usually end up playing one second tier firm off against another. For example, the number four brand which is not in distribution will offer a great deal. The buyer will promote that brand. Volume will be lost by the other brands. Brands number one and two will respond with consumer-oriented activity and advertising. Brand number three will probably be kicked out of distribution to make room for the number four brand. Thus by instituting trade-oriented price concessions, number four displaces number three to become the new number three. In all likelihood, the displaced firm will start formulating marketing plans to try to regain its former position. In a year or two, they will present the retailer with a great deal and the whole scenario starts over.

Over time the second tier firms are played off against one another by the buyers until they fold or get into other products. Because of this, a higher proportion of their marketing resources are trade oriented. Given limited marketing resources, these firms cannot acquire first tier status because they are not able to use their money to develop consumer product differentiation. Usually the only way a manufacturer can get out of this trap is to sell out to a first tier consumer products

conglomerate which has the financial and personnel power to break the buyer-induced cycle.

As the long-run demand for a product declines, retailers gradually cut back on the number of brands carried. The cutback usually follows a sequence similar to the following, Five brands (three national, two private label) are cut to four brands (two national and two private label). Next the lower quality private label is dropped, leaving two national and one private label brand. When the product category volume drops to specialty products status, the stores usually carry only one national brand and one private label product. As this point, there is rarely any real price promotion activity at retail level. A firm will not normally be successful in entering this category. This is because it would have to take on a first tier firm and private label to which retailers give preferential treatment. As a result, these products are the forgotten items which generate generous profits for all participants (brand manufacturers, retailers, private label processors, and perhaps growers) in the food system.

In the final analysis, the SOPs used by retailers to buy brand food products erect substantial barriers to entry at the manufacturer level. The only way to overcome the power of retail buyers is to engage in massive consumer advertising tactics which create significant product differentiation and to have personnel (either their own or brokers) who can manage the products through the system. These provide formidable barriers to entry for all but the largest (first tier) firms.

An interesting paradox exists. Contemporary procurement SOPs are partially responsible for developing strong national manufacturers and increased manufacturing concentration. Yet buyers fear these brand firms

and will attempt to give smaller firms a break as they attempt to enter the grocery business. They do this in an attempt to discipline the dominant manufacturer. A small brand manufacturer recounted the following events as he tried to introduce a new product. The new firm offered the chain their product at a cost of twenty-one cents a unit to be sold at thirty-seven cents a unit. The deal also included a forty cents per case promotion allowance. This sixteen cent retail price margin equalled that being obtained by Brand X. The chain countered by offering to buy the new product for twenty-five cents (four cents higher) and selling it for thirty-three cents (three for a dollar) a unit. Thus the margin was reduced to eight cents with the retailer providing massive merchandising support. This resulted in the lowering of volume of Brand X.

The chain then went to work on Brand X by pointing out that it needed to lower its prices and give some promotion monies. The new entrant gained shelf access in year T but what of its prospects for year T+1? It now has a low price, low margin position. The new manufacturer acknowledged the problem but responded that he had no future at all unless he succeeded in T+1. This new entrant survived because of two factors. First, Brand X was owned by a first tier firm. So rather than cut margins, it increased advertising. Thus product category margins returned to sixteen cents a unit. Second, the product category was growing rapidly. Thus the new entrant had a better chance of surviving. The Brand X behavior provided 1) a profit umbrella and 2) its advertising increased category consumption to the point that two brands could survive. Had the market been stagnant or declining and the retail buyer abandoned the new entrant in year T+1, the firm probably would have failed, at least with this product.

The above example gives the impression retail buyers SOPs help lower the barriers to brand food manufacturing. In a theoretical sense they do, but the above behavior is for a single retailer in one market area. In order for a new firm to successfully gain national distribution, it needs many retailers to grant it concessions in more markets. This combination of circumstances is unlikely. What usually happens is that new entrants run out of working capital before they reach national distribution. Some firms may have developed strong regional brands but their continued development is stopped. The most viable solution and the one most often used by these firms is to sell out to a large national conglomerate firm which markets consumer products.

All the grocery buyers interviewed during this research were asked the following question, "Do you foresee the possibility of there being any new firms entering the brand grocery business in the future?" The answer was negative and nearly unanimous. With rare exception, they said that entry into the brand product manufacturing business is blockaded. Retailer procurement SOPs are partially responsible for this competitive position.

7.8.5 The Probable Structure of Food Manufacturing in the Future

As explained in the foregoing section there seems to be little hope for a major influx of new competitors in the grocery segment of the food manufacturing industry. The dynamic results of contemporary procurement and merchandising favor large, multiproduct, well-financed manufacturing giants and conglomerates. Well-managed, smaller firms will probably be able to develop consumer franchises and profitable levels of market shares in regional markets and firms will probably provide some

competitive pressure in some product categories in some markets. However, it is doubtful that these regional manufacturers will be able to amass sufficient capital and personnel to develop a fully coordinated marketing program with consumer advertising and differentially recognized salesforces. Therefore regional brands will most likely have to sell their consumer franchises to manufacturers which market on a national basis. These will most likely be the first tier manufacturers who have higher profit rates and are therefore able to outbid second tier firms for the promising regional firm's assets. Under these conditions, food manufacturing will, at best, maintain the current level of concentration or, more likely, gradually become more concentrated as fewer and fewer grocery marketing firms survive.

7.9 The Effects of Procurement Practices on the Organization of the Food Retailing Sector

7.9.1 Brand Product Procurement Practices

The relative economic advantages and disadvantages of chains and independents are well documented. Integrated corporate chains are believed to have lower costs garnered from various economies of scale and more effective operational control. Independent retailers, on the other hand, are said to be more responsive to changing economic conditions and are better able to match the specific demands of consumers in their isolated market areas. Chains are believed to excel on operations; independents are believed to be more innovative merchandisers.

Independents who are affiliated (most are) with progressive wholesaling operations are not at a great competitive disadvantage. Cooperative and voluntary wholesalers provide much of the necessary long-run

support (stores cite acquisition, market research, financing) and operational aspects (advertising, record keeping, labor training) needed by retailers to be competitive. These services are provided at fees which are usually competitive with the costs of integrated chains.

The buy-in SOP does produce a competitive disadvantage for some independent retailers. Under Robinson-Patman Act rulings, brand manufacturers are required to make sure that all retailers have the opportunity to avail themselves of the manufacturers' deals and promotions. Thus independent stores will nearly always be able to offer their consumers the same product at the same price as a chain store. Chains will often be first on the market with the deal however. This is because of their control of distribution and their smaller communication lags between stores and headquarters. However, when the wholesale organization buys in at the end of the deal, that lower priced merchandise may not be made available to the stores. Retailer owned cooperatives will almost always pass on the savings to their owners but like chain store owners may or may not pass on the savings to consumers. However, voluntary wholesalers will rarely pass on the savings to stores.

The economic logic is that wholesalers are competing against integrated chains which often run their warehouses (wholesale operations) at cost. Therefore the only way for nonintegrated wholesalers to make a profit is to 1) be more innovative and profitable, 2) generate money off of trucks and distribution, and 3) generate revenue from speculative buying. Thus most wholesalers will use buy-ins to generate profits for their own operations. Given this fact, independents will, buying through wholesalers, ceteris paribus, have higher product costs than chain stores. This will be especially noticed in competitive markets

where chains will be forced to use some of their bought in products as specials to try and differentiate their operations to the consumer.

The general impression left by the executives interviewed was that affiliated independents will continue to survive. Many of the voluntary and cooperative wholesalers are some of the most innovative food distributors in the food system. Their inherent efficiency is usually enough to overcome any procurement advantage enjoyed by integrated chains. Unaffiliated independents will find it increasingly difficult to survive because they will be unable to generate the flow of goods, equipment, and accounting expertise at prices which will keep them competitive.

Two practices observed in the brand procurement process that can have structural implications for retail food distributors are 1) the use of transshipped deal merchandise and 2) the ability to hide coupon misredemptions. Large multimarket chains can, if the deals are sufficiently large, profitably ship deal products from one market to another. This means that chain stores operating in several markets can have lower product costs than single market retail competitors. It is impossible to transship a large number or volume of products. However if the products transshipped are consumer sensitive items, the multimarket chain can use these to differentiate its stores.

While a few of the largest wholesalers and cooperatives have the opportunity to transship, they are much less likely to do so. This is because transshipment might imply that the wholesaler was showing favoritism to certain affiliates.

In addition, multimarket distributors can use their geographic dispersion to launder coupon misredemptions. Occasionally, coupon wars will break out in local market areas with retailers redeeming them for

double or triple their face values. Manufacturers know the historical redemption rates in individual markets and resist paying for coupons collected in these wars. Single market firms are thus often forced to absorb the cost of these coupon wars. Geographically dispersed firms can ship some coupons to other markets and mix them with normal coupon redemptions without raising the redemption percentage in any market above the critical level which spurs manufacturer resistance.

Again, the above are minor competitive advantages. They can, however, have a significant impact on the margin. In a highly competitive situation, a succession of these small factors applied over time may be sufficient to create increased retailer concentration.

7.9.2 Private Label Procurement Practices

Another advantage integrated chains have over independent retailers is their larger and more effective long-run private label programs. It is generally assumed that private label products are more profitable than their brand counterparts. Chains with their own private label programs tend to have a higher proportion of their sales in private label and therefore have a presumed potential profit advantage. This research clearly indicated that the various private label buying organizations have achieved the same procurement economies as have the large chains. Thus independent retailers are not at a procurement disadvantage. However, independent retailers will rarely have the commitment to private label programs that large chains do. Most likely, the private label logo and name in independent stores are of a general format which does not identify the products as the independent retailer's own products. As a result, they tend to view the controlled labels they buy as just

another set of products. Thus even though their private label goods may have the approximate cost of private label goods, they often do not generate the volume of private label profits that integrated chains do. As independents grow into medium-sized chains, they may eventually reach the size at which they can profitably implement their own private label procurement system. The most recent evidence suggests that \$1 billion in sales a year is the point where it is profitable for a chain to drop its controlled label source and develop its own labels. This figure would also be applicable to voluntary and cooperative wholesalers. As their aggregate sales approach this \$1 billion figure, they can develop their own controlled labels. Currently, nearly all retail chains and distributors of that size have their own private label programs. Presently, a few chains are approaching this threshold. Consequently, most independents will likely continue to use controlled labels for their private label merchandising.

It is not clear how competitively significant an in-house private label system is. Independent retailers seem to be holding their own. In addition, the relative importance of private label does not seem to be growing in grocery retailing. However, inasmuch as private labels are associated with lower food prices, and consumers continue their vocal opposition to brands, private label may become a more competitive advantage in the future. If this happens, independent retailers with controlled labels which are often slightly less profitable than private labels may be at a competitive disadvantage.

7.10 Some General Observations Important for Policy Issues and Debates

7.10.1 The Importance of Vertical Relationships

A central theme of this analysis is that the interaction between food distributors and manufacturers/processors is critical to understanding how the food system works and therefore responds to policy initiatives. Vertical relationships are very important in some specific policy debates. Several of these are briefly discussed below.

7.10.2 Impacts of Robinson-Patman Act on Food Firms

Manufacturers use the Robinson-Patman Act (R-P Act) to resist the distributors' attempts to use their procurement power to wrestle "special" corporate or personal financial concessions. While there are exceptions, it does appear the R-P Act is effective in preventing large distributors from gaining large concessions from suppliers like those which were allegedly occurring in Ontario, Canada.⁵ Thus the R-P Act does appear to be partially responsible for the relatively equal distribution of power between food distributors and manufacturers observed in the United States food system.

It is questionable, however, whether the R-P Act has accomplished its original goal of preventing large chain distributors from "buying cheaper" than their independent competitors. Because manufacturers are responsible for making certain that every retail competitor (whether an independent store or large chain) in a market gets the same cost-adjusted price quote, they have structured their promotional activities so that the smallest retailer is able to adopt the deal program if he desires. As a result, retail distributors benefit from deal provisions (like buy-ins and stock protection) in direct proportion to their size. Thus over

the years the R-P Act may have actually helped, rather than hindered, the development of large national food distributors.

The enforcement of the R-P Act is similar to many disease inoculations. An active, publicized period of enforcement reinforces the preventive effects of the Act. Over time, the power of the Act gradually wears off and more and more isolated outbreaks of violations are observed. At such times a booster shot of enforcement is needed. The interviews indicated that the last round of active Robinson-Patman enforcement is wearing off in that more and more differential price concessions are being given. If it is deemed that the Robinson-Patman Act is still a useful social policy given the current structure of the food system, it might now be advisable to have a short period of renewed enforcement.

7.10.3 Differential Access to Consumer Advertising

Procurement is intricately related to food advertising. The structural evolution of the brand grocery business is determined to a large extent by contemporary advertising practices. If the public is concerned about what direction the grocery industry is going, then formulating policy to deal with food advertising is necessary. This observation is not new. What this research does imply is that advertising policies need to recognize the interrelatedness of advertising with retailer decision making.

To assume that food advertising "brainwashes" consumers into buying a manufacturer's products is very simplistic. Many of the current advertising practices used are designed to provide countervailing power against shelf policy decisions of food distributors. In order to achieve retail distribution and to execute competitive strategies, manufacturers need to

advertise to consumers. Otherwise retailer buyers would most likely usurp and internalize manufacturer price reductions.

Advertising thus provides the countervailing force manufacturers use to blunt the power retailers get from shelf ownership. Any change in public policy which alters the use of advertising by manufacturers will fundamentally alter the distribution of power in the food system. The tendency would be for food system control to shift toward food distributors and particularly those largest national distributors. Whether or not this power redistribution would improve food system performance needs to be an explicit part of the food advertising policy debate.

The basic variable which differentiates food manufacturers from one another is the relative market position of their products. The leading market position or a second position with nearly equal percent sales are what prevents retail buyers and merchandisers from forcing the item into price competition. Leading market positions arise from strong consumer franchises. Strong consumer franchises result from a product having unique characteristics so that consumers consciously seek out the product. Consumer advertising is part of the process of developing a franchise but not the entire process.

Access to consumer advertising is however required to 1) maintain the product's leading market position against retail buying tactics and 2) needed to expand the product into new market areas. Therefore, access to consumer advertising (particularly T.V. advertising) is the basic barrier to new manufacturers and smaller manufacturers trying to expand. Manufacturers also need to have access to personnel who know how to structure their advertising and promotions so as to elicit the needed behavioral responses from food distributors. Access to

advertising is a necessary but not sufficient condition for success in the grocery manufacturing business.

The statement was made earlier in the analysis that for all practical purposes entry by new firms into the national distribution of brand grocery products is blocked. The most likely entrants into national brand grocery distribution are those firms with leading market positions in other food products or with regional brands. These manufacturers have or can overcome the second barrier (knowledge of retailer behavior) to entry described above. To be successful at the regional level, they have had to learn the basic rules of retailer behavior. It is the first barrier (advertising) which almost totally prevents these firms from becoming competitive forces in the retail stores on a national basis. The current strategy taken by these firms is to sell out to a national conglomerate food firm or grocery products manufacturer. In this way they can become a part of a large firm which is one of the few which can effectively advertise on a national level. These kinds of mergers usually escape contemporary antitrust laws because they are conglomerate rather than horizontal mergers. If the public is concerned about increased aggregate concentration in grocery manufacturing, it should be aware that these mergers tend to eliminate most of the likely new entrants into the grocery business.

Clearly, existing public statutes are unable to effectively address this phenomenon. New approaches are needed. There is a need for a conglomerate merger law. The basic problem with most proposals is that many important food mergers would escape. This is because most conglomerate merger proposals use asset and/or sales size as the "trip" variable. Dollar sales and asset size are not the critical variables for

food manufacturing mergers, relative market share is. A leading brand factor in a regional market may have sales and/or assets under \$50 million. Nearly all conglomerate merger proposals would exempt such a merger. Yet, it is the control by fewer and fewer larger consumer products companies of more and more leading market share items which is the real competitive policy issue. Effective policy must recognize this market share condition.

7.10.4 Distributor-Brand Label Comparability and Policy

There are four basic factors setting brand and private label products apart. First, brand product manufacturers assume responsibility for all aspects of their products, including development, testing, marketing, transportation, and sales. Second, with some exceptions to be noted in Chapter 5, brand products are produced by a set of suppliers different from those manufacturing private label products. Third, basic supply and demand conditions vary across broad product groups (i.e., canned groceries, frozen foods, paper products, etc.) and as a result, different procedures and practices are used to procure different types of private label products whereas brand procurement SOPs are more uniform. Fourth, all of the product creating functions normally handled by brand manufacturers must be performed or directed by private label buyers. The standard procedures used to accomplish these functions are summarized below.

Development and testing of private labels is largely foregone by the buyer SOP of attempting to copy the product identity of the leading brand in his market. Product specification, quality control, and label development procedures are retailer buyer proxies for product development

activities. Buyers have designed transportation procedures to meet their inventory and bargaining needs. The private label booking system has evolved into a system that allows for a nearly continuous product flow without the buyers being responsible for much of the risk common to most commodity-based food products. All these standard operating procedures interact to form the output of the private label system.

Are these private label products identical or directly comparable to their brand competitors? For some products, in some markets, at specific times they are, but generally brand and private label products are not the same. The following statements summarize why this is the case:

1. There are different levels of private label products. Generally, first and second label products are not comparable in quality. Only first label private labels approach brand quality specifications.
2. Because retailers attempt to copy the leading brand in their market area, first label private labels can and often do differ from each other in different markets. Therefore if Private Label A is different from Private Label B, then Private Label B must be different from Brand A.
3. In any given market, several retailers will be attempting to copy one brand. Given a subjective grading standard, the probability is that the specifications for first label private labels will not be the same and therefore not comparable to the copied brand. Cases were discovered in this research where two competing first label private label in the same market were different USDA grades (one was Fancy; the other Extra Standard). The Fancy grade private label product might be comparable to the brand, but in no way is the other first label private label comparable to the brand.
4. Variable quality in the supply of raw product requires that the system be able to adjust to this variance. Part of the adjustment process (See 5.6) involves changing private label specifications. Section 6.4.5 demonstrates that (a) brand manufacturers tend to have less variable quality and (b) have adjustment mechanisms which do not involve changing their products' specifications.

5. Brand and private labels are, for the most part, packed by different firms. Brand manufacturers support research and development departments which develop new varieties and improvements to their products. Adjustment lag time and the inability of private label firms to gain access to proprietary secrets often results in brand product formulas which are not duplicated or capable of being duplicated.
6. A brand manufacturer with distribution in all retail firms in a market often has production/distribution economies which are not available to a single retailer selling his brand in that market. In order for a private label buyer to create the necessary price difference requires that he alter (lower) product specifications to reduce cost. This factor is especially noticeable in slower moving and manufactured private label items.

All of the above reasons highlight why it is difficult to determine and misleading to assume that brand and private label products are nearly identical. Assumptions to that end involve the normative judgement that real and perceived differences between brand and private label products are valueless. Using this assumption in policy analysis gives the impression that the elimination of price differentials between distributor and brand products will leave consumers with the same product and service mix that they have now but at lower prices. More important however is that policy makers may begin to assume that all products are identical, and they begin to formulate specific policies (like labeling laws) on that assumption.

7.10.5 Policy Actions and the Distribution of Power in the Food System

The two countervailing loci of power in food distribution are 1) access to and strategic use of consumer directed advertising by manufacturers and 2) ownership and control of shelf space by retailers. This is not a new observation. The National Commission on Food Marketing highlighted this fifteen years ago.⁶ A point often overlooked in contemporary

policy debates is that substantial actions which diminish the relative strength of one segment in food distribution will most likely transfer more power to other segments.

Recent initiatives that question food advertising and other food manufacturer marketing tactics must recognize the redistributive impacts on power distributions of these kinds of policy suggestions. A substantial alteration of a manufacturer's ability to directly advertise to consumers will greatly enhance the power of larger food chains and distributors. Distributor power comes from controlling access to shelf space. This vertical power is only tangentially related to horizontal market power. Consequently, countervailing structural policy initiatives in food retailing will probably not affect the transfer of power. Increased distributor power may have some deleterious effects on food system performance.

Policy discussions about food manufacturing industry initiatives need to weigh the net benefit and cost impacts of proposed changes in the relative power distribution between manufacturers and retailers. Thus a critical question to be considered is, will food system performance be enhanced by shifting more power to the already powerful food distributors?

7.11 The Handy-Padberg Model Revisited

In 1971, C. R. Handy and D. I. Padberg's article entitled "A Model of Competitive Behavior in Food Industries,"⁷ postulated a vertical, behavioral intersection between four food industry subgroups identified as 1) a food manufacturing oligopoly core, 2) a large fringe of small and medium sized food manufacturers, 3) a food distribution oligopoly

core (large food chains) and 4) a large fringe of small and medium sized food retailing firms. These four collections of firms are vertically linked.

Large manufacturers were said to concentrate on selling to the merchandising, new products oriented to small/medium food retailing firms. The cost control, efficiency oriented, large food distributors link with the limited line, efficiency oriented small and medium sized processors. Handy and Padberg then postulate that these two vertical units compete against one another for the consumers' attention. The large distributor/small processors sector tends toward price competition with limited differentiated private label products. The large manufacturer/small retailer sector tends toward various nonprice, new products competitive strategies. In this way, according to the authors, the two oligopolistic elements (large manufacturers and large distributors) in the food industries avoid direct confrontation. The conclusion is that consumers have a system which performs better because these units do not use their resources to battle each other for strategic advantage in a bilateral oligopolistic situation.

The legitimacy of this model is determined by the value set held by the reader. Many economists operate with different sets of performance dimensions and criteria which discount the value of new products, marketing techniques, and advertising. These outputs of the system are viewed as useless products of the powerful elements in the system who have the resources to shape consumer preferences. Since the consumers do not know their own minds, their revealed preference for these products is thought to be by some not socially desirable. Thus any model which

ascribes value to nonprice competitive behavior is deemed illegitimate and deserves to be ignored or condemned as undesirable performances.

Other economists, however, believe that product variety, new commodity forms, and new shopping environments are indications of good, dynamic industry performance. To these economists, the Handy-Padberg Model is a new conceptualization which is very useful for redirecting public policy. Thus the appropriateness of the model for policy is dependent in part on the normative precepts under which various economists operate.

Independent of the policy implications of the model, the question remains--does the model represent an accurate description of the food industries today? It is obvious from the preceding material that the food system structure described by Handy and Padberg still exists. There is a dual manufacturing system, one for brand products and another for private-controlled label products. As described by Handy-Padberg and further documented in this study, independent retailers tend to be less oriented to private label. Thus some of the basic elements of the system remain the same today. However, the winds of change are beginning to alter some of the basic economic behaviors leading to the Handy-Padberg findings.

Actions of the powerful oligopolistic elements (core manufacturers and grocery distributors) have adopted SOPs which are partially responsible for the demise of much of the fringe sectors described in the Handy-Padberg model. The ranks of private label suppliers seem to be shrinking rapidly; partially because of buyers' bargaining tactics and partially because of governmental policies. As the number of suppliers shrinks, the cost advantage of private labels will start to dwindle.

This is because there will be less competitive pressure among suppliers, and buyers will be less likely to be able to play one supplier off against another. Thus large distributors will gradually lose the value of low private label prices to differentiate their operations as low-cost, efficient operations.

Likewise, small unaffiliated retailers are beginning to have increased difficulty competing with the larger more efficient and/or predatory food distributors. Thus in order to survive, independent retailers have affiliated with cooperatives and wholesalers who have adopted operational and private label strategies similar to those of the big distributors. The advent of individual product computer scanning will allow the large integrated distributors to gradually develop very specific, localized stores to match local consumer demands. Thus chain distributors will be able to counteract the basic inherent merchandising advantage small retailers have had through time. Given this factor, independent retailers will have no recourse but to direct their affiliated organizations to develop strategies (like forced distribution) which will neutralize the operational efficiency of large integrated chains.

The author thus speculates that the organization of the food industries is evolving toward a different structure than that discussed by Handy-Padberg. There will be three substructures in existence including 1) a core of locally oligopolistic food distributors (both chains and groups of affiliated independents), 2) a shrinking oligopolistic core of brand food manufacturers, and 3) a core of large, diversified private label suppliers.

Briefly, the basic logic for this structure is as follows. Unaffiliated independent retailers will probably continue to shrink in numbers

and total grocery store sales. The needs for retailers to have modern accounting, merchandising, and distribution backup will require them to join some sort of affiliated organization. Members of the affiliated organizations will become more operations-oriented while the chains are becoming more merchandising oriented. As both of these large distribution groups all coalesce toward a more standard operating-merchandising mix, various market segments will begin to arise, including convenience stores, limited assortment stores, warehouse stores, superstores and hypermarkets. In the past these segments were catered to by different firms. The trend seems to be for existing grocery store distributors to diversify into these submarkets. Thus the diversified retailing services which were provided in the Handy-Padberg Model by two vertical channels will most likely be provided by one core set of grocery distributors. The consumers' preferences for diversity will be satisfied by one group of firms instead of two.

The small oligopolistic core of brand grocery manufacturers will continue to shrink in number. Whether their total influence will grow beyond their current position vis à vis private label is questionable. The behavioral relationships between distributors and brand manufacturers will continue to be similar to current ones. Brand manufacturers will attempt to circumvent distributors with direct advertising. Retailers will attempt to play one manufacturer off against another in order to obtain price and allowance concessions. As this oligopolistic core of manufacturers becomes more conglomerate, the balance of power will gradually shift more and more to the manufacturers which means that distributors will have to rely increasingly on their private labels for disciplining brand behavior.

The current procurement SOPs of distributors and the actions of various government agencies make it increasingly difficult for the small and medium sized private label processors to survive. In order to successfully service retail accounts in the future, private label firms will need to develop a large portfolio of accounts. Thus in the future they will most likely be the ones serving retail, industrial and institutional accounts. This kind of structure has evolved in the frozen fruit and vegetable processing industry. As there are fewer private label suppliers, consumers will less likely benefit from protracted price decreases which occur as a result of the difference between processing capital acquisition and salvage costs, weak seller market power and full production orientation. The benefits of private label products to the consumer will probably depend on how the large distributors decide to interplay their private labels with the brand products they stock.

In summary, the food industries are evolving into a "new competitive behavioral model." The fringe distributors and processors are disappearing or consolidating into one of the three dominant groups. This consolidation of four groups into three will change competitive behavior and therefore many of the policy recommendations made by Handy and Padberg.

7.12 Some Conclusions About the Effects of Retailer Procurement and Merchandising Practices

In a quantitative multivariate analysis, the researcher looks not only for the significant influences but for the relative explanatory power of them. In this qualitative analysis, the researcher has tried to identify the significant aspects of procurement which influence food system structure. It is impossible to assess, however, what proportion

of the observed changes in the system are due to procurement actions and what portion are due to other stochastic and nonstochastic influences.

The following are some conclusions arising from the analysis in this chapter.

A. Retailer SOPs Effects on Commodity Subsector Vertical Coordination

1. Part of the historically observed price-quantity cycles in fruit and vegetable subsectors is a function of vertical coordination practices.
2. Three distinct loci within the subsectors are instrumental in vertical coordination:
 - a. Merchandisers do not recognize or are not concerned about subsector coordination needs. In addition, there are incentives for them not to alter their behavior to help match demand with supply contingencies.
 - b. Buyers have incentives to transmit faulty demand information to private label processors.
 - c. Processors have economic incentives to run their facilities at full capacity. Also, the structure of the private label industry often results in firms consciously disregarding economic signals.
3. In most cases, brand manufacturers have the personnel, information, and financial resources to coordinate their inventories with consumer sales.
4. Brand and private label products are economically linked in such a way that brand manufacturer coordination behavior is partially responsible for coordination actions in the private label products sector.
5. The consequences and costs of existing coordination practices are almost entirely borne by the private label processing sector through higher costs and/or costs of inventory management.
6. Brand fruit and vegetable product manufacturers seem to be choosing to abdicate their historical role in subsector coordination:
 - a. Manufacturers are increasingly using spot sales and purchases in the cash markets instead of marketing resources to balance inventories.

- b. Manufacturers seem to be gradually moving toward buying processed products from other packers to which they add their labels.
- 7. The SOPs of merchandisers, buyers and brand product managers are such that current coordination practices affect commodities to the extent that they may lose their status as major food products.
- 8. Minor fruit and vegetable products undergo the same coordination cycles except that the consequences of coordination practices are proportionally more destructive for these items since they are in greater danger of losing shelf space altogether.
- 9. The inflexibility of raw product adjustment in the short run has led to coordination practices induced institutional development in the perennial fruit and vegetable crops:
 - a. Grower bargaining and marketing orders are relatively more predominant in perennial crops.
 - b. The existence of and movement to processing cooperatives is paramount in perennial crops.
- 10. As annual vegetable crops develop more specialized growers and capital, many of the same institutions will begin to predominate the annual subsectors as they do the perennial.

B. Some Policy Considerations

- 1. The dynamic evolution of the commodity subsectors suggest that marketing orders and grower bargaining be evaluated in a broader context than their impacts on short-run pricing issues. Both institutions have some use in dampening commodity supply variation which seems to be the driving force in subsector evolutionary change. Producer-sponsored generic advertising programs could, if properly implemented, help influence retailer merchandiser decisions so as to better match demand to supply contingencies.
- 2. Proposed exclusive agency bargaining and markets for forward deliverable contracts would go even further in altering the evolving structure of commodity subsectors.
- 3. Failure to recognize the dichotomous nature of grocery distribution; the heterogeneity of the firms producing grocery products; and the critical role played by food distributor buyers leads to incomplete policy analysis which results in policy proposals whose unforeseen consequences can reduce food system performance.

C. Structural Consequences of Contemporary Coordination Practices

1. Current coordination practices have indirect impacts on food system structure:
 - a. Brand products manufacturers tend to shift away from commodity-based food products. Disintegration of processing and marketing seems to be a common strategy. Thus, the commodity loses the power of the manufacturers marketing expertise.
 - b. The coordination burden falls on private label processors who have a difficult time bearing the costs. Since cooperatives have several advantages over proprietary firms, and growers have large economic interests in commodity coordination, there is a gradual shift to grower-owned cooperative fruit and vegetable processing. This trend is especially pronounced in perennial and annual crops where growers need substantial amounts of specialized capital.

D. Retailer SOPs Effects on Food System Organization

1. Current private label procurement practices of food distributors are resulting in the selection of a relatively few large, diversified private label suppliers causing small private label suppliers to go out of business.
2. Current procurement practices of brand products by food distributors have differential effects on brand manufacturers:
 - a. First-tier manufacturers can, through specialized knowledge and adequate financial resources, effectively manipulate the retailer procurement process so as to give their products guaranteed retail distribution.
 - b. Second-tier manufacturers are precluded from becoming first-tier manufacturers due to inadequate financial resources and by buyers' SOPs which push marketing monies toward distributors and away from consumer advertising. These firms over time are merged with first-tier companies or go out of business.
3. Buyers see few, if any, new entrants into national distribution of brand grocery products. This and other evidence shows very strong barriers to entry in this important segment of the United States food system.
4. Contemporary procurement SOPs seem to have only a minor impact on food retailing structural evolution:
 - a. In brand product procurement, the Robinson-Patman Act seems to prevent large distributors from gaining significant buying advantages over smaller distributors.

- b. Nearly all retailers have access to equally priced private label merchandise. Differences between chains and independents is usually the result of their differing levels of commitment to private-controlled labels.
- 5. Large brand manufacturers and food distributors enjoy a countervailing power relationship. Public policy which significantly influences either segments' sources of power will conversely influence the bargaining power of the other. Public policy in vertical systems requires a recognition that net changes in system performance is what is critical.
- 6. The evolving structure of the food industries requires the formulation of a "new" model of competitive behavior in the food industries.

CHAPTER 7

FOOTNOTES

¹James D. Shaffer and Larry G. Hamm, "The Exclusive Agency Cooperative as a Vertical Coordination Mechanism," Coordination and Exchange In Agricultural Subsectors, NC 117, Monograph 2 (Madison: University of Wisconsin, Research Division, College of Agriculture and Life Sciences, 1976) pp. 155-164.

²"New Directions in Buyer-Seller Relationships," Chain Store Age, April 1973, p. 41.

³Presentation by a Vice President for Market Development of a large conglomerate consumer products marketing firm to the Advanced Food Processing and Distribution Management Class, MTA/AEC 831, Michigan State University, October 1978.

⁴For documentation of this trend in the food industries see, Loys Mather, "Advertising and Mergers in the Food Manufacturing Industries" NC-117 Working Paper No. 19. Research Division, College of Agriculture and Life Sciences, University of Wisconsin, Madison 1979.

⁵See Ontario Federation of Agriculture, Toronto, Canada "Brief to the Royal Commission on Discounts and Allowances" February 1979, 55 pp. Mimeographed.

⁶National Commission on Food Marketing, Food from Farmer to Consumer, Government Printing Office, Washington, DC, June 1966, pp. 96-97.

⁷C.R. Handy and D.I. Padberg, "A Model of Competitive Behavior in Food Industries," American Journal of Agricultural Economics, 53 (May 1971) pp. 183-90.

CHAPTER 8

A SUMMARY OF THE IMPLICATIONS OF FOOD DISTRIBUTOR PROCUREMENT PRACTICES ON FOOD SYSTEM STRUCTURE AND COORDINATION WITH SUGGESTIONS FOR ADDITIONAL RESEARCH

In most food pricing policy debates a recurring refrain is that wholesale and retail prices do not simultaneously adjust with farm prices. System price lags cause producers' and consumers' concern, often lead to charges of exploitation, and are difficult for policy makers to explain. Understanding the processor-retailer interface and what happens within food distribution organizations is critical to explaining why the food system operates as it does. This study documents many aspects of the dynamic operation of food processors and distributors. It particularly concentrates on the influences of food retailer procurement practices on food system coordination and structure.

More recent interest has been in vertical subsector analyses. Attempts have been made to explain the operation and performance of food system subsectors. However, most of the initial work has concentrated on producer-first handler issues. Many subsector researchers were unable, because of data and complexity, to follow agricultural commodities all the way through the retail distribution channel. Many products become parts of different product categories and are subjected to the discretionary power of food distributors.

This research attempted to contribute to both the understanding of vertical coordination and structure in the food system. By examining

retailer procurement behavior, the dynamic forces causing structural and other changes in processing and manufacturing industries came into focus. Equally important, however, is that this analysis permits subsector researchers to better understand how and why food distributors view and treat individual products in the system.

8.1 A Conceptual Framework

Earlier work on vertical subsectors and vertical coordination has been hampered by the lack of a fully-developed, commonly-accepted conceptual formulation. This research is no exception. The author attempted to develop an analytical framework. Previous conceptual approaches used to analyze vertical systems were reviewed. Those components which seemed to be particularly relevant to food systems were incorporated into the framework. Earlier work by Bruce Marion was especially important to this part of the study.

The Richard Cyert and James March formulation of a theory of a firm's behavior is a key part of the conceptual framework used. There is a need to link a firm's behavior to vertical coordination. The Cyert and March concepts work nicely; especially the concept of standard operating procedures (SOPs). The SOPs are fairly well defined rules which determine a firm's behavior in response to short-run feedback from its environment. By using SOPs, firms deal with 1) the uncertainty of their environment, 2) maintaining viable intrafirm coalitions, and 3) their limited capacity to assemble, store, and utilize information.

Task performance rules define the everyday operation of the firm. Functional task SOPs (procurement, merchandising, etc.) are critical to vertical coordination. The SOPs for procurement and merchandising of

grocery products set the basic market conditions for processors and manufacturers. Their response to these SOPs in turn influences their actions toward their suppliers and producers. This research was dedicated to enumerating and explaining these retailer SOPs.

Procurement and merchandising SOPs are therefore part of the vertical coordination process. Embodied within food distribution SOPs are practices which determine and/or influence the flow of economic information and economic control within the food system. SOPs can influence the composition, completeness, accuracy, and timeliness of price, quantity, and quality information in the system. Of particular importance are SOPs which impact in food distribution organization's demand information critical to the decision making of other food system participants. Likewise SOPs which result in inaccurate, ill-timed, or incomplete information increase system uncertainty and may significantly alter food system performance.

Procurement and merchandising SOPs also partially determine functional tasks and responsibilities assignment in the system, thereby partially determining the level of risk other segments must bear. Thus retailer SOPs have a great deal of influence on the relative rates of return various producer, processing, and manufacturing segments receive over time. These relative economic returns establish the economic incentives for structural change and evolution. Careful analyses of procurement and merchandising SOPs reveals the likely structural configuration of vertical subsectors in the future. At this point, debate about the relative performance outcomes resulting from this particular set of behavioral SOPs can begin. Likewise, understanding the underlying SOPs

helps establish an expanded set of policy variables which could be manipulated in order to alter evolving food system performance.

While the framework used in this research accomplished its intended purpose, it is by no means a comprehensive, fully-consistent theory of vertical systems. Vertical system analysis is sometimes criticized because no commonly recognized and accepted theory exists. If vertical systems analysts are to escape charges of being ad hoc, they must re-dedicate themselves to do more disciplinary research into a theory of vertical coordination. Perhaps a useful strategy is for every subsector study in the future to take the theoretical developments of the most recent studies and to strive for continued theoretical progress.

8.2 Research Limits and Design

The conceptual framework developed is generally applicable to all vertical systems and all procurement decisions of food distributors could have been included in the analysis. Chapter 3 was designed to limit the study and to identify relevant categories for designing an interview format.

In an overview of the food system, several important distinctions were made. First, this research was limited to the at-home (grocery store) segment of the system. Procurement practices in the away-from-home (hotels, restaurants, and institutions) await other studies. Second, only grocery procurement practices were examined. Trade literature reviews and consultations with industry observers indicated that produce and meat procurement SOPs are very specific and not transferrable to other products. Third, a distinction between processing and manufacturing was made. Manufacturers take raw product and process it into

different forms and add a complement of marketing activities. Processors only take raw products and/or basic ingredients and add value only by changing product form. This distinction is critical for understanding vertical coordination practices and the evolving structure of the food system.

Three organizational characteristics of food distributors were found to be important for designing a study sample including 1) the functional assignment within distributor organizations; 2) the separation of functions in different firms; and 3) the existence and organization of separate distributor brand networks.

Critical to this analysis is the observation that procurement and merchandising functions are not necessarily assigned to the same individual within retail firms. Coordination of product movement within distributor firms often requires communication between two individuals. This communication gap is extenuated when procurement and merchandising are located in different firms. Affiliated independent retailers usually retain merchandising decisions but order products from distributor organizations who perform the procurement function. The interview sample was controlled for the organizational form (chain versus distributor buyers) on the a priori hypothesis that buyers in different organizations might face different incentive structures and therefore have different procurement SOPs.

Even more diverse than brand grocery procurement is distributor-private label product procurement because of the number of different methods and organizations involved. Private label procurement organizations were classified and described. The five basic private label procurement organizations were delineated and used to control for the

interview sample. As with retailer organization form, private label procurement organizational arrangement were hypothesized as being an important factor which might lead to different procurement SOPs.

To further limit the study, one set of commodities were selected as the target for analysis. Preconditions for selection included that the commodity group 1) exhibit significant supply variation; 2) have both brand and private label segments and 3) be sufficiently mature so that the procurement SOPs would not be in a rapid state of change. Processed fruit and vegetable products were selected. In addition to the above characteristics these products constitute a small but important component of total store sales and are particularly important to the North Central region of the United States.

A priori evidence gained through trade literature reviews indicated that canned fruit and vegetable products had different procurement patterns than did frozen fruits and vegetables. Because of this, the interview sample was segmented to include both canned and frozen fruit and vegetable processors. Brand fruit and vegetable sellers interviewed included brand manufacturers and brokers. Private label sellers included proprietary and cooperative fruit and vegetable processors and private label brokers.

In total, seventy-nine personal interviews were conducted: thirty with buyers and forty-nine with sellers. More interviews were conducted with private label buyers and sellers than with brand buyers and sellers. Generally, there was much less information available in the trade literature on private label procurement practices. A mirror-image interview technique was employed whereby buyers were asked how they buy and then

suppliers were asked how buyers bought this served to check accuracy of responses.

Responses seemed to center on the same basic points and the SOPs seemed to be fairly consistent and stable across buying and selling firms. Toward the end of the interview process, interview emphasis was shifted as it became apparent that merchandising SOPs were also important in explaining food system coordination. Merchandising SOPs, however, were primarily derived from trade literature reviews.

8.3 Brand Grocery Product Procurement Practices

Chapter 4 includes an enumeration and explanation of the standard procurement practices used to buy brand grocery products which are generally applicable to all brand grocery products and not limited to only processed fruit and vegetable products. This is also partially a function of how brand grocery buyers jobs are defined and the buying systems used by distributors.

Some firms use separate buying and merchandising departments. Others (principally chains) use buyer-merchandiser systems whereby the buyer also has merchandising responsibility for his products. Some firms still use a buying committee system for determining many buying decisions. Irrespective of the buying system used, buyers usually have experience in buying many different types of products during their careers. Thus the procurement SOPs tend to get standardized over all types of products.

The other critical fact is that brand buyers have extensive job descriptions which often include more duties than just buying. They thus have little time nor commitment to understanding the basic market conditions surrounding individual products. Also buyers are most often

salaried employees of distributor bureaucracies. Their buying decisions and SOPs are conditioned by internal, inter- and intradepartmental constraints. All of these factors combine to form considerable impediments to adjustments to individual grocery products.

A recurring theme in this analysis is that because of buyer indifference, individual grocery products need their manufacturer's backing. This is true not only for new products but also well-established products. For example, successful new product introductions require both consumer-directed and trade-directed promotion activity. Consumer-directed activity such as television advertising, free samples, and manufacturers' coupons, are designed to create product differentiation and consumer loyalty to the product. Trade promotion activity is designed to overcome buyer and merchandiser indifference toward individual products by making those products more attractive relative to their close substitutes.

Over time the components of successful consumer and trade promotions have become fairly standard. Trade activities include buying and merchandising allowances, special purchase terms, and slot charges. Most firms desiring to enter the grocery business understand what is required.

Brand grocery buyers often are overwhelmed with the number of manufacturers' new product offerings. They therefore have developed criteria for choosing which new product offerings to accept for distribution and which ones not to accept. These criteria include:

- Advertising support

- Test market results

- Packaging considerations

Manufacturer's reputation

Product originality

Advertising support is usually evaluated by the extent and distribution of television and radio advertising and product coupons. Test market results are examined for sample bias, demographic completeness, and for pricing relevance. Packaging considerations include not only the attractiveness and convenience to the consumer, but also how the product would adapt to the rigors of wholesale and retail distribution. Manufacturer's reputation has two key elements; has the manufacturer lived up to past promises and commitments to buyers and have the manufacturer's more recent new products been successful. Product originality refers to whether the product is really new or just a minor variation of some existing product.

Buyers trade off among these criteria. However, most evidence indicates that the level of a manufacturer's advertising support is perhaps the most important criteria in determining new product acceptance. With extensive television and coupon support, buyers often accept products which they feel might have otherwise failed.

In order to introduce new grocery products on a national level requires substantial capital often amounting to millions of dollars. However, money is a necessary but not sufficient condition for new product success. Those manufacturers who can coordinate the consumer promotion activity with lagged grocery buyer responses to trade promotion activity will significantly increase the probable rates of success of their new products.

Procurement of existing grocery items has some similarity to the procurement of new items in that advertising, coupons, and trade

activities are equally important in existing item procurement SOPs. However, in existing item procurement, store ordering and warehouse inventory control-buying systems are important to the procurement process. These systems usually incorporate the record-keeping function for all grocery products both brand and private label. As such, all buying decisions are made from the numbers generated through these systems.

Computerized inventory control systems do a good job of tracking produce quantities. Buyers know, for example, how many cases of a particular item are selling each week. These systems are able to keep historical movement data so that buyers are able to compare item movement of previous weeks and years. In addition, most of these systems contain all the descriptive material about products and suppliers necessary for executing buying orders. Most programs will automatically print purchase orders when stocks are too low. Most buyers are able to override the computer systems if they need to make special orders which are not recognized by the computer's simplified re-order programming.

Inventory control programs can carry current price and margin data along with the data about quantity. This data is limited however. Often the price data do not reflect price concessions via stock protection clauses and buy-ins at the end of deals. Also, the price data does not match the historical quantity data in the system. Thus there is no way for the buyer to know with these systems why product movement increased dramatically in some past time period.

Most buyers keep a price monitoring system which is independent of the inventory control systems such as noncomputerized cardex records. Here buyers are able to record such things as manufacturer's deals, retail promotions, and competing product promotions. With both data

systems, professional buyers can mentally recreate the market factors which caused a product's previous movement adjustments.

The combined operation of quantity and price monitoring systems tends to create a product movement and promotion cycles. As buyers search their records for explanations as to why a product was selling well a year ago, they observe that there was a group of promotions. They press suppliers for similar price concessions this year. The process tends to repeat itself year after year. Why do retailers always put baked beans on special on Memorial Day? Because consumers always buy them on Memorial Day. Why do consumers always buy baked beans on Memorial Day? Because grocery stores are always putting them on special on Memorial Day.

Occasionally, for whatever reason, manufacturers will want to reduce product prices to increase the products' sales. For this strategy to be successful, consumers must be presented with a lower price and they must recognize that the products are on special. The price reduction will be ineffective if retailers usurp the lower wholesale price and do not pass it forward or if consumers do not perceive and recognize the price change. Brand manufacturers have instituted various programs designed to induce retail grocery buyers to react in ways which will benefit the suppliers' products. Over the years, certain sets of programs (deals or promotions) have evolved and become standard practices in the food system.

The basic composition of most deals is that in return for a wholesale price reduction on the brand product, the retail buyer and/or merchandiser agrees to perform certain actions. These performance clauses usually involve one or more of the following conditions:

That the retailers implement special product display techniques on-shelf and/or off-shelf.

That the retailers reflect all or part of the price decrease to the consumer for some time period.

That the retailers allocate some of their newspaper advertising space to the manufacturer's product.

Performance conditions were originally established to ensure that retailers passed wholesale price reductions on to consumers. Retailers resent these conditions and have over the years bargained with manufacturers for other deal provisions. For example, promotion periods often run for four to six weeks while retailer performance can be met with one or two weeks of compliance. In addition such concessions as stock protection clauses and buy-in options have all been allowed to become standard deal provisions. In spite of all these concessions, retailers are still tempted to take the deal price concession and neglect performance requirements. With literally hundreds of deals available weekly to retailers, manufacturers have tried to find other methods to ensure retailer selection of their deal and compliance with that deal's provisions.

Here again direct consumer promotion enters as a necessary tool for the manufacturer. By extensively informing the consumer via television and coupons that product prices have changed, manufacturers can force retailers to reflect price changes and to fulfill other performance conditions. Without the ability to go around food distributors directly to the consumer, manufacturers must bid against one another with deeper trade allowances and/or special promotion provisions in order to have their price reduction--increased movement strategy work at the retail level.

Without direct consumer participation, retail buyers induce wholesale price competition among manufacturers. Without retail competition

there is no assurance that the induced wholesale price decreases will be passed on to consumers.

Promotion and deal prices could be calculated by reducing list prices or by giving temporary reductions off of list prices. When food prices were frozen by the government to halt inflation in 1973-74, list prices were used as the bench mark price. Since then, manufacturers have changed their pricing patterns. List prices are adjusted upward frequently and deal pricing is done off of list. The effect of this is to keep regular shelf prices high.

One way to reduce prices to consumers without altering the wholesale or retail price structure is by offering coupons to consumers. Since 1973, there has been a dramatic increase in manufacturer's use of coupons. Research on the causes and effects of manufacturer coupons is greatly needed. Hypotheses needing investigation are the relationship between use of coupons by manufacturers to fears of government price controls, and to the level of food retailing competition.

Another impact of the pricing behavior of high list-frequent deals is the development of limited assortment (box) grocery stores stocking only basic grocery items which move at high volumes and at low prices. Some retail competitors allege that box stores take advantage of existing deal provisions, especially buy-in clauses, to buy large quantities of deal merchandise only. Calls from retailers to manufacturers to stop this box store strategy have asked for implementation of additional performance requirements on standard deals.

The advent of box store competition has upset standard procurement practices for established grocery products which may be a sign that existing retailers were attempting to usurp too much of the manufacturer

deal price concessions for themselves. Likewise, this could be a classic case of cream skimming, which could be detrimental to the food retailing industry. As extension of this research would include investigating the causes and implications of selective deal purchasing behavior.

Currently, brand manufacturers offer deals within regional markets which are largely determined by the patterns of retailer competition. Manufacturers are required by the Robinson-Patman Act to ensure that all retailers within a market area get the same cost-adjusted price. Consequently, manufacturers use region- or zone-based pricing with adjustments only for quantity purchases. The recent deregulation of trucking (June 1980) could have a significant impact on brand grocery pricing. Large distributors with their own truck fleets can, via backhaul provisions, provide for the shipping and transshipping of deal merchandise in quantities not easily duplicated by smaller retailer competitors. There may again be calls by manufacturers for changes to standard procurement practices and provisions. In the extreme, deregulation and backhauling can destroy the current pricing bases for most brand grocery products. Research into the likely structural and performance consequences of moving to "new" SOPs needs to be initiated.

Procurement SOPs for existing grocery products seem to be well established and stable. There is an inordinate amount of gamesmanship and bargaining between manufacturers and their competitors and between manufacturers and retailers which takes place within these SOPs. The resulting dynamic implications for the manufacturing structure are significant. Some signs, however, indicate that some of the procurement SOPs are at variance with current market conditions and developing trends

enumerated above. A significant upheaval in the procurement process for brand products in the near future might come about.

The SOPs used by retailers to drop items from distribution are also nearly universal and stable. Products may be eliminated from distribution as part of 1) the introduction of a new product; 2) competition from close substitute products; and 3) systematic product group reviews.

Most retailers, because product category shelf space is relatively fixed in the short run, will drop one item for each new one introduced. In rare instances they will drop product facings from several products in order to make room for the new item. The rule seems to be to drop the lowest volume item in the category in which the new item is being added. Some buyers will drop one of the existing items of the firm which is introducing the new product. This "quid pro quo" SOP has significantly different implications for dynamic behavior of manufacturers and their ability to use product proliferation to garner more shelf space.

When a manufacturer reintroduces a product by offering trade allowances to retailers, the buyer often drops the slowest moving brand product in the category. While this appears to be similar to the above SOP, it differs because this is not a new item. Decisions to drop items induced by competition are critical in the gamesmanship between manufacturers.

Products often get dropped when the buyer systematically reviews the entire product category or department. At these annual or semiannual reviews all buyers and merchandisers systematically assess product mix and shelf space needs. With a few exceptions (one-of-a-kind or specialty items), these reviews also use the slowest volume criteria.

Although treated separately, the three classes of brand product procurement procedures (new product, existing products, discontinued

products) are all interrelated. The computer programs which form the basis for inventory control develop the statistics on which many buying decisions are made. The role of television advertising and manufacturers coupons is intricately related to the buyers' and merchandisers' requests for price concessions and merchandising support. The brand wholesale grocery market is very fluid and dynamic. Simplifying assumptions about its operation obscure many critical forces which explain food system behavior and performance.

8.4 Distributor Label Procurement Practices

In many respects private label buying is more difficult than that of brand label. Because distributors have to formulate design, and market their products, buyers need to be knowledgeable in many areas which do not usually concern brand product buyers. While some of the principles of private label buying are similar to brand procurement, distributor label procurement SOPs are more extensive and often more specific. Chapter 5 contains a very complete description of the operation of the private label-distributor label procurement system. Interviews concentrated on processed fruit and vegetable products. Therefore the procurement SOPs documented are applicable only to commodity products. Specific differences in SOPs for manufactured distributor label items were noted in a separate part of the chapter.

Private label buying personnel differ from brand label buyers because of the technical expertise needed to develop specific products. An understanding of label design and management, transportation institutions, quality control, and perhaps most importantly the everyday market conditions for their specific commodities is needed. While a brand buyer can

substitute one brand for another to ensure that consumers have a choice, private label buyers cannot. They must be able to supply their products on a continual basis at prices which achieve the firms overall marketing strategy.

There are fewer private label buyers because many retail organizations buy private label through buying organizations. These buyers are centrally located and usually do not have merchandising authority. Thus, even though they are well informed about product supply conditions, they usually do not have direct access to retailer merchandising power.

Private label programs are developed because they give retailers and/or distributors one or more of the following:

- A product with sufficient differentiation so that it cannot be exactly matched by competitors.

- A higher retailer margin than normally exists for comparable brand items.

- Categories of products which give consumers a value choice across quality and price characteristics.

- Exclusive control over the pricing, advertising, and merchandising of a group of items.

The concept of most private label programs is that their products should be of equal or better quality, have lower consumer prices and higher retailer margins than their brand product counterparts. Private labels are copies of brand products and therefore have no value for consumer awareness without a brand comparison. When a private label is the only label in a category, it ceases being a private label and becomes a differentiated brand.

New private label items are added when a product has sufficient volume and market stability so that a distributor label could be added which adheres to the basic price-margin concept. Depending on the

category's volume, the private label can be added quickly. More often, however, distributors wait until some of the original brand competitors have lost market share and have excess production capacity available for hire.

When private label items are dropped, it is usually part of systematic product category reviews. Because private labels carry the distributor's name, there tends to be greater resistance to dropping private labels than to dropping brands.

The first step in private label procurement is defining the product and product characteristics. Product specifications are established. The SOP is to copy the product characteristics of the leading selling brand in the distributor's market area. If that product can be sold at a lower price and higher margin than the brand, this specification is adopted. If it cannot, the buyer and/or the private label organization must decide which product characteristics to change in order to meet the price margin conditions.

If product volume is sufficiently high, private label distributors will use multiple private labels. Second and sometimes third (now generic) labels are added to the category. These additional labels are usually designed to provide a price alternative to top quality brand and first label distributor labels. To achieve these lower price-higher margin constraints, additional product characteristics must be altered.

Since distributors specify product content and products flow through stores on a continual basis, private label buyers must develop procedures for monitoring private label product quality. Three types of quality monitoring programs were identified: distributor-run, distributor-supplier run, and supplier run. The key differences between the three

revolve around the extent of the distributor's commitment to capital and personnel investments and concern about product consistency. The best run quality control programs have very systematic sampling and monitoring procedures. A few private buyers after issuing product specifications leave all quality control to suppliers. Quality control is critical in the private label system because of the very competitive nature of product procurement. In order to meet their price-margin conditions, private label buyers are always maneuvering for the lowest prices. If suppliers are pushed to breakeven or below cost sales, they will naturally attempt to alter the real price of the product by not adhering to product specifications.

Commodity-based private label products not only have variable prices but also variable quality. Are retail private label buyers willing to adjust or modify their specifications to more closely match the availability of various product qualities? Publicly, specifications especially for first-label products are not variable. The transaction costs involved in changing specifications on an annual basis is high. However when the supply of quality product precludes rigid adherence to formal specifications, adjustments are made. The most common adjustment method is to alter second and third label specifications. Buyers will normally try to alter marketing plans (promoting more second label, for example) rather than substantially altering product specifications.

Because of commodity price uncertainty, private label buyers have evolved institutional procedures to deal with variable prices. These SOPs are included in a booking system.

Basically the booking system is a set of verbal agreements between buyers and sellers, where the buyer maintains the option to take delivery

of the product only if he finds the price quoted at the time meeting his expectations. There is no formal commitment of the buyer to a forward price or a set quantity. Suppliers are expected to have the booked quantity available if the buyer decides to take it.

Buyers book the product in early spring, usually after annual crop planing decisions are made and are usually in the form of thousands of cases to be shipped in the next market year. Buyers and sellers usually monitor bookings on a quarterly basis. Buyers book the same product from many suppliers and are thus able to "pull" bookings from those which they feel are on the market price.

The booking system is very effective in protecting the buyers from market price changes. They are able to have the product on order without incurring inventory losses or gains during the marketing year. With ample supplies, buyers are also assured of getting the lowest price. The system shifts most risk to suppliers. However, in short crop years the booking system could work against buyers.

When supplies are short and buyers must maintain product flow to the stores, bargaining power shifts towards private label suppliers who have developed a complicated prorating system to allocate short supplies among the various buyers. The prorating system in theory treats every buyer equally, while in practice allowing suppliers to reward certain buyers.

The booking system also could distort demand signals in commodity subsectors if buyers were to consistently overbook. A buyer could overbook with the intention of having suppliers produce more product than the buyer really intends to buy. This kind of strategic overbooking

increases the magnitude of commodity quantity-price cycles and may result in short-run exploitation of small private label suppliers.

Evidence from this study indicated that strategic overbooking is not a serious problem. Because of the small number of suppliers, overbooking buyers lose credibility. Suppliers are able to discount this type of overbooking. However, some natural overbooking does occur caused by the fact that much demand information useful to the system is still impacted in the retail sector.

Aside from the basic payment terms, private label wholesale pricing has little in common with that of brand grocery. A key difference is that private label suppliers do not use promotional pricing with its associated performance criteria, rather private label prices are straight price quotes. Quotes are usually recent list prices or prices discounted from list prices.

Private label pricing is also F.O.B.-based pricing. Buyers must therefore be concerned about the costs of getting the product from plant docks to retail distribution centers.

Since there are no promotion prices, there is little formal price protection in the wholesale private label market. Rarely do private label suppliers grant stock protection clauses and formal buy-in procedures as do their brand counterparts. However, private label buyers with their superior intelligence networks are usually able to anticipate significant market price changes. On a rising market, they can buy-in. In a falling market they can refuse to pull their bookings until the price has stabilized. The operation of the booking system serves as an informal price protection system. The flexibility granted by the booking system probably accentuates wholesale market price movements.

Buyers make rising markets stronger and weak markets weaker. Should individual buyers get caught with the product on a rapidly falling market, they can often use their superior bargaining position to get suppliers to lower prices to market levels.

Because a brand grocery item is common to all buyers, the Robinson-Patman Act is supposed to ensure all buyers that they are receiving the same prices but it does not apply as directly to private label products. In theory, each retail buyer could have different specifications and therefore different products. Regulators would have to prove price differences were not justified by quality-determined cost differences. Since regular cost justified Robinson-Patman cases are very complicated and difficult to litigate, price difference case justified by cost of quality would be nearly impossible. The lack of assured procurement price comparability by the Robinson-Patman Act is one reason private label buyers are very skilled.

Wholesale private label fruit and vegetable pricing follows distinct patterns during the marketing year. After-pack opening sales (late summer); fall canned goods sales; after Christmas holiday sales; and National Food Processors Association Convention sales (February) are the four major pricing periods in the private label market year. After each of these pricing points, price negotiations usually involve small adjustments around routine shipping patterns. Although these markets are fairly competitive, market pricing activity is not volatile everyday during the marketing year.

Transportation costs can make up a significant portion of private label product costs which is especially true for products grown on the West Coast and shipped East. Private label buyers almost never accept

less than truckload or carload (LTL) shipments as they cost substantially more than full car or truckload shipments. This practice discriminates against smaller suppliers who supply slow moving products. They need to have additional fast-moving products to fill out loads or they have to participate in storage-in-transit programs.

Storage-in-transit programs are mechanisms to merge the needs of inventory management with transportation rates. Products are shipped in full load lots at a through rate between two cities even though the product stops and is reloaded at an intermediate point. At the intermediate point the product can be unloaded and reloaded in smaller quantities with other slower moving items. Therefore the distribution center only receives the minimum quantities it needs. Retailers are billed for the transportation and average warehouse costs. If the suppliers products (now cased and labeled) are moved out of storage quickly, they do not lose money; then if products stay in the storage-in-transit warehouses too long, they lose money. Since private label buyers control shipping from the warehouses, suppliers are at a strategic disadvantage. Larger private label suppliers, recognizing the savings from forward warehouses, have started to establish their own distribution networks.

Historically there have been sufficient numbers of processed fruit and vegetable suppliers so that buyers have been able to choose from favored vendors. Buyers select suppliers on the three basic performance criteria of quality control, price, and service levels to the buyers. Since the distributor's reputation is closely related to its private label products, buyers need suppliers who can consistently deliver products which meet the buyer's specifications. Next suppliers must be able to supply those products at prices consistent with those obtained by

competitors. The service level is a catch-all phrase which indicates how well suppliers have taken care of the little everyday details involved in private label transactions.

The number of suppliers used by a buyer depends on the size and geographic distribution of the buyer's retail stores and the type of product being purchased. Large national distributors need geographically dispersed suppliers in order to minimize transportation costs when shipping to dispersed warehouses. For commodity items the booking system provides buyers with price and risk protection. In order for the booking system to work, the buyer needs several suppliers to play off against one another.

Buyers in the interviews indicated that they tended not to buy private label from manufacturers who also have a brand franchise for that product. For commodity items, dual-brand firms would be unreliable suppliers because they would service their brand accounts before their private label accounts. Private label buyers will, however, buy excess merchandise from manufacturers. Several manufacturers also indicated that they would prefer not to sell to private label buyers because retailers could use their brands' shelf space allocation to bargain for private label concessions. Because of these considerations in processed fruit and vegetable products, there is little use of dual brands.

Although more constrained than buyers, suppliers can also favor certain buyers. When possible, suppliers prefer to deal with effective but fair buyers. They prefer buyers who have sufficient organizational power to move and sell products quickly to consumers when the supplier needs to sell more of the product. They also would prefer that buyers be honest and that they approach business dealings in a professional manner.

Although the elements of a private label program are available to all firms, there are perceivable differences in the private label programs of various retailers. These differences trace back to the basic purpose or philosophy applied by high level management to their private label programs. The "Franchise Development" philosophy is characterized by 1) a long-term commitment to product consistency, 2) a corporate commitment to professional private label personnel, and 3) a goal of developing private labels into differentiated brands. The "Competitive Response" philosophy entails programs, as the name implies, put together to match or meet retailers competitors private label programs. These programs usually have 1) a short-run lowest-price orientation, 2) little long-run planning for facilities or personnel, and 3) inconsistent supply and merchandising patterns. Firms with different philosophies will often have buyers with different buying behavior. These differences are important to understanding the dynamic operation of the processed fruit and vegetable markets.

There is very little retailer vertical integration into processed fruit and vegetable processing. The availability of competitive suppliers and the inherent risks in commodity processing seem to have prevented integration. Where extensive vertical integration has taken place, commodity uncertainty has been controlled. During the private label interviews, three vertical integration traps were discovered. Detailed explanations of the 1) "Capacity Utilization" trap; 2) "Transfer Price" trap; and 3) "Preferential Treatment" trap were given in Section 5.12.2.

During the course of studying private label fruit and vegetable procurement, several differences in SOPs used to buy manufactured versus

commodity based private label products were discovered. Some of the more important differences include:

- Fewer supplying firms on buyers' lists
- No formal booking system
- Supplier-developed specifications
- Formal policies for supplier terminations
- Less volatile pricing

This is an area touched on by this research which needs further investigation. Of particular importance is the identification of the suppliers of manufactured private label products.

Early in the research, it was clear that different procurement SOPs were used by frozen private label vegetables. A separate section (5.14) discussed these differences. Frozen vegetables have a much higher private label market share than do canned products. Therefore private label pricing dominates the wholesale grocery pricing of these products. Frozen products also have higher average quality specifications because shelf space is not available to stock lower grades and consumers of frozen products seem to be more quality conscious.

Another key distinction is that unlike canned products, frozen products have very significant institutional and industrial sales. Those markets seem to have different procurement patterns and thus seem to dominate (at least for some products) the retail market pricing. Because many frozen vegetables can be individually quick frozen, they do not have to go into final consumer packages until the time of sale. This flexibility gives suppliers more market bargaining power. Finally, frozen vegetables cannot be easily merchandised and promoted in as many different stores as are canned goods.

These differences suggest that frozen fruit and vegetable products undergo significantly different vertical coordination processes. Before these can be explained, further research is needed into the procurement practices of institutional and food manufacturer buyers.

Because of the recent notoriety, a section on generic or "no brand" products was included. Historically generic fruit and vegetable products have always been sold in grocery stores since some second labels, most third label, and many packer brands were the same types of products. Never have these products received as much promotional effort as they have gotten through retailers' attempts to differentiate their "no brands." As a result, such efforts may affect consumer preferences for price-quality trade-offs in many products. High inflation and falling real incomes can only enhance these preference changes.

This research included a detailed description of private label marketing of commodity products which leaves one lasting impressions. Irrespective of all the formal organizational structures and operational procedures in the system, the distributor label system is still a personal business. The aggregate behavior of all participants functioning within vague sets of unwritten procedures is one feature which gives private label procurement a unique character.

8.5 Food Retailer Merchandising and Brand Product Marketing Standard Operating Procedures

Suppliers indicated during the interviews the necessity to understand retailer merchandising and brand manufacturer marketing practices in order to understand how retailer behavior affects food system coordination and structural evolution. The final interviews concentrated

on merchandising and marketing behavior which was augmented by trade literature data.

A theoretical presentation depicting individual consumer demand for individual food items was a prelude to explaining merchandising and marketing SOPs. Consumers do not respond to many price changes on individual grocery products. Small price changes at retail may not be perceived. Even after the consumer recognizes a price change, purchasing behavior may not be altered because the search cost to find a new product may exceed the savings from the price change. Retailers' merchandising actions have the role of eliminating perception thresholds and reducing reaction thresholds. In theory, retailer merchandising shifts the market demand curve either up or down and facilitates increased or decreased product movement thereby increasing cyclical price movement amplitude.

Trade interviews indicated these are precisely the effects of merchandising SOPs. Suppliers consistently indicated that their wholesale price changes did not bring sufficient consumer demand adjustment without retailer merchandising actions. The critical constraint faced by suppliers, especially private label and small brand suppliers, was getting merchandising actions by retailers.

Two general merchandising rules were identified. First, retailers prefer to put heavily used or fast moving products on special. These products have the greatest consumer drawing power and are therefore more effective for the retailers in increasing store traffic. Second, merchandisers prefer to promote (at least in advertisements) brand products. Brand products project a more known value market-wide and enable consumers to compare. Promoting private label only projects value to the firm's

existing customers. Slow-moving private label items are thus particularly disadvantaged when attempting to gain access to retailer merchandising power.

Shelf location of a product and the number of facings it is given are some of the key merchandising decisions affecting it. Facings and location are determined by product movement. Products without promotion, if their movement slows, may get moved to poor locations and/or have fewer facings. When that happens volume can drop further. Without some marketing push, products can enter self-destructing cycles until they are dropped from the shelf entirely.

Adding display signs to a product's shelf increases movement. However, the most significant merchandising SOPs is moving the product to special end-aisle displays. The addition of special point of purchase signs and advertising can increase sales even further. These increased sales are the main reason manufactureres uaually include these types of activities as part of deal performance criteria.

Food manufacturers generally plan and execute strategies to increase and/or maintain their product's market share position over competitors' products. In order to achieve sales goals, they have to gain access to the sales power of retailer-controlled merchandising. They do this by the elaborate price and promotion activity explained in Chapter 4. By giving price concessions to retailers in return for display and newspaper advertising space, manufacturers can increase the product's movement. This combined with consumer-directed advertising and coupons assures retailer compliance.

The very largest, multiple product brand manufacturers will have elaborate marketing plans subdivided by market regions. The whole

process becomes a game whereby trade and consumer promotion are used to get retailer behavioral responses which will enable that firm to better its competitors. Major firms have developed elaborate promotion matrices which are based on implicit product merchandising, advertising, and price promotion elasticities. From these matrices firms make decisions on how best to allocate their marketing and advertising dollars. If a product is unfortunate enough not to have favored status, it will languish for lack of manufacturer market support.

Executing these complex strategies is difficult. Trade and consumer promotions must be precisely timed and coordinated. To implement marketing programs, manufacturers have developed extensive field forces composed of brokers and/or manufacturer representatives who do the many little tasks necessary for effective marketing. In the process they transfer labor and information to retailers. The result is that those manufacturers with effective field forces gain differential access and treatment from merchandisers. Professional, well-coordinated field representation is a necessary condition for success in grocery selling.

The marketing management tasks of manufacturers increase dramatically when products are commodity based. Variable supplies will force them to expand valuable marketing resources to help balance demand with supply conditions. With manufactured products, all marketing resources can be used for playing the marketing strategies best suited for the brand firm. Consequently, manufactured products have a higher rate of return. This is the basic reason why major fruit and vegetable manufacturers seem to be shifting away from commodity based items which is accomplished either by developing only high-processed new products or

by disintegrating the firm's marketing and processing functions. Some major firms are doing both.

This trend clearly needs further research. The extent to which disintegration has occurred requires documentation and needs to be explained to both producer and consumer groups. Questions are raised as to where these marketing firms will obtain processed products and what implication this procurement pattern will have on private label processing structure. This future research could also be expanded to investigate this trend in other commodity subsectors.

Given the importance of merchandising decisions to product flows through the system, it is clear why understanding the internal functional structure of food distributors is critical to understanding vertical coordination practices. When merchandising and buying are separated by person and/or organization, coordinating procurement and merchandising becomes more difficult. Brand manufacturers' field representatives bridge that coordination gap. Private label suppliers have no such ability; they can only try to curry favor from those private label buyers who can influence retail merchandisers.

The coordinating role ascribed to merchandising is based on trade interviews and data which indicate how powerful merchandising SOPs are. Better and more complete data and evidence are needed. A high priority research project would be to use data coming from the UPS scanning systems to test, document, and publish the sales impact of various merchandising techniques. Only this kind of evidence can substantiate or dismiss many of the arguments made in this research.

8.6 Coordination and Structural Impacts and Policy Implications of Food Distributor Procurement Practices

To this point the behavior of several food system participants were analyzed separately including food consumers, retail merchandisers, brand grocery buyers, private label grocery buyers, brand grocery manufacturers, and private label sellers. Understanding the coordination and structural implications of their composite behavior requires that their individual behaviors be linked with dynamic evolutionary analysis. The conceptual framework developed in Chapter 2 of this research was used to follow the flow of control and information through the food system. Both single-year and multiple-year scenarios were used to isolate the likely structural impacts of the current array of procurement and merchandising SOPs. Because this was a complex undertaking, some of the policy implications associated with various aspects of participants behavior were discussed concurrently with the analysis.

Food retailers control much of the food merchandising, procurement and distribution functions. The latter function (transportation, warehousing) is the only one in which they maintain almost complete control. They abdicate a great deal of control of merchandising and some control of procurement to large food manufacturers. Manufacturer deals and promotions compensate the retail sector for this transfer. Food distributors abdicate this power only to the largest food manufacturers who have the financial resources to advertise and affect consumers directly. Smaller brand manufacturers without advertising and extensive field representation and private label suppliers are not able to manage merchandising and procurement decisions to the benefit of their products.

Retail distributors also largely control the flow of demand information to the rest of the food system. The advent of the UPC scanning technology will dramatically increase the amount of quality of demand information. Distributors, however, have no incentive to transmit demand observations. Brand manufacturers are able to obtain impacted demand information by purchasing it from private information services. No comparable service exists for private label suppliers. Most of the demand information obtained by fruit and vegetable processors is through the booking system.

The flows of control and information are important aspects of vertical coordination. Food distributors are in a pivotal position to affect coordination. However their responses to the incentives they face alter coordination flows to the rest of the system. Most importantly, their merchandisers have incentives not to alter their behavior to help match demand with supply contingencies; and their buyers have incentives not to release demand information and perhaps to transmit faulty demand information.

Given this vertical coordination behavioral pattern, certain products and firms are affected differently. If consumers face nearly totally inelastic demand schedules for individual products, appropriate merchandising actions must be taken by food retailers. These are the conditions under which supermarket products must operate; including commodity-based processed fruit and vegetable items.

Assuming that there are only five active food system participants (national brand sellers, above average and average private label suppliers, above average and average private label buyers) and that brand and private label retail pricing are directly linked, scenarios depicting

what happens to major canned fruit and vegetable products under various one year supply conditions were constructed. These results were then expanded over several year periods to hypothesize about the likely impact of current coordination practices on various commodities and firms. Some of the more significant conclusions include the following.

Brand and private label pricing are linked at retail. Therefore historically brand manufactures' marketing strategies designed to balance their internal supply situations have had the effect of helping the private label sector balance its inventories. However when the brand manufacturers use spot sales and purchases to balance inventories, or if they disintegrate from processing, their coordinating marketing behavior is lost to commodity subsectors. The entire burden then falls on the private label sector.

Without access to merchandising power, private label suppliers must bid against one another through lower prices for retail buyers attention. Typically insufficient merchandising action is forthcoming. In long crop years, inventory of processed product backs up with private label suppliers having to bear the costs. In short years, supplies are depleted too quickly and retail prices are higher than economically necessary.

Over time, the consequences can become worse. If prices are forced below those justified with coordinated merchandising behavior, producers of both annual and perennial crops will disinvest. The total disinvestment may be greater than that justified by longer run cost and demand conditions. Conversely, if prices are run extremely high for several years, consumers will shift to alternative products and market will shrink. Producers might increase investment dramatically. In several years, excess supplies will arise and the cycle can start again.

These commodity cycles when combined with retailer merchandising and procurement SOPs can seriously threaten the survival of products in grocery distribution. Major fruit and vegetable items, if their prices are ratcheted up over time, can lose major item status. When this happens concurrently with brand manufacturer disintegration, the consequences can be serious. Some of the more minor commodity items, once caught in the deficit merchandising cycle, are actually in danger of losing their shelf space altogether.

Contemporary procurement practices can clearly produce poor economic performance. Products which could be produced at prices consumers are willing to pay are not available. Producers have responded rationally to economic incentives and over time the products have fallen from consumers' conscious preference patterns. The result is often painful resource relocation such as between commodities and geographic producing regions which would have been avoided under different coordination conditions.

Inflexible merchandising leads to variable incomes for growers which is proportionately more significant for perennial fruit crops and annual vegetable crops which require specialized investment. Grower bargaining, marketing orders, and the move toward grower-owned processing cooperatives are institutional responses to current coordination consequences which may improve vertical coordination performance.

The composite effects of current coordination practices is to lower the longer term rate of return to processing fruit and vegetable products. The structural directions are clear. Brand manufacturers are shifting away from these relatively less processed food products and toward more highly processed manufactured foods. The brand firms continuing to sell

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commodity-based products will most likely purchase these products from existing private label processors. Private label proprietary processors are also recognizing the longer term market prospects. They are either exiting the industry or selling their equipment to processing cooperatives. Only cooperatives appear to be willing and able to accept current rates of return.

The dynamic conversion to cooperative fruit and vegetable processing seems more certain in the future. Clearly the long-run economic returns in an all cooperative industry will have to adequately compensate the resources invested. However the basic shifting of risk and assignment problems have not been solved. Addressing these problems requires 1) some sort of supply planning institution(s) which is long-run oriented and 2) methods for effectively generating transfer prices between growers and their processing facilities. Research on both of these problems is needed.

The dynamic evolution of the commodity subsectors suggests that marketing orders and grower bargaining be evaluated in a broader context than their impacts on short-run pricing issues. Both institutions have some use in dampening commodity supply variations which seem to be the driving force in subsector evolutionary change. Proposed exclusive agency bargaining and markets for forward deliverable contracts would go even further in altering the evolutionary structure. Producer-sponsored generic advertising programs could, if properly implemented, help influence retailer merchandising decisions.

It must be remembered that all of the above are partial analyses and only deal with coordination in the retail market system. To have a complete understanding requires similar research efforts of food markets

in 1) institutional procurement SOPs and 2) industrial procurement SOPs. Both these segments make critical menu/product line decisions which dramatically affect demand for some food products. How these firms respond to commodity uncertainty is also important. They could either not affect, dampen, or accentuate the coordination consequences of retailer SOPs. When all of these components are understood, perhaps systems modeling tools could be applied in an attempt to quantify some of the relationships postulated in this research.

Food distributor procurement practices directly affect brand manufacturing industry structure. This occurs primarily because of the differential effects procurement SOPs have on different types of manufacturers. When manufacturers are classified as 1) first tier firms which have access to significant amounts of direct consumer advertising and 2) second tier manufacturers which attempt to get distributors to help market their products; these different impacts are clear. First tier manufacturers can, through specialized knowledge and adequate financial resources, effectively manipulate the retailer procurement process so as to give their products guaranteed retail distribution. Buyers' SOPs push second tier firms' marketing monies toward distributors and away from consumer advertising. Second tier manufacturers are precluded from becoming first tier firms because they are financially foreclosed from gaining effective consumer advertising exposure. Over time second tier firms either merge with first tier companies, revert to private label processing, or go out of business. So significant are the differences between first and second tier firms that most buyers interviewed indicated that they saw few, if any, new entrants into national distribution of brand grocery products.

This analysis seems to suggest that successful entry into brand grocery manufacturing is essentially blockaded. The critical variable in brand food distribution seems to be market share commanded by a product. Brand marketing expertise (consumer advertising and field representation management) is readily transferable over most grocery products. The only potential entrants to national grocery distribution are independent firms with high regional market shares in specific grocery categories. Existing merger policy designed for horizontal and vertical mergers is inadequate to prevent conglomerate acquisition of these most likely entrants into successful brand marketing. If the public is concerned about continued competition in food manufacturing, legislation limiting leading firm acquisitions of high market share regional firms is critical.

Because of transportation and inventory cost trade-offs, private label buyers prefer multiple product firms. These, of course, tend to be the largest private label suppliers. Small firms must either process price-competitive major items or be willing to go into storage-in-transit programs. Both of these options are disadvantageous over the longer run.

Procurement SOPs interface with policy issues also. One basic policy error is to assume that all firms in a processing industry are homogeneous. First and second tier manufacturers demonstrate that fallacy. Policy makers must also recognize the dichotomous nature of grocery distribution. Not recognizing the difference between private label and brand grocery products leads to policy recommendations which can be very harmful to the private label sector. Source and nutrition labeling proposals are two such proposals. Failure by policy makers to

recognize differences between brand and private label producers' ability to adapt to and economically incorporate policy proposals could lead to the elimination of the effectiveness of the private label product system.

Large brand manufacturers and food distributors enjoy a countervailing power relationship. Public policy which significantly influences either segments' sources of power will conversely influence the bargaining power of the other segment. Banning television advertising, for example, would greatly enhance the power of large food distributors at the expense of brand manufacturers. Public policy in vertical systems requires a recognition that net changes in system performance is what is critical.

This recognition needs also to be carried over into food system policy research. Traditional industrial organization research often based on homogeneity and nondichotomous assumptions can lead to incomplete and misleading conclusions unless vertical behavioral relationships are addressed.

By the qualitative nature of this research, many relationships between behavioral variables and structural and performance conditions were inferred. Empirical verification was not possible because, for the most part, necessary data only exist in private institutions and therefore were not readily available to the researcher. Attempting to empirically examine some of the most basic dynamic implications of procurement merchandising practices is clearly a high priority research endeavor.

Communicating these behavioral relationships is also an important task. This research would seem to be fertile ground for food distribution system simulation modelers. Incorporating the retail-manufacturer

pricing process into current food pricing and margin calculations should increase both their explanatory and predictive abilities. In addition, it is vital that these behavioral relationships get incorporated into the plethora of policy proposals to regulate the output (food labeling issues, food safety issues, etc.) of the food system.

8.7 Epilogue

If there is one factor that became clear during the course of this research, it is that the modern food system will not equitably incorporate the needs of the uncertainty-filled agricultural commodity subsectors. One could reasonably expect the food system to respond to agricultural commodities when their relative share of the food dollar was large. However, as the marketing system has grown to the point where it totally dominates the proportion of the consumers' dollars spent on food, one cannot reasonably expect the system to adjust to the needs of commodity growers and the economic conditions of farm commodities. Rather, the powerful food manufacturers and grocery distributors will select away from commodity-based food products.

From a policy perspective, it might be reasonable to require the food system to adjust to commodity subsectors where the raw product value of the food item is fairly high. Thus, institutional innovations which require retailers, distributors, and processors to respond to price-quantity cycles in beef, fresh vegetables, etc., would be appropriate policy. However, in processed fruit and vegetable products, the raw product's share of the product's value will decline even further. Thus, requiring 80 percent of the food system to adjust to accommodate the remaining 20 percent might well probably produce more system costs than

benefits. In conclusion, it would seem that the salvation of many commodity-based agricultural subsectors includes policies and institutions which stabilize raw product supplies and develop products which fulfill the exacting requirements of modern food marketers. Attempts to force, via public policy, the bulk of the food system to adjust to commodity subsector needs will probably just accelerate the system's flight from commodities.

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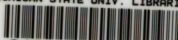
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