

## **PRESENTATION TO THE FTC SLOTTING FEE WORKSHOP**

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### **A. INTRODUCTION**

1. "Slotting fees" refer to a broad class of expenditures paid by manufacturers to retailers. These types of payments sometimes are referred to more generally as "trade spending." The competitive effects of trade spending may differ according to the form in which they are paid, the conditions under which they are paid and the details of the market structure of the upstream and downstream markets. Thus, understanding and predicting the competitive effects of trade spending requires a detailed market analysis.
2. As such, a legal rule of per se illegality clearly would be inappropriate. The agency should be very careful in contemplating intervention in this form of competition.

### **B. ECONOMIC FUNCTIONS OF TRADE SPENDING**

3. I want to begin by discussing some of the economic functions of trade spending. These functions can lead to economic benefits.
4. Retailers traditionally have earned a return on their investment by marking up the wholesale price charged to them by manufacturers. However, a two-part pricing structure involving lump sum payments to the retailer as well as variable (i.e., per unit) charges paid to the manufacturer also are possible. In this regard, the lump sum payments are a method of charging manufacturers directly for the retailer's scarce shelf space. In this way, a structure resembling vertical integration by the manufacturer might be created. For example, at least if manufacturers were permitted to set the (maximum) resale price charged by the retailer, then a retail store would resemble a series of kiosks, each owned and controlled by a particular manufacturer.<sup>2</sup> This methodology shifts greater risk to the manufacturer and may give the manufacturer greater control over the presentation of its brands. For

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<sup>1</sup> I would like to thank David Balto, Serge Moresi and John Woodbury for helpful comments.

<sup>2</sup> Maximum RPM probably would be enough because of the retailer's "double marginalization" incentives.

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example, a recent *Business Week* article suggested that Pepsico might want to place its thirst quenching soft drinks next to its Fritolay Division's thirst-creating salty snacks.

5. This business plan has efficiency-enhancing properties. In the short run, the shelf space is allocated to the manufacturers that value it the most. In the long run, competitive retailers are signaled to expand shelf space according to its value to manufacturers. (Of course, one also must be cautious with the efficiency claims. When products are differentiated, the winning bidder for scarce slots is not necessarily the most efficient buyer.<sup>3</sup> When there are barriers to entry into the creation of shelf space, the market will not necessarily reach the efficient outcome. And, as discussed below, it is possible that a dominant incumbent manufacturer may purchase exclusives that raise significant entry barriers to new entrant brands.)
6. Payments also sometimes are made by manufacturers to induce retailers to stock new brands. Such payments have the effect of shifting more of the risk of failure from the retailer to the manufacturer, particularly where the payments are paid up front as a lump sum. This risk shifting may have beneficial incentive effects to the extent that the risk of brand failure is due to the manufacturer's product formulation and roll out strategy.
7. Trade spending may involve fixed or variable payments, or both. That is, payments may involve a lump sum, up front payment that does not depend on the quantity of goods sold. However, payments also may be made on a per unit basis, so that they reduce the retailer's effective wholesale price. Some types of trade spending falls in between these two ends of the continuum. In particular, lump sum payments may be made contingent on certain performance by the retailer, such as an advertising program, special product placement, coupons or price reductions, and so on. My understanding is that the breakdown of trade spending across these categories varies by brand, category, retail chain and geographic market.
8. To the extent that payments depend on the number of units purchased by the retailer, the payments tend to lead to a lower retail price paid by consumers. To the extent that lump sum payments depend on the retailer's performance, consumers benefit from that increased information, convenience or lower prices induced by the performance requirements. Thus, the existence of these performance criteria for lump sum payments means that lump sum payments can have similar competitive effects to variable payments. Thus, it is more difficult to draw a bright line between lump sum and variable trade spending in terms of expected competitive effects.
9. Another factor that makes it more difficult to draw a bright line is the way in which trade spending is negotiated. I understand that sometimes

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<sup>3</sup> See A. M. Spence, *Product Selection, Fixed Costs, and Monopolistic Competition*, 43 *Review of Economic Studies* 217 (1976); S. Borenstein, *On the Efficiency of Competition for Operating Licenses* \_\_ *Quarterly Journal of Economics* \_\_ (1988).

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manufacturers agree to a total amount of annual trade spending when the contract with the retail chain is made. Then, subsequent negotiations determine the breakdown of this spending into fixed versus variable, performance-based versus unconditional.

10. Where payments are made on a lump sum basis *with no performance requirements*, microeconomic theory would predict that they are not passed through directly to consumers in the short run in the form of lower prices. However, even in this case, consumer benefits may occur in the longer run from the effect of the payments on spurring retailers' investments in new or larger stores. This increased investment can benefit consumers in the form of increased convenience and retail competition, which also can lead to lower retail prices.
11. The existence of these benefits suggests that antitrust enforcers should be wary of interfering with this form of competition in the absence of proven consumer harm.

**C. SLOTTING FEE COMPETITION AMONG ESTABLISHED BRANDS**

12. The existence of fixed slotting fees and other forms of trade spending can affect both competition among manufacturers of established brands and competition among retailers. I understand that there will be a full session tomorrow discussing these issues. Therefore, I want to remain fairly general in my comments.
13. As a starting point, when payments are made on a per unit basis, they generally can be viewed as wholesale price reductions. These price reductions then would tend to be passed through to consumers as lower retail prices.
14. Lump sum, unconditional payments are more complicated and their effects may depend on market structure. I can not run through all the possible outcomes here. Greg Shaffer's work in this area is perhaps the most interesting and provocative. In Professor Shaffer's model, competition with lump sum slotting fees can lead to higher short run retail prices under some conditions.<sup>4</sup> Thus, a policy of prohibiting these slotting fees in principle could lead to lower retail prices. I am sure that Professor Shaffer and the panel will discuss this work tomorrow.

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<sup>4</sup> Intuitively, since manufacturers must earn nonnegative profits, slotting fee contracts accompany wholesale prices which are above production marginal cost. Retailers who sign such contracts not only receive a direct up-front payment but also benefit indirectly from the reduced downstream price competition. By committing to a relatively high wholesale cost, a retail firm essentially announces its intention to be less aggressive in its pricing. Other firms then are induced to raise their retail prices, and the original firm gains through the feedback effects. See G. Shaffer, *Slotting Allowances and Resale Price Maintenance: A Comparison of Facilitating Practices*, 22 RAND Journal of Economics 120 (1991).

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15. In Professor Shaffer's model, there is no formal agreement among the manufacturers. Instead, it is slotting fee *competition* that leads to a sub-optimal outcome for consumers. This raises the question of whether the conduct could be reached under the Sherman Act or Section 5 of the FTC Act. Unfortunately, I do not have time to comment on this issue.
16. However, I do want to discuss one other interesting antitrust issue raised by this work. In Professor Shaffer's model, the customers who purchase the brands subject to the fees are worse off from the higher retail prices. However, the retailers are better off from receiving the slotting fees. This raises the question of whether the benefits to the retailers are cognizable benefits under the antitrust laws. (In this discussion, I will take as given the assumed result that slotting fees raise short run retail prices for the brands. And, I will ignore other non-price efficiency benefits possibly caused by the slotting fees.)
17. Let me approach the antitrust question as follows. At a starting point, it is clear that at least for some purposes, antitrust would view the retailers as the consumers. For example, if a group of manufacturers fixed the wholesale prices of their brands, the retailers would be the injured consumers. Now, suppose that a group of manufacturers made a naked horizontal agreement to eliminate fixed slotting fees. It could be argued that this non-competition agreement would and should be treated as per se illegal price fixing.
18. But, maybe not. The manufacturers might defend by saying that the no-slotting-fee agreement benefits consumers in the form of lower retail prices. Assuming that the manufacturers could prove that retail prices do fall (and they clearly would have a heavy burden in the case of this naked agreement), their claim would seem to constitute a permissible defense under a consumer welfare antitrust standard.
19. Of course, the manufacturers' claim involves just a short run analysis. As discussed earlier, if there is competition among retailers and no barriers to entry, the fixed slotting fees over time will tend to lead to additional investment and expansion at the retail level. That investment could benefit consumers in the long run as new and larger stores are constructed. This increased competition also could lead to lower prices in the long run.
20. This analysis then suggests that the short and long term consumer benefits should be weighed and balanced. And this balancing raises two interesting and knotty antitrust issues.
  - First, there is the issue of the proper weights to be placed on short term versus long term benefits. The 1997 revision to the efficiency analysis in the Merger Guidelines make it clear that the short run is given more weight, both because it is more immediate and because the effects are less speculative.
  - Second, there is the Philadelphia National Bank ("PNB") issue. The long run consumer benefits from the manufacturers' agreement impacts all

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products, not mainly the brands sold by these manufacturers. Almost all of the benefits would accrue in other brand markets. Thus, it is not clear that these cross-market benefits would be cognizable under *PNB*. This is not exactly like the facts of *PNB*, where the losers were small businesses in Philadelphia and the gainers were large corporations who borrowed in New York. In this case, it is the same consumers who buy various brands. But, that is not necessarily enough to make permit the markets to be aggregated in the Merger Guidelines. For example, suppose that the agreement involved specialty brands purchased by only one discrete group of consumers.

21. These two points explain why consumers may benefit from the no-slotting-fee-competition agreement. As a result, it might well be appropriate to evaluate this hypothetical slotting fee non-compete agreement under a rule of reason standard, rather than applying the per se rule. At the same time, it clearly does not justify a rule of per se legality for such agreements. Slotting fees do have other potential competitive benefits in terms of risk allocation and allocation of scarce shelf space.
22. Does even permitting rule of reason analysis for this agreement go too far? The fact that this example involves a naked, horizontal non-competition agreement may well raise suspicious antitrust antennae. But, suppose that the conduct were ancillary to a merger. Suppose that it is predicted that a merger among two competing brands will lead to a reduction in slotting fee competition. Moreover, suppose that it can be established that this reduction in slotting fees will have the effect, *ceteris paribus*, of reducing retail prices for those brands. Indeed, suppose that this price-reducing effect exceeds the potential price-raising effect of eliminating competition among the brands. As a result, consumers are made better off from the merger and its effect c f eliminating slotting fees, at least in the short run. Thus, even if the price-reduction defense is not permitted in the naked agreement case, it clearly seems sensible in the merger context.

**D. EXCLUSION AND EXCLUSIVE DEALING**

23. Fixed slotting fees and other forms of trade spending also can affect entry competition. Most of the criticisms of slotting fees seem to focus on this issue.
24. Before discussing these theories, I want to raise two caveats from the earlier discussion. First, fixed slotting fees can shift the risk of product failures from retailers to manufacturers. This risk shifting actually can facilitate new brand entry. This is because it gives manufacturers an instrument for convincing retailers to carry their new products. Second, to the extent that retailers collect "scarcity rents" for their scarce shelf space, entry costs may be increased. However, these increased costs do not by themselves raise an antitrust problem if the problem is real resource scarcity.

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25. Notwithstanding these caveats, one situation where there is a potential antitrust problem is when a dominant incumbent manufacturer uses fixed slotting fees to gain a broad set of exclusives. By offering high slotting fees in exchange for excluding new entrants, barriers to entry are increased and entry can be deterred or marginalized. In the absence of sufficient competition among established brands, this can permit the manufacturer to charge higher wholesale prices, which then would be passed through to consumers in the form of higher retail prices. Where the slotting fees both raise rivals' costs and create, enhance or maintain market power, consumer harm can result. This is just an application of the general analysis of exclusive dealing and exclusionary rights. In the absence of sufficient offsetting efficiency benefits, the exclusives are anticompetitive.
26. Of course, this analysis raises the question of why the entrants can't simply compete in the "market" for exclusives. I have written about this issue in detail elsewhere.<sup>5</sup> In my view, competition for exclusives is not inherently competition on the merits. When a firm pays a retailer for an exclusive, it is not simply paying for distribution. It is also paying for the right to exclude new entrants from the store, even if the store has room for both brands. In this sense, it may be purchasing market power as well as distribution. In fact, the purchase of market power might be the primary motive. Of course, exclusives can be beneficial when they eliminate free riding or create other similar efficiency benefits. But, those interbrand benefits are not inherent in every exclusive. In fact, where there are exclusives, interstore price competition may be softened by the fact that the stores' offerings are differentiated.
27. The exclusive tends to be worth more to a dominant incumbent than undoing the exclusive is worth to an equally efficient entrant. This is because the entrant can earn only the (more competitive) duopoly return, whereas a dominant incumbent can earn the monopoly return. For example, suppose that the incumbent could earn \$200 if it gets the exclusive and so retains its monopoly. If the entrant gets distribution and breaks the monopoly, suppose that both the entrant and incumbent each would earn \$70, for a total of \$140. Because competition transfers wealth from producers to consumers, the total profits fall from competition (e.g., from \$200 to \$140). In this case, the entrant would be willing to bid up to \$70 to obtain distribution. In contrast, the incumbent would be willing to bid up to \$130 to prevent the entry, an amount equal to the reduction in its profits from competition. The incumbent thus would win the bidding. This result obtains as long as the aggregate profits fall

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<sup>5</sup> See T. Krattenmaker and S. Salop, *Anticompetitive Exclusion: Raising Rivals Costs To Achieve Power Over Price*, 96 Yale L.J. 209 (1986); S. Salop and R. C. Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards and Microsoft*, 7 George Mason L.R. 617, 637-8 (1999).

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from competition.<sup>6</sup> This example also shows why competition for shelf space can not be assumed to reach the efficient outcome.<sup>7</sup>

28. This is not a "deep pocket" argument. The incumbent's bidding advantage comes from the fact that it is already established and the fact that monopoly profits exceed duopoly profits. Entry barriers are raised because the entrant's need to outbid the incumbent artificially raises its fixed costs of entry. The cost increase is "artificial" in the sense that the exclusivity does not have real and direct efficiency benefits, but instead is designed to raise barriers to entry.
29. Nor does competition for exclusives between a dominant incumbent and a new entrant take place on a level playing field that is likely to maximize consumer welfare. Even if the exclusives are short term, an entrant faces a coordination problem in that it needs to get enough distribution to achieve minimum viable scale and maintain adequate investment incentives. The exclusives also can lead retailers to expect the entry to fail, raising the fees the entrant must offer. In addition, if the exclusives are long term and involve staggered expiration dates, the period before the entrant can achieve viability is lengthened and retailer expectations of the entrant's failure are reinforced. Thus, fixed slotting fees can succeed in creating entry barriers without creating net consumer benefits.
30. This raises the question of why a retailer would cooperate in allowing its supplier to achieve market power. This result can occur for two reasons. First, a single retailer ignores the effect of its decision on others. As a result, the supplier can compensate the retailer for its own harm and still earn money from the incremental power gained with respect to others. Second, if a retailer believes that the entrant likely will fail because other retailers are granting exclusives, then it would not require significant compensation to grant exclusivity as well.<sup>8</sup> Both these reasons flow from the same point: *competition is a public good*.
31. One last caveat, however. In this analysis so far, I have been assuming that the slotting fees involve fixed payments. The situation is more complicated when the payments are made in the form of wholesale price discounts that remain above cost. The discounts will tend to be passed through to

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<sup>6</sup> S. Salop, *Strategic Entry Deterrence*, 69 American Economic Review (Papers and Proceedings) 335 (1979). See also S. Borenstein, *supra* note 3.

<sup>7</sup> Long run entry by new retailers could lead to additional shelf space in the market. But, there are natural scale economy impediments that limit this entry. And, the incumbent could outbid the entrant for this exclusive too.

<sup>8</sup> E. Rasmusen, D. Ramseyer and J. Wiley, *Naked Exclusion*, 81 American Economic Review 1137 (1991).

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consumers in the form of lower retail prices and, thus, create a short run consumer benefit that must be balanced.<sup>9</sup>

32. Thus, a full rule of reason analysis would evaluate the impact of the slotting fees on competitors, competition and efficiencies, in order to evaluate the net effect on consumer welfare. Given the complexity of these issues and the multidimensional effects of lump sum slotting fees and other forms of trade spending, a cautious antitrust approach is appropriate.

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<sup>9</sup> In the case of fixed slotting fees, the fees will not be passed through directly, but can lead to potential consumer benefits in the longer run, as discussed above.