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Illustration by Neil Vandenberg

$how Them the Money

Retailers drive some exceptionally hard bargains; questionable fees have vendors crying foul.

Not long after Rite Aid confirmed its $3.4 billion deal to buy more than 1,800 Brooks and Eckerd drugstores, it summoned all the confectionery suppliers that had provided products to the Brooks chain to offer them a "special opportunity." Rite Aid told the suppliers they would need to pay $9,000 for every SKU they had in Brooks Drugs if they wanted to maintain their placement in the new combined chain. They also asked them for a purchase allowance (based on a percentage of annual volume) and extra dating for payments — 90 days above regular terms. In addition, suppliers were required to pay Rite Aid a sum equivalent to 1.5 percent of the last year's sales of products to Brooks. This "conversion" fee was intended to defray the costs of revamping old Brooks' stores to their new Rite Aid banner, including signage, racking and store remodeling.

"Our first reaction was, 'This is going to be very expensive,'" says one of the vendors involved, who requested anonymity. He estimated it would cost him 50 percent of the total of last year's sales to Brooks to "participate" in the offer. Moreover, he was fearful that if he didn't participate, the products that he currently had on the shelves at Rite Aid were in jeopardy of being pulled.

"We were paranoid," he admitted. "If Rite Aid could do this in the drug arena and get away with it, then what's to stop other retailers in grocery and mass from doing it in their channels? They might be thinking, 'All we have to do is ask.' And then we'll be strapped by all our retailers."

Fairness questioned

Another manufacturer, who also requested anonymity, was able to whittle down the fee through negotiation, but only after the sobering recognition that if it lost its presence in Rite Aid, another supplier with deeper pockets would take its place. "There are only three major drug chains, and as a supplier we'd better be in all three," he said. "We didn't want to lose our presence in their stores and have some other supplier take that business."

The end result was that some candy makers paid a larger percentage of the fee than others, further calling into question the equitability of the fee. But when pressed for details, nearly all of the suppliers contacted were reluctant to speak on record about acquisition-based fees. They all agreed they were unjustified — if not discriminatory—but refused to publicly criticize them for fear of reprisal.

Rite Aid isn't the only retailer that has asked its suppliers to help it shoulder the financial burden that accompanies a major acquisition. When CVS bought 1,200 Eckerd stores in 2004, it approached its suppliers with a request for purchase-based allowances. In the grocery industry, "pay to stay" fees are prevalent in many categories, and have been so for more than a decade. (Both Rite Aid and CVS declined our request for an >>>

WHAT WOULD MR. ROBINSON THINK?

The practice of retailers charging suppliers fees to defray the cost of mergers and acquisitions is not illegal, according to the Robinson-Patman Act. But it's illustrative of the complexity of the issue to examine the impact of federal legislation on the trading partners involved, and how it's shaped their responses to the situation.

Passed by Congress in 1936, the Robinson-Patman Act forbade any company engaged in interstate commerce to discriminate in price to different purchasers of the same product when the effect would be to lessen competition or create a monopoly. Originally designed to supplement the Clayton Anti-Trust Act, Robinson-Patman was intended to protect independent retailers from chain-store competition, but it was also strongly supported by wholesalers eager to prevent large chains from buying directly from manufacturers at lower prices.

In the context of the times, Congress believed that large retailing giants like A&P and Sears, Roebuck could dominate the market by using their high-volume buying power to extract special deals, including quantity discounts, free promotional materials, and purchase allowances — all of which would be unavailable to their smaller competitors. Sen. Joseph Robinson and Rep. Wright Patman argued that the size of the chains gave them an unfair advantage by enabling them to negotiate price concessions and rebates from their suppliers.

A product of the Great Depression, Robinson-Patman has been criticized throughout its history for the faulty economic theory behind it. Even the Supreme Court called it "complicated and vague in itself and even more so in its context." Almost from its inception, critics pointed out that Congress passed the act with the protection of small grocers and wholesalers in mind rather than in the interest of competition.

The irony, of course, is that suppliers now find themselves increasingly under the thumb of those same multi-location chain stores, but are prevented from taking coordinated action by the very act that was originally designed to keep them in check. "It's a Catch-22," says one veteran confectionery executive, who declined to speak on record. "Manufacturers can't get together to discuss these kinds of fees because that would be collusion," he continues. "So there's very little they can do in opposition.

"Every few years someone in Congress will express moral outrage, they'll call for an investigation, and they'll take testimony … but nothing ever happens," he says. "The Federal Trade Commission (FTC) has said this is not a priority even though it's been going on for years. It's why trade relations in this industry stink." ■

interview. We contacted eight other retailers in various channels, but all declined to comment.)

"These trade practices are not new," says Mark Baum, who runs the consumer product goods division of Diamond Consulting, a management consulting firm that provides services ranging from merger and acquisition strategies to supply chain management. "In the grocery channel they've certainly intensified through consolidation and competitive pressures, and we're seeing the same thing in drug.

"We have a history of enabling these practices, which go back to slotting fees, which initially were justified as introducing new items into stores that had a lack of available shelf space," Baum continues. "However, these legitimate costs gave way to whatever price the market could bear. Larger chains could charge more than small chains, so the price varied depending on the company. It became a 'pay to play' fee and has become embedded in the cost of sales for manufacturers. The result is that those suppliers who have a great demand for their products are not as burdened as small companies. In that sense, it's a somewhat insidious practice."

Chasing the dollars

These kinds of fees — heaped upon slotting allowances, deductions, reclamations, and other charges — have made it harder and harder for mid-sized and small manufacturers to reach the market through these distribution channels. Major candy manufacturers can absorb these one-time hits, or sic their 10-person deduction-dedicated legal teams on the retailers to negotiate away a good portion of the charges. Small suppliers, on the other hand, lack the resources and/or the bargaining power to push back — and many can't afford to walk away from the business.

"This kind of activity has always been in the industry, but the new kinds of fees we're seeing today were never used," says Jay Pearlman, president of Ludo LLC, a Cleveland-based interactive novelty candy company. "Are they unethical? Yes. But the retailer has the right to do whatever they want to do, and the manufacturer has the right not to participate. It absolutely hurts small manufacturers in a way that it doesn't hurt the Mars, Nestlés, and Hersheys of the world, who can pull these allowances out of marketing development funds. And the little guy knows that if he refuses to pay these fees, there are big companies lined up behind him who will."

Small guys squeezed

In Pearlman's opinion, the practice damages the industry by squeezing out smaller companies. "Now when you go into an account, you see the same products. Do you really need five different sizes of Snickers on the shelf? The less choice for consumers makes all the stores look the same — and one of the things that make our industry so great is the variety."

Because of the nature of his company, Pearlman doesn't have to chase the dollars the way that some other confectioners do. "I made a decision a long time ago that when I got my business to a certain size, I would choose who I want to do business with," he says. "I have some great customers that it's a pleasure to work with. One customer, for example, charges slotting but I know exactly what I'm getting into, and they have a decent justification for their fees. The distributor can go into the stores and reset the planograms for us, and we'll be charged for the reset — but that's reasonable."

What seems so unreasonable to most suppliers is the disconnect between the fee and the understandable expectation that it will be used to merchandise their products. As one former candy executive said, "Why is money changing hands between buyer and seller when no sales are happening?"

Take slotting fees, for instance. Retailers need to evaluate the sales and margin potential of any change in merchandise they sell, so they charge suppliers a fee to offset the costs associated with their efforts to determine which item will be cut back — or eliminated — to make room for a new item. Suppliers aren't doing cartwheels because they're charged slotting fees, but at least they understand the business rationale behind them.