FEDERAL TRADE COMMISSION

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In the Matter of:)

WORKSHOP ON SLOTTING ALLOWANCES.)

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MAY 31, 2000

Room 432

Federal Trade Commission

6th Street and Pennsylvania

Ave., NW

Washington, D.C. 20580

The above-entitled matter came on for panel discussion pursuant to notice, at 2:00 p.m.

CHAIRMAN PITOFSKY: Good afternoon, everyone. I'm Bob Pitofsky, chairman of the Agency, and it's a great pleasure for me to welcome you to this workshop on slotting allowances and other grocery marketing practices.

This is an important subject. Indeed, we've come around to the view that it's increasingly of importance to competition and consumer welfare in the grocery sector of the economy.

We come to this hearing, as we do in other situations, with no fixed preconceptions. I'm convinced that there are circumstances in which slotting allowances make great business sense and contribute to consumer welfare. I'm sure there are others in which they are competitive problems, and probably in many situations they're competitively neutral.

What we're looking forward to here is a day and a half of opportunity to hear from a wide array of people -- large and small businesses, consumer representatives, practitioners and academics -- about which is which, where slotting allowances are efficient and effective, and where they raise problems.

In doing so, I'm especially pleased that this is an opportunity to renew an FTC role that I believe its founders had in mind when this agency was created in

1914. The founders were Louis Brandeis, later Mr. Justice Brandeis, and President Woodrow Wilson. The idea was not simply to have another law enforcement agency, but rather an agency that would anticipate problems in the commercial sector, work with business, work with consumers, get the facts, anticipate these issues, report to the public and report to Congress.

And some of the great successes in the agency in its early years were exactly that sort of project, like hearings on stock market manipulation, which led to the establishment of the Securities and Exchange Commission. We've tried to restore that tradition over the last five years with hearings on antitrust and innovation, global competition and privacy on the Internet. I regard this as in that tradition of investigation, hearings, workshops, proposals.

I don't think we're going to end up with a federal slotting-allowance commission. I certainly hope not, but it could sensitize this agency to the issues that are involved.

We will hear today and tomorrow from 40 people representing assorted views in this area, and the staff has been at work on this for several months. We've interviewed some 80 people, and those interviews will be part of the record. The interest is very high.

Actually there was a time when the staff was a little concerned about holding this workshop. There wouldn't be enough people who would testify. There weren't enough people who would be interested. I think the people here today, the number of people here today, and in an overflow room elsewhere in the building, shows that we didn't have anything to worry about.

Let me also acknowledge and thank the work of Susan DeSanti, the head of our policy planning unit, and David Balto, and their staffs for the tremendous work that they've done in putting this session together.

Our first speaker today will be Senator Christopher Bond, Chairman of the Senate Committee on Small Business. He has long demonstrated an acute interest and a special sensitivity to these issues, and he wanted to contribute his thoughts at the start of our workshop. His schedule didn't permit him to be here, but he has submitted a statement by means of a videotape.

Are we ready to run that? We are ready. We're not ready?

MR. BALTO: Yes, we're ready.

(Whereupon, the videotaped statement of Senator Christopher Bond was shown.)

SENATOR BOND: Thank you for joining us for today's workshop hosted by the Federal Trade Commission.

As Chairman of the Senate Committee on Small Business, I applaud the FTC for convening this workshop to explore the antitrust implications of slotting allowances and other potentially anticompetitive retail trade practices. The FTC's decision to hold this workshop is a timely response to the growing concerns about slotting allowances among consumers and the small business community.

For small businesses, this is a very serious subject that touches the livelihoods of owners and employees alike.

At our hearing last fall before the Senate Small Business Committee, small grocery manufacturers testified with hoods and voice scramblers to conceal their identities, because they feared retribution from dominant manufacturers and retail chains. Following the hearing, the Committee's investigators looked at other industries and found evidence of slotting and other questionable trade practices in the sale of books, computer software, compact disks, consumer electronics and even fresh produce.

We interviewed over 200 small manufacturing representatives who spoke of marketplace abuses of dubious legality, which are destroying small manufacturers and limiting consumer choice.

The Senate Committee on Small Business will continue its bipartisan efforts to assist the FTC in every way possible to combat slotting abuses. We look forward to receiving recommendations and guidance from the FTC on these matters.

This workshop presents manufacturers, retailers, academics, attorneys, and public policy professionals with an open forum and a unique opportunity to work directly with the antitrust regulators at the FTC.

This is truly a complex problem and I hope today's workshop will shed new light on slotting abuses and other practices prohibited by the Sherman Act, Robinson-Patman Act, and Clayton Act. I assure you that my ranking member, Senator John Kerry, a Democrat from Massachusetts, and I, as well as the other Committee members, will be watching very closely to see the recommendations which come from this session as well as from the FTC investigations.

We thank you for your efforts and we look forward to working with you to ensure that small businesses who manufacture products for retail shelves have the opportunity to present those products and consumers have the choices that these small businesses can provide. Thank you.

(Whereupon, the videotaped statement of Senator Christopher Bond was concluded.)

MS. DESANTI: Good afternoon. I also would like to welcome you. I'm Susan DeSanti. I'm Director of Policy Planning at the Federal Trade Commission, and it's my good fortune to be here this afternoon to learn from what we hope will be an excellent workshop.

I want to be very clear in giving the credit for putting this together to David Balto, who has worked in a terrific manner with his team. David is Assistant Director for Policy and Evaluation in the Bureau of Competition, and together with his team of Neil Averitt, an attorney in his shop, Chris Garmon, of the Bureau of Economics, and my Deputy Director for Policy Planning, Bill Cohen. They've done a perfect job in putting all this together.

To begin the afternoon, we're going to have two presentations to help set out some of the basics about slotting allowances -- what they are and how they fit into retail promotion practices generally.

The first will be by Professor Greg Gundlach, an associate professor of marketing in the Business School at Notre Dame. Professor Gundlach has taught marketing for more than a decade, and we have found that he has done some of the most comprehensive and thoughtful work on slotting allowances so we asked him to make this presentation about his research.

The second presentation will be by David Balto and Neil Averitt who I've just mentioned. David and Neil, together with economist Chris Garmon, have been taking a closer look at slotting allowances for the past several months, talking to literally dozens of manufacturers, retailers, consultants, and even other lawyers and economists.

David and Neil will briefly discuss some aspects of the competitive analysis of slotting allowances and also will provide a road map of the questions that will be discussed at the panels that we will be having today and tomorrow.

Professor Gundlach?

MR. GUNDLACH: Thank you, Susan. I'm very pleased to be here today to join you to talk about a very complicated phenomena called slotting allowances and fees. My role today is to provide a foundation for discussion over the next two days' deliberations, and the way that I'll be doing that is to report, as Susan mentioned, on a study that was conducted by myself, Bob Bloom, Joe Cannon -- colleagues that investigated management views of slotting-allowance practices.

An article that draws together most of the research that I'm presenting today appears in this month's issue of The Journal of Marketing.

Let me provide you with just a basic overview of my discussion today. The objectives of the study were to obtain the management views -- that of manufacturers and retailers -- as it relates to these practices. We are very much interested in the types of practices found, in terms of the nature of fees, their usage characteristics, just how these fees were used in practice, what types of fees, administrative practices, and what kind of trends were involved.

In addition to that, we were also interested in factors that managers felt contributed to the occurrence of slotting fees over time, and most interested in the role and effect of these fees as they relate to various outcomes. What we found in this regard were two schools of thought based on the literature, and I'll talk about those more specifically in time.

Our approach was to focus on the grocery industry, which, through industry interviews, we found to have the highest prevalence of slotting practices. We incorporated a large-scale national survey that gathered the opinions of both manufacturers and retailers. Almost 1,200 manufacturers were surveyed, in addition almost 1,200 retailers.

The one caveat that I have to note in this study is that we gathered the opinions of managers. While in one respect this is an excellent approach in that it allows us to talk to those specific individuals who are involved in the practices, it also should be mentioned that these are the opinions of managers, and the appropriate caveats must be accompany that type of interpretation of many of the results.

For the study, we focused on fees that we thought were most common in practice. These fees are identified here and also on the poster board exhibits. As you can see, they cover what we might refer to as the life cycle of a product at retail. We were interested in the five types of fees: Presentation fees, or fees made for the privilege of making a sales presentation; more common slotting fees, in terms of the rubric or up-front payments of cash, promotional dollars, or merchandise to obtain shelf space for a product; display fees, or fees paid for special merchandising and display of products; what are referred to as pay-to-stay fees, or fees paid to continue stocking and displaying a product; as well as failure fees, or fees paid when a product does not meet expected goals.

I should mention there are several other types of fees when you speak to manufacturers and retailers, and different names are often attached to the fees that I've listed here.

In terms of what we found in speaking to manufacturers and retailers, I report here mainly the results where both manufacturers and retailers tended to agree on the subject matter. The most frequent types of fees included slotting fees or up-front payments of cash, promotional dollars or merchandise to obtain shelf space of a product, and display fees, which are fees paid for special merchandising and display of products.

The other fees that I mentioned were found to be less common in use but still used. In terms of trends, when asked to report back in terms of the past five years, retailers and manufacturers told us that retailers were more likely to require slotting fees of all kinds.

We are also interested in the administrative practices associated with the use of slotting fees. Given the private nature of these fees and their often off-invoice nature and character, we were interested in whether or not the policies and practices and procedures associated with these fees were changing.

What we found were that written contracts were not that commonplace, and while negotiations -- in terms of negotiations, some manufacturers were able to negotiate -- there was only a limited increase in negotiation over time. We also found that not all manufacturers were viewed as paying the same for the similar type of SKU.

An area of particular interest for us was the types of product categories where slotting practices were most often found. We asked individuals to report back three categories in which they identified slotting practices to be heavily used and three categories where they found slotting practices to be lightly used.

A variety of different opinions exist as to why we would find slotting fees in various different categories. For example, some suggest that slotting fees should be found in lower-margin categories as a basis to bolster retailer profits in those categories. Another opinion is that higher-margin products are where slotting practices are found, and the basis for this opinion is that the slotting fees themselves compensate for the lost revenues and opportunity costs if the product fails. Still other opinions suggest that slotting fees will be found where shelf space is at a premium, such as what might be found for frozen foods and other dairy products.

Our findings were really somewhat confused as to any one of those hypotheses. However, we did find that product categories of heavy use included frozen food, dry grocery and beverages; and those of light use included fresh meats and seafood, produce, and deli.

An important inquiry for us was whether or not these fees had extended into products that were no longer considered new products, that is established products. Many of the explanations that I'll focus on later require as an assumption that we're dealing with new products. The results here were mixed. Manufacturers felt the practices had extended into more established products. Retailers were somewhat neutral in terms of their views.

Another area of interest for us was identifying the factors that were contributing to the occurrence of these fees. What did manufacturers and retailers believe were the basis for these fees to occur in the first place? While I have a variety of different factors listed, I'll push quickly through those in terms of their groupings and provide you some basis for our result.

As many of you know, new products and those types of common proliferation issues -- novelty, failure, and technologies associated with new products -- are commonly identified. Cost and profit factors are also mentioned. Channel structure issues are also captured in many arguments, and, in addition, promotion and branding factors.

Let me highlight some of these that might not be self-explainable. In terms of the retailer influence under channel structure, while some studies disagree, some contend that the increasing consolidation and other factors have increased the market clout on the part of retailers leading to the occurrence of these fees.

On the promotion and branding area, the use of push strategies on the part of manufacturers to get their products to the marketplace is also highlighted. The distinction here is that all strategies are strategies of promotion focused directly towards the consumer to create demand on the part of the consumer and thereby pull the product, in this case a new product, into the marketplace.

As a result of the increasing costs of these types of promotion practices and what has been referred to as their lessening effectiveness over time due to diminished consumer loyalty, a lack of differentiation of new products, as well as the emphasis on short-term profits, have caused some manufacturers to shift from "pull" forms of promotion to "push" strategies in which incentives are provided directly to the trade in order to promote a new product.

Finally then, in terms of promotion and branding, I should point out that the increasing growth of private-label store brands has been identified as a factor. Increasingly these products are accounting for a growing percentage of products in any category. These products have higher margins and often don't have slotting fees associated with them.

Often slotting fees are viewed as a basis for compensating retailers for the lost opportunity of products in these types of areas. Our results on both sides of the score card, manufacturers and retailers, we found some agreement, typically in the area of new products. Both manufacturers and retailers agreed that the growth in the number of new products, and the high failure rate of new products, both contributed to slotting fees. Both manufacturers and retailers agreed that the increasing use of "push" strategies by manufacturers were also a contributing factor.

Where manufacturers and retailers disagreed, however, was in the area of retail influence as a factor, and, on the retailer's side, the increasing cost of handling new products.

An area of particular focus for the study was examining the variety of explanations that have been provided in the literature to explain slotting fees and their effects. Just exactly what are the role and effects of slotting fees and similar practices?

In examining the literature, we found two schools of thought with associated explanations underlying each. On the one hand, the efficiency school saw slotting fees as a mechanism for improving distribution efficiency and enhancing competition. On the other hand, the market power school viewed slotting fees as a tool for enhancing market power and undermining competition.

Let me focus on the explanations that underlie those two schools of thought. Underlying the efficiency school there are a variety of explanations that focus on different aspects of the relationship between manufacturers and retailers, as it relates to new products and how they're handled in the marketplace.

One explanation is the signaling and screening argument. The contention here is that slotting fees enable manufacturers to communicate and retailers to evaluate information regarding new products. The key here is that slotting fees are used as a mechanism to distinguish successful products from those that are not, both on the part of manufacturers signaling what they believe to be the most successful products through paying slotting fees, and retailers screening the payments of these fees for products to discern which products they believe will be successful in the marketplace.

A second argument under the efficiency school is risk shifting. Slotting fees here are said to help reallocate the risks of new product introductions to those best able to control them. The view here is that manufacturers, as a source of product innovation, are more informed about the potential success of a new product and therefore should also address the risk in terms of those new products. Here slotting fees are viewed as simply a mechanism for shifting that risk back to those who are believed to be best informed -- that is, to the manufacturers.

Another argument is cost sharing. Here slotting fees are deemed to compensate retailers for the increasing costs of introducing and managing a proliferation of new products. The contention here is that many new products are introduced without sufficient support or testing. Manufacturers as a source of innovation are suggested in this respect to be also responsible for sharing those costs associated with the introduction of that product.

Another contention is that slotting fees serve as a basis for enabling retail shelf space to be allocated to its best and highest use. The idea here is that shelf space is a commodity, and a slotting fee is simply a bid for that shelf space. The assumption is that the highest bid is also associated with the individual company that is in the best position to generate the greatest returns through providing products in the form and variety most desired by consumers.

Demand and supply apportionment is also another explanation. Here we see slotting fees being suggested to help equate the supply of new products and their demand by consumers. An assumption underlying this explanation is that there's been an oversupply of new products, increasingly new products being offered to the trade. Many of these lack the type of true innovations that are associated with "new" products.

Slotting fees here are a mechanism that is used as a basis for incenting retailers to accept these products that they might not otherwise, therefore providing an opportunity for new products to enter the marketplace. Overall, all of these mechanisms of efficiency can be identified as facilitating practices for lowering retail prices by simply adding efficiency to the distribution channel.

A second dimension of the final explanation is that the slotting fee is a basis for unbundling the cost of the shelf space from the cost of the product, thereby reducing the price paid by retailers and allowing them to compete more aggressively in the downstream market.

The other school of thought is that slotting fees are a tool for enhancing market power and undermining competition. In this respect, a variety of explanations suggest that slotting fees are associated with the exercise of market power in a variety of different ways. Generally, slotting fees are thought to reflect the exercise of acquired market power on the part of retailers toward manufacturers.

As a result of consolidation, technology infusion into the retail marketplace, and a proliferation of new products, the argument is that retailers have achieved a higher level of market power, and slotting fees are simply a mechanism for exercising this power upwardly through the distribution channel.

A second explanation is that slotting fees enable retailers to discriminate among manufacturers, particularly large versus small firms. Because of the private and negotiated nature of slotting fees, retailers are said to be able to ask for and receive disproportionate payments from large and small manufacturers. In addition, retailers large and small are also distinguished in terms of their ability to acquire fees from upstream manufacturers.

A third explanation under the market power school is that slotting fees are a competitive mechanism that enables larger and more resourceful competitors to foreclose smaller rivals from access to required inputs, such as retail shelf space.

Here shelf space is viewed as an essential input to the distribution process, and through bidding up the price on the part of an aggressive competitor, they're able to raise the cost of rivals in terms of their ability to acquire that shelf space, thereby foreclosing them from the market.

A fourth explanation of the market power school is that slotting fees have damaged manufacturer and retail relationships, leading to overall concerns for channel efficiency. The idea here is the acrimony and conflict associated with the slotting fees and practices has created such dysfunction that it has led to concerns for the interaction between manufacturers and retailers who are ostensibly positioning the channel to enhance one another's offering to consumers.

One explanation of this, or one illustration of this, is the effect that this dysfunctional conflict has had on the consumer information. Many manufacturers view the slotting fees as simply a practice that they need to address, and they thereby often shift funds -- or it's said that they shift funds -- out of their downstream promotion budgets to compensate and pay for these fees.

Finally, overall, these explanations are viewed as a facilitating practice for raising retail prices through diminishing retail competition. The second dimension of that argument is that the up-front payment and the positive impact of slotting fees on retailer profits diminishes the incentive for retailers to compete aggressively in the downstream market, leading to higher prices.

In asking managers to provide us with feedback on various aspects of these explanations, our findings, as you might imagine, were mixed. In the matrix here, you can see how manufacturers came out in terms of their tendency to agree or disagree with aspects of each of the explanations compared to retailers. Let me focus your attention to the upper left-hand corner where we find agreement on both the part of manufacturers and retailers; that is, both manufacturers and retailers agree as to these explanations.

On the efficiency side both manufacturers and retailers tended to agree that slotting fees did help shift the risk of new product introductions in the marketplace back to manufacturers, and as well that they helped to apportion the oversupply of new products to a less than commensurate demand on the part of consumers.

At the same time manufacturers and retailers agree that slotting fees were associated with the exercise of retail market power, were also associated with discrimination in terms of practice, and that overall were a facilitating practice for raising retail prices. I have to throw in a caveat here again to indicate that these are the opinions of manufacturers and retailers and we need to characterize the results in that respect.

Overall some of the conclusions that can be drawn are identified here. In terms of nature and usage, what we're really dealing with is a family of practices. Slotting and display fees appeared to be most common on the part of the sample that we surveyed, but all different types of fees are found in the marketplace. Overall some manufacturers appear to be able to negotiate these fees, and not all appear to be paying the same amount, according to the opinions of manufacturers and retailers.

We found that the application of slotting allowances varies across the different product categories. Overall trends include one that retailers are more likely to require all of the fees. The policy and practice has become more formalized, with a limited increase in negotiation, but still written contracts are not commonplace. The fees themselves are suggested to no longer be limited to new products. Again, manufacturers provided a yes to this answer. Retailers were more neutral.

A variety of different factors have led to the use of slotting fees, and while the explanations vary, there appears to be some support for both schools of thought as they relate to the role of effective slotting fees.

Thank you very much.

MR. BALTO: Thank you. I'm David Balto. I want to start off with a couple housekeeping notes. First, there is an overflow room in 332. Second, for those of you who missed the handouts, we'll make extra sets for you. Third, if there are any professional golfers here who think this is the place to register for the Kemper Open, you're sadly mistaken.

I'm here to tell about what the FTC's been doing the past several months on the slotting allowance project. Antitrust, it's always said, is a process of sort of rolling up your sleeves and getting to know the facts. That's what Neil, Chris and I have been doing for most of several months.

But just to give you a little background, as many of you know, this has been an area of intense congressional interest. There have been congressional hearings both before the Senate Small Business Committee and the House Judiciary Committee, and Will Tom, our former Deputy Director, testified before the House Judiciary Committee. We've worked closely with the Hill staff, and I want to express our thanks to Paul Conlon and Damon Dozier of the Senate Small Business Committee who have assisted us greatly during this project.

Let me say something at the outset, an important thing about the antitrust laws. We're talking here about distribution practices, arrangements between manufacturers and retailers, and when antitrust looks at those practices, we take a balanced approach. There are really relatively few rules of per se legality and per se illegality. We look at most cases under what's called the Rule of Reason, and we ask ourselves whether or not the practice ultimately harms the overall level of competition -- whether or not, because of the practice, there are higher prices, less choice or less product innovation.

And the purpose of the antitrust laws, a well known maxim, is "to protect competition and not competitors," so the elimination simply of one competitor from the market does not necessarily raise antitrust concerns.

What have we done for the past several months? Well, we looked and we saw there was relatively little scholarship on the subject, there was relatively little empirical research. So we went out and we chose five product categories to look at, and we picked these categories because they're very different in nature. Some of them had products that turned over frequently. Some of them were products that turned over slowly. Some of them were markets that seemed relatively competitive. Some of them seemed more like dominant firm categories.

And for those five products, we went and spoke to every manufacturer, and with very few exceptions, the manufacturers were all willing to talk to us. Then to really get to understand some of these product categories, we went and actually visited the manufacturing facilities to understand what the economies of manufacturing the products were.

But then there was the other side of the equation, the retailing side of the equation. We visited retailers, both large and small, in about eight states, and we spoke to most of the largest retailers in the United States. We asked them not only about these product categories but about their general practices and policies involving slotting allowances, and when they took us through their supermarkets, we went category by category through the stores and they told us how slotting allowances affected their decisions about which products to choose and which products to market.

Let me emphasize, that in this matter, like any other FTC inquiry, confidentiality is totally protected. We researched this at the beginning, and we determined that there was no way that anyone could discover the names of the individuals we spoke to, so we assure absolute confidentiality to the people who participate in our inquiry.

Of course, there are other slotting inquiries going on at other federal agencies.

Let me talk about our own study. What are the key questions we've been asking? Well, our first question is, what are the terms of the agreement? Then what is the market context? What's the likely competitive impact, and if we determined ultimately that the impact was anti-competitive, what remedies were feasible or appropriate?

In terms of the agreement, we asked the kinds of questions you would expect and the kinds of questions we'll ask during our first panel. Were slotting allowances for a right to get into the store? Were they related to a specific amount of shelf space? Are slotting allowance for preferential shelf space? Are they used by exclusive or dominant suppliers? Are they used to go and place other suppliers in an inferior position? And of course, like any kind of agreement, we look at the duration of the agreement to determine whether or not it's anti-competitive.

The market context is critical, and here we asked two questions. Were these allowances offered at the instigation of the manufacturer or the retailer? And once we asked that question, we asked ourselves, What were the markets like? Were the manufacturing markets competitive, or were they dominated by a dominant firm, or did they involve new entrants? We asked the same question on the retail side of the equation.

Now, as Greg articulated so well, there are many procompetitive rationales, and we heard from the retailers that there are scores and scores, hundreds of new products that are presented to them every day and that slotting allowance oftentimes serve as a mechanism for which they can differentiate between those products that are likely to be successful and those products that are unlikely to be successful. They also served other interests such as guarding against risk.

Of course we also heard from manufacturers, numerous manufacturers about concerns over exclusivity, and exclusivity of course can be a serious concern. Of course, under the antitrust laws, exclusivity does not have to be 100 percent to raise competitive concerns, but it's most likely to be a problem where it involves exclusivity over critical distribution outlets and it's for a significant period of time such that the excluded manufacturer really is significantly harmed, unable to effectively compete.

If we determined that there is a likelihood of competitive harm but also some likelihood of efficiency, we have to ask ourselves whether or not there are less restrictive alternatives that the retailer can use to achieve the same efficiencies, and here we asked retailers about the use of failure fees or other promotional funds that might both signal the likelihood of success and also account for the potential for risk.

There's the issue of category captains which Neil will talk about in just a minute, and also one of the ultimate questions we had to grapple with, what are the possible consumer benefits? Well, slotting allowances may lead to more product introduction, and it may help the retailers who lack information to determine what are the products that consumers most desire. On the other hand, there are possible consumer harms both from increased prices, decreased product variety, and decreased product innovation.

The hard question, of course, is if you determine that there is a competitive problem, what would be the appropriate solution? If slotting allowances were banned, would we see similar types of practices which would lead to the same kind of anti-competitive results, or would we see that promotion programs would turn to more efficient formats that are more likely to benefit competition.

One thing we frequently do here is supermarket merger enforcement. It's one of the biggest parts of our merger enforcement. In fact we bring the second largest number of our cases in supermarket merger enforcement, and one of the concerns that we've heard from a number of sources is that slotting allowances are only a symptom of greater problem of retailer market power on the buyer side, and that that should be an issue that should be considered in our supermarket merger enforcement.

As Neil will explain, we'll grapple with that issue over the next two days. And now it's time for me to turn this over to Neil who will give you the format of today's program.

MR. AVERITT: Thank you, David. I've got a pleasantly transitional task to perform here. We've heard a very comprehensive background description of slotting allowances and of the factors that may lead to their use. We have coming up a workshop that's going to have a number of people with very diverse backgrounds and with good expertise.

My remarks right now are intended to bridge between these two phases of the workshop and to tee up some specific questions which we hope the members of the workshop can begin to revolve in their minds. These are questions on which it will be very helpful if we could have your thinking.

To give a patina of rationality to all of this, we propose to divide the workshop into five different panels, one later this afternoon and four tomorrow. These panels will take up different, more or less distinct aspects of the slotting allowance issue. You can see the five of them there.

Let me take a moment to talk about the similarities and differences in Panels 2 and 3. Those two panels will be discussing two theories that have been advanced as to what slotting allowances are all about.

Panel 2, "Exclusion and Exclusive Dealing," will take up the hypotheses that slotting allowances are brought about at the instigation of large manufacturers with great financial resources, who are using slotting allowances to buy shelf space, to exclude competitors, and thereby perhaps to acquire market power. This wouldn't happen in all cases necessarily, but, the theory goes, this might help in some cases, and it's something worth watching for.

The third panel will take up a different theory that's been proposed -- that slotting allowances are instead a manifestation of retailer power, that some retailers have acquired market power at least as exercisable upstream toward their suppliers, and have elected to exercise this power through slotting allowances. Again, the theory says this isn't always the case, it doesn't necessarily happen that way, but it happens often enough to be of concern.

Let me note two qualifications at this point. One, by putting these theories on the table we're not necessarily expressing any view as to whether they're true or false. These are merely issues to be explored in the workshop, and we value your thoughts on them. Second, by setting these two theories up in two different panels, we don't mean to imply that they exist in watertight compartments. Obviously they can exist in various combinations and balances.

So those should be the main panels and the basic structure of the workshop.

Let me take a minute now and run through some of the specific questions that you might want to consider in each of the panels.

Panel 1 is on "Types, Trends and Effects of Slotting Allowances." That will be the panel of the people around the table now, and the panel that will meet later this afternoon. It will be in some senses a discussion of the same issues that we've been hearing about for the last 45 minutes, but at greater length and in greater detail.

There are a number of specific questions that are presented by this topic. What are slotting allowances? Are they for new products? Are they pay-to-stay fees? How are they negotiated? Are they always used? What do these things tell you about the purposes and effects of the allowances? Are the allowances intended to cover or reimburse retailer costs in taking on a new product?

If to reimburse costs, what kind of costs are involved? Is it the management cost of reprogramming computers, or the labor cost of resetting the shelves physically, or the business cost of risk of product failure, or the opportunity costs of not taking on some other product that might have done better? Were those costs identified? Do the slotting allowances match up with them? Do the costs explain what the allowances are all about?

How closely do the allowances follow the costs? Do the costs explain the allowances, or is there still some increment in the allowances that would need to be explained in some other way? What effect do the allowances have on the consumer demand? Do they increase it? Do they depress it.

And finally, what becomes of the slotting allowances? How does the money go? Is it used to reduce the price of the product? Is it used to reduce the price of some other product in the store? Is it reprogrammed by retailers to cover overhead expenses like physical facilities or bigger parking lots? Or can the slotting allowance be kept simply as profit?

And that should bring us to the end of today.

Panel 2 will then convene at some shockingly early hour tomorrow morning and will take up "Exclusion and Exclusive Dealing." This is a panel that will look at the hypothesis of aggressive exclusionary conduct by large manufacturers. An initial question to be considered is, does this type of manufacturer conduct raise the capital cost of entering a market or of remaining in the market? Are slotting allowances a significant increase to the cost of doing business? If so, does that tend to squeeze out less well financed competitors?

If so, can the capital markets respond to make money available to those competitors? Are there less exclusionary alternatives, as Dave Balto was discussing, by which manufacturers could perform whatever necessary functions that are performed by slotting allowances without raising the capital-cost bar so high?

And then the later questions that this panel might want to consider would ask whether there are any more overtly exclusionary practices in play beyond simply raising capital costs. Have some manufacturers bought additional or preferential shelf space? Have they bought outright exclusivity?

And then finally we reach the question that's the jackpot question for any antitrust inquiry: What effects, if any, does any of this conduct have on competition? In other words, exclusionary conduct is not necessarily a problem if only some firms are excluded but if the market remains competitive, but that's a question we have to look into. Have the markets in fact remained competitive?

Here the panelists might want to look at those questions from two different angles. Is the market price competitive, a traditional inquiry of antitrust law, and you might also want to consider, Is the market competitive in other non-price terms such as variety and innovation and consumer choice. That will bring us then to the tend of Panel 2.

The third panel will convene later tomorrow morning and will look at the second theory to be tested, and that's the theory that a slotting allowance is some sort of manifestation of some underlying retailer market power.

Here the story to be examined is that retailers have market power, at least exercisable upstream, having possibly acquired it through mergers, and have elected to exploit that power through slotting allowances. Again, we have no opinion about whether this hypothesis is true or not, but it does raise some questions.

Do slotting allowances and does the structure of the market in fact suggest the possible existence of general national power among supermarkets? What is the national concentration ratio in the supermarket business? How does this compare with other industries?

Now, if it doesn't appear that supermarkets have power on a general national basis, is it possible that they have it in some more specific circumstances? Might they have it, for example, in a potential way which could be exercised if they began to buy more centrally, if they stopped buying through independent warehouses or divisions and bought according to a central program?

Or might supermarkets have market power in certain local geographic markets, even if they don't have it nationally? In other words, could there be certain products that will trade only within a certain narrow geographic range, possibly perishable products that can't be shipped very far, and could supermarkets have market power against the suppliers of those products even if they don't have it generally?

So those are probably the substantive questions for the "retailer buyer power" panel, leading up at the end to the question of remedy. That question is, If there appears to be a problem here, is the remedy one that we ought to seek out in terms of slotting allowance doctrine, or is it a remedy we should look for in terms of our merger enforcement policy? And a component to that question might be, Which avenue of remedy would allow the simplest and clearest and most effective remedial action to be taken?

We'll break for lunch at that point, and then when we reconvene tomorrow afternoon, the topic will be category management, which has been alluded to a couple times this afternoon. It will begin with a question, What is category management? Is it, as generally described, simply a practice of disciplined and quantified study of product movements, giving a disciplined and quantified way of allocating shelf space, or is it something else?

Then what is the role of the category captain? Is that, as commonly described, a manufacturer, usually the largest manufacturer in a product category, who's designated by the retailer to provide advice on the management of that category? Is that the role or is the role something else?

Then does the role of the category captain present antitrust issues of its own? In some sense category management and category captains is an approach that competes with and is to some degree a substitute for slotting allowances. It's an alternative way of picking products and allocating shelf space, perhaps. But does it raise questions of its own?

For example, the category captain gives advice vertically down the distribution chain to the retailer. Does that create any possible issues? Could that advice be biased in a way that lets the category captain give a preference to its own products and to exclude or recommend against the products of other manufacturers?

And then if so, what does that mean? Does the retailer have a way of knowing whether this is going on? Would the retailer be able to control for this problem if it were to exist, and would the retailer be motivated to control for it in the first place?

Category captains can also raise horizontal issues at both the manufacturer and the retailer level.

At the manufacturer level, the horizontal issue can come up because a category captain is after all a supplier, one of several competing suppliers of a particular product. In its role as category captain, it communicates with the retailer, and the possibility exists that the retailer will be giving information back to the category captain about what other products, what other manufacturers in that category are doing. Then the question is: Is this sensitive, competitive information? Does it create competitive problems? Is it a practical problem in the first place, or does this involve the kind of information that circulates, the sort of things that will be generally known in the industry in any case? "No harm, no foul," perhaps?

Then, finally, there's a possibility of

horizontal information exchanges at the retailer level. If you have one firm that's going to be the category captain to several different retailers, the possibility exists that that firm can be an intermediary, conveying information from one retailer to the other.

The questions would then exist: Does this occur? Could it occur? Is that likely to be a practical problem? Or instead, is it more likely that different retailers will choose not to have the same firm as a common category captain? Would they prefer perhaps to have their own category captain who would be devoted more particularly to their own interests? Interesting issues to resolve.

Finally, having, I'm sure, about as many interesting issues as we can deal with we will come to Panel 5, which will be "Policy Recommendations." This is going to be a panel to try to pull together the law, the economics and the business information that's been developed over the previous day and a half, and to convert it into recommendations of further studies for the Commission staff or possibly further action for the Commission itself.

What, if anything, should be done about slotting allowances? (A compact bottom-line question.) What, if anything, should be done about category captains?

Should our merger enforcement policy become more active in this area? Should we take more account of buying power? And finally, would guidelines be useful? Is that a sensible next step to consider?

So that should be the outline of, I think, a very interesting, very productive day and a half. We're immensely grateful for all of you for being here, to the people who will be participating in the five panels, to the other people who are attending and observing. I hope you all enjoy the hours ahead.

Let me close with two administrative matters. First of all, we'll take a 15 minute break at this point to reconfigure everything.

MR. BALTO: Why don't we make it ten minutes.

MR. AVERITT: A ten minute break to reconfigure things for the first panel, and then second, we would invite all of you to attend a reception at the end of the day, which will be held upstairs in the Top of the Trade cafeteria. So we'll look forward to an interesting panel and then to seeing you all upstairs. Thank you very much.

MR. BALTO: We'll start again at five minutes after three.

(A brief recess was taken.)

PANEL 1: INTRODUCTION TO THE MECHANISMS, TRENDS, AND EFFECTS OF SLOTTING ALLOWANCES

PANEL 1 MODERATORS

DAVID BALTO, FTC

SUSAN DESANTI, FTC

PANEL 1 GUESTS

DON SUSSMAN (Ahold)

PETER DE LA CRUZ (Attorney)

DAVID NICKILA (Portland French Bakery)

SCOTT HANNAH (Pacific Valley Foods)

WINSTON WEBER (Consultant)

AKSHAY RAO (University of Minnesota)

MARK DENBALY (ERS)

JAY CAMPBELL (Associated Grocers)

ROBERT UKROP (Ukrop's)

GREG GUNDLACH (Marketing academic)

JOHN EAGAN (Costco)

BOB HOUCK (CoAMS)

BART WEITZ (Academic)

STEVE SALOP (Transition Speaker on exclusivity)

MR. BALTO: If everyone would try to take their seats. Again there are seats in room 332. I'm David Balto. Along with Susan DeSanti, we're going to moderate today's panel. I want to give you our ground rules as moderators. We're tyrants. The way you are recognized to speak is for you to lift your name tent in a vertical fashion and then to wait for us to call on you. When you're called on please identify yourself, if we haven't already identified you, so that the court reporter knows who you are. As far as we can tell, you have no lifelines in this endeavor. You cannot call upon the audience, and you can't phone a friend.

Let me start off by having us each identify ourselves, both for the audience and for the court reporter, doing this clockwise starting with Susan.

MS. DESANTI: I'm Susan DeSanti, Director of Policy Planning at the Federal Trade Commission, and when you identify yourself, please give your affiliation. Thank you.

MR. NICKILA: Hi. My name is Dave Nickila from Portland, Oregon, 50 percent of owner of a small bakery called Portland French Bakery.

MR. UKROP: Good afternoon. My name is Bobby Ukrop. I'm president and CEO of Ukrop Supermarkets, a 27 store retail chain in Richmond, Virginia.

MR. GARMON: My name is Chris Garmon. I'm from the Bureau of Economics at the Federal Trade Commission.

MS. SULLIVAN: I'm Mary Sullivan, and I am an economist at the antitrust division of the U.S. Department of Justice.

MR. RAO: My name is Akshay Rao. I'm a professor of the business school at the University of Minnesota, not to be confused with the governor of Minnesota.

MR. WEBER: My name is Win Weber. I'm president of Winston Weber & Associates. We are a management consulting firm. We work with retailers as well as suppliers worldwide in the areas of category management and collaborative relationships between both retailers and suppliers.

MR. SUSSMAN: My name is Don Sussman. I'm executive vice president of purchasing and supply chain of Ahold U.S.A.

MR. GUNDLACH: Greg Gundlach. I'm professor of marketing at the Mendoza College of Business at the University of Notre Dame.

MR. DE LA CRUZ: I'm Peter De La Cruz with the Washington, D.C., law firm of Keller and Heckman.

MR. CAMPBELL: Jay H. Campbell. I'm President and CEO of Associated Grocers in Baton Rouge, Louisiana. Associated Grocers is a retail-owned company that distributes grocery foods and merchandise to independent retailers.

MR. HANNAH: My name is Scott Hannah, CEO of Pacific Valley Food, Bellevue, Washington, primarily frozen vegetables and potato products.

MR. HOUCK: My name is Bob Houck. I'm Vice President of Strategic Planning with CoAMS, Incorporated. We're in Chicago, and we manage and consult on co-op advertising and trade promotion programs.

MR. AVERITT: I'm Neil Averitt, an attorney on the staff of the Federal Trade Commission.

MR. DENBALY: My name is Mark Denbaly, Economic Research Service of the U.S. Department of Agriculture.

MR. EAGAN: John Eagan, vice president and senior general merchandise manager, Costco Wholesale, Los Angeles region.

MR. WEITZ: I'm Bart Weitz. I'm a professor at the University of Florida.

MR. BALTO: And I'm David Balto with the Office of Policy and Evaluation. Our goal today is to go over the basics of slotting allowances to get some sense of why slotting allowances are required, what purpose they serve, and how they've changed over time.

I want to start off today by asking Don Sussman and Jay Campbell about why you use slotting allowances. Don?

MR. SUSSMAN: A number of reasons. First, we think that slotting allowances help us defray the real costs of bringing new products onto our shelf. There are really costs associated with putting the products on to our store shelves physically, changing our store shelf planograms, putting the new items into our computer systems, and physically onto our and into our warehouse. These are real costs that we incur. Slotting does help us defray the cost.

The second reason is risk. There's the risk of that new item that we bring on fails. There's no proven track record on new items. There's also the risk involving the item that we discontinue to make place for the new item. That existing item has an income stream associated with it. When discontinuing that item we lose our income stream and also the customers that have bought this item in the past can be somewhat disenfranchised, so there's both risk of the new item failing and risk of giving up the existing item.

The third reason is there an income stream associated with slotting. This income stream does help our profitability, and we treat this in Stop & Shop and in Ahold as another form of gross profit. Every dollar of slotting that we generate is an item -- is a dollar that we don't have to generate from the customer.

We have a budget. We have a certain amount of return we need for our stockholders. The more slotting we have, the less pressure there is on pricing.

The fourth reason is variety. I just want to say that we have slotting that would be considered in the industry on the high side. We acknowledge that. We also think we have the best variety, one of the largest varieties on a category-by-category basis in the industry.

We think more manufacturers are able to find room on our shelves for their products -- both small, diverse manufacturers as well as large manufacturers. We carry more items. That's not the most efficient model, but we think it does the best job of satisfying our customer. There is a cost to that. We think the slotting fees help us offset the cost.

MR. BALTO: Thank you. Jay?

MR. CAMPBELL: We are very similar in the sense that we have the need to add new items, to broaden our selection and variety of offerings to our independent retailers. The major difference is that we bear the risk ourselves since we are a wholesaler. We do not have the avenue to force it downstream into the retail outlets.

Therefore, the definition of slotting to us is a slot in the warehouse, and we use slotting to make available space for a new item to start the distribution process, and then we likewise bear the risk of loss on that item as well as the risk of the item that we currently have that it will be replacing.

Then we have to make plans of distributing that item through a network of stores where they are free to buy or not to buy that particular item. Our job is to ensure that we get information disseminated out to the stores to ensure that they are interested in trying to put it into their network at the retail level.

For us it is not really a profitability issue as much as it is a cost coverage issue. Obviously it becomes a profitability issue if you don't cover your cost. It becomes a negative profitability issue, but slotting has served that purpose very well so that we are constantly encouraged to add new items because it does cover the cost of introduction and distribution of new items.

MS. DESANTI: Could I ask a couple follow up questions? Don, I was wondering, could you speak a little bit more about the cost of new product that are associated -- that you associate with new product introduction? And also a follow up question: Do you only use slotting fees in connection with new products?

MR. SUSSMAN: In terms of the cost, it differs by category. It differs by item, but if you want me to list the items, I'm not going to list the individual costs, but typical ones.

MS. DESANTI: Typical.

MR. SUSSMAN: New items are presented to us. We then have to discontinue existing items, which means taking the physical product out of the stores and out of the distribution centers. The new item rarely goes into the same shelf location as the old item. Either they're a different size, or it's a different piece of the subcategory, which means a planogram change. A planogram change has to be executed in each of our stores. That takes people. It takes money to do that, plus the disruption to the business while it's being done.

Our warehouses, same thing. We have existing products in there that have to be discontinued. New item haves to be received, have to be put away slots in the warehouse have to be made, and they don't always go where the existing product goes. The new item might be a lighter case than the other case, so again we have to redo our warehouses somewhat to accommodate the items.

All these things are real costs that happen over and over in each of our stores, happen in each of our warehouses, and happen each time a new item comes into the process.

MS. DESANTI: Do you only use slotting in connection with new product entry?

MR. SUSSMAN: That's correct.

MR. BALTO: Don, let me follow up. Does the amount of slotting fee vary by item depending upon what you estimate the costs are?

MR. SUSSMAN: First of all, I'm going to be talking mostly about Stop & Shop, which is the largest division of Ahold U.S.A., and it's where I've worked the last three and a half years until January. That's really what I'm knowledgeable about, so my answers will use Stop & Shop as a frame of reference.

I'm sorry, the question?

MR. BALTO: So my question is: Do they vary per item based on the specific cost that you --

MR. SUSSMAN: Yes, they do. We have different slotting guidelines in each of our categories depending on the size of the item, the amount of shelf space it takes, the turnover on the item, the category growth of the item.

Largely they're somewhat historical. They're not in a lockstep with the costs associated with the items, but they are generally following the costs associated with handling items. Larger bulkier items tend to have higher slotting costs than smaller high profitable items.

MR. BALTO: If any of the consultants want to offer an opinion on any of these items, just let us know.

MS. DESANTI: Why don't we give the consultants an opportunity to speak in their experience --

MR. BALTO: Right.

MS. DESANTI: -- What have you seen?

MR. WEBER: Win Weber, and since we consult for a broad range of retailers across the country, we see various behaviors. If we take a Stop & Shop, exactly as Don has said, in a regular practice, they cost out their cost appropriately by category and by item. We see other retailers who frankly request slotting allowances who frankly do not figure out the costs as precisely as a Stop & Shop would, but in fact try to get as much from the manufacturer as they can.

We have other situations where our retailer clients do not charge slotting allowances but will accept slotting allowances if offered by manufacturers.

And we have one situation we've been tracking for five years now, where a client of ours asked all suppliers to sign a letter, and if the offerer signed a letter stating they were getting all possible allowances, they would not charge slotting allowances.

That has grown to where we have 40 percent acceptance of that policy, where an officer of the company, a manufacturer, will say, You are seeing all of the possible allowances, and therefore they will not ask for the slotting allowances. The buyer will then ask for slotting allowances from those manufacturers who in fact are not willing to sign, because we're dealing with the fundamental issue here, and that is any buyer or any category manager is being paid to make sure that they get the best or equal to the best cost in the marketplace.

And today in the industry it's very hard to find out what those specific costs are, so there are various pressures that the retailer is working under and the manufacturer is working under. That's why we see many types of menus, I guess, of how this works.

MR. BALTO: Mr. Weber, is there some reason these firms take these different approaches? Is there something -- some characteristic that you notice? Does it relate to what kind of market power they have in individual markets? Does it relate to what part of the country they're in, anything like that?

MR. WEBER: I think you see slotting allowances more prevalent in some areas of the country. You have companies with different philosophies. You have companies that account for their allowances differently. You have differences -- some who are everyday low price retailers, versus high-low retailers. So there are different philosophies of conducting business, and I think that's the best way to look at it.

MR. BALTO: Mr. Weber, how have slotting allowances changed over let's say just this past five years?

MR. WEBER: Well, I've been listening to the indications of slotting allowances over the last ten, and frankly, when I worked on the manufacturer side, I was paying slotting allowances in 1979. So I think, let's put slotting allowances in perspective. This is a 20-year phenomena or more, and in that context I think that I haven't really seen any significant changes over the last five years, to be frank.

MR. BALTO: In the amount of slotting allowances?

MR. WEBER: The amounts are in a relative ball park. I've seen the size $25,000 for multiple-store chains. I see slotting allowances paid based on one free case per store instead of dollars. I've seen it as high as two free cases per store because then the manufacturer can work off a cost of goods basis and it's less expensive for them, so there are ways that these things are served up, and I would look at no standard.

MR. BALTO: Mr. Sussman, how have slotting allowances changed at Stop & Shop over the past several years?

MR. SUSSMAN: Basically our category rates have been frozen for the last two years. Our business has grown, so overall I would say slotting has not grown as fast as our overall business has grown.

MR. BALTO: Mr. Campbell?

MR. CAMPBELL: From an amount standpoint?

MR. BALTO: Yes.

MR. CAMPBELL: No difference.

MR. BALTO: So they've been stable for how long?

MR. CAMPBELL: Five years.

MR. BALTO: Mr. Houck, do you have any observations of the trends of slotting allowances or why slotting allowances are used?

MR. HOUCK: I would like to comment on something, the opposite side of what Mr. Weber was talking about. Many retailers might say, You give me all -- something equal to the total amount of allowances, and then I won't ask for slotting. Something that I've heard about a lot on the manufacturer's side is the flip side of that, which is that some manufacturers, if you asked them how much they're paying in slotting allowances, they really don't know, because they are looking more in terms of giving their sales reps a blanket percentage of allowances that they could deal with, and it's up to the rep to break it down any way they want.

So the rep may have 12 percent of the sales price to play with. He can break it down as 3 percent for slotting allowances and 9 percent for volume rebate or any way that he wants to. The manufacturer doesn't care as long as he stays within the guideline percentage.

MR. BALTO: Can I have an observation by either the consultants or the retailers, how do slotting allowances differ from other forms of product promotion, and how are they similar? Don, do you want to start?

MR. SUSSMAN: Well, what makes slotting allowances different is that slotting is an up-front payment for the introduction of a new item, and that's the end of the slotting allowances. Other forms of promotion, say when you run an ad, is that every time you run an ad you receive the ad fee. Slotting is a one-time happening.

In the Ahold world, certainly the Stop & Shop world, the manufacturer pays the slotting. The product gets on the shelf, and from then it depends on how well that product reforms. It could be on the shelf for the next ten years. An ad fee or other fees, say an ad fee, comes every time we run an ad so it is recurring every time that event reoccurs.

How are they similar? For us they're all forms of income, and they all go to the same pot, so we try not to worry about what pot they come into. We have got a sales and a profit budget, and like I said before, the more we are able to generate from one source, the less pressure there is to generate from other sources.

MR. BALTO: Jay or Bob Ukrop, do you have an observation about this, how they're similar or different from other forms of promotion?

MR. CAMPBELL: I don't really consider slotting from our perspective to be a form of promotion. It's really in our world a cost coverage item for the introduction of new items. It's not going to impact the way we go to market with an item. When I look at promotion, it's how we're going to market with an item from a marketing standpoint and from a promotional standpoint.

Those are going to be different types of funds that a manufacturer may make available. In most cases those things are done as the gentleman down here said, through a pooling of funds that are done on an allocated basis, and that's what your allocated pool to go to market is.

MR. BALTO: Win or Bob Houck, do you have an observation about how slotting differs from other forms of promotion?

MR. WEBER: Bob, you want to go first?

MR. HOUCK: Sure. I agree that it is not promotional. It is a cost coverage or something associated with getting the new product into the store. However, looking at it in terms of how it is done in different ways in other industries, the same thing, typically in other industries, other than grocery, you will see that it is usually covered through some sort of an introductory allowance which would be in excess of the normal trade promotional allowance.

So, for example, if you were introducing a new product in the apparel field, you might have a 5 percent co-op allowance on that product, but during the first three months or six months, you might offer 15, 20, 25 percent allowance, which would cover the cost to the retailer of promoting that product during the introductory period and give an early allowance to the retailer.

So that would be how it would differ in other industries and how it would be the same as to some extent. They're still covering the risk for the retailer of taking on a new product and promoting that new product for them.

MR. BALTO: Win?

MR. WEBER: Basically the menu of allowances that manufacturers offer are designed to drive the market share of their brands, consumption. Hopefully there's a pass-through to the consumer of X percentage of every dollar. Slotting allowance is basically going into profit, I guess is the way I would look at it, for many of the reasons that have been discussed.

MR. BALTO: To --

MS. DESANTI: Scott Hannah?

MR. BALTO: Scott, I'm sorry.

MR. HANNAH: I'm going to take a different track. Slotting allowances are bad. They're evil. Two things.

I'm not going to sit right now and answer all these arguments from the retailers, but number 1, the consumer loses, and that's the first thing we should all think of. The consumer loses.

Those slotting allowances are very expensive. They're more expensive than the trade advertising that we do, the displays, the ads, the shelf talkers. They're much more expensive than media advertising we do. They have to be built into the cost of the product. They add no value to the product. The consumer loses.

The second point is that it's very detrimental to small and medium size business. I've worked for the big corporations. I've been with P&G, Bristol Myers, had my own small company. If you're a big conglomerate, you can take that slotting allowance and can spread it over a hundred, 500 items in the store. There's no way that you as a small manufacturer can come in with a few items and charge that slotting allowance against your proforma. It is impossible.

Thank you.

MR. BALTO: Scott, we're going to get back to that. I wanted to -- let me turn it around a little bit. Is there anybody here who can tell us that slotting allowances are no more than a discount off of price, that ultimately they result in lower prices to consumers?

MR. SUSSMAN: Say it again, please.

MR. BALTO: Is there anybody here that can tell us that slotting allowances are no more than a discount off of price, that ultimately they result in lower prices to consumers?

MR. EAGAN: Yes, in my world that's --

MR. BALTO: Identify yourself.

MR. EAGAN: John Eagan, Costco Wholesale. We don't ask for slotting allowances. What we do is see what part of that menu they're on, or see what the amount of the menu they represent, and we look for other ways to do it. But everything in our world goes to the net landed cost of the product. So we have an allowance that goes to lower the cost of the goods that we recorded in our books, and we work on the margins based upon what our net landings are.

So if they called it slotting allowances, it just goes in as a discount to lower the net landed cost for us.

MR. BALTO: Why don't you explain this a little more. At Costco, do you accept slotting allowances or do you just make them change the wholesale price?

MR. EAGAN: We don't even ask the question, Is there a slotting allowance here? What we do is say, Are you paying other discounts or what is your menu of discounts, and if slotting allowance is on there, we want to get the same bottom line. We want to get the same landed cost or the lowest cost the manufacturers offering in the marketplace.

Whether they call it a slotting allowance or advertising allowance or promotional allowance doesn't make a lot of difference.

MR. BALTO: But back to the supermarket, can you make the case that slotting allowances are no more than a discount that results in lower prices to consumers on those items?

MR. CAMPBELL: I think you're talking apples and oranges. If you don't have the slotting allowance you're still going to incur the cost of introduction of the item, the distribution, setting up the item, doing the planograms and doing the retail space shelf allocation. So somebody bears the cost, and so it's going to be flowing through at some point.

If it's done by the distributor, done by the retailer or done by somebody in the chain, it's going to happen.

MR. SUSSMAN: I would take the macro view that in total those slotting allowances, all streams of income help lower cost, and if they weren't there, the pressure on prices would rise. Our manufacturers bottom lines are a multiple of what most retailers are. There's no guarantee that, if the manufacturer didn't pay that, their bottom line wouldn't go up even higher.

In order to maintain our bottom lines we would have to raise our prices, so yeah, we look at slotting allowances, all forms of income as a way of holding down our retail pricing.

MS. DESANTI: Bobby.

MR. BALTO: Identify yourself.

MR. UKROP: Bobby Ukrop from Ukrop's. We're trying to serve our customers, and we want to give the customers the items they want. If a smaller manufacturer comes to the table, and I don't know how they do it at the other companies, but like they can't pay, they can't afford it, and so we would try to help like a Virginia company, a smaller company.

I imagine the other companies do the same thing, that you try to give a person a chance to sell their product. Those people don't have the money to pay like the bigger companies do as a practice. However you deal with the menu, the menu's there, but somehow I guess we can't forget about the customers. In this process, it's the effort to try to generate the income, the revenue that comes from these allowances, though we also have to keep in mind that the customers should have the opportunity to have some variety they might not otherwise have if we didn't allow the smaller manufacturers to get in the game without paying the slotting allowances, because for some people, there's no way they can afford to do it.

Even yesterday we had somebody come and want us to sell sweet potato muffins and sweet potato cookies from their recipes. Just a couple items this couple wanted to try to sell, and there's no way anybody would give them the time of day if they had to pay slotting allowances.

So I think in some cases you don't. Even though there's some cost associated, if you put those products in, then you perhaps will make that up on others who will pay, so you can again have the items that your customers will want.

MS. DESANTI: Let me ask a followup because, Don Sussman, I think you connected slotting allowances with increased variety in your stores, if I understood you correctly, and I was wondering if you could speak to his points.

MR. SUSSMAN: I was making a point that if slotting led to less variety, I don't think you would find a correlation between the higher-slotting-charging supermarkets and the higher variety associated with those supermarkets. There are other models out there, club stores, Wal-Mart, all these. They carry less variety on a category by category basis.

Yes, they are more efficient, but it's a different model. They don't have the variety. They can go to market in a different manner. The customer decides what's best. In terms -- I'm sorry, in terms of --

MR. BALTO: I'm sorry.

MR. SUSSMAN: In terms of small vendors, though, we have a very active diversity vendor program. Victor Thomas runs that and will be joining us tomorrow, and we're very committed to small vendors, both the minority owned and just small, and getting them started, giving them a helping hand because it's good business.

It's not only that we waive slotting fees, that's not enough. Most small vendors don't know how to do business with a big company. You have to hold their hand, get them started. We've had many successes over the years, of small companies that have gotten their start on our shelves one store at a time. We're very proud of that. There are ways for small vendors to get on our shelves, and we've showed the staff many examples of these.

MR. BALTO: Mr. Weber?

MR. WEBER: Win Weber. I could build an argument to suggest that slotting allowances actually could encourage the wrong variety. We've done several studies with retailers and found that if in fact slotting allowances are part of the bucket called buying income and the buyer or category manager has a certain buying income target, that to achieve those targets they may be more inclined to buy an item with a high slotting allowance or with slotting allowances to hit their targets to the exclusion of an item that would best serve the consumer.

So I think when we look at variety, we have to look at the fact that this can encourage the wrong variety to be purchased.

MS. DESANTI: Are you saying in essence that in your experience you have not seen that slotting allowances are a means by which to signal the product most likely to be successful, the most product most desired by consumers?

MR. WEBER: I do not believe slotting allowances signals one iota how the consumer is going to buy a product. You look at advertising, consumer promotion, the quality of the product, the uniqueness of the product, the category the product are in. There's a lot of factors to be considered. A slotting allowance does not signal whether or not that product is going to be successful in my opinion.

MR. BALTO: Scott?

MR. HANNAH: Scott Hannah of Pacific Valley. A follow up on the man from Virginia. It's a very interesting note about the local products down there. Picture a Washington potato, almost as good as an Idaho potato, and you create a totally fat free low calorie french fry, which is tested and ranks good. A local chain thinks it's great. They take it in.

Then the local chain is bought by a big regional chain out of Portland, and we're in trouble. We're warned we're in trouble. They're doing this systematic buying. Buyers are eliminated. The next thing that happens is that group is bought by a really big chain in Cincinnati, so you lose your local touch.

MR. UKROP: I would argue we shouldn't have those kind of people come to Virginia. (Laughter.) I think that's the difference with independents. Again we as a local independent, we buy from someone like we talked about earlier -- like Jay was talking earlier about his company -- and so we don't really deal a lot in slotting allowances.

It mostly comes through our wholesalers doing it. We do receive some but not at the magnitude of some others. But one of the things we think local independents are able to do is provide more variety. I don't know about all the Stop & Shop stores, but we work hard. That's one of our differentiating characteristics. It's the variety to not only give local people the opportunity to come and buy local or Virginia products, but at the same time -- I think the natural and organic product's a good example because there's so many of those coming in now and we buy through a different supplier, and there's really no slotting fees we know with regard to those products. There's no way those products will pay to be on the shelf, but we want to have them because the customers want them.

I do think on another subject that was mentioned earlier, the class of trade issue, I wish we could get those products that Costco has that are not available to us because manufacturers don't necessarily make us aware of those products.

We have to go ask for them. I think that slotting is just one piece of this puzzle, and you all put up an array of fees there. But there are a number of ways that the independent is really kind of odd man out in having things made available to him or her because of the so-called class of trade issue, which is another thing that's probably more important than the slotting.

MR. BALTO: Don Sussman, I see he wants to reply.

MR. SUSSMAN: Not to Bobby, but to something that was said before. First, I think there aren't any guarantees that because a product has a slotting fee, that it's going to be success. But even with slotting, many, many products have come to market, and I think the lower the buyer is to getting new items out the more bucks we would see, so I do believe that.

The second piece is there's no question that people can mismanage their business, manage for today and bring in items strictly to collect slotting fees but that's death over the long run.

Ultimately what we have to sell is satisfied customers, and if we clog our shelves with items that don't sell because we're taking the buck today, we won't be in business tomorrow, and the customers will tell us that.

MR. BALTO: I want to get a little more of the manufacturer's perspective and call on David Nickila, Peter De La Cruz, or Scott Hannah. Give us a feel for how slotting allowances are negotiated. The retailers have sort of painted a picture that they're willing to negotiate. Is that what really goes on in the real world?

MR. NICKILA: My name is Dave Nickila of Portland, Oregon. We're a relatively small bakery. We do about seven and a half million dollars a year. We started in 1995 so we're very young. The end of 1999 was the first time we came really involved with the slotting issues. We have major chains -- we have Wynnco, Safeway, Albertson's and Fred Myers -- and they're all owned by a lot of other big companies.

But we have four of them, and one of the suppliers came to us and told us that they're opening a new store so we have to give them two cases of every SKU that we have in the store. Okay? That amounted to $568. Well, this chain has 12 stores, and with this new store, there's no way we can recoup that amount of money in the first year of operation. They actually withdrew it from our account receivable account.

We confronted them on it. I had Margie, our gal in charge, give them a call, confronted them with that, that we can't handle that, we're not big enough to handle that. Basically we told them that our backs to the wall, we could give you $150 roughly in product to get going, and they sent us a check for $418.

We have a letter from another one of the chains saying that the two cases per SKU is going to be basically their policy and that we should develop a policy of our own if that's not acceptable, and it seems like this is coming about. It's affecting us, since we're relatively small.

Part of the reason I wanted to be here is the fact that we deal with a product to all the grocers here. We direct deliver it. We supply -- and there's quite a bit of cost involved in delivery. We guarantee it. We provide a reasonably good margin for them at 25 percent, and we try to build a business with service and quality, and this is the way we've operated, and now all of a sudden other factors are coming in.

There are other things. I don't want to belabor it, but I'm just saying that these slotting fees are a concern for us because we cannot afford to do this. There's an old adage, and I'm going to clean it up a little bit, is once you've prostituted yourself, it's pretty hard denying the fact that you're a prostitute. The fact is that we don't want to do that, we favor equal and equitable treatment for everybody we deal with. We don't want to favor this chain over here versus this chain over here, and unfortunately, we're kind of the only ones that still feel that way.

But what we've seen in our marketplace is that the independents, such as this gentleman right here, a small chain, are having a tougher and tougher time to survive, and they've always been kind of the ones to be leaders in innovations and so forth. We're having no ability to get into the grocer, to the buyers heart at all. We carry no clout. We carry no big wallet, so we are concerned, and I don't know how far this is going to go.

The grocers, I'm not here to knock them, they've cooperated and they've worked with us, but it's getting more and more difficult because we don't have that much to bring to the table for them.

So I think allowances are a concern to us. We provide promotional allowances. We want to run cents off and everything else, and a grocer will pass on a part of that, but at the same time we distribute in our marketplace all the chains except for one, the one that gave us the first slotting allowance. They discount. The rest of them up-price.

So if we're beginning with a 25 percent margin and they're up-pricing, they're making more than the 25 percent, and so consequently it's very difficult for us to try to find a vehicle to justify doing too much if our products are being up-priced. To me it's unfair to the consumer. The consumer is the one we're worried about in this conference. Savings are not necessarily passed on, and like I said, I don't see where slotting allowances in our industry are going to save the consumer any money.

MR. BALTO: Thank you, David. By the way tomorrow morning at 8:30 we'll be hearing from a number of other manufacturers who will raise concerns similar to David's. Peter De La Cruz?

MR. DE LA CRUZ: I don't know whether Scott wanted --

MR. HANNAH: What?

MR. BALTO: You're the one with the tent up.

MR. DE LA CRUZ: Sure. I put the tent up really in response to the question about how slotting fees might be differentiated from other promotional allowances. Certainly I think one distinguishing feature is that, usually from the manufacturer's perspective, I think for promotional allowances, they would have an ad or end of aisle display or something like this.

This statement isn't intended to disagree with the characterization that slotting allowances are not promotional allowances, but if you were trying through your question to determine whether they were promotional allowances, I think that might be a distinguishing feature.

MR. BALTO: We'll get to that question. Jay Campbell.

MR. CAMPBELL: You want me to respond to a question? I wanted to respond to several things, the gentleman down here, your consultant.

MR. WEBER: Yes.

MR. CAMPBELL: You made a statement that slotting allowances have never reduced price, et cetera, et cetera, and people are going for the gusto and the bucks and all that.

I think the market somewhat dictates that, and I believe Ukrop said -- had quite honestly said that if you don't put up the right products at the retail shelf at the right price, then you're going to fail anyway, so if you go for those bucks and you don't put in this gentleman's bakery goods, you're not going to have the variety and selection the consumer seeks, so in effect the marketplace is going to control that.

And if there is a chain or if there's a regional competitor or a local independent who chooses to go for the bucks instead of going for what the consumer wants, he's going to fill ultimately, and I think that's the reality.

And your point from the standpoint that there are competitors that do not want to put your product in, that might be their mistake, and then I would seek out those who are willing to put your products in. Since you do direct store delivery you wouldn't do business necessarily with my company, but I can assure you the independents in our market would want the differentiation on their shelf, would want to have an item that is not a me-too item for them where they could differentiate from the big competitor out there who chose not to put your item in.

And I don't think it's all bad. In fact I think that's very good.

MR. NICKILA: I totally agree with you, the fact being though that the independents are getting fewer and fewer, and the consolidation of chains and everything else is getting pretty well established right now, so therefore it's very difficult for us to seek that market out.

MR. BALTO: Basically --

MR. CAMPBELL: Then let's bring up the issue of why there are becoming fewer and fewer independents, and that would shift the discussion to the slotting allowances that are offered, are the allowances in general that are offered, are they offered fairly to all competitors?

That is the bigger question as opposed to anything that we could talk about the rest of the afternoon. Is everything offered on a fair and equitable basis to all the competitors in the marketplace? And if they're not, then you are seeing preferential treatment paid, then you are fueling the fire for the bigs to get bigger and the smalls to disappear.

MR. BALTO: Mr. Campbell, what is your sense on that issue?

MR. CAMPBELL: The sense of that issue?

MR. BALTO: Yes.

MR. CAMPBELL: Is that we have a significant concern each and every day, that as a competitor in the marketplace, we want to be assured that we have the availability of every product that's out there, every packaging alternative on that product, the pricing, the promotion and the payment terms that are offered to each competitor on a fair and equitable basis.

If we receive that, we feel we can compete each and every day, and we won't worry about our retailers surviving in the future if that is done. If that is not done, and we're not receiving those products or the packaging or the pricing or the promotion or the payment terms, then we're ultimately destined to fail.

MR. BALTO: Okay. Let me go to an empirical question which anybody can provide information on. How large are slotting allowances typically, and how does this play into the question of how expensive it is to enter a market? Scott?

MR. HANNAH: Yes, Scott Hannah, Pacific Valley Foods. Slotting allowances are growing. I'll talk in terms of "per-store" because we talk about $50,000 or $10,000, you don't know how many stores you're talking about. So We'll talk one item per store or one SKU per store.

It used to be roughly like $25 on the West Coast, a little higher in Los Angeles but the volume was there. They're growing significantly. We're up to $75 to a hundred dollars in the West, and I've talked to fellows on the East Coast, and they say that's a bargain. It's up to $250 to $300 per store, so it's easy to do the math. If you have two items and a hundred stores, it's impossible.

As far as negotiating, that's a question. Are buyers willing to negotiate? They used to be, and they did negotiate somewhat, but lately they're not negotiating, and I'm not sure why. That's all I have to say.

MR. BALTO: Do you have some examples of where they're being demanded unilaterally without any form of negotiation?

MR. HANNAH: What is being told is they don't know your product. They barely know your product. This may not be the right answer that you're looking for, holler if it's not, but they don't know the type of media campaign you have. They don't know what type of trade promotion you're buying.

But the word is very clear. If you're not going to pay a hundred dollars a store for 100 stores, or a hundred thousand dollars, don't bother coming in. It's that pointed.

MS. DESANTI: Could I ask a follow-up question, Mr. Hannah?

MR. HANNAH: Sure.

MS. DESANTI: One of the participants earlier spoke about the possibility of smaller manufacturers getting in at a small level to begin with, a few stores at a time and then growing the market. In your experience is that a valid option, or are there problems with that?

MR. HANNAH: There are problems with that now, mainly because of the merger situation I mentioned. I'm not against mergers, don't get me wrong, but it's caused computer problems, logistics problems, where let's say you have separate warehouses in Seattle, Portland, Oregon, Spokane, et cetera, and you decide to make one massive warehouse in Oregon to cover the whole north Pacific.

So it's become very difficult to come up with a product to satisfy just a local need, and that's out of sympathy for the retailer because they're trying to achieve efficiencies.

MR. BALTO: Win Weber, is there something you would like to say about the amounts of slotting allowances and how that may translate to the cost of entry?

MR. WEBER: Well, I think that first of all we should sort of position this, that there are a broad range of behaviors in this industry, both on the retailer side as well as the manufacturer side. I sit and observe over a hundred buying or negotiation sessions a year purposely to stay on top of this.

And there are some retailers who are extremely disciplined in how they manage their businesses and manage their costs, as Stop & Shop has. There are other retailers who frankly are what I would call very unethical on how they back this business.

On the supplier side, there are some manufacturers -- and I think we should add the words consumer power here as well as just retailer power and manufacturer power. There are those suppliers that have very strong brands, high brand loyalty, who are very ethical. Any retailer knows when those suppliers walk in that the retailer across the street is getting exactly the same price. That's on one side.

On the other side, we will see retailers or suppliers frankly who are dealing in the deal of the day, and frankly the retailer is sitting there not knowing whether or not they're getting the same cost as the retailer across the street.

I had one of our retailer clients ask me some years ago, Win, how do I know if a supplier is giving me the best cost, the cost equal to the one across the street. I had to give him a lousy answer. I said, When the supplier says no, and very few suppliers will say no if they have great franchises.

Behaviors are driven on the supplier side in terms of whether they have strong brand loyalty or whether they're in commodity markets. If you're in commodity businesses and brands are substitutable, then negotiations may be a bit different. So there are a broad range of behaviors you see out here in the industry.

MR. BALTO: Let me just follow up with something. To what extent do retailers waive the allowances and give a break to smaller suppliers?

MR. WEBER: It's interesting. As Bobby said we work with a number of regional chains, and they have a tendency to actually be more sympathetic to the smaller suppliers. I think it's because they themselves grew and had to work their way up, and so I see this type of behavior across more than just one or two.

MR. UKROP: I would argue the same thing takes place with customers, not just the retailer's suppliers. It's all built in trust and relationships, so that those of us that are perhaps closer to our customers by virtue of being smaller and maybe in a region or locale, there's a connection. There's an increasing connection with these people, and it could be your neighbor that's bringing in the product or a guy or gal that's just starting up a new business and you're trying to help them get going, and you try it, but you put an amount out there, there's no way.

What we know is if it's successful there's a good chance the competitors will put it in there. Our competitors won't put it in until they see it sell at our store. Those people will get shamed into putting in those products, but I think that happens a lot of times. I think that has to do with the fact that when the big get bigger, they don't have time, they tend to not be as attentive.

But they don't have time because most often they're driven by shareholder value where smaller independents are pretty much private companies. And so they're more interested in taking care of their customers and associates than the shareholders. So that gets back to this: How people treat people, and it's a golden rule in a way.

MR. BALTO: Let me turn to Don Sussman and pick up on a question that Susan asked before. Is it possible for a small manufacturer to sort of enter incrementally perhaps by having its products just shown at just a small number of stores, and then based on slotting allowances for that limited number of stores and that limited display, building a success record, and then being able to enter chain-wide without as great a need for slotting allowances?

MR. SUSSMAN: Absolutely. At Stop & Shop we have many examples of this. I'll give you one -- a company called Lebonal Canola Oil, based out of Connecticut and who started about ten years ago. A couple who actually immigrated from Portugal made this stuff in the garage and delivered it to ten Stop & Shop stores. They soon outsourced it to somebody else who packaged the product for them with their formula, and they put it into our wholesaler, our specialty wholesaler, it's now in distribution at 204 Stop & Shops as well as four or five other major companies serviced by the same wholesaler.

We're proud of those examples. There are many obviously in this scheme at Stop & Shop, since we do about $7 billion a year. They're relatively small to the total, but there are many in there, and we have an organized program to increase then.

MR. BALTO: Let me also ask you, Don, you said earlier that slotting allowances are used sort of like as a general revenue stream to just basically improve the stores.

So if we walked into a retailer that used slotting allowances and another retailer who didn't really use slotting allowances, what differences would we see?

MR. SUSSMAN: Quite honestly I couldn't tell you that. I can tell you about my stores.

Once an item is put on the shelf, it's got to make it on its own, however it got there. When a vendor pays to put a new item on the shelf and gives a slotting, we feel we owe six months, and at the end of six months we sit down and review the history, and if it's accomplished its initial objectives, it's there forever until something else comes along to displace it, so we don't assign shelf position by slotting.

That's just part of the accept or reject discussion. We have a buying committee. Lack of slotting fees does not eliminate an item, and having slotting fees does not guarantee acceptance of an item. It is part of the equation.

MR. BALTO: That six-month period of time, by the way, for any of the retailers or the consultants: Is that the normal period of time, or do people have longer periods of time to require slotting allowances? Win?

MR. WEBER: In terms of how long you're going to watch a product?

MR. BALTO: What's the period of time you're acquiring it for?

MR. WEBER: Well, usually you see it in the initial shipments. You don't see the slotting allowances continuing for an extended period of time. That's my observation. Don, I don't know.

MR. SUSSMAN: Sorry. I misunderstood. It's a one-time payment, but we guarantee the manufacturer at least six months to establish the movement, and we won't review it until it's had a good chance for six months to establish its movement within the category.

MR. BALTO: Let me return to Bart Weitz.

MR. WEITZ: I'm Bart Weitz of the University of Florida. I have a professorial comment and hypothesis. I think one of the things that appears to be happening or has been happening over the last 10 or 15 years is that there is a huge drive towards greater efficiency in the supermarket industry. A lot of that was initially brought up by the development of alternatives to buying groceries in supermarkets, such as Costco or Wal-Mart.

And part of that drive towards efficiency is to be much more careful about the items that are stocked and to try to use some of the methods that Mr. Weber probably consults with to sort of track the cost of individual items, the total cost of that item and allocate overhead appropriately and so on.

So what eventually happens is that, as you were saying about Costco, you know how much your end product costs or total costs are when you look at each of your products, and then you can figure out which ones you want to put on the shelves and which ones you don't.

So I think what is happening is is that the supermarkets are driving towards efficiency. That leads them to also consolidate to some extent too, and what enables them to do that is sort of this increase in technology and communication systems that provide you with the information to be able to do that.

Now the question is, what happens if you sort of look at the competitive dynamics? What will happen is that there will be opportunities that will come up where people that aren't being driven by these terrific efficiencies and want to have more variety will start up supermarket chains or manage their supermarket chains that have more variety, perhaps Ukrop's or something like that.

So you'll have a choice. You can either buy at Wal-Mart at a lower price and have less assortment, or go to Ukrop's and have more assortment and perhaps pay higher prices because they have higher price with more assortment.

I think it's very difficult to sort of manage that competitive dynamics from a government's point of view. The consumer's going to figure out how that plays out, and if they don't want variety, if a consumer doesn't want variety or as much variety as they have had in the past, then supermarkets are going to respond by providing at a with lower cost with less variety.

MR. BALTO: Let me just mention that the

government only intervenes where there's true market failure and that the market doesn't effectively function.

Let me turn to John Eagan because Bart's comments sort of struck me as a question. John, can you explain to us a little more why it is that Costco doesn't use slotting and is sort of aiming for the lowest wholesale price?

MR. EAGAN: Well, our objective is to get the lowest net landed cost so that we can offer our members, the customers, the lowest possible price for the value that they're receiving. We view things like slotting allowances as an increase in cost that the consumer ultimately pays for, and I don't want to pay for the slotting allowances that Stop & Shop have or Safeway.

I don't want the manufacturer's cost spread out over all their customers. We try to get down to the menu pricing so we can take that part out of the equation, so we don't pay for slotting allowance that was paid for a Ralph's or a Safeway or someone like that as part of their overall cost of goods.

MR. BALTO: I want to turn to the issue of managing risks and try to get some of our academics in, Professor Gundlach, Professor Rao and Mary Sullivan. Would one of you want to sort of phrase the managing-risk argument, and perhaps Professor Rao can talk about the degree that his research has sort of focused on that issue and supported it or found it lacking. Greg?

MR. GUNDLACH: The risk argument is basically that the proliferation of new products brought about considerable risk on the part of retailers who have to manage that risk in terms of the acceptance or denial of a product in the marketplace.

The source of the innovation at the same time is the manufacturer, and, since the retailer then incurs that risk, slotting fees allowances are the basis and mechanism used to shift that risk back to the source of innovation.

You can look at the number of products that have entered the marketplace and track them over several decades. The latest reports here are that the number of new products offered to the trade exceed 23 to 24,000 at present, where only ten years ago the number of products in the trade were approximately in the vicinity of 12 to 15,000.

So there are a number of new products and not all of them being able to fit on the shelves enhances that risk.

MR. BALTO: I probably should have actually started with Don Sussman and Jay Campbell and Bobby Ukrop. Is that a significant reason why you request slotting allowances?

MR. SUSSMAN: Absolutely.

MR. BALTO: How do you see it from your perspective?

MR. SUSSMAN: Well, I think I'm plowing over ground I went over, but basically there's a risk in terms that a new item will fail, and we're going to wind up with both inventory and cost in our system for items that have not brought new customers to the category or have not increased our sales.

There's a risk that we're going to give up the income stream for items that we're selling and that we've discontinued, and the third risk is again disappointed customers. Even a slow moving item has customers who choose it over the assortment of competitive items, and when we discontinue that item to bring on a new item, there are going customers who are going to be disappointed. Those are all risks as we see them.

MR. BALTO: Professor Rao and Mary Sullivan?

MR. RAO: Mary, you want to go first?

MS. SULLIVAN: Well, I just have a quick question. I think the theory of the managing risk is a theory that slotting allowances are efficient, and the theory assumes that somehow the manufacturer's better able to bear this risk than the retailer, and if that's true, then shifting the risk is efficient.

So I just have a question rather than a comment. Why would the manufacturer be in a better position to deal with this risk? An explanation for why the retailer might be in a better position to understand and deal with the risk is that the retailer sells many different products in a given category and might be better able to evaluate what is going to sell in this store, in this location and so on. That was a question.

MR. BALTO: Does anyone want to answer Mary's question?

MR. SUSSMAN: I would be happy to. If you look at Stop & Shop in the grocery side of our business, we probably have between nine and ten buyer category managers managing 15,000 SKUs. They do a pretty good job of managing the information flows and the product as we see them, but we don't know enough about every category and every item.

We depend on our manufacturers to do a lot of the basic store research for us, and manufacturers are driven by many things, one of which is just to get increased shelf space and to grow their market shares. That's their jobs.

So if they can displace a competitor's item with one of their own, even if their item sells less than their competitor's item, they've won. That's what their motivation is, and so we kind of depend on the manufacturers to help us understand what customers want in a category.

Yeah, we have our own opinions, but we can't rely on our own judgment. There's too few of us and we have a lot of work to do, and with so many new items coming out we really do feel that the manufacturer has to manage this for us.

MR. BALTO: By the way we will get into the specific issue in more detail in the category management panel right after lunch tomorrow. Akshay?

MR. RAO: The issue of risk sharing is kind of interesting. I think the answer lies in between, and to continue on Bart's comment, this is going to be very professorial in the sense that I'm not going to take a position.

I actually have some data on the topic, and it turns out that there are some circumstances in which manufacturers know more than retailers and there are other circumstances in which retailers know more than manufacturers. Depending on the degree of information asymmetry between the two, depending on who knows more, there is a tussle about information.

And if the product is likely to not fail in the judgment of the retailer, there is a likelihood that it will succeed, that's where the negotiation starts, and if the retailer knows more than the manufacturer does about the likely success of the manufacture, then the manufacturer winds up paying a higher slotting fee, so ultimately it is a contingency. It is an interaction over the likely success of the new product.

If the product is likely to fail, then the conversation does not even begin. No amount of slotting allowance will get you into the shelf if the retailer does not believe it's going to succeed. But should the retailer privately come to believe that the product -- be it flashing lights on diapers that are wet -- that it's likely to succeed, and the manufacturer does not have the market and research information to support the likely success of the product, then the retailer, quote, unquote, extracts a relatively high slotting allowance from the manufacturer.

So I'm not exactly sure whether that speaks to your question, but it's been weighing on my mind for the last 24 hours, and I had to get it off my chest.

MR. BALTO: By the way, Professor Rao and one of his colleagues a have recently published paper. They did empirical research that actually looked at this issue, and it's a very interesting paper.

Let me turn to John Eagan. We've heard why grocery store retailers need slotting allowances to deal with risk. Why isn't that a problem at Costco?

MR. EAGAN: We look at the event of selling product to the consumer. The manufacturer does their portion. We do our portion, and it's a continuum that goes from development of the item all the way through and to the end user. When the manufacturer does their part and I do my part, it gets accomplished.

It's a different business in the club industry because of the volume that we run. We don't really run into big risks of a lot of inventory around. We can flush goods out pretty quick. Our biggest concern would be if we asked a manufacturer to come up with labeling. Getting rid of packaging for them would be a bigger risk than finished goods because the goods move so quickly, and it isn't around a long time, and we can do it by price, by reducing the price to get rid of it, or other ways.

I mean, if the manufacturer wants to share in that, that's fine. We will accept that, and we'll drop the price accordingly to help blow it out, but we don't have warehouses where we have this inventory stocked in, so it's not an issue as it would be with a wholesaler or a retailer.

MR. BALTO: Don, did you want to reply to that?

MR. SUSSMAN: I think everything you said is true, but I also think that we have more store brands on the supermarket shelves than in club stores, and club stores have a limited assortment. They tend to choose the proven items, not that we always jump on new items, but when you have a limited assortment you have to make sure everything you carry is a winner.

MR. BALTO: Right. Let me ask as long as we're dealing with the risk issue, are there less restrictive ways dealing with the risk issues such as a failure fee? Scott, if you wanted to speak to the earlier issue, that's fine.

MR. HANNAH: This risk?

MR. BALTO: Yes.

MR. HANNAH: Not the same thing. It's tied together with failure fee, but I'll give you a true case scenario, which I think means more than anything. About five or six years ago we came out with a very deluxe petite frozen vegetable that was microwavable in a poly bag, came out perfect, delicious, et cetera.

It was not tested. We're a small company. Chain store buyer says, How do I know this will sell? Well, the offering of $50,000 wouldn't make it sell, you see, so together we decided let's take five stores as a test group. The buyer said, if you can increase my profits over a six-week period versus the same control group, you're in. I think that to me is an excellent approach of risk, and by God, it worked. I was a little spooked with that kind of test but it worked.

Another thing about risk that you were saying is there is a risk, but the retailer has to share the risk. We're all in the food business together, so this mystifies me just a little bit. You have slow-moving fees and we have discontinuance fees. If we had an item that was slow moving and the buyer said, You either add a slow moving fee or get this item up to a hundred cases a week, I would find out why that item wasn't moving and would make it move, discontinue it, or pay the fee. So that's another approach.

MR. BALTO: So, Scott, what are the possible alternatives to a slotting fee that could sort of deal with the retailer's concern that at the end of the day they're going to have a lot of unsalable goods that they've got to get rid of that they've ultimately paid for?

MR. HANNAH: Well, I talked to another gentleman from the midwest during break, and he said the same thing. Some of these things you take for granted, but a lot of companies guarantee their products. They won't guarantee that they'll sell at a specific rate, but if they don't sell or meet certain objectives you go pick them up.

In other words, a buyer does not have a risk of having to close these out and take a loss. Our brokers, our sales agents or whatever just go around and pick these darn products up and get them out of there, give our apologies. I know there's other costs associated with that, but that's one way to do it, and another is a discontinuance fee or a warning of a slow-moving fee.

MR. BALTO: Okay. Bob Houck?

MR. HOUCK: I have one observation that just occurred to me and then one alternative way of dealing with slotting allowances.

One involves some other industries. This is somewhat along the lines of a discontinuance fee or a slow moving fee or whatever, I've never heard of that one before. In some other industries what is typically done with introductions of new products is generous mark-down allowances. When you're selling in the new product you offer high mark down allowances or -- and maybe this isn't practical in the grocery industry -- but typically again in other industries they will offer very generous return policies. Simply they're guaranteeing the product. If it doesn't sell, return it to us and we'll take it back. So that's one of the ways it's done.

Alternatively, one of the things that some manufacturers will do, who would prefer not to do mark-down allowances, is that they'll offer very generous scan-down programs for their new product introduction. Scan-down is where they pay so much per unit on what is sold out based on scanner data from I. I. Nielsen or something like that. Some will offer incremental scan down allowances -- if you sell above a certain unit volume, it will increase the amount per unit that we offer. And that is a kind of guarantee to the retailers that if they get behind a product and promote it, they will be rewarded very generously.

MS. DESANTI: In your experience how frequently do you see these different types of practices that you've just described being used? Are those frequently used, not very frequently used, and if so do you have any observations about what problems might be associated with using those alternatives?

MR. HOUCK: Well, the sort of things I was talking about in terms of mark-down allowance and return polices and everything, that is really outside the grocery industry. That is more in other categories of retail. The scan-downs, that is a grocery thing or grocery and drug, and it's done a lot. It isn't done that much with new product things, but it is done occasionally there, and it was just something that occurs to me, as where I've seen it used it does seem to be effective.

MR. WEBER: I have some thoughts.

MR. BALTO: First Professor Rao.

MR. RAO: Just a comment on the failure fee versus slotting allowance issue. If you accept the notion that slotting allowances signal, and I suspect despite my data that there is some truth to that argument, that if a manufacturer walks in to a retailer and says, Here's a million bucks and a bottle of beer with a pickle in it, it will actually sell well. It probably does communicate something, much like a failure fee does.

A failure fee is essentially a warranty, so if you take that analogy and apply it to our world, when you purchase clothing from Lands End and are given a lifetime warranty, some people abuse it. By the same token, some retailers could abuse the warranty and the failure fee, and as a consequence the failure fee fails to signal.

However, the slotting allowance does not fail to signal, so all other things being equal, they will both signal, but the likelihood that the failure fee will fail to signal is higher because of potential abuse. It also is advantageous to a manufacturer because if you have a good product you never have to pay the failure fee. It's much like not having to fulfill a warranty on a good product.

So that's all I have to say.

MR. WEBER: I just have a couple thoughts. The cost of failure is quite high both to the retailer as well as the manufacturer. There's no winner in failure. On the manufacturer's side just about every retailer today asks for guaranteed sale. Forget slotting allowances, forget failure fees for a second. Just about everyone asks for guaranteed sale, and there's a point in time, let's say in six months, if an item isn't selling, a retailer is going to tell the manufacturer to ship back the goods from the warehouse.

And now we've moved product in the reverse direction in the distribution system, which it wasn't built for, and there are tremendous costs there. The supplier owns tremendous inventory that they're going to throw in the ocean or whatever, at tremendous cost, depending on what they spent on advertising and they didn't sell the product through.

The retailer has cost, product left on the shelf. It's either marked down or sold through. Seldom do the manufacturers pick up it off shelf. There's a tremendous cost here.

To start talking about slotting allowances and failure fees, when we look at the cost structure of every retailer, the movement of product through the distribution chain, the cost is different for every retailer. They all have different areas of efficiency and inefficiency, and I think to try to tailor some type of formula, structure for slotting allowances or failure fees, I think it would be virtually impossible because of the financial dynamics of retailing and suppliers today.

I think what we're looking at is to make sure the retailer knows, and the supplier knows, that if the retailer is charging slotting, at least some suppliers today will just shift money from promotional dollars over to slotting allowances.

The bottom line is the supplier has not spent one more dollar, but if the retailer wants a slotting allowance, give him a slotting allowance, fine. They'll just take it away from promotion, display, and that's happening today. There's a perception that certain retailers are making more money with their slotting allowances. I can argue with many of the major suppliers today that the retailer is not getting one dime more. We're just moving stuff from bucket to bucket.

MR. BALTO: Let me follow up on that. Mr. Weber, should we look at that as being an innocuous practice, that money is going from other promotional funds into slotting allowances, or is that an inefficient practice because other promotional practices may be more efficient at increasing demand?

MR. WEBER: Well, the most inefficient spend for a supplier in a category that's a non-expandable consumption category, the most inefficient spend is trade promotion dollars because trade promotion dollars do not build brand equity. Trade promotion dollars drive price and share but they do not build category consumption and brand equity.

As a percent of sales, trade promotion dollars have became increasing since 1970s at the expense of being able to spend in advertising in a marketplace where advertising is much more segmented today. So if the suppliers are trying to build brand equity, trying to drive their cost structure within reason in trade promotion, they're trying to move most of their dollars toward feature prices or toward display and trying to keep as little as possible from not working toward the consumer.

So the larger suppliers today who are working with market development funds are just putting slotting into the menu and saying, Fine, it's the retailer that wants to earn the money that way and it's performance is defined as slotting allowances, just like performance may be defined as feature prices, fine, and that's where the industry is heading.

MR. BALTO: I understand that these things may be equivalent in some perspective. Should they be equivalent from the perspective of consumers? Are consumers better if the money is spent in one pot rather than another pot?

MR. WEBER: I really don't know.

MR. BALTO: Mary Sullivan first.

MS. SULLIVAN: I would like to go back to failure fees for just a moment. I just heard a couple of good reasons why you might want to pay a slotting fee rather than charge a failure fee after the fact. One is that if slotting serves some sort of signaling role, you would actually be more likely to choose a good product with a slotting fee.

The second is that there are failure costs that you might be able to prevent if you could just stop a bad product from being introduced, but ignoring those two reasons for now, I can think of another reason why a failure fee is less efficient, and it just seems to me that it might be harder after the fact to charge a failure fee than it would be to charge a slotting allowance up front, especially when the manufacturer wants to get the product on the shelves.

And there might be genuine disagreements about what constitutes failure. There are also occasions in which a manufacturer may go out of business in which he simply can't collect the fee.

MR. BALTO: Jay Campbell?

MR. CAMPBELL: All of the things that have just recently been discussed in the last 20 minutes or so to me are very innovative and creative ways of doing business in the American marketplace. And I think that whether you call it a presentation fee, a slotting fee, a display, a pay to stay or failure fee, these are all creative ways that people do business. Now, whether they're right or wrong is not relevant. It's still going to impact someone's profitability whether they're at the manufacturer level, distribution level or retail level.

The real concern from a governmental standpoint should be is are these things disclosed by the manufacturer to all the competitors in the marketplace. If they are not, then you have a problem, and also if they are not fairly and equitably distributed in the marketplace in that fashion through marketing development funds or any other buckets that are out there. Are the buckets created on a fair and equitable basis to all competitors? That should be our concern.

Whether we come up with a whole new fee structure or new allowance structure or anything like that, and it's real creative and real cutesy, shouldn't be our concern. Our concern should be: Is it offered equitably, fairly and disclosed by the manufacturer to all the competitors in the marketplace?

MR. BALTO: Greg?

MR. GUNDLACH: I want to go back to the discussion of risk, just from the standpoint of how failure fees might relate. But before that, I think there's a couple observations that could add to the discussion here.

The type of risk that we're dealing with is approximately 80 to 90 percent. It is upwards 20,000 items that are offered in the trade and that actually fail each year, so in my mind the level of risk needs to be looked at.

What is driving that risk? If you look closely at it, many people believe it's the lack of development of novel and truly innovative products in the marketplace, and many categories being at the mature level and offering only brand extensions, line extensions and things of that nature.

So we want to address risk. I think we need to get back to understand where the risk is coming from and the nature of that risk.

Another point to add to the discussion is that really the management of that risk has to be addressed from both perspectives. While the source of innovation is the manufacturer, once that product is in the retailer's hands, the retailer has also something to do with the success of that product, so untangling where and whose failure it is becomes a difficult issue.

I think those two issues overlay a lot of the discussion.

MR. BALTO: Steve Salop has joined us. By the way, to wet your whistle for tonight's reception, Steve will be making a separate presentation to us at the end of this panel. It's actually a transition device to our panel on exclusivity. Steve will share some thoughts about how we should look at exclusivity in this setting. Steve?

MR. SALOP: Actually I thought I was proposing a toast to slotting fees. I wanted raise a somewhat broader view of risk, and it has occurred to me that perhaps we should think about slotting fees and the growth of slotting fees as redefining the retailer business model towards something -- moving away from retailers earning profits from marking up the wholesale price of the products they stock to one in which they rent the shelf space and give the manufacturer greater control over the shelf space and let the manufacturer bear the risk that the products they put on the shelf, and the way in which the products are placed and the pricing of the products doesn't make economic sense.

So it's something I wanted to raise to the group. In that regard, I read an article recently in which PepsiCo said that what they wanted do was put their thirst-inducing salty snacks on the shelves next to their thirst-quenching soft drinks, and they were hoping to convince retailers to do that.

And it occurred to me that, well, why couldn't Pepsi just rent some shelf space in order to try out that concept, let them bear the risk that it would be a good idea versus not a good idea.

MR. BALTO: Let me turn to Scott Hannah.

MR. HANNAH: I've heard before of this "bucket of money" approach, where if you don't or can't pay a certain slotting allowance, just offer so much for displays in the store, trade advertising, whatnot, and let the retailer take that money and apply it toward slotting allowances if it wants. Correct me if I'm wrong, that's what I think I heard.

What you're doing as a manufacturer is shooting yourself in the foot. In other words, we buy these displays, end displays I'm talking about, separate displays to increase the sales like six to seven times during that period. The idea is to get awareness to the consumer. If we cut those down to one display or two displays for the year and apply that money in slotting allowance, I don't see where the gain is. I don't understand that type of thinking at all.

As far as a failure fee, if you have other products in the store -- I can see what the lady was getting to, if you have other products in the store failure fee is not a problem because the buyer can say, Hey, look, you promised to pay a failure fee and you owe this failure fee. You're still shipping us six other items of this other brand. If you want to keep that in there or not have it deducted from your invoice, you pay this failure fee like you promised.

But if you go in with five items and you have no other items in the store and you fail, that could be a problem. It could be a bookkeeping nightmare to put up an escrow account or something. But the point is the slotting allowances up front take away from the very thing you're trying to do, and that's promote the product, advertise a product. That's the bottom line.

MR. BALTO: Don Sussman?

MR. SUSSMAN: Ultimately what we're after is satisfied customer sales and profits, and it's the retailers and the manufacturers who do that best that are going to be successful. It's for the market to decide who's doing that best, and for the customers that's essential.

MR. BALTO: Bart Weitz?

MR. WEITZ: I just wanted to respond to Dr. Rao's point about changing the model of retailers. It seems that if that's your vision, then basically the value that retailers add to the equation is lost. One of the values that they add is to provide an assortment that their customers want, and what you're doing is saying, I'm just going to let manufacturers bid up and buy this space, and therefore now I'm sort of not providing this value of providing a tailored assortment, I'm leaving it up to the manufacturers just to do that.

It seems to me that gets back to the point that Mr. Sussman mentioned. Slotting allowances aren't the only thing that determines whether they put something on the shelf, because the retailer is serving the consumer by weeding out these products where a manufacturer says, Well, I'll just do anything I can to get this on the shelf even though I know it's a bad product.

MR. BALTO: Jay Campbell?

MR. CAMPBELL: Isn't that the beauty of the marketplace? Some people make stupid decisions and some people make great decisions. If you want to sell your shelves out to a manufacturer, then let them and hope they're my competitor because then my retailers will be very, very successful.

MR. BALTO: I want to go back to the issue of cost just for a chance for some additional observations by either the consultants or the retailers or anybody else. To what extent do slotting allowances approximate the actual cost of new product introductions. Any observations?

Professor Rao.

MR. RAO: My data suggests that folks with lower costs, retailers with lower costs, actually get larger slotting allowances. This I can only explain by speculating that they're larger, more powerful, so their unit costs are lower and they are able to extract higher slotting allowances.

MR. BALTO: Professor Rao, did you look at the size of the retailers in their individual markets, that being a potential factor?

MR. RAO: Yes, the sample of retailers that I'm looking at is homogenous in terms of size. There's a nice classification amongst the people who do receive slotting allowances and those who don't in terms of size, and then when you look at the folks who do receive slotting allowances, they're relatively homogenous so there isn't that much variation, hence the speculation.

MR. BALTO: Mary Sullivan?

MS. SULLIVAN: Just a clarifying question. Did your study include in its measure of cost the opportunity cost of foregone profits from the discontinued product?

MR. RAO: Right. We had three measures of cost. I'm going to try to recall. One was the opportunity cost. One was the cost of shelving. And one was the cost of data management related to the new product introduction.

MR. BALTO: Another invitation to the--

MR. SALOP: Can I ask a question?

MR. BALTO: Yes.

MR. SALOP: One would think that the lower cost stores would have higher market shares so that the higher slotting fee could be corresponding to the higher market share. So did you control for the higher -- for market share in this?

MR. RAO: No. I had a measure of retailer power relative to other retailers, whether they were more powerful or less powerful, and on that they did not differ, but I did have a measurement.

MR. UKROP: Bobby Ukrop, I would like to ask how you define powerful.

MR. RAO: Powerful in the sense of retailer power?

MR. UKROP: Yes.

MR. RAO: Whether they considered themselves to be more powerful than their competitors.

MR. HOUCK: How large were these companies?

MR. RAO: They didn't tell me. It's kind of difficult to get information about slotting allowances from retailers, as you can imagine. They do not want to reveal more than they really have to.

MR. UKROP: I was just wondering, do we know whether or not the public companies that continually -- the consolidators -- are those people kind of driving this increase or the use --

MR. RAO: Do not know and cannot tell from my data.

MR. BALTO: One more invitation to the supermarket folks or the consultants to talk about how slotting allowances are used, the degree they're related to costs. Don Sussman.

MR. SUSSMAN: I would just say if you're asking whether the real cost we do have with bringing in new products and discontinuing old are greater than our slotting fees or less than that, our slotting allowances more than cover expenses, if that's the question.

I want to make a point that though it sounds like we're against new items, just the opposite. New items are really are the life blood of industry. Even though most new items fail, they do provide a lot of buying power and stimulation to the customers.

So we're very much in favor of new items, and we bring on new items and try to give them every chance to try to succeed so it's not at all that we don't like new items to come forward.

MR. BALTO: Bart Weitz?

MR. WEITZ: If I understand the efficiency argument correctly, it isn't that the slotting fee should cover costs, they should cover risks. The costs to introduce an item might be very similar across items, except maybe for these size problems and things like that, but the idea is that the risk would be different and you would charge a higher fee when there was a bigger risk under that theoretical argument.

MR. BALTO: Can I ask people, would you expect, based on risk assumption or whatever pro-competitive rationale one ascribes to, would you assume because of that that you would see that slotting allowances differ by product or that they would be the same?

MR. SUSSMAN: Different by category, absolutely.

MR. WEBER: Win Weber. I don't even know how you could define risk. I could argue that a supplier going into the marketplace with sampling, heavy advertising, driving awareness, initial trial, the risk there could be a lot different than the supplier who's coming in and just putting a product on the shelf with a slotting allowance hoping it's going to sell.

So there's so many components in this issue of risk definition. It goes well beyond costs in my judgment.

MR. BALTO: Don Sussman.

MR. SUSSMAN: Well, I can tell you -- I can give you an example of risk. Our dairy cases, we just can't build them big enough. Everything in the dairy case moves. It's a growing part of the business. Items that we discontinue out of our dairy case would be winners on the dry part of our business, so to take any item out of our dairy case, we have items that are being discontinued that average two or three cases per week per store. Those would be big successes in any other categories.

To discontinue one of those items that's a big risk for us, so, yes, we would look for higher slotting fees in the dairy category for that reason.

MR. BALTO: Are slotting allowances paid for preferential shelf space? What's the experience of the panel?

MR. WEBER: Win Weber. I have not seen evidence of slotting allowances in preferential shelf space.

MR. BALTO: Anybody else?

MR. HOUCK: Two things. One is there are allowances that might pay for preferential shelf space, but that wouldn't be a slotting allowance. That would be a display allowance of some type. There are allowances being paid but it's not a slotting allowance.

I also wanted to go back to something Win said. He was talking about how there is greater risk if the manufacturer isn't doing sampling and promoting and such. Therefore, you would have to pay a higher slotting allowances.

And that's exactly what we've talked about to some extent. In some cases manufacturers are moving some of their money from promotional funds to slotting allowances. If they moved it back to promotional funds they might not need as much in slotting allowances.

MR. BALTO: Are slotting allowances charged for existing products? Are there pay to stay fees? Anyone on the panel? Nobody knows of any instances of pay to stay fees?

MR. WEBER: I have not seen evidence of pay to stay fees, so that's an answer.

MR. BALTO: Scott Hannah.

MR. HANNAH: You can't name names, but no. I heard one of my brokers out of the midwest recently said that a wholesaler, no one here I don't think, is charging a pay to stay fee.

MR. BALTO: For what types of goods?

MR. HANNAH: It's in the frozen food category. And these items are not in the bottom. They're like in part of the bottom third, so I'm not sure what's going on there.

MR. BALTO: I take it that Associated, Ukrop and

Ahold don't charge pay to stay fees?

MR. SUSSMAN: That's correct, Stop & Shop and Ahold do not.

MR. CAMPBELL: However, if they were offered to a competitor in our marketplace, then I would expect them to be offered to me.

MR. WEBER: Let's redefine this just for a second, and that is if you're in a category where there is low or no brand loyalty, whereby the retailer has much greater negotiation power because you do not have consumer power on the pull side, then you have the issue of substitutability and an item or a brand on a shelf, possibly the retailer will say, You're going to have to lower your costs or pay me promotional allowances to stay.

I don't view that as pay to stay, but that's a reality in commodity businesses in terms of substitutability, so I think we should look at it that way as opposed to pay to stay.

MR. RAO: Can I ask a question about that? Why would they do that? Is there some other product knocking on their door coming in that would make them more money?

MR. WEBER: Yes.

MR. RAO: In the commodity business?

MR. WEBER: Yes.

MR. BALTO: Professor Salop?

MR. SALOP: I guess I don't know whether I'm confused or surprised by this conversation. If I think about various brands where there's a strong number 1, and then there are a number of other brands competing to be number 2, and I could certainly imagine, I have seen situations where the supermarket only carries two brands and different supermarkets in the city carry different, so they all carry the strong number 1, but then they vary in the number 2 brand they carry.

And are you saying that supermarket chains do not go to the manufacturers and say -- no, to the 2, 3 and 4, the people who want to be the number 2 and say, Look, we're going to carry the number 1 and we're going to carry one other brand and we want to hear the package that you'll give us if you want to be the number 2. You're saying that doesn't occur at your chains?

MR. SUSSMAN: No. No, you're talking about slotting fees. After an item has been there a year, we go back and say, Hey, if you want to stay for year two, you have to pay again. That's what we consider slotting fees, absolutely.

If an item is under attack, we'll look at the item and say, We're going to discontinue you unless you have a better product coming out and give us a better package, and they can respond with lower cost, higher promotions, absolutely. That's an ongoing negotiation. They have to fight it out on our shelves, but it's not a slotting fee issue per se. It's a total package, sales, profits, customer satisfaction.

MR. SALOP: Fine. Okay.

MR. BALTO: It's time for our first ultimate question? What's the impact on consumers? Anybody here can contribute. What's the impact of consumers in terms of price? You can repeat things you've said before. Scott?

MR. HANNAH: Sorry for the repeat because I think I spoke at first about this, but it can't help but increase prices to the consumer. I don't see how not. It's a very, very expensive item. I did a little quick math showing this item introduced in Seattle, Washington. For a product with four items, you would spend $200,000 on slotting allowances, 150 on media advertising, about a hundred thousand dollars on trade promotions. Where is that $200,000 going to go? You have to raise your price. It's simple math.

MR. BALTO: Bob Houck?

MR. HOUCK: I really don't have any thoughts on it. To me it seems like a wash. It's all different funds.

MR. BALTO: Okay. Don Sussman.

MR. SUSSMAN: I do the math differently. We've got a bottom line to make. We have a return on our assets to make. All forms of payment help us keep our prices down to the customer. If those payments stop, we either have to raise prices or make less money. The manufacturer will have more money. What they do with that money has no guarantees.

MR. BALTO: Professor Weitz?

MR. WEITZ: It's my impression there are studies that have been done that have looked at this shifting market power from manufacturers to retailers which is supposedly one of the bases for this use of slotting allowances. Most of those studies show that actually who benefits is the consumer, and that the costs get lowered, the retailers don't make more profit, the manufacturers don't make more profit, but that the prices that consumers have been paying for supermarket items has actually been going down.

MR. WEBER: I do not believe that that is the result of slotting allowances. That is the result of a giant competitor with supercenters that in fact is setting the market pricing in core categories, and it's changed the competitive landscape throughout the United

States.

MR. WEITZ: I guess my point was is that you brought up this factor that there have been slotting allowances for 20 years, and for 20 years the amount that people are paying in supermarkets is actually not going up, and so it doesn't seem to have a negative effect on pricing.

MR. BALTO: Mary Sullivan?

MS. SULLIVAN: Just as a matter of theory, if slotting allowances serve some sort of efficient role, if they have an efficiency associated with them, then maybe a manufacturer's costs really are going up a couple hundred thousands, but maybe somebody else's cost are going down more than a couple hundred thousand dollars somewhere else in the system.

So ultimately you could have this thing that looks like a cost increase actually resulting in lower prices ultimately for consumers, although that's just a theoretical point. I really don't know anything about it.

MR. BALTO: Okay. Next part of the question -- by the way, I should add we here at the FTC spend a considerable amount of time looking at supermarket merger enforcement, and part of the reason why is because it's a very competitive industry that we want to make sure stays very competitive.

What about the impact not only on price but the impact on consumer choice, on product diversity, in the development of new products and innovation? Any comments on the impact of slotting allowances in that area?

MR. CAMPBELL: I think it's somewhat unrelated to slotting allowances itself. It's more related to the publicly held business world and the privately held business world. The publicly held business world has to make a return on assets, return to stockholders, and they have to make informed decisions, and they may choose to have a more limited assortment as does a Costco or as does maybe the Stop & Shop stores, unlike Bobby Ukrop as an independent because they're going to make that decision for different criteria.

You have to satisfy Wall Street versus satisfy mom and dad, that's a lot different in doing that, and I think it's a business decision that's going to be made each and every day by each and every competitor.

Again this is becoming redundant, but I think the real issue we have to be concerned with is, Are all of the promotions, the pricing and the products and the packaging being offered to all competitors on a fair and equitable basis? That is the more pressing concern than whether slotting allowances are hurting competition or doing anything like that.

MR. BALTO: Don Sussman?

MR. SUSSMAN: I go back to the fact that even if we have the biggest variety, we also have slotting fees so I think the empirical evidence says that slotting fees are not keeping variety down. Our stores have 30 to 50,000 items in them, and I guess if you're saying that we would have more items if we didn't get slotting fees, I have a hard time with that argument.

I don't believe that slotting fees are keeping variety down.

MR. BALTO: Yes, Bobby?

MR. UKROP: I feel like when push comes to shove the category manager is going to decide on behalf of our customers, and I think fundamentally long-term that's what's going to move a product. From an independent's point of view we're fighting the giants. You have to scrap for everything you can get, and what you don't want to find out is the guy down the street is getting something more than you're getting.

You may be getting more volume than those people, but you're not getting your fair share. That's why it's very important to have a level playing field, and I guess that's why we pay money for the FTC to watch dog, make sure that there is a level playing field in this area. It's not just slotting. It's a whole realm of things with the big guys versus little guys, public versus private, and competition at its best. That's the American way.

MR. BALTO: One more question. Should consumers care if promotional funds go into slotting allowances or other types of promotional funds such as better advertising, more couponing, things like that? Scott Hannah?

MR. HANNAH: Yes. If you've got a new product, I believe the number 1 objective is to make the consumer find out about it. If you're going to take the money which you could devote to media advertising or displays in the store or ads in the newspaper, then it doesn't make any sense to me at all, why would you take this money away from promoting that product and put in a slotting allowance and not say it doesn't affect the consumer. Of course it affects the consumer. She doesn't find out about it -- or he. Go ahead.

MR. WEBER: I think it's how you ask your question. Does the customer care?

MR. BALTO: Should the consumer care?

MR. WEBER: The consumer doesn't know.

MR. BALTO: The question, should the consumer care?

MR. WEBER: But frankly I think that the slotting allowances generally are a very small percentage of the total cost of putting products into a marketplace. You may have an exception on some small brands where obviously it's a large percentage of the total costs. I would argue that slotting allowances do in fact create a barrier in terms of being able to introduce items with smaller brands as you've defined.

MR. BALTO: Bobby Ukrop?

MR. UKROP: I was going to ask the smaller manufacturers, what do you propose ought to happen to make it so there's a more level playing field for you, because I think it's got to be really tough? We're actually a small manufacturer as well. We sell baked goods to other people, and we haven't been confronted with this issue yet because we don't have any customers yet at this stage. But I guess in a way we sell to our friends, the people we know that are our size, who don't ask us for those things.

I guess if you could paint a picture for the FTC what would that be?

MR. HANNAH: Yes. Again I mentioned earlier I worked for some pretty big corporations but if you come in as a pretty small manufacturer like myself and the man from Oregon, and you have to charge those slotting allowances totally against the product that you're bringing in, it is impossible. I'll sit down with any of the retailers and show you on paper that if you're a conglomerate and you can spread that slotting allowance over a hundred, 200 items in that store, yes, as the man down there said, it is not a big deal, but be careful how you look at that. See my point?

MR. CAMPBELL: But hasn't the market responded with specialty retailers as well? You have gourmet, specialty food. Now you've got natural food, ethnic foods, and it's opened up a whole wide array of opportunity for people to sell goods at.

It doesn't mean it has to be in the supermarket operation. I can understand that you may not get it into a Stop & Shop, but you may get it into a local independent and have the breathing room for a particular item.

We see all the time Cajun and creole seasonings. People make it in their backyards, for God's sake, and they bring it up to us and want us to distribute the product, and in many cases the chain stores in our market go to our retailers and buy it off the shelf to put it on their shelf because they're not going to put it in their distribution center so they'll buy it off the shelf of one retailer and put it in their stores.

MR. HANNAH: Can I direct that? In the West -- I think you hit on new industry. I was thinking, a couple weeks ago in the West a company called Trader Joes out of Pasadena made a name for themselves by doing just this. There's an organization in Washington State called Washington State Specialty Foods Association, and these people, in their backyards practically, come up with some fantastic foods, but it blows them away thinking of getting into a Safeway or a huge chain with the cost.

And what they're being told by the consultants is that you need to get that store into the mainline supermarket, so it's very frustrating, very frustrating. But, yes, I think you hit on possibly a new way to go in the specialty store.

MR. BALTO: One last comment.

MR. SUSSMAN: Trader Joes is part of Oldies, which is a huge German company, and the bottom line is that there are many models out there with products introduced into the market differently. You asked does the customer care. The bottom line is I don't know if they care about the question, but they vote every day, and they vote where they buy and what they buy, and I think the market works.

MR. BALTO: Let me close off this panel at this point. Thank you everybody on this panel for excellent presentations and lots of really valuable information.

We thought it would be valuable for us to hear from Professor Steve Salop of Georgetown Law School who is a real expert in the area of exclusive dealing and exclusion and spends a little time nowadays thinking about how to split up a certain Fortune Ten company Steve has been nice enough to prepare some comments that will help us think about the issues that we're going to deal with tomorrow, especially in terms of exclusive dealing. The panel can continue to sit here. Steve, if you would step up the podium at the corner of the room to make your presentation.

MR. SALOP: Thank you. I think I'm going to repeat what Mary Sullivan said to all of the real world people at the front table. These are theoretical statements. I don't really know what I'm talking about.

But what David Balto asked me to do was to try to put the issue of exclusivity into an antitrust context, and so that's what I'm going to do. This is going to be very theoretical and really very much geared toward antitrust law and antitrust economics, not towards the scrappy real world of getting your individual products on the shelf, although I think one can make the connection.

What David asked me to talk about was how slotting fees can be used to raise rival's costs and raise barriers to entry, the scenario that I've done a lot on over time, so I'm happy to present it.

In this sense slotting fees are just a method of achieving exclusivity, just like any other method of achieving exclusivity that we've studied in antitrust. The basic idea is that by offering high slotting fees to chains in exchange for excluding new entrants, then the incumbent, dominant incumbent can benefit by erecting barriers to entry which can then deter entry or minimize entry to a limited number of stores, and in a sense marginalize it.

And under those circumstances, in the absence of sufficient competition -- that is, if there is insufficient competition among other established brands -- then the dominant manufacturer can gain power over price. It can gain the power to charge higher wholesale prices, which then will be passed on to consumers in the form of higher retail prices.

So under those circumstances, where the slotting fees both raise rival's costs and then more importantly from the point of view of antitrust give the manufacturer the ability to create or enhance or maintain market power in the downstream market, then there can be consumer harm.

In those situations, that just shows sort of gross consumer harm. Of course we've also been talking for the last two hours about the potential efficiency benefits of slotting fees in terms of allocation of scarce shelf space or risk shifting and so on, and those would need to be taken into account.

In the absence of offsetting efficiency benefits, then there would be net consumer harm. In the end this sets out a Rule of Reason antitrust analysis, where you first look at harm to competitors, then harm to competition, and of course offsetting efficiency benefits. That's sort of the headline of it all.

Now, this raises a number of questions, a number of antitrust questions. The first one, and the one that gets the most play among antitrusters, is why do you need implicit government intervention in this area? Why can't the entrants simply compete in the market for exclusivity? If an entrant has to compete in the market for selling their hot sauce, why not in the market for getting distribution as well?

And that's a legitimate question, but I think that the courts and lots of commentators have gone much too far in the direction of laissez faire on this issue because competition for exclusives is not competition on the merits. Competition for exclusives inherently is paying a retailer, not just for distribution of your own product, but more importantly for the exclusivity, that is, for not carrying, for not distributing other competing products.

And when you purchase the right to exclude, that's not inherently competition on the merits. That's not inherently pro-consumer. Only if those efficiencies lead to direct efficiency benefits, elimination of free riders and so on are there efficiency benefits, and that's not inherent in every exclusivity.

Indeed, the primary motivation and the primary effect of exclusivity may be the purchase of market power. That is, when you buy an exclusive, you're not just getting distribution. You're also attempting to buy market power, and where that can be shown, then there is consumer harm and there is room for government intervention. There's market failure.

This again raises the question, Would we think that the dominant firm would be more likely to win in the bidding for exclusives against an equally efficient entrant? And I think the answer to that is yes.

The reason why is because the incumbent is willing to pay in order to protect its monopoly power whereas the entrant is only willing to pay up to the competitive rate of return.

Let me present to you very quickly an example I use when I teach this. Suppose that you have an incumbent with monopoly power, and it's earning $200 or $200 million, whatever. Now suppose there's an entrant coming on the scene, and if the entrant gets distribution and succeeds in the marketplace, then the incumbent will only make $70 and the entrant will make $70.

Note that if you have competition, then aggregate profits are going to be $140 -- $70 each -- whereas if you had the monopoly profits would be $200. That's no surprise. Competition transfers wealth from producers to consumers, so naturally one would imagine that the aggregate profits when you have competition are lower than when you had the monopoly.

But take those numbers and translate them into the amount that the incumbent would be willing to bid for the exclusive and the entrant would be willing to bid to get on the shelf. The entrant might reason as follows: If I get on the shelf I'm going to earn profits of $70, so the must I would be willing to pay is

$70, hopefully I would be able to pay much less, but if I had to, I would pay up to $70 to get on the shelf.

The incumbent's decision calculus is somewhat different however. The incumbent would say, Well, right now I'm making $200. If the entrant gets on the shelf, I'll only be making $70 so the value to me of getting an exclusive is the increased profits, i.e. $130. I get $70 if the entrant's on the shelf. I get $200 if I'm alone. The difference, $130, is the value to me of keeping the entrant off.

So the incumbent would be willing to bid up to $130. Again the incumbent hopes that he can get it for less than $130, but if push came to shove he would be willing to pay up to $130. Well, in this example the incumbent wins the bidding. The incumbent is willing to pay up to $130. The entrant is only willing to pay up to $70. So the incumbent has a systematic willingness to pay more than the entrant does, and so the incumbent will tend to win the bidding for exclusives.

Now, obviously this depends on my numbers, right? You could pick any numbers you want, but what makes that result go is nothing more than the fact that the monopoly profits are bigger than the competitive profits.

As long as the total profits, i.e., the $200 number, are bigger than the profits that the two of them would make if there were competition, that is the $140 number, then it's worth more to the incumbent to keep the entrant off the shelf than it is for the entrant to get on the shelf. The reason why is because it's the purchase of market power. In my example the incumbent is paying in order to maintain the monopoly power that it has.

And for this reason you cannot count on competition for exclusives, or in the supermarket context competition for shelf space. You can't count on that to reach the efficient outcome.

This is a very general result. Severn Bernstein has done sort of that similar research with respect to airline slotting fees at slot-constrained airports, because it's a really fundamental microeconomic argument.

At the same time I want to stress this is not a deep-pocket argument. It's not like deep-pocket pricing predation. The incumbent's bidding advantage does not come from the fact that the incumbent has more money. The bidding advantage comes from the fact that the incumbent is already established on the shelf and the fact that monopoly profits exceed duopoly profits or competitive profits.

The entry barriers are raised because the entrant needs to outbid the incumbent, and that raises the entrant's cost of entry, and that's the barrier, and it's an artificial barrier to entry because the exclusivity was not intended to achieve an efficient benefit of internalizing free-riding or allocating shelf space efficiently.

What the incumbent was fundamentally buying was the right to exclude the entrant from the shelf. Where that's all that's going on, the incumbent will tend to win and that can be anti-competitive -- not always, but it can be.

"There's not a level playing field" would be a way to put it. I think somebody used that expression earlier. It's not a level playing field even if the exclusives are short-term, and even though I know there are a lot of cases that say that exclusive dealing, where the exclusive-dealing contracts are short-term, is virtually per se legal.

And what I'm really saying is that from an economic point of view that result does not make sense. Even if the exclusives are short-term, and can be undone on demand, the entrant faces a coordination problem. The entrant can't survive just by being on the shelf of one store. Entrants need to get a distribution network established, and they need to make enough money to maintain adequate investment and advertising incentives.

What the exclusive can do then is lead retailers to think that the entry's going to fail, that the incumbent will be able to outbid the entrant for the exclusive. That will in the first instance raise the fees that the entrant needs to pay, and will make it less likely that the entrant will get anybody to buy on.

In addition, if the exclusives are long-term, which they often are, and if their expiration periods are staggered, this will create a second coordination problem for the entrant. The period before which they could achieve viability is lengthened. It also increases retailer's expectations that the entrant will fail, and again that makes the retailer more willing to give the exclusive to the incumbent even if the slotting fee is very small.

So as a result, the fixed slotting fees can succeed in creating entry barriers without creating consumer benefits.

This brings me to last question, which is one that David Balto raised for me when we talked about this in preparation. He said, Well, why would the retailers go along, why would the retailers shot themselves in the foot by creating a monopolist or allowing this firm to maintain monopoly power as in my example? Don't they like competition?

The answer to that is yes. Retailers clearly like competition, they want manufacturers to be competitive. But there is a free rider problem, a public goods problem. A single retailer would have a tendency to ignore the effect of his conduct on the success of the entrant overall because the retailer is only one of many retailers, and the retail sector is highly competitive.

Since they ignore that, the monopolistic, dominant manufacturer can pay a number of retailers enough that they're compensated for the loss in competition, and then it can make money on the monopoly that it achieves with respect to others.

In addition, if the retailers think that the entrant is likely to fail, then they would be willing to settle very cheap. Suppose the incumbent says, Well, my price is a hundred dollars, I'll give it to you for $99. Now, it's true that if the entrant comes in and succeeds, the price will go down to $50.

So which do you want, do you want $99 or do you want to buy the lottery that it might go down to $50? Well, the retailer might think, Well, gee, I would like to go with the entrant, I would rather pay fifty. But if the retailer thinks the entrant is going to fail, a dollar is better than nothing, and if all the retailers think that, then the entrant will fail.

So you have sort of a chicken and egg problem. It means that the slotting fees may not even compensate the retailer for the loss of competition. Again, the reason why this occurs in an otherwise well-functioning economic system is the very reason why we have antitrust. Competition is a public good, and so you cannot count on consumers making deals with firms or retailers making deals with manufacturers, to ensure that competition will be maintained in a situation where you have potential for monopoly power.

So this theory is well within standard Chicago-based antitrust, although it reaches obviously a somewhat different answer. I'm also not saying, and I don't want anybody to think I'm saying, that these exclusives or slotting fees should be viewed as fundamentally anticompetitive or the FTC should follow some sort of per se rule or quick look rule towards slotting fees.

Quite the contrary. In my example, I have left the efficiencies out, but very often slotting fees do have efficiency benefits. Where they do, these need to be taken into account and balanced.

So what the FTC should be doing is running through a full Rule of Reason analysis on these things. Are competitors harmed as our rival's costs are raised? Are barriers to entry raised? Second, even if they are, is there sufficient competition among established firms to maintain adequate competition? And if the answer to that is that there is adequate competition, then the fact that competitors are harmed does not raise an antitrust question.

Where you've got not only competitor injury but also competitive injury, then there's a potential market power problem, and in that case you need to balance off the harm for the market power against the efficiency benefits that potentially accrue from the slotting fees.

So just as you shouldn't assume that the slotting fees are efficient, by the same token you shouldn't assume that they're inefficient or you shouldn't put in such a high "less restrictive alternatives" bar that no one could ever meet them.

Instead you should do the usual kind of full Rule of Reason analysis, and I think that's the sort of antitrust that we should use with respect to the exclusives.

Thank you.

MR. BALTO: Steve, why don't you stay up there.

If anybody has questions, you're a professor, and you're used to answering any questions. Does anyone want to ask any questions?

MR. REYNOLDS: I have a question. You said at one point that you didn't think this was a capitalization issue or an ability-to-pay issue but was just a straightforward case where it's more valuable to the monopolist than it is to the duopoly situation? .

MR. SALOP: Yes.

MR. REYNOLDS: Can you expand a little bit more on that? I think I would argue with that, that we are talking a lot about a deep-pocket kind of an issue.

MR. SALOP: Where there is a deep pocket issue there is a deep pocket issue. I'm not saying there can't be a deep pocket issue in addition, but even if it's two big corporations, even if one is Procter & Gamble and the other is General Foods, when Procter & Gamble first rolled Folger east, it was worth more to General Foods to maintain the Maxwell House monopoly than it was for Folger to bust in and create competition. Therefore, Maxwell House would have been willing to pay more than Procter & Gamble would have been willing to pay to get in.

MR. BALTO: Steve, what should we look for in terms of evidence of consumer harm? What would be the indicia you would look for in a good enforcement action?

MR. SALOP: Higher prices first and foremost. I would be worried about simply looking at a reduction variety because by definition, if you exclude a rival, variety goes down. Any time there's a supermarket merger, the person that lives across the street from the supermarket that was closed is worse off, but we clearly don't view that as sufficient to prevent efficient supermarket mergers, and I think I view variety the same way here.

MR. BALTO: Mary?

MS. SULLIVAN: I have a practical question, an empirical question, an observation I guess. When I go to the supermarket, I think I observe that there's a lot of products in each category. Now, some of these products are highly differentiated, so they might not be perfect substitutes with one another. I'm just wondering what that observation does to your theory, which views two competitors and says and one of them is going to end up with an exclusive.

MR. SALOP: Well, you know, I think if there are 50 brands of toothpaste and the exclusive only keeps out one more and the one they keep out isn't particularly helpful, that would be a situation where I don't see any harm to consumers.

But if there are 50 brands of toothpaste and the one that's coming in is coming in head-on against the dominant firm, if there were a dominant firm in toothpaste, and if it was really going to create much lower prices, then there would be harm to competition.

By way of analogy, there are 6,000 banks that issue VISA cards, so you think eliminating one VISA issuer would not make any difference, but when AT&T started issuing The Universal Card, all of a sudden annual fees went from $20 down to zero and really didn't come back.

Now, there's a situation where one very efficient large-scale entrant made a difference even in a situation where there were 6,000 competitors.

MR. BALTO: Please identify yourself.

MR. BLOOM: My name is Paul Bloom from the University of North Carolina. How would you observe lower prices when you don't really have the ability to have a Kroger? What happens if you didn't have the ability?

MR. SALOP: Good question. Good question. This is what makes antitrust hard. I'm a firm believer in econometrics to begin with. We use econometrics in major analysis and you can use econometrics here as well. Very often you'll have a situation I think where the entrant has succeeded in rolling out in part of the country but not in other parts of the country, so in that case you could do a comparison.

In other situations you might find that the entrant was in the market and then over time gets knocked out, is forced to exit, and then you can do a before and after type of study.

MR. BALTO: Bob Steiner?

MR. STEINER: Steve, one of the things that bothers me is perhaps partly a deep-pocket issue, and that is the format in which slotting fees are paid. In the grocery business it's pretty much a dollar and cents figure up front. In other business, we heard about the apparel business, and it's new in the home center business -- it's a percentage off the order, new order, new item allowance.

That way even a small manufacturer is going to be able to sell at above average variable cost from his first order. I know what I'm talking about here. Even Home Depot, which has got a lot of power, or Wal-Mart which has a lot of power, as I understand it do not ask for a dollar and cents amount up front, and that's what is a possible barrier to the entry to a smaller manufacturer. He can pay a percentage, he can't pay an up-front fee.

MR. SALOP: The way in which entry barriers are raised is just that way. An up-front lump-sum payment goes into the extra cost of entry. It's just like you need to build a plant or you need to pay something to the contract manufacturer, you need to pay something to the retailer as well, and it raises your capital cost of entry.

And it could put you in a position that you can't price above cost, in which case you won't enter.

MR. STEINER: I'm talking about the difference between a variable cost to the manufacturer and a lump sum fee.

MR. SALOP: I'm agreeing with you.

MR. STEINER: I didn't get that from your answer. Maybe some of the people on the panel want to talk about this. I think from what I've seen in accounting that a slotting fee goes mostly to headquarters. It goes to some fund, and it's not competed away, and if it were a variable cost in the food business, I think it would probably be competed away.

I've seen -- for instance I don't know how many of you have seen the March study, the Harvard Business Review case report. They have direct product pricing for every category, and they have assigned all the costs applicable to it, but then there's a little footnote that says certain things such as slotting fees are not allocated.

MR. SALOP: I think this is mainly something for the panel. What I heard in the period I was here was some members of the panel said it was passed on in terms of lower prices.

As an economist, what I can say is that microeconomic theory predicts that an up-front lump-sum payment, not conditioned on retailer performance would not be passed on in the short run, but by making retailing more profitable would have a tendency to lead to greater investment in the retail sector which could lead to more variety and ultimately more competition in the long run and ultimately to lower prices that way, okay?

It's also true in the work I've done that the distinction between lump sum payments and variable payment is too simple because sometimes lump sum payments are only paid if the retailer carries out certain performance, whether it's an end cap or cents off coupons or ads or other performance.

And in that case, the lump sum I think acts more like a variable payment because it incentivizes the retailer to do something that benefits consumers, so you pay the retailer say a million dollars in exchange for a promise that the retailer will lower the price of the commodity by 20 cents, that's going to be something that's going to benefit consumers, and that's just like -- in economic terms acts just like a reduction in the wholesale price.

MR. BALTO: The person in the back, and that will be our last question. We'll have time during the reception to ask more questions. Stand up and identify yourself.

MR. FLICKINGER: Sure, Burt Flickinger. Just one quick comment. I worked on the independent retailer side representing a lot of independents on the wholesaler side. The manufacturer side with P&G, and also the chain side. In the example that you gave, in terms of exclusivity, in many cases with slotting fees, aren't supermarkets still on net paying higher prices? Because in your Folger/Maxwell House example, I was part of that test market, and we took all of P&G's merchandising monies and slotting fees and passed those along to the consumers.

So before P&G introduced, we were selling Maxwell House at 2.49 an equivalent pound on sale. When P&G introduced Folgers we were selling it at 99 cents an equivalent pound.

MR. SALOP: Arrest this man. He's a predator in pricing.

MR. FLICKINGER: When I was working with P&G later, and we did have marginal agreements and slotting fees, most of the retailers we sold to passed the slotting fees on in terms of lower cost to the consumers. But even with slotting fees, we found that we oftentimes had to pay higher promotional dollars or an equivalent through Wal-Mart or a Home Depot or any of the other retailers, because in asking for price rollbacks they in a "total bucket of trade allowances" were asking for more and more money from us than the supermarket industry ever did.

And even with slotting allowances, aren't the other retailers that have more category dominance, more category exclusivity, getting greater resources than the supermarket channel even with the slotting fee?

MR. SALOP: This is an interesting observation, a complicated set of questions, and I think you've really made the transition from today to tomorrow. What I can say is that, as a theoretical matter, lump sum payments that are not performance business based, according to microeconomics do not get passed on.

Lump sum payments that are performance based or variable payments like promotional dollars per case, that's like a reduction in the wholesale price and will tend to get passed on. Now, there has been some economic theory done, most notably by Greg Shaffer who will be talking tomorrow, that has built economic models that show that when there are slotting fees, that tends to raise wholesale prices, not through a mechanism in which manufacturers say, I have to recover a certain amount of money, but rather through the competitive interaction among manufacturers. Under those circumstances they tend to lead to higher retail prices. But that is a model, and there are other models in which you didn't get that result.

So a key question, a key question for the FTC is, Under what circumstances do fixed slotting fees lead to higher prices versus variable slotting fees leading to lower prices? That's the $64 question.

MR. BALTO: Thank you, Steve, and thank you to the audience. The reception is on the 7th floor. Let me forewarn you, this is an FTC staff sponsored reception so you shouldn't expect anything extravagant.

The 7th floor is known as The Top of the Trade which also serves breakfast and lunch, and tomorrow's lunch is fried chicken.

For those people who are interested, we should be distributing a copy of Steve Salop's paper tomorrow. And we look forward to seeing you at 8:30 tomorrow morning.

(Time noted: 5:20 p.m.)

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C E R T I F I C A T I O N   O F   R E P O R T E R

CASE TITLE: WORKSHOP ON SLOTTING

HEARING DATE: MAY 31, 2000

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above cause before the FEDERAL TRADE COMMISSION to the best of my knowledge and belief.

DATED: JUNE 15, 2000

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DEBRA L. MAHEUX

C E R T I F I C A T I O N   O F   P R O O F R E A D E R

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

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