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# Policy Notes

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## Slotting allowance: an overlooked angle in grocery retailing

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Consumers are confronted by more product categories and increasing number of brands per category today compared to ten years ago. A quick glance at a store's shelf would find at least 13 brands of sardines, 8 brands of milk, and 5 brands of detergent soap, all vying for consumer attention and patronage. How these goods reach the household shelves largely depends on how the supermarket retailer positions them in its shelf space. This retailing practice implicitly invokes competition among the manufacturers for the limited amount of store space. Evidence of this kind of competition is inferred from the growing, albeit overlooked, practice of slotting allowances or shelf space rental fees. The rapid product proliferation, combined with limited shelf space, can significantly shift the balance of power away from the manufacturers and transfer it to the retailers.

*Slotting allowances* are payments made by manufacturers to retailers in order to have their products displayed on the store shelves. The fees include shelf-space fees, display fees, pay-to-stay fees, failure fees, and others. These are often referred as lump-sum, up-front fees paid for stocking the products, especially the new ones. Pay-to-stay fees are also collected for matured products to sustain customer patronage and increase market share. This unregulated business practice emerged in the European and American markets with the rise of the large chain stores in the 1980s, starting with department supermarkets and spreading to other stores that sell electronics, books, medicines, and computer software. Prices are negotiated in secrecy appearing in different names and forms (Schaffer 1991).

This Policy Notes focuses on this relatively unexplored business phenomenon. Specifi-

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cally, it informs the consumers that the practice of charging shelf-space rental fee is a potential source of retailer power that may yield positive and negative consequences. Two divergent views on slotting allowance are presented: (1) the efficiency gain principle, and (2) the anticompetitive prospect. While it is the concern of policymakers to protect the welfare of consumers, the same kind of protection must also be extended to the producers (or manufacturers) with the objective of achieving a positive welfare gain for society in the short and long run.

### The Philippine retail market: a synopsis

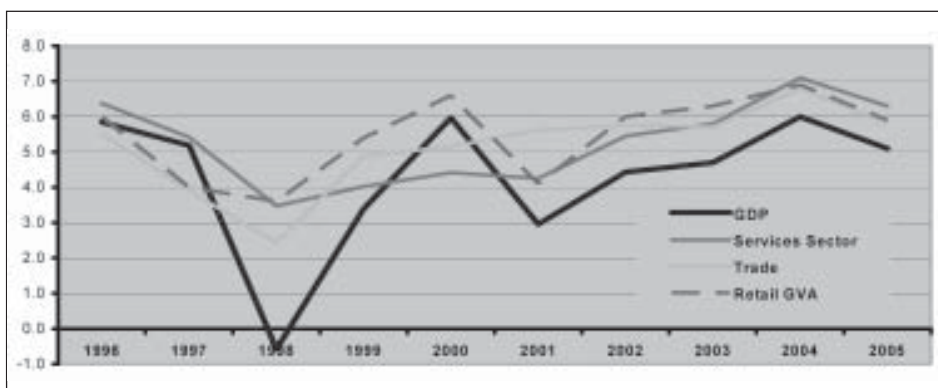
The Philippine economy grew at an average rate of 4.9 percent for the period 2000-2005 (Figure 1). The steady increase in output performance from 2001 until 2005 was mainly due to the sterling performance of the service sector, which was propelled by the dynamic retail trade sector. Despite lingering inflation and recurring oil price hikes, the retail trade sector continues to experience output growth and shows off its resiliency during economic cycles. Retail trading accounts for more than 20 percent of gross national output and over 75 percent of the total trade sector. From a share of 20.8 percent in 1996, its contribution to output reached a high of 28.4 percent in

1998, with revenue steadily increasing from P4.5 million in 1996 to P8.2 million in 1998.

Retail sales as a component of consumer expenditure have likewise been on an uphill trend. From 28.4 percent in 1996, it rose to 38.4 percent in 1998 and possibly as high as 61 percent in 2003.<sup>1</sup> The spurt in retail sales is fueled by the country's expanding consumer base and growing personal consumption expenditure. With an annual population growth rate of 2.4 percent, the country's current population of 80 million Filipinos complements well for the retail industry where much of the consumer expenditures are on food and personal products like clothing and footwear, and transportation and communication. As of 2004, the country has over 442 malls, 780 supermarkets, 796 convenience stores, 4,162 groceries, 7,300 drugstores, 39,000 market stalls, and more than 448,000 sari-sari stores.<sup>2</sup> Taken collectively, there are over 500,000 retail establishments catering to the spending needs and whims of 80 million Filipinos.

In March 2000, the Retail Trade Act was enacted wherein the retail sector was liberalized. This policy initiative allowed foreign retailers to set up operations in the Philippines. Popular foreign names like Wal-Mart and Carré Four dominated the retail scene with promises of wider array of products, lower prices, and alternative shopping pleasures. After five years though, not a single store of these giant foreign retailers has landed on Philippine soil. Instead, what the Filipinos had witnessed is the rise and proliferation of local retailer SM all over the urban areas. From

Figure 1. Growth of GDP, services, and retail sector, 1996-2005 (in percent)



Source: National Income Accounts

<sup>1</sup> Based on Euromonitor estimates.

<sup>2</sup> BusinessWorld (2004)

Luzon to Mindanao, SM made its mark in key urban cities with its signature box-type architecture fashioned with a new color combination of neon green and bright orange aimed to attract a younger and wider genre of shoppers. Indeed, the dominance of SM, together with another retailer giant Robinson, cannot be denied (Figure 2).

The retailer does not simply put goods on the shelves for the consumer to purchase. His functions are much broader and include managing relationships with manufacturers, managing logistics such as distribution and inventory, and developing and sustaining customer relationship (Dueñas-Caparas 2005).

### The retailer in focus: a certified two-timer?

Products flow from one producer to many consumers through the retailers. This essentially implies that the retailer caters to two markets:

the distribution and intermediate markets (Figure 3).

The *distribution market* is where goods flow from the retailer to the consumer. A retailer gains competitive edge over its rivals if the products it sells are priced relatively lower than others. This can be achieved through cost efficiency, and economies of scale and scope. However, consumers also consider other factors in their choice of retailer. First is the **geographical location** of the retail outlet. The proximity of the retail outlet to the consumer highlights the convenience in making purchases even if product prices are slightly higher. Another dimension of retail competition is the **product selection** a retailer carries. Competitive advantage increases if the retailer is able to stock the best product range at reasonable prices. Knowledge on consumer needs and on market operations are necessary tools to achieve this advantage. The last dimension of

Figure 2. SM malls/outlets, greater Metro Manila area, 1999-2006

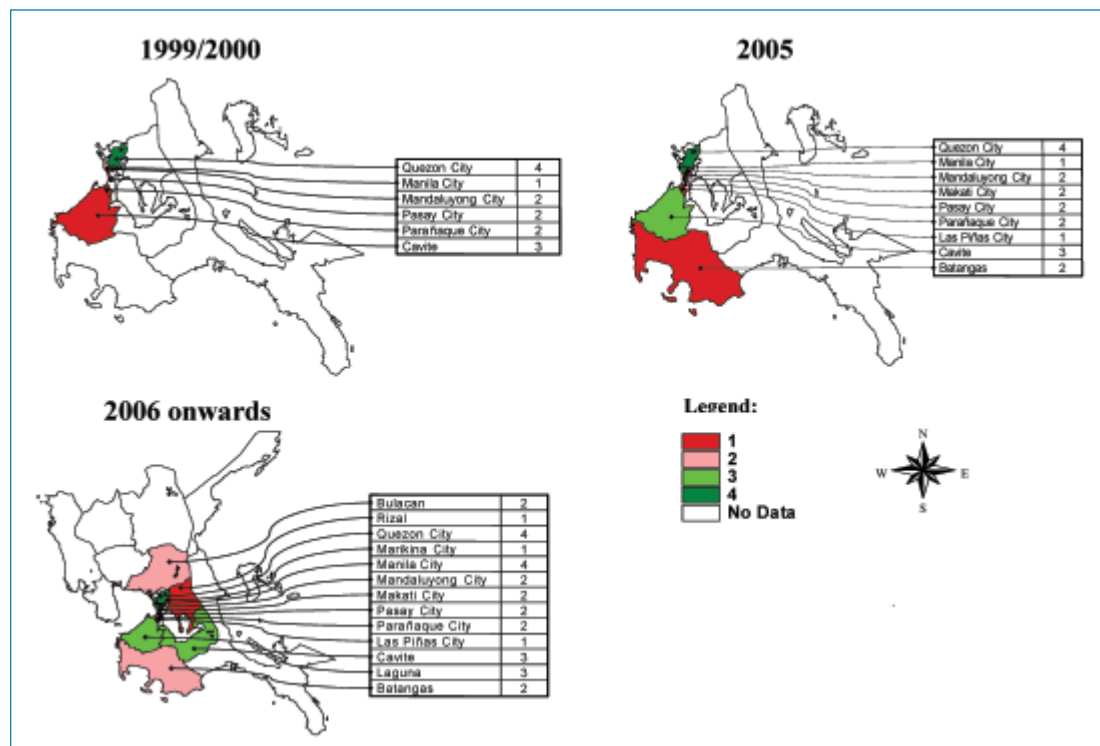
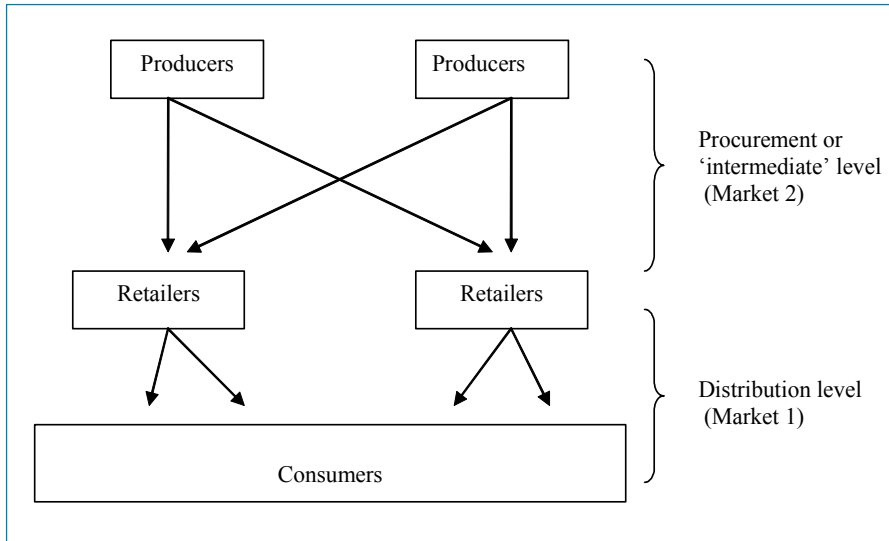


Figure 3. Flow of goods at the procurement and distribution levels



Source: Mazarotto (2001)

retail competition is the provision of an effective and efficient **retail service**. A retailer must also know and consider how to present said products. Shop ambiance, point-of-sale service and after-sales service are some retail services that nurture loyalty among consumers.

In the *intermediate market*, goods flow from the producers/manufacturers to the retailers.<sup>3</sup> The relationship between the retailer and manufacturer involves a two-way traffic, with the supply chain on one side and product management on the other. Retailers have the tendency to get involved in the supply chain for various reasons: (1) to ensure that the products are delivered to the shops on time and are of desirable quality, (2) to reduce the costs incurred when products are stocked in the retailer's warehouses, and (3) to maintain a reputation of exclusivity where the manufacturer will not supply to other retailers. If retailers tend to get involved in the supply chain management, the manufacturers also have reasons to exert particular control over some aspects of retailing. In particular, the manufac-

turers want assurance that: (1) products are retailed appropriately, (2) staffs of the retailers are properly trained, (3) retailers carry out the right level and type of promotion, and (4) product's physical position within the store is in preferred locations.

A close interdependence exists between the two markets. The retailer's share in the distribution market determines the volume of procurement from the manufacturers where a bigger distribution share requires larger procurement volume. The larger volume in turn brings a more favorable buying condition from the manufacturers which can be converted into ways

to improve the retailer's position in the distribution market.

#### **Retailer power: shelf space anyone?**

Product categories are increasing almost every year. Shampoo is now retailed in sachets to address consumers' varying needs. As these product categories increase, so does the number of brands that go along with them. Marketing these brands is one challenge a manufacturer faces, but making these products physically accessible to the consumer is an even tougher task.

Since it is rare, though possible, that a manufacturer directly sells its products, the task of making these products accessible to the consumer rests on the shoulders of a retailer.<sup>4</sup> Essentially, the retailers become producers or suppliers of store and shelf spaces.

<sup>3</sup> In the Philippine setting, manufacturers usually have a distributor and do not directly deal with the retailers.

<sup>4</sup> For this article, the retailer is narrowly classified as supermarket/grocery operators.

Traditional economic tools of analysis state that if there are suppliers of shelf space (the retailers) and there are those who demand it (the manufacturers), exchange of goods and services takes place when both parties agree on the price. Consider the case when there is a limited supply of good (retailers do not expand shop space fluidly) and the demand for that good increases (more brands coming out that have to be displayed). The result is an upward pressure for prices to go up. In the intermediate market (market for manufacturers and retailers), this price is reflected in the slotting allowances and becomes a possible source of power for the retailer (or buyer).

The practice of charging slotting allowance is currently generating discussion and serious investigation in the European market. The reason is simple. Many regard it as a facilitating measure where large retailers can elicit (intermediate) market power, effectively transferring the profit from the manufacturers to the large retailer. Retail power argument suggests that in many local markets, high retail concentration implies concentrated shelf space ownership in the hands of few retailers, enabling them to demand slotting allowances. This means the manufacturers are at the mercy of the retailers. If and when the manufacturers fail to deliver the demands of the retailers, this could lead to nonexposure of the product in the retail shop and lesser product variety for the consumers.

Some analysts, however, believe that there are efficiency gains in charging slotting fees which

**Table 1. Two views on slotting allowance**

Efficiency-enhancing Arguments	Anticompetitive Rationale
Retailers charge slotting fees to distribute their limited shelf spaces more efficiently.	Slotting allowance is an exercise of market power by large retailers and serves as a facilitating device for the oligopoly retailers, resulting in higher retail prices.
New products run the risk of failing to penetrate the consumer market. Retailers carry the risk of marketing failure and unsold inventory. By charging slotting fees, the risk is passed on to the manufacturers who introduced the new product, forming an insurance against the risks.	Retailers use slotting allowances to extract manufacturer profits by exercising retail power, thus adversely affecting smaller manufacturers and reducing consumer access to products.
Retailers carry the high quality-strong demand product with or without the slotting fee since this will increase revenue. The reverse is true for poor quality products—the retailer will not carry a poor quality product even if it charges shelf space fee. Hence, information carried out by charging shelf space fee only covers the uncertainty on product quality and demand.	

Source: Wang 2001

minimize the risks in retailing. For consumers shopping at big retailers, slotting allowance is beneficial because the big retailer may be able to depress the consumer price in order to play stiff competition against its closest rivals. This can be done by negotiating a low wholesale price (say, up to the marginal cost of the manufacturer) or favorable wholesale agreements (like one box free for every 10 boxes). Table 1 presents the two divergent views on slotting allowance.

### What is the score of slotting allowance in the Philippines?

Some Filipino big retailers are charging slotting allowance. Below are some information gathered from an interview conducted with a big retailer operator.<sup>5</sup>

<sup>5</sup> Name of person interviewed and retail establishment withheld as requested.

- Generally, there are three basic categories in grocery retailing: (1) food, (2) nonfood, and (3) fresh and frozen.
  - The food section includes processed meat and fruits, bread, milk, breakfast items, and the like. In the nonfood section, it includes toiletries, cleaning agents, house decors, and kitchen items. Fresh and frozen section is the wet market area where one can get unprocessed chicken, pork, fish, and beef.
  - Each section has a *gondola* or a rack where products are put on display. Rental fee for each rack depends on the pace of product turnover and the position of the rack in the selling area.
  - Retailers carry the products either on consignment basis or outright purchase. Goods on consignment can be returned to the manufacturers if they did not leave the rack for a specified period of time while outright purchased goods are products that are purchased by the retailers. Normally, goods on consignment are charged shelf-space rental fee while the latter are not.
  - Shelf-space rental fee is lower in the non-
- food section compared to the food section. One gondola for a nonfood item costs approximately P1,500 to P2,500 per month.
  - End racks have higher rental fees since they are the most ideal location and highlight the product. Food items are charged as high as P27,000 per month in shelf-space rental.
  - In some cases, manufacturers comply with the slotting allowance but the suggested retail price (SRP) is negotiated with the retailers in order to protect the manufacturers' share in the consumer market.
  - Bar codes are sold for P0.25 per product in case the manufacturers do not have the codes placed in the goods.
  - Some retailers have affiliated companies related to manufacturing. In these cases, products of the affiliated companies have preference in shelf space location over their competitors.

### Slotting allowance: what now?

Consumers are primarily concerned with prices and choices while producers are interested with profits. These matters are greatly influenced by how the retailers perform their functions and effectively distribute the goods from one end to the other.

From the consumers' perspective, the practice of charging shelf space fee may elicit an indifferent attitude so long as it does not increase prices and lessen product variety. If retailers are able to partake of the manufacturers' profits because of slotting allowance, the transfer of profit from the manufacturer to the retailer would likely have little effect on the consumer as long as the retailer meets the expectations of the consumer. The manu-

#### Box 1. The European retailing experience

The European policymakers impose some restrictions in retailing. Some of these are (1) zoning regulations, (2) opening hours, (3) marketing techniques, and (4) interactions between retailers and suppliers. Generally, rigid zoning laws are imposed that prevent the entry of new retailing formats with efficient scales of operation. In the *British market*, there are technically no zoning laws but in practice, they are used vigorously to prevent new large stores or malls from developing to undermine the existing retail base. In *Germany*, there are restrictive zoning laws but the most important regulation covers the operations of retailers, in particular, the opening hours. In *France*, there are laws restricting the operation of larger stores.

Some analysts consider these regulations as factors that hindered the competitive evolution of the retail industry and delayed the diffusion of innovations or changes in the structure of general merchandise retailing.

Source: Baily (1993)

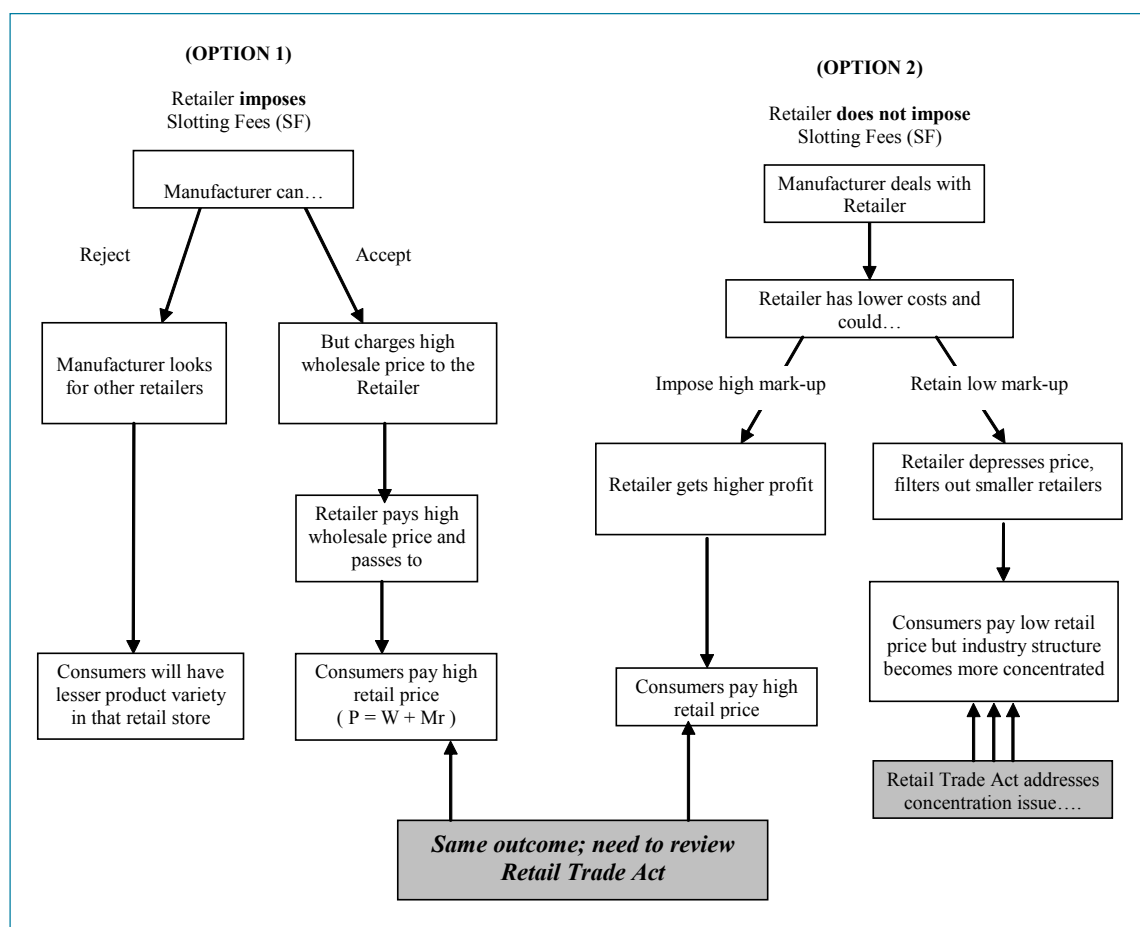
facturers, on the other hand, may regard slotting allowance as a facilitating device. Whether or not the retailer charges these fees, the manufacturer is confronted with options that will affect his objective of maximizing profit.

Figure 4 shows the process and mechanism through which slotting allowance could affect manufacturer and consumer welfare. In spite of the arguments favoring slotting fee, the simple flow chart details three possible alarming outcomes with the incidence of slotting fees: (1) reduction of product variety, (2) higher retail prices, and (3) low retail prices but unfair competition in the distribution market.


These outcomes can be complicated further depending on the structure of the distribution industry. The degree of market concentration suggests the amount of buying power a retailer can exercise. A highly concentrated market can elicit larger buyer power through bulk or volume purchases. While large retailers could yield countervailing measures and lower consumer prices in the short run, it poses tough competition against relatively smaller retailers where the lower prices undercut smaller stores and eventually drive them out of business.<sup>6</sup>

<sup>6</sup> Recall that large retailers can offer lower consumer prices because they are able to negotiate a favorable wholesale price resulting from bulk purchases. The same cannot be said for smaller retailers.

**Figure 4. Possible effects of slotting fees**



Unfortunately, this issue is not addressed by the existing Retail Trade Act in the country. The Act mainly addresses competition issues in the distribution market—from the retailer to the consumer—and does not deal with manufacturer–retailer relationship. The Act allows the entry of foreign players to operate in the retail business with the thrust of making the market more efficient. With more players in the industry, the goal was to lower consumer prices and increase product variety. However, this did not happen because the expected entry of foreign players did not materialize. Instead, certain local retailers became even bigger and more dominant with their substantial investment and knowledge in the local market thereupon affecting the size and structure of the distribution market.

In view of the above, it may be the right time to review the existing Retail Trade Act and see how it can address issues relating to manufacturer–retailer relationship that eventually affects the distribution market structure. 

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