ANTITRUST ANALYSIS OF SLOTTING ALLOWANCES AND CATEGORY MANAGEMENT CONTRACTS

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My comments are based upon two forthcoming articles co-authored with Benjamin Klein (available on the website):

(1) The Economics of Slotting Contracts (forthcoming JLE, 2007)

(2) Antitrust Analysis of Category Management: *Conwood v. U.S. Tobacco*

Slotting arrangements: per unit time payments made by manufacturers to retailers for shelf space.

- usually bind the grocer to provide shelf placement for a six month to one year period
- can cover both new and established products
- arose in grocery retailing around 1984
- over the past 20 years, have become more pervasive, increasing in size and covering a larger number of grocery products

Anticompetitive theories do not explain the growth and prevalence of slotting contracts:

- Frequently used by manufacturers with small market shares
- Most involve only short-term shelf space commitments
- Significant economies of scale in manufacturing are absent for many grocery products where we observe slotting contracts
- Anticompetitive theories do not explain the growth of supermarket slotting contracts in the 1980s

Two key economic questions that must be answered with respect to slotting fees are:

1) Why must manufacturers explicitly contract with retailers for the provision of shelf space?

2) Why do shelf space contracts sometimes include exclusivity provisions?

Slotting contracts solve incentive incompatibility involving retailer undersupply of promotion when there are little or no inter-retailer competitive effects from the supply of promotional shelf space

A Promotional Services Theory of Slotting Contracts

Retailers supply less than the joint profit-maximizing level of promotion because they do not consider the manufacturer profit margin on incremental sales

For many products

- the retailer's incremental profit
  - $(P_R - MC_R)$,
- is a small fraction of the manufacturer's incremental profit
  - $(P_W - MC_M)$

For Price Competition:

inter-retailer competitive effects offset the relatively small retail margin to approximately produce the optimum amount of retail price competition

$$(1) \quad \frac{dQ_R}{dP_R}(P_R - MC_R) = \frac{dQ_M}{dP_W}(P_W - MC_M)$$

$\frac{dQ_R}{dP_R}$ is much greater than $\frac{dQ_M}{dP_W}$

because there are

inter-retailer competitive effects

in addition to

inter-brand competitive effects

However, because promotional shelf space creates "impulse sales", there are small inter-retailer demand effects

$$(2) \quad \frac{dQ_R}{dS} \approx \frac{dQ_M}{dS}$$

Therefore

$$(3)\quad \frac{dQ_R}{dS}\ (P_R - MC_R) < \frac{dQ_M}{dS}\ (P_W - MC_M)$$

The distortion is not present on all forms of non-price competition.

If consumers value the non-price service and will switch retailers in response to its supply, e.g., free parking, the joint profit-maximizing quantity will be supplied.

$$\frac{dQ_R}{dS}(P_R - MC_R) = \frac{dQ_M}{dS}(P_W - MC_M)$$

In these fairly general circumstances, the manufacturer will want the retailer to provide more promotional shelf space for its products than the retailer would otherwise provide and a separate contract for shelf space will be necessary.

But the fact that manufacturers compensate retailers for promotional shelf space implies that retailers have the incentive to cheat on the implicit understanding by not supplying the contracted for level of promotion.

There are many pro-competitive rationales for exclusive shelf space arrangements, such as those observed in *Gruma, Conwood, McCormick*, and *Harmar*.

- Facilitating contracting over promotional shelf space by efficiently defining what the manufacturer is purchasing
- Exclusivity allows the retailer to obtain a greater rate of return on its shelf space by committing its promotional sales to the manufacturer
- Shelf space payments, regardless of their form, are passed on to consumers in competitive retail markets

Category management contracts an alternative solution to the promotional shelf space contracting problem when consumers' demand for a particular brand is high.

- The efficient shelf space contract in these circumstances is a limited exclusive
- Category management contracts are a form of limited exclusive which delegate performance to the manufacturer and the policing function to the retailer

- *Conwood* paradoxically appears to impose a more stringent standard on category managers than dominant firms with full exclusives
- UST's conduct violated tort law but was unlikely to generate anticompetitive effects

Lessons for Exclusive Dealing Analysis

- Full or limited exclusives, including category management contracts, are frequently an element of the competitive process for distribution and “make economic sense”
- Section 2 standards must vigorously enforce the requirements that plaintiffs demonstrate an anticompetitive effect under a rule of reason analysis