Emerging Trade Practices and Trends in Fruit and Vegetable Markets

By

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My speech focuses on research findings from a recently released Economic Research Service (ERS) study I co-coordinated with Linda Calvin of ERS, entitled "U.S. Fresh Fruit and Vegetable Marketing: Emerging Trade Practices, Trends, and Issues."[1] This study is one of three undertaken by ERS to assess the changing nature of the relationship between fresh fruit and vegetable shippers and food retailers, and the implications for competitive behavior. The study presented today was designed to identify and characterize the types of trade practices used in the produce industry, including fees and services provided by shippers, contracts, and other marketing strategies. The study responded to the growing national attention and interest in fresh produce trade practices.

Starting in 1999, the Federal Trade Commission and the U.S. Senate Committee on Small Business conducted hearings in which industry leaders, government officials, and academics offered their perspectives on how both the recent wave of supermarket mergers and the growth of new trade practices have affected various industries, including fresh produce (U.S. Senate, 1999 & 2000; Federal Trade Commission, 2000). Shippers are concerned that recent retail consolidation has led to market power and the growing incidence of fees and services. Retailers argue that these new trade practices reflect their costs of doing business and the demands of consumers.

Trade practices is a broad term that refers to the way shippers and retailers do business, including fees such as volume discounts and slotting fees (see box), as well as services like automatic inventory replenishment, special packaging, and requirements for third-party food safety certification. Trade practices also refer to the overall structure of a transaction—for example, long-term relationships or contracts versus daily sales with no continuing commitment.

[1] By Linda Calvin and Roberta Cook (coordinators); Mark Denbaly, Carolyn Dimitri, Lewrene Glaser, Charles Handy, Mark Jekanowski, Phil Kaufman, Barry Krissoff, Gary Thompson, and Suzanne Thornsbury. Market and Trade Economics Division, Economic Research Service, U.S. Department of Agriculture. Agricultural Economic Report No. 795.

This study compares trade practices in 1999 with those prevalent in 1994, placing them in the broader context of the evolving shipper/retailer relationship. To augment information that is publicly available, we interviewed 74 produce shippers, retailers, and wholesalers about their firms and trade practices. The interviews focused on seven products: California grapes, oranges, and tomatoes; Florida grapefruit and tomatoes; and California/Arizona lettuce and bagged salads. The retail and wholesale sample included eight national chains (three headquarter and five division offices), six midsize regional chains, and three large general-line wholesalers. The buying firms were queried about these same products so that shipper and retailer responses on trade practices for each of the respective products could be compared. Some highlights of the study follow.

Study Highlights

Retail Concentration. The 4 largest retailers' share of grocery store sales rose from 17 percent in 1987 to 27 percent in 1999, the share for the top eight rose from 27 to 38 percent, and the share of the 20 largest grew from 37 to 52 percent. Shippers are concerned about the accelerated pace of consolidation in part because market structure is still very fragmented at the shipper level for many commodities, implying low countervailing power relative to the fewer, larger buyers.

Shipper Concentration. While shipper consolidation is occurring, it varies significantly across commodities. For example, in 1999 there were 149 California grape shippers with none estimated to account for over 6 percent of total industry sales. In contrast, there were only 25 California tomato shippers, with the top four and eight shippers accounting for 43 and 70 percent, respectively, of total 1999 California tomato sales. While there were 54 bagged salad firms selling to retailers, the top 2 firms accounted for 76 percent of total fresh-cut salad sales in supermarkets. Hence, for a few fresh produce items, concentration of sales at the shipper level has surpassed that of retailers, even though the sales of these firms are still small relative to those of the large retail chains.

Many Factors Affect the Shipper/Retailer Relationship. Retail consolidation is not the only factor affecting the shipper/retailer relationship. Changes in consumer preferences for variety, convenience, and food safety; changes in technology; and changes in shipper consolidation have all played a part in the evolution of the two industries and their interactions. For example, recent low f.o.b. prices experienced in the fresh orange industry are likely related in part to emerging consumer preferences for more convenient and often imported substitutes known as “easy-peelers,” such as clementines, independent of retail consolidation.

Number of Buyers. Despite perceptions to the contrary, when shippers reviewed their records, many found relatively small changes in the number of regular customers when considering all buyer types. While some shippers reported a decrease in the total number of customers, roughly as many reported an increase. Most shippers believed that the number of retail customers had declined, and the majority viewed this as harmful. Other shippers were selling to fewer but larger retail accounts and felt this reduced their transaction costs. With declining retail customers, most shippers thought they had less negotiating power and were more fearful of losing accounts if they did not comply with buyer requests. Some shippers were replacing retail accounts with other types of buyers, sometimes due to declining competitiveness in serving the needs of large retailers. In any case, many shippers are adjusting their marketing strategies to sell to other types of buyers.

Marketing Channels. The share of sales to conventional retailers was either stable or declining for all products. Regardless of how marketing channel shares changed over the 1994-99 period, direct grocery retail sales remain the most important marketing channel for sales of all the products studied except California and Florida tomatoes (tomatoes are typically sold to repackers servicing final buyers). Although the share of total sales to conventional retail buyers did not increase for any product in our sample, for grapes, oranges, and California tomatoes, the absolute dollar volume of sales to this channel did increase. This was due to growth in the total sales volumes for the sampled firms rather than an increase in the retail share of total sales.

Increasing Role for Mass Merchandisers. An important factor affecting the share of produce sold to grocery retailers is the growth in competition from mass merchandisers. The share of shipper sales to mass merchandisers, although starting from a small base, was up across all commodities with the largest gains in grapes, oranges, and grapefruit. The competitive effects of mass merchandisers on conventional retailers are evident in that the share of direct sales to conventional retailers was stable or declining in the face of the growth in direct sales to mass merchandisers, consistent with broad food industry trends. Combining mass merchandisers (also retailers) with conventional grocery retailers, the “retail” share of sales increased for every crop considered except California and Florida tomatoes. This broader definition captures the evolving structure of the U.S. food marketplace in which a new type of retailer is playing a greater relative role.

Retail Buying - Corporate, Division, and Field Buyers. While consolidating retailers often cite the potential for lowering procurement, marketing, and distribution costs, many recently merged chains are still in the process of integrating their buying operations. Indeed, over the last 5 years, retailers reported that the number of their buyers remained fairly constant at the corporate and division levels, although 18 percent reported a decline in field buyers. As retailers fully integrate their acquired chains and implement new procurement models designed to streamline the supply chain, the buying practices of retailers may become more centralized than they have to date.

Importance of Largest Buyers. While the total number of buyers of all types may not have changed much for most shippers over the last 5 years, the importance of the largest buyers has increased, but only slightly. The share of the top four buyers of total shipper sales ranges from 22 to 45 percent of sales, depending on the product. The largest increase in this share was for Florida tomato shippers, from 34 percent in 1994 to 45 percent in 1999. Such dependence may compromise shippers' power in negotiating with buyers over prices and requests for fees and services.

Importance of Largest Suppliers. For their part, retail buyers reported quite concentrated purchases, with their top four suppliers providing from 85 to 97 percent of total purchases depending on the product. As retailers source from fewer suppliers, shippers will likely become more account-oriented in their marketing strategies, providing products and services tailored to the needs of specific large accounts. These trends may be consistent with greater payment of fees; as the value of the business generated by individual accounts grows, suppliers may feel increased incentives to comply with fee and service requests to gain or keep the business.

Daily and Advance Sales. Traditionally, the fresh produce industry has concentrated on daily sales. For commodities (grapes, oranges, grapefruit, and tomatoes), daily sales remain the most important sales mechanism across all types of buyers, but the share declined from 72 percent in 1994 to 58 percent in 1999. The use of advance pricing arrangements for promotions increased from 19 to 24 percent over the same time period and it appears that the number of weeks in advance for which prices are fixed has grown as well.

Use of Contracts. The use of contracts is also becoming more common as a means for managing risk. The emergence of forward contracting in the produce industry is a reflection of the growing emphasis on supply chain management. This procurement model is designed to more closely coordinate supply and demand and reduce non-value adding transaction costs. The point of distinction (between contracts and daily sales) is ongoing sales and marketing agreements with buyers versus single shipments. In 1999, short-term contracts accounted for 11 percent of total commodity sales (grapes, oranges, grapefruit, and tomatoes) through all marketing channels, and long-term (annual or multiyear) contracts 7 percent. Between 1994 and 1999 growth came entirely in the use of long-term rather than short-term contracts. Indeed, mass merchandisers apparently substantially reduced their use of short-term contracts in favor of long-term contracts over this period. Our commodity shipper sample reported that 29 percent of their sales to mass merchandisers were under long-term contract in 1999, compared to 13 percent in 1994, while short-term contracts declined from 48 to 41 percent of the sample's sales through this marketing channel. Lettuce sales mechanisms through all marketing channels in 1999 were similar to other commodities, except all contracts were long term. Bagged salad shippers indicated that annual or multiyear contracts are the standard for retail sales.

Contract Mechanisms. Contract mechanisms for managing price and volume varied but the most common arrangement, accounting for 29 percent of the contract types reported, was fixed price contracts with minimum volumes, followed by fixed price contracts with a volume range, at 23 percent of the total. Automatic inventory replenishment contracts were also becoming more common, representing 14 percent of the contract types and indicating the growing importance of mass merchandise channels, where these are most commonly used. Forward contracting mechanisms are expected to continue to evolve as firms grapple with the challenges of managing risk and profitability in the sale of perishable commodities where weather can substantially and unexpectedly affect supply, demand and quality, generating serious ramifications for market prices.

Fees and Services. Most shippers and retailers reported that the incidence and magnitude of fees and services associated with transactions had increased over the last 5 years; a few tomato shippers reported no change. Data were collected from commodity shippers on actual fees paid to the top five retailer and mass merchandiser accounts. They were usually around 1-2 percent of sales for most commodities. Bagged salad firms reported a range of fees paid of 1-8 percent for all retail accounts. Fees paid to all retailer and mass merchandiser accounts averaged $5,200 and $8,700 per million dollars of sales, respectively, for the interviewed grape and orange shippers, compared with $10,100 for the grapefruit shippers and only $1,300 for California tomato shippers. Fees can make the difference between profit and loss, especially for commodity shippers who act as price takers and are therefore less able to pass costs along to customers. Services per million dollars of sales were less than fees for all the commodity samples, averaging from $1,200 for grapes to $4,400 for grapefruit. However, many firms did not keep close track of the cost of fees and, in particular, services. This is likely to change if fees and services continue to grow.

Types of Fees. Overall, 48 percent of the types of fees requested were new in the last 5 years. The most frequently paid type of fee is the volume discount, a trade practice that has been used for years, although shippers agree that the incidence and magnitude of this fee has increased. Shippers generally viewed this fee as having a negative or neutral impact on their business. Still, volume incentives have the potential to promote a more stable relationship between suppliers and retailers; as the retailer buys more units from the supplier, costs per unit decline, providing an incentive for the retailer to buy larger quantities (over the season) from a particular supplier. Shippers may also gain efficiencies in marketing by increasing the size of accounts. However, many shippers felt that volume discounts make more sense as a trade practice for branded food products than for produce commodities, arguing that they don’t sell off of a list price with built-in profit margins.

Slotting Fees and Fresh-Cut Produce. While slotting fees (defined, in this case, as an upfront fee to gain retail shelf space for a new or existing product) have long been used in the grocery store outside of fresh produce, they recently entered the fresh produce department with the advent of fresh-cut fruits and vegetables. Slotting fees are now common for fresh-cut produce and may be either requested by retailers or offered by shippers. Most bagged salad shippers reported that it was shippers, not retailers, who first introduced slotting fees to this industry in an attempt to buy market share from their competition, and that the fees began prior to the last wave of retail consolidation. None of the bagged salad shippers revealed the exact size of the slotting fees requested or paid by their firm or for individual accounts, but several talked about the general use of slotting fees in the bagged salad industry. Slotting fees were reported to range from

$10,000-$20,000 for small retail accounts to $500,000 for a division of a multiregional chain, and up to $2 million to acquire the entire business of a large multiregional chain. Some bagged salad firms have shifted to selling private-label product rather than their own brands because slotting fees are not used in that segment of the industry.

Slotting Fees and Commodities. Commodity shippers fear that slotting fees will become standard practice in their industries now that they have been introduced into one section of the produce department. However, in contrast to fresh-cut shippers, none of the commodity shippers reported paying slotting fees as defined above. A few were asked to pay though, and some lost accounts when they failed to comply. In addition, a few paid fixed, upfront promotional allowances and equated these with slotting fees. While lettuce shippers did not pay slotting fees, they have felt the effect. Shippers paying slotting fees for bagged salads and also selling lettuce were thought to have an advantage over lettuce-only shippers because buyers were receiving, in effect, slotting fees on a bundle of products.

Types of Services. Service requests are also increasing, with 77 percent of requests reported as new in the last 5 years. According to shippers, the most common service requested is third-party food safety certification, with one-third viewing it as harmful and the remainder feeling that the impact of providing this service is beneficial or neutral. Despite all the recent attention given to category management in the produce industry, only 28 percent of shippers reported having received a request to supply this service, with 19 percent actually providing this kind of technical support to retail clients.

Comparing Fees and Services. Shippers tended to believe they receive more benefits from providing services than from paying fees. Hence, 79 percent of service requests were complied with, compared to only 58 percent for fees. The consequences of non-compliance were greater for fees than services, with 41 percent of fee requests not complied with resulting in lost accounts, compared to 21 percent for service requests.

Adverse Effect on Smaller Shippers. Fees and services can more adversely affect smaller shippers if they are fixed and equal in cost across all shippers. While fees are generally per-unit costs, services are mainly fixed costs and so may be more difficult for small shippers to implement since they are spreading the costs across fewer units. If requests for fixed fees and services grow, smaller shippers may need to seek alternative buyer types. Preliminary canvassing of shippers for this study indicated that smaller shippers were already selling very little to retail buyers. Aside from the issue of fees and services, small shippers are generally unlikely to provide adequate volume to supply large retailer needs.

Conclusions

Current concern focuses on the potential for slotting fees to enter the commodity side of the fresh produce industry. However, all types of fees can affect a firm's bottom line. Commodity firms do pay fees, and they are increasing. In 1999, fees of all types averaged about 1-2 percent of sales for most commodity shippers, but ranged from 1 to 8 percent for bagged salad shippers. Given low margins in the fresh produce shipping industry, these fees may be sufficient to determine whether a firm earns a profit or loses money over the course of a season. Hence, this research demonstrates that a focus on slotting fees is far too narrow when examining fees paid by shippers.

Why are fees and services increasing in incidence, magnitude, and type? What lessons can be learned from the experiences of the products studied here? A one-size-fits-all explanation is most likely a simplification. We can say that, in general, the relationship between shippers and retailers has changed, but only partly due to retail consolidation. Retail consolidation does not necessarily lead to market power. Market power may, indeed, play a role in new trade practices but that is an empirical question to investigate. Fees and services are also a function of several complex factors such as changes in consumer demand, technology, supply and demand conditions, shipper marketing strategies, buyer procurement strategies, the structure of the shipping and retailing industries, and the level of interfirm rivalry.

Another pressing question is whether slotting fees will eventually become common in commodity transactions. Bagged salad shippers, as sellers of a differentiated, branded product requiring dedicated shelf space year round, are more able to incorporate slotting and other types of fees into their pricing structures and may find that slotting fees can provide a benefit to their firms in terms of acquiring shelf space. In contrast, commodity shippers as price takers are less able to incorporate slotting and other types of fees into their cost/pricing structures so incentives are low to offer slotting fees as a strategy for capturing market share from competing suppliers. Even if retailers have market power, it may be difficult to apply slotting fees to commodities unless and until they are available year round from a relatively consolidated shipper structure.

Hence, while current conditions in the commodity side of the business may not lend themselves to slotting fees, this may change. If more commodity shippers consolidate or form strategic alliances to match the needs of fewer, larger buyers and become year-round operators capable of supplying large, consistent volumes with the quality specifications desired by individual accounts, it may be easier for retailers to request slotting fees. However, if a consolidated shipper structure were to prevail, it is not a given that slotting fees would become the norm since countervailing power could help shippers resist these fees. The intensity of interfirm rivalry becomes critical at this point; with shippers either capable of resisting fees or offering them as a strategy for capturing market share from competitors. On the other hand, if retailers focus on supply chain management approaches where they operate more in partnership with preferred suppliers, slotting fees may be less of a factor.

Finally, the research highlights the evolution of the produce industry toward a more vertically coordinated marketing system with many sellers attempting to provide more services and greater volumes of consistent quality produce to meet the needs of increasingly larger retail buyers. For many commodities large buying firms are becoming more dependent on a few key shippers capable of meeting their more complex needs. Smaller and medium size shippers are often selling more to other types of buyers, including wholesalers, foodservice and independent retailers. However, consolidation is also occurring in wholesale and foodservice channels, highlighting the future need for smaller shippers to target markets in which they can compete effectively. The diversity of fresh produce (more than 350 items/varieties sold) and consumer segments continues to offer opportunities for niche players with focused marketing strategies.

Slotting Fees

One of the retail fee types most of concern to fresh produce shippers is slotting fees, where suppliers are charged for access to shelf-space, usually for new products although suppliers may also pay slotting fees for existing products, commonly referred to as pay-to-stay fees. Slotting fees, common to manufactured grocery products, have not traditionally been used in fresh produce departments. Manufactured grocery products are generally available year-round from the same supplier with consistency in quality, sizing, volumes and pricing. Manufacturers are generally not price takers, exercising control over pricing and able to pass along fees to buyers by incorporating them into their pricing and allowance structures.

In contrast, fresh produce commodities are generally produced seasonally, often by different suppliers in different seasons, intra- and inter-seasonal quality and sizing may vary, weekly volumes may be inconsistent, and individual shipper volumes may be low relative to retailer needs. All of this means that retailers often can't procure all or most of their volume from one or limited suppliers. Furthermore, as price takers shippers have less ability to incorporate slotting and other types of fees into their cost/pricing structures so incentives are low to offer slotting fees as a strategy for capturing market share from competing suppliers. Several of the above factors also act as disincentives to retailers charging slotting allowances for most fresh produce commodities, as retailers are accustomed to using multiple suppliers for the same commodity, rather than locking in shelf-space for a specific supplier on a year round basis.

On the other hand, over the last decade the introduction of fresh-cut and branded fresh produce has stimulated the emergence of slotting fees in this segment of the fresh produce department. Value-added produce is produced and marketed much more like other manufactured grocery products, requiring dedicated year round shelf-space. Therefore, these items lend themselves to slotting fees, both from the perspective of retailers and suppliers that may find their usage helpful in market share battles with competitors. Hence, despite the current high profile of slotting allowances in the fresh produce industry trade press, they are not prevalent beyond the fresh-cut category where they may be supplier as well as retailer induced.