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**The Determinants of Retailer Power within Retailer-
Manufacturer Relationships: Evidence from the Irish Food
Manufacturing Industry**

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Abstract

This research investigates the determinants of retailer power within retailer-manufacturer relationships by specifying and testing three models of retailer power. It is based on a sample of 55 Irish food manufacturers and their experiences of relationships with Irish and British retailers. The study adopts the view that the existing body of research into relationships with retailers is fragmented, and that a more complete understanding of these power relations may be obtained by simultaneously focusing on three sets of factors. The factors are industry specific, firm and product specific, and relationship specific.

Much of the existing empirical work investigating power relations implicitly assumes power to be unidimensional through the measures employed. Consequently, the current study investigates retailer power, measured as a unidimensional construct. However, the work proceeds to explicitly acknowledge that power is multidimensional by examining retailers' power over manufacturers' product related and margin related activities. In examining these two dimensions of power, findings of a more strategic nature are obtained.

The analysis draws on the importance French and Raven (1959) attributed to observability as a determinant of power. While neglected throughout the power literature, observability, by introducing monitoring activities, provides a bridge with the transaction cost literature. In this way, specific investments, and the role of retailers' branding strategies, are incorporated into our study of power. The relationship between retailers' monitoring activities and power is specified. Proceeding from monitoring activities, the analysis sheds light on the determinants of inter-firm integration between retailers and food manufacturers. The role of specific investments, symmetric dependency, brand portfolio

and retail influence on price are highlighted. The analysis of retailers' product related power supports the role of retail concentration, product shelf-life, manufacturer specific investments and retailers' product monitoring activities. Examining retail margin related power points to the importance of retail concentration, own brand penetration, the importance of economies of scale in manufacturing, product shelf life and manufacturer specific investments. Finally, retail power, measured as a unidimensional construct, is found to be related to own brand market penetration, the importance of economies of scale in manufacturing, manufacturer specific investments and retailers' monitoring activities.

Chapter One

The Determinants of Retailer Power within Retailer-Manufacturer Relationships: Evidence from the Irish Food Manufacturing Industry

1.1 Introduction

There is a growing body of literature that provides evidence of increasing retail involvement in food manufacturing activities. This body of work supports the view that food retailers are gaining greater control over strategic activities, which were formerly the remit of manufacturers. Indeed it appears that some food manufacturers are accommodating greater retail influence over strategic variables, which are themselves the source of the manufacturer's competitive advantage. The basis for such accommodations and the increase in retailer power is imprecise. An examination of the relevant literature points to a series of variables that may contribute directly or possibly indirectly to the growth in retailer power. Examples include greater retail concentration, excess capacity in manufacturing, the growth in own brand penetration, more strategic use of own brands, retail integration into the distribution function and the emergence of strategic alliances among retailers and suppliers. However the existing literature is fragmented and does not clearly take account of the potential interconnections among these variables. Consequently some variables may be attributed with determinacy, which may be more appropriately posited elsewhere.

Another trend clearly emerging from the literature is the move away from market contracting towards more "domesticated" markets with pronounced features such as

relationship stability and idiosyncratic investments. Focus is shifting from competition among firms at the same level of the marketing channel to chains of competing firms identified by their retail customer. Such developments have potentially unwelcome effects such as increasing barriers to entry and exit and ultimately in the move towards more retail specific supply chains. Under these conditions, manufacturers are more likely to face the prospect of having to tie their allegiance and futures to individual retailers. The concern here is that under such a regime, the disproportionate burden of risk is borne by the manufacturer.

From a manufacturer's perspective, a greater understanding of the dynamics of retailer power is critical. While it is proposed here that greater retail influence over manufacturing activities is not in itself undesirable and may indeed be very positive, the surrender of control over key strategic variables is not to be advised without extreme caution. This study sets out to investigate the factors that determine the extent to which manufacturers have ceded control to retailers. In doing so, it proposes to highlight some of the hidden costs of doing business in an environment where retailers, for the moment, dominate. Because the study focuses on industry, firm and mode of governance characteristics rather than on individual retailers, the results should be more general providing applicability across a range of retail markets and manufacturing industries.

The purpose of this study is to investigate the determinants of retailer power and influence over food manufacturers' activities. In particular, the research proposes to:

- identify the range of food manufacturing activities over which retailers exert influence and power ;
- identify the factors that promote and facilitate such retail control;

- To specify a model of retailer power and to estimate the contribution of each factor in the determination of retail power.

Chapter two commences our review of the Irish grocery and food manufacturing sectors. It is largely contextual. It adopts an evolutionary approach, tracing the development of the Irish grocery sector since the 1950's. It highlights the changes that have occurred in the Irish grocery channel over the period and points to some of the key drivers of change. One of the chief aims of the review is to gain a deeper understanding of the nature of the interaction between the grocery and indigenous food manufacturing sectors over the period. The second aim of the chapter is to ascertain whether or not the Irish food manufacturing sector can act as an appropriate sampling frame for the study of retailer-manufacturer relations in the food sector in general. To address this issue the chapter examines the diversity of trading relationships that the Irish food manufacturing sector enjoys. This part of the chapter is based on primary research, as little secondary information existed regarding this issue. As much of the study takes individual retailer-manufacturer trading relationships as its basic unit of analysis one requirement is to ensure that our sampling frame offers a sufficient degree of variation of such relationships.

Chapter three sets out to identify constructs and measures that may prove fruitful in the pursuit of this study. It reviews the existing literature on the organisation of economic activity within a series of vertical relations. The chapter initially focuses on the marketing channel literature, which draws heavily on the construct of power. The review aims to develop a clear understanding of the power construct as it evolved through the literature, the units of measurement employed by earlier authors and their findings with respect to power and vertical relations. The second part of the chapter reviews an alternative

explanation of the co-ordination of vertical relations as espoused in the neoclassical model. In particular, the review focuses on the emergence of the transaction cost literature. This literature is selected primarily because it facilitates the incorporation of information asymmetries, monitoring costs and specific investments into the study. It is argued that by considering both these literatures, a pool of mutually consistent constructs may be identified, which can aid a more detailed examination of our specified relationships and yield a more potent insight into and a deeper understanding of retailer power and influence.

Chapter four focuses on the existing literature on retailer-manufacturer relationships. The purpose of the chapter is to assess the work of earlier scholars, the hypotheses tested, methodologies employed and the findings on interrelationships that exist between the sectors. The chapter sets out to gain a deeper understanding of the determinants of the balance of power within retailer-manufacturer relationships and, by considering the existing literature as a whole, establish a broader perspective in which to base the current study. In this fashion the chapter acts as the basis for formulating a series of hypotheses drawing on existing work but extending it by establishing new or formerly implicit interconnections.

Chapter five addresses the methodology to be employed to test the hypotheses established in chapter six. The chapter has two major concerns. The first is the composition of an appropriate sample to test the hypotheses. The second is to construct a series of measures with which to test the hypotheses. Much of the chapter is given to testing the individual measures to establish that they measure what is required in a reliable fashion. Consequently that chapter devotes considerable effort to establishing construct validity.

Chapter six develops and tests the series of hypotheses that forms the basis of this study. Because of the fragmented nature of existing empirical research on retailer-manufacturer power relations, the chapter adopts a cumulative approach. The chapter formulates a series of hypotheses based on earlier research, which cumulatively establish a more precise understanding of the determinants of retailer power. In this manner the hypotheses are intended to build upon one another. Thus each finding represents a potential building block for a more complete understanding of retailer power. One of the strengths of such a broadened perspective is that it facilitates separating out determinants of retailer power. More focused studies, while having their own particular strengths, run the risk of identifying second order determinants as primary determinants because of the imposed restriction on variables gathered. The chapter is based on the framework that retailer power may be viewed as acting through three sets of characteristics:

- industry structure (retailing and manufacturing);
- firm and product characteristics ;
- and mode of governance.

The hypotheses are organised according to this framework and, when considered together, provide a broader and more detailed study of the phenomenon under review.

Chapter seven provides a more considered discussion of our results. Given the cumulative nature of the results chapter, chapter seven draws on all our findings. It considers the identified relationships and associations among the variables employed in more detail and, based on the findings, establishes three models of retailer power. The first seeks to explain retailer power over manufacturers' margin related activities. The second seeks to explain retailer power over manufacturers' product related activities, while the third seeks to explain retailer power when measured as a unidimensional construct. In the ensuing

discussion, the findings are integrated into the existing literature highlighting its unique contributions. To complete the study the chapter highlights some of the limitations of the current investigation and points to some research questions emerging from the work.

Chapter Two

The Irish Grocery and Food Manufacturing Industries

2.1 Introduction

The structure of the Irish grocery trade has changed considerably over the last forty years as the forces of demographic trends, legislation and technology in addition to changing consumer needs and preferences shaped and continue to shape the grocers' trading environment. Over the period, structural change in the grocery sector has had substantial consequences for the operation of the entire marketing channel delivering food products to the Irish consumer. The role of the wholesaler has evolved substantially, embracing many of the functions associated with the retail operation. Grocers themselves found the nature of their business changing rapidly as economies of scale and scope, in conjunction with legal constraints, came to play a central part in the way they operated and in the determination of their profitability. While some grocers have prospered, managing to adapt to the changing times, others have succumbed to competitive pressures. Moreover, there has been an increasing awareness of the role of the grocer as an integral agent in the food marketing chain. The nature of retail and manufacturer/supplier relations is being subjected to closer scrutiny as awareness of its impact on the allocation of scarce resources, employment and consumer satisfaction increases.

The purpose of this chapter is twofold. First, it sets out to examine the conditions underlying the evolution of the Irish grocery market over the last forty years and to assess the impact, if any, on the evolution of the retailer-manufacturer relations. The analysis takes the mid 1950's and the abolition of resale price maintenance as its starting point and proceeds to evaluate the

effect of price competitive forces on a heretofore protected sector. It investigates the conditions underlying the emergence of the multiple grocer together with the conflict and resultant change that this new phenomenon introduced to the food marketing channel. The role of the legislature is central to the unfolding of competitive pressures in the Irish market and the development of the Irish retail environment and as such is an integral part of the review.

Second, the analysis turns to the food manufacturing sector, focusing on its development since entry to the EEC, and evaluates the extent of its dependency on both domestic and foreign retail markets. Here the concern is with the scope of Irish food manufacturers' portfolio of retail markets and the range of demands to which they have had to respond. The analysis focuses on food manufacturers' dependency on the UK market in particular. While both the Irish and UK markets display some similarities, they have differed significantly in many strategic aspects of their businesses, e.g. own brand, distribution, use of technology etc. Finally, the chapter draws the two sectors together highlighting the nature of the dependency that exists between the manufacturing and the retailing sectors.

One of the chief difficulties in researching the Irish grocery sector is the lack of reliable performance data on the main operators. This is due primarily to the fact that the sector is dominated by private interests who are under no obligation to release details of their commercial performance into the public domain. Other substantial operators have tended to be foreign owned with their accounts consolidated into their parents' returns. Therefore much of the data utilised below were sourced from enquiries into the grocery sector by various agencies. Market share figures are frequently used. However, caution needs to be used when

interpreting them. First, as they measure share within selected and limited product fields, they serve as limited proxies for the overall market. Second, the product fields measured change over time with additions and deletions occurring on a relatively frequent basis. Unfortunately the first problem cannot be surmounted. The second problem has been minimised by using data series as they appear in existing literature. This is considered to be appropriate as much of the data obtained was furnished to government advisory bodies such as the Restrictive Practices Commission.

2.2 Retail Competition and the Channels of Distribution

At this point, it is appropriate to examine the nature, evolution and consequences of competition within the grocery sector. The 1955 enquiry into the grocery trade by the Fair Trade Commission resulted in the implementation of the first (1956) Groceries Order and the abolition of resale price maintenance (Fair Trade Commission 1956) (Hereafter FTC 1956). Since then there have been three further public enquiries and four reviews of the Restrictive Practices act as it applies to the grocery trade. This level of scrutiny has been primarily due to the dramatic evolution of the sector and the concerns raised about the nature of competition and the consequences for independent grocers, manufacturers and consumers.

2.2.1 The Demise of the Wholesale and Independent Sector

Traditionally the grocery wholesaler played an important role in the supply chain for food products in the Irish market. However, in the early 1950's it became apparent that changes were occurring to wholesalers' share of trade. While imported goods were channelled through

wholesalers, an increasing proportion of domestically produced products were being purchased directly from manufacturers. The principal agents behind this trend were the larger grocers in the Dublin area where most of the large manufacturers were also situated (FTC 1956).

The emergence of the multiple grocer had not yet gathered any real momentum. These grocers existed to a limited extent in Dublin and on a very localised basis throughout the country (FTC 1956). However, where they did exist, their limited geographical distribution facilitated a considerable degree of centralised control. In many instances store managers had discretion only with respect to the purchase of perishable produce, while longer life products were purchased by the organisation's head office. Many of the existing multiples also carried out much of their own distribution, with most operators conducting a wholesale business. In these cases, manufacturers delivered to the wholesale warehouse, where the individual store's orders were assembled and dispatched to the outlet.

Retail trade associations played an important role in the marketing channel during the 1950's. The largest of these was the Retail Grocery, Dairy and Allied Trade's Association (RGDATA). One of the more important functions of this organisation was to ensure "fair profit margins for its members in commodities, the prices of which are either officially controlled or fixed by manufacturers" (FTC 1956:41) and the maintenance of the independent grocers' position in the marketing channel. One of the more interesting activities carried out by RGDATA was the policing of competition among its members to ensure adherence to the pricing regime under the conditions of resale price maintenance. There is strong evidence indicating the anti-competitive stance of the association. RGDATA itself argued that " the

force of competition and the desire of manufacturers to achieve low prices and capture a wider share of the market is so great that an association such as RGDATA is most necessary to offset the inequality of bargaining power of the individual grocers when faced with strong manufacturers” (FTC 1956:42). Indeed the Association frequently took upon itself to report price-cutting grocers to the manufacturers concerned, requesting that forces be brought to bear and either prices restored to recommended levels or supplies disrupted (FTC 1956). Manufacturers who failed in this regard risked being boycotted by the organisation’s members.

The level of retail price competition prior to the abolition of resale price maintenance was minimal with many products subject to price control. For instance, wholesale and retail prices were specified by order of the official price control for both butter and sugar. Manufacturers or suppliers specified the retail price for most other domestically produced and some imported products. The price was usually enforced through price marking, advertising or direct instructions to the grocer (FTC 1956:24). There is evidence that failure to charge prices in accordance with recommendations regularly resulted in discontinuity of supply (FTC 1956). Manufacturers frequently attempted to specify wholesale prices although allowances were usually made to permit consideration of competing brands.

There is evidence to suggest increasing interchannel competition with manufacturers attempting to usurp the wholesalers’ role. “In many instances however, the gross margins available to wholesalers make it economically difficult for all but a small number of wholesalers to compete with manufacturers for the business of grocers whose orders entitle them to quantity terms at higher rates” (FTC 1956:33). Indeed it appears that price

competition was more intense at wholesale level, with manufacturers, wholesalers and retail buying groups all competing for the affections of the grocer. Further pressure was exerted on the wholesale sector by grocers claiming wholesaler status and attempting to qualify for discounts from manufacturers. These discounts served to either enhance the grocer's profitability or price competitive position. The difficulty of identifying genuine wholesalers was clearly recognised by various manufacturers but it does not appear that concerted efforts were made to restore a level playing field (FTC 1956).

During the 1950's and 1960's, most channel innovation concerning the role of either the grocer or wholesaler occurred in the Dublin area. This is unsurprising given the geographical distribution of the population and the increasing concentration of consumer purchasing power in and around the capital. One such innovation was the establishment of the retail buying group, Allied Dublin Merchants (ADM) in 1954, which had a significant impact in the wholesale market in the Dublin area. This development appears to have been the first major onslaught by a component of the retail sector on the wholesale function. The retail members of the group were its shareholders and provided the initial capital investments required to set up and operate a warehouse. Many of the individual members had sufficient scale to purchase supplies at the optimum terms provided by manufacturers. However, the buying group enabled these to achieve increasing efficiency through better management of stocks and increasing stock turnover (FTC 1972).

ADM's success had an immediate impact on the channel. Despite initial difficulties in acquiring wholesale terms from many manufacturers, the group stimulated intense competition within the wholesale sector. While RGDATA frequently took upon itself the role

of price advisor with government, manufacturers and suppliers alike, it had not intended to act as a purchasing agent for its members. However, in light of continued pressure from its members, due no doubt to the success of ADM, RGDATA established Merchants National Co-operative (MNC) as a wholesale buying society in 1956. Within three years the co-operative was operating three depots located in Dublin, Cork and Ballyshannon.

The pressures on the wholesale sector were partly self induced. Throughout the late 1940's and early 1950's, wholesalers through their trade associations, attempted to fix prices to grocers and obtain optimal terms from manufacturers and suppliers. The size of these fixed margins would have proved alluring to the manufacturing, importing and retailing sectors. Consequently many of these firms internalised the more attractive aspects of the wholesaling function. Manufacturers' ability to identify the more lucrative segments of the retail business and grocers' ability to identify the more attractive product areas would have left wholesalers operating in fewer attractive product areas and serving the more costly components of the grocery market. Indeed manufacturers' prices direct to grocery outlets would have had the effect of reducing the wholesale margins, particularly in the concentrated Dublin market.

Given the constraints imposed by resale price maintenance, retail competition during the 1950's was largely based on differentiation with emphasis on service. Multiples competed on the basis of delivery services, credit facilities and product range (FTC 1956:21). However, moves to reduce costs through the reduction of these services were already appearing in the Dublin market (FTC 1956:23). In general, multiple operators, because of their volume purchases or wholesaler status, were given better buying terms than the single outlet operator, although the generosity of the terms varied from manufacturer to manufacturer (FTC

