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To: Ken Kelly (modified and enlarged as a submission to FTC)
Re: Comments on "Are Slotting Allowances Anticompetitive?"

1 – **Slotting Fees as a Signal**

At the FTC Workshop on slotting fees many of the participants observed that slotting fees were just one element of the "bucket of funds" over which a manufacturer and retailer will bargain. I agree. The fact that P&G doesn't pay slotting fees and that Wal-Mart doesn't ask for them doesn't really change the character of the negotiations. You can be sure that the two contestants will still bargain hard over price, various promotional monies and the performance of certain functions.

Still, if slotting fees were somehow the only form of promotional payment that was permitted, you would find that manufacturers who simply offered sizeable slotting allowances were signaling weakness, not strength ! In the vertical competition between manufacturers and retailers the formers' chief weapon is a strong brand franchise and the latter's a large share of the relevant retail market. As you may recall, I have frequently written that a brand is strong when consumers are more apt to switch stores within brand than brands within store should a retailer fail to price the brand competitively or decide to discontinue it or not to stock it in the first place. When these two relationships are reversed, the brand is weak. Manufacturers of strong brands are able to command a relatively high price and need offer few promotional allowances and other concessions because they know retailers must stock their brands and sell them at a thin margin. Manufacturers of weak brands must beg the retailer to stock them by offering a lower invoice price and more allowances and other concessions than competing brands with stronger consumer franchises. Hence, if a manufacturer wants to signal the retailer that his new item is one in which he has great confidence, he will try to mimic the behavior of a manufacturer with a strong brand and refuse to offer a slotting fee or offer only a low one.

We heard an interesting illustration of these dynamics at the FTC Workshop when a Stop & Shop executive described his firm's negotiations with Starbucks when the latter first made its coffee available to supermarkets. In keeping with its practice, Stop & Shop initially demanded a slotting fee. Starbucks refused and held tough. Stop & Shop decided that too many of its clientele would seek out this brand at other stores if it didn't stock Starbucks coffee. So Stop & Shop gave in and bought Starbucks without receiving a slotting fee.

Of course, any experienced buyer for a retailer has long since seen all the ploys used by manufacturers' salesmen to get him to take on the new brand. Therefore he may pay no attention to the size of the slotting fee being offered and make his decision on other criteria. That certainly is the implication of the survey results of Bloom, Gundlach and Cannon which showed that both manufacturers and retailers disagree with the statement that "slotting fee size is a good indicator of the likely success of a new product." In all events, I think we can reject the notion that simply offering a sizeable slotting fee signals a manufacturer's confidence in his new introduction.

By "simply offering", I mean that the manufacturer is not also asking the retailer to give his line most all of the counter space devoted to the category or to accept some other exclusionary terms that are only credible when demanded by the manufacturer of a dominant brand, such as McCormick. If a salesman for a weak brand made such a demand he would be laughed out of the buyer's office. So, in a few instances strong manufacturers might offer a sizeable slotting fee, but these cases are easily distinguishable from slotting fees offered by a weak manufacturer, because the strong manufacturer will demand far more than that the retailer stock his line, which is all that the weak manufacturer hopes to achieve by offering a slotting fee.

The Format of Slotting Fees

Slotting fees originated in the grocery business. In grocery, promotional allowances have traditionally been deducted from invoice and have largely been indistinguishable from a price reduction. They therefore have gotten competed away like a price reduction. This is in contrast to the practice in many non-food categories in which advertising and other promotional allowances were not deducted from invoice but were payable later upon proof of performance. I surmise that by requiring slotting fees to be paid by a lump dollar sum in advance, supermarkets wished to avoid having to compete them away. And in practice it would appear that slotting fees paid to supermarkets are not shown as a deduction from cost of goods sold but are a "below the line" payment that goes into some corporate fund. Through this format, slotting fees could tend to raise prices to consumers especially in markets where retail competition is less vigorous.

However, I believe the chief anticompetitive effect of this format is to serve as a barrier to entry to the new product introductions of smaller firms. I don't see that your access to the capital markets discussion gets at the problem. A $50,000 lump sum payable in advance is a far riskier proposition to a producer with $5 million in sales than to the dominant firm with $50 million in sales. I believe it is the ratio of the size of the up-front fee to the company's sales or net worth that determines its exposure to risk.

Fortunately, there is an easy remedy – just adopt the format that is already in place in many classes of trade that have "new item" allowances. These are in the form of a percentage deduction from the opening order. Although they can be sizeable (for instance, perhaps 25% in the home center industry that the leading retailer often collects), the small manufacturer is not disadvantaged. For even after deducting the percentage fee, the proceeds from the opening order exceed his variable costs and thus make a positive contribution to the firm's overhead and profit. As always, the larger manufacturers will pay a smaller percentage allowance than smaller ones and larger retailers will receive larger percentages than smaller retailers. But that is a fact of life with any allowance and not unique to slotting fees.

3 – **Allocating Risks of New Products between Manufacturers and Retailers**

Perhaps you will think my views here are a biased reflection of my career as a manufacturer, but I cannot see that slotting fees are useful devices if they allocate more risk to the manufacturer. Ken, you are misinformed in adopting the assumption that ignoring sunk costs of R &D, manufacturers will make money "even if the product is a dud." If the major retailers are overstocked because the new item proves a dud, you can be sure that they will return the goods to the manufacturer or negotiate for mark-down monies that enable them to close out the item without taking a bath. I can tell you from experience that for every dollar of inventory of a new item in retail stores, the manufacturer may have on the order of $3 in his warehouse and another dollar or so in components that he has ordered but not yet received. So if the new item "bombs out", it is the manufacturer who already "has to eat" the excess inventory.

Moreover, if slotting fees have the effect of shifting further costs on manufacturers they will become less willing to undertake investments in R&D, production engineering and in introductory marketing and advertising campaigns, which outlays become sunk costs once the item is in production. The retailer's risk on new items is already relatively trivial and to shift more risk to the manufacturer is certain to discourage innovation.