



Changing Power Relationships in US Food Industry: Brokerage Arrangements for Private Label Products

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A shift in the distribution of power within the US food system has occurred over the last two decades. The dramatic increase in "street money" (such as slotting allowances) paid by manufacturers to retailers reflects this shift in power and increases the comparative advantage of large vs. small manufacturers and the entry barriers into manufacturing. The growth of "in-house brokers" (IHB) for private label products is seen as another instrument for street money. The characteristics and implications of IHB are explored. © 1998 John Wiley & Sons, Inc.

This article has four main points. First, there has been a fundamental shift in the power relationship between food manufacturers and food retailers in the United States over the last 15 years. Second, an important characteristic of this shift is the dramatic increase in the amount of "street money" paid by manufacturers to retailers, much of which goes directly to retailers' bottom line. Third, some instru-

ments for street money, particularly slotting fees and in-house brokerage arrangements, increase the comparative advantage of large manufacturers versus small manufacturers and significantly increase the entry barriers for manufacturers. Fourth, these developments are of particular concern because they are inconsistent with a consumer responsive food system in which manufacturers and retailers are rewarded on the basis of their efficiency, product innovations, and ability to satisfy consumer preferences. Instead, the size of a manufacturer's bank account has become an important criteria for selection.

Shift in Power Relationship

"Vendor participation programs" is a synonym for the multitude of ways retailers have found for manufacturers to contribute to the retailer's welfare. Some of these participation programs, such as co-operative advertising, in-store demonstrations and promotions, and product giveaways at grand openings have existed for a long time and serve manufac-

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turer, as well as retailer, interests. The new approaches are programs like slotting and in-house brokerage that seem to mainly serve as a conduit for manufacturer contributions directly to the supermarket's bottom line. And, as these more blatantly one-sided arrangements have been accepted, retail chains have also become more aggressive in asking for other contributions.^a For example, if a product fails, many retailers now expect the vendor to pick up the product, reimburse the full cost, but not receive any rebate on the slotting allowance.

The fees for "participation programs" appear to be less and less tied to costs and based more upon what the "traffic will bear." For example, a small manufacturer of a specialty meat product indicated that they have encountered slotting fees that range from zero to \$25,000 per item for a chain division, and the average was \$2500 to \$5000. Slotting allowances have a large range, depending on the product, the amount of shelf space involved, and the region of the country.

Slotting allowances bear little relationship to the costs incurred by retailers for adding a new product and/or deleting an existing product. The Deloitte and Touche 1990 report¹ for the Joint Industry Task Force estimated total wholesaler and retailer costs as follows:

	Cost Per SKU Per Store	
	Wholesaler	Retailer
Product Introduction	2.02	13.51
Product Deletion	1.65	16.11

Based upon these estimates, if slotting fees covered the total wholesale and retail costs of both product introduction and deletions in a 50 store chain, this would amount to \$1664.

Slotting allowances vary greatly; hence, any generalization is hazardous. However, they seem to be used largely as a rental for retail shelf space. This

^aOne example is the letter received by a supplier from a Midwest grocery chain concerning sponsorship of the chain's annual golf tournament. The supplier was "assigned" the 18th hole to sponsor and informed that the cost was \$12,000.

often means there are terms in the agreement regarding the number of competing brands and the division of shelf space.^b Thus, slotting arrangements can be used as a way of excluding competing brands. Because the process is akin to auctioning off store shelf space, slotting bids can be more effective than predatory pricing in building market share and raising entry barriers.

There has been a paucity of research on slotting allowances in the food industry. Yet, based upon the industry people interviewed in this research, slotting fees are by far the greatest entry barrier for most small- and medium-sized manufacturers. They increasingly seem to be used as an instrument for exclusion. The broad competitive consequences certainly warrant research. However, many manufacturers are reluctant to publicly criticize retailer use of slotting fees for fear of retribution.

In-House Brokerage for Private Labels: Another Source of Street Money

Section 2c was included in the Robinson-Patman Act amendment to the Clayton Act to prevent retail chains from using dummy brokerage companies as a way to enjoy discriminatory prices without violating Section 2a. As written, Section 2c is a per se violation; however, the Federal Trade Commission (FTC) appears to be basing its enforcement actions on the extent to which there is injury to consumers.

The modern-day version of in-house brokers (IHB) originated on the east coast in the late 1960s and early 1970s. The early IHBs were conceived to assist supermarket chains with their private label (PL) programs. The emphasis was on providing services such as quality specifications and quality control, label design, inventory management, selection of suppliers, procurement, and PL pricing and merchandising. As IHBs evolved, more emphasis was placed on commission rebates and less on services. There is now a considerable range in the ac-

^bFor example, a manufacturer of specialty baked goods agreed to pay a small retail chain \$30,000 with the understanding the chain would stock only one other brand and would devote no more than 25% of two bakery shelves in each store to the rival brand. In this instance, slotting fees are sometimes paid annually.

tivities of IHBs. At one extreme are IHBs that do little more than collect commissions from PL manufacturers and pass along a major portion to their retail accounts. In these situations, 80 to 95% of the brokerage commission is rebated to retail accounts, sometimes in the form of "purchased services." At the other extreme are IHBs that still focus considerable attention on the services to retail accounts and that rebate 50% or less of the brokerage commission. In many cases, these IHBs give rebates "in kind" by putting chain personnel on their payrolls, renting office space, buying reports from the chain, and performing service functions that were previously performed by chain personnel.

It is useful to compare IHBs with local (or independent) brokers. Local brokers are selected by the manufacturer, represent that manufacturer's interest in a particular geographic area, and are paid by the manufacturer. Local brokers handle a limited number of products and usually represent only one manufacturer ("principal") per product. They attempt to sell their principal's products to all the supermarket accounts in the area, and they specialize in knowing the consumers and wholesalers/retailers in a particular market.

Because a local broker generally represents only one manufacturer of a PL product, it is in their interest to build that manufacturer's business. The greater the sales, the larger the broker's commission. Thus, local brokers frequently provide chain buyers with merchandising ideas of ways to increase sales. The more local brokers who call on a chain, the greater the number of ideas that are likely to be presented.

IHBs are selected by grocery chains or wholesalers. Although they receive brokerage commissions from manufacturers, IHBs primarily serve the interest of their retail accounts. There is usually one IHB that handles the bulk of the PL business (50–70%) for a given retail chain or division. Thus, IHBs "represent" a large number of products and frequently deal with more than one manufacturer per product.

In order to sell PL products to a retail account with an IHB, manufacturers usually must sell through the IHB. Thus, IHBs tend to be exclusive "gate-keepers" and wield substantial degrees of power.

Trade sources estimate the four leading "master" brokers (or IHBs) in the United States are Dayman Associates, Cal Growers Corp., Marketing Management Inc. (MMI), and Federated Foods.

Of these, Dayman is by far the most service oriented. The other three generally pass on most of the brokerage commission to their retail accounts. A lawsuit against Albertsons and Federated Foods (for interference in the business of 13 Boise, Idaho, brokers) found that Federated Foods was passing on 96% of the brokerage commission to Albertsons.

Trade sources estimate that these four companies account for roughly 70% of the in-house brokerage business, and that in-house brokerage arrangements now represent close to 60% of the outside supplier PL business (i.e., not self-manufactured). These figures are admittedly rough estimates. The main point is that IHBs have become widespread. With no reining-in from the antitrust agencies, IHBs continue to grow. Some of the large chains, like Kroger and Safeway, have organized their own IHB arrangements (Safeway's IHB is called Pivotal Sales Co.).

Role of PL Products in Food System

In the United States, there are approximately 26,000 supermarkets (minimum sales of \$2 million), which account for 80% of all grocery store sales. Supermarkets dominate the retailing of food in the United States. Roughly three-fourths of these supermarkets are operated by corporate chains (11 or more stores); most of the remainder are members of cooperative or voluntary groups.

Chain or wholesale organizations that supply supermarkets buy merchandise from a large number of manufacturers. In 1992 there were about 17,000 food manufacturers in the United States with total shipments of \$383 billion (1992 Census of Manufactures). Products from these manufacturers account for about 70% of the sales of a typical supermarket. An additional 10% of sales are from unprocessed foods (mainly fresh fruits, vegetables, and eggs). The remaining 20% of sales are from nonedible grocery products (e.g., paper products, soaps, tobacco), health and beauty care, and general merchandise (e.g., magazines, brooms). For the whole store,

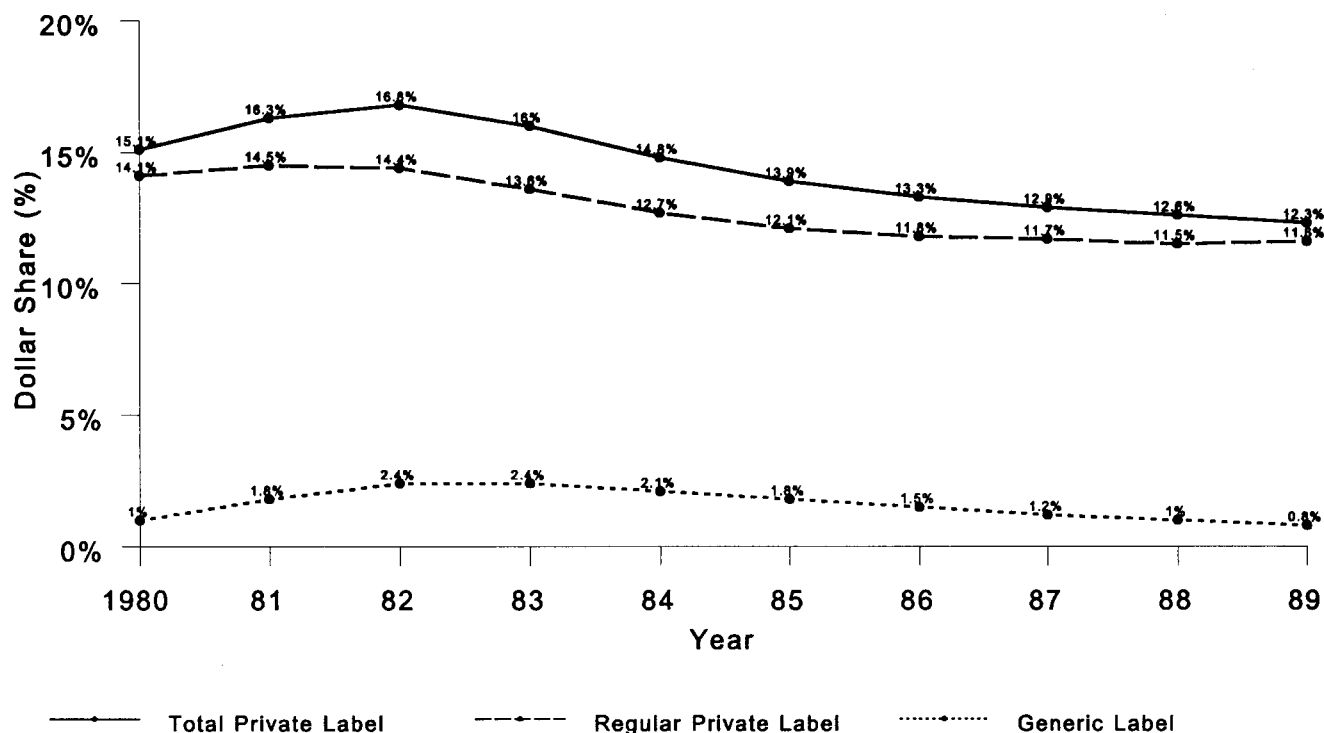


Figure 1. Food stores' private label and generic dollar shares for all departments combined. Source: SAMI Food Store Service, for the period ending December 12, 1989. The Arbitron Co.

about 60 to 65% of sales are from manufacturer brands of products, 20 to 25% are from unbranded products (e.g., fresh beef, fresh produce), and 15 to 20% of sales are from PL or store brands.

The trend in PL market share during the 1980s, based upon SAMI data,^c is shown in Figure 1. From a high of 16.8% in 1982, the PL share of store sales declined steadily to 12.3% in 1989. Changes in PL share are mainly driven by consumer income and employment. PL share peaked during the recession of 1982. The PL share is also influenced by the level of competition in PL manufacturing, brokering, and retailing. If, over time, the price of PL products increased relative to advertised brand prices, PL share would be expected to decline.

^cUntil it went out of business in 1991, SAMI collected data on warehouse shipments from a large number of food chains and general line grocery wholesalers. Their data set does not include fresh meat and poultry, fresh fruits and vegetables, and products that are delivered directly to stores (e.g., soft drinks, fluid milk, crackers and cookies, ice cream, fresh baked goods). Roughly one-third of supermarket sales are missing from the SAMI data.

PL products play several important roles in the food system. Perhaps the most obvious role is that they provide an alternative to advertised brands that is often comparable in quality and significantly lower in price. "First line" PLs are often intended to match the quality of the leading manufacturer brand. Three studies during the 1970s and 1980s found PL averaged 12 to 20% less in price than advertised brands.²⁻⁴ For individual products, the range in price differences is much greater.

The presence of a lower priced alternative provides direct benefits to consumers who buy PLs. PLs also introduce a degree of price competition for advertised brands. Indeed, Wills and Mueller³ found that brand prices in 133 product categories were negatively and significantly related to PL share. The higher the market share held by PLs, the lower were brand prices. On average, PLs were priced 18% less than the leading brand of product.

Parker and Connor⁵ found that PL share in 1975 was inversely related to product class CR4 and the advertising to sales ratio. These authors also found

that monopoly power in food manufacturing was positively related to product class four-firm concentration ratio (CR4) and the advertising to sales ratio. The tracking of causality in these studies is admittedly not totally clear. However, there is definite support for the notion that PLs tend to have higher market shares in more price competitive product markets.

One of the inferences from the above findings is that the performance of PL products is important in and of itself but also because it may stimulate competition among branded products. A healthy viable PL segment is important to consumers and to the health of the food industry. The need for increased competition among branded products is generally the greatest where PLs have small market shares—products such as baby food, breakfast cereals, soft drinks, cigarettes, chewing gum, and cake mixes. In most of these cases, the branded product segment has substantial market power. In addition, the PL share is so small (usually <5%) that there may be only room for one or a few efficient size PL manufacturers. Economies of scale barriers into the PL strategic group may be quite high. Thus, in these cases, there may be a lack of effective competition in the PL strategic group, as well as in the branded product strategic group.

Underlying Causes of IHBs

The shift in power to food retailers that has occurred over the last 15 to 20 years is in part an outgrowth of increased concentration in the US supermarket industry. Nationally, the concentration of sales in the supermarket industry has increased slowly and remains relatively low (top 20 chains did 38% of US grocery store sales in 1987). However, at the local metropolitan level, the concentration of sales has increased substantially and is now very high, on average. In 1987 the average four-firm supermarket concentration (SCR4) was 77.9% in 321 metropolitan statistical areas (MSAs).⁶ For 177 MSAs with identical definitions in 1977 and 1987, Figure 2 indicates high and sharply increasing levels of concentration. SCR4 was less than 60% in only 9% of these MSAs and exceeded 80% in almost one-half of the MSAs.

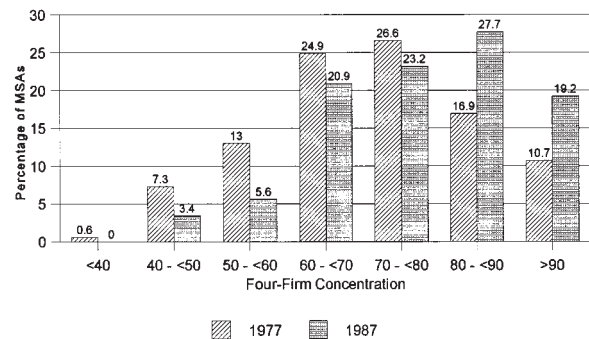


Figure 2. Supermarket CR4, 177 MSAs, 1977–1987.
Source: Franklin and Cotterill.⁶

There have been few scholarly efforts to examine the monopsony power of buyers. However, there is considerable anecdotal evidence that supermarket chains and wholesalers do exercise buying power and that local market concentration affects buying power. Procurement in grocery retailing takes place one division at a time. For example, although Kroger has over 2000 stores and may occasionally buy certain products for all stores, this is generally not their modus operandi. The 12 divisions of Kroger each tend to buy independently.

Similarly, food manufacturers tend to sell their products metropolitan area by metropolitan area. Manufacturers recognize that if they are to develop sales in a particular MSA, they must be on the shelves of the leading retailers. If a manufacturer aims to penetrate the Washington, DC, market, for example, it is imperative to sell to Giant and Safeway, who together account for nearly three-fourths of the Washington, DC, market. Many MSAs now have a dominant firm or dominant duopoly. Because retailers can largely determine whether a manufacturer's product has a chance to be sold in an MSA, the higher the level of MSA supermarket concentration, all things being equal, the stronger the buying position of the leading supermarket firms.

The shift in power from manufacturers to retailers may be partly due to the vast increase in the information controlled by retailers due to computerized scanning data. Retailers now have enormous power to evaluate manufacturer tactics. Reflecting the shift in power, manufacturers now spend 70% of their promotional budgets on the retail trade (coop-

erative advertisements, special displays, in-store demonstrations, buying deals) and 30% on consumer advertising and promotions. Fifteen years ago these figures were reversed.

One industry observer believes the large number of leveraged buyouts (LBOs) in the supermarket industry in the mid-1980s contributed to the environment in which slotting allowances, IHBs, and other street money devices blossomed. Chains that had gone through LBOs needed cash to service their debt; slotting allowances and IHBs satisfied that need. And, once retailers discovered they could successfully demand cash payments, they became bolder and more aggressive.

Effects of IHBs

The impacts of IHBs depend upon the companies involved and one's point of view. At least in some cases, IHBs provide clear benefits to the PL programs of their retail clients. Dayman Assoc., in particular, is often identified with enhanced and stronger PL programs. Dayman employees help plan and execute store brand strategies, including product specifications, package design, procurement, pricing, and merchandising.

However, Burt Flickinger III, a retail consultant, estimates that only one out of four chains retain IHBs in order to gain access to more sophisticated management of their store brand programs.⁷ The remaining three-fourths of the chains are mainly seeking the brokerage rebate in Flickinger's estimation.

The possible benefits from IHB programs are acknowledged even by critics. However, who should pay for such benefits is a major point of contention. Although IHBs are "contracted" as representatives of PL manufacturers (with considerable encouragement by retail chains), they function primarily as service providers to retailers and wholesalers. If the retail chain is the main beneficiary, should they not be the one paying the bill?

Steve Howell, an ongoing and persistent critic of IHBs, contends that IHBs are part of a systematic effort by the retail industry to move accounting costs backward in the system. Howell contends that

retailers are willing to accept price increases from suppliers in return for cash payments (slotting, etc.) and shifting of costs. IHB commissions, slotting fees, and other street monies have become a profit center within many chains to which more and more attention is paid.

Competitive Effects of IHBs

My conclusions are based upon telephone interviews with 10 PL manufacturers and approximately the same number of local brokers. Such a limited sample provides only very tentative conclusions that may be useful for future study and investigation.

Effects on Costs and Efficiency

In many cases, IHBs add another middleman to the food marketing system. Because the IHB is not truly the manufacturer's representative, many PL manufacturers find it necessary to employ an independent broker or maintain their own sales force. Where this is the case, manufacturer selling expenses tend to increase. Either double brokerage payments occur or IHBs and manufacturer sales forces are both involved.

This is not always the case, however. A few of the manufacturers interviewed felt there was no difference in their selling costs with or without IHBs. These manufacturers largely considered IHBs as substitutes for local brokers on a given account. The manufacturers who had this reaction were the leading PL suppliers of their products. If a company is the dominant supplier of a PL product, they may be able to sell through IHBs without having additional sales representation.

Effects on Manufacturer Selling Price

There were clearly two responses to this question: for products in which the manufacturer has somewhat more control over price, increased selling

expenses are passed on through higher product prices; in some of the intensely competitive commodity type industries, however, this apparently is not possible. Here, any increase in manufacturer selling expense reduces manufacturer profits. Manufacturers involved in these product markets maintain that they charge the same price with or without IHBs and that the “market” will not allow them to pass on higher costs. IHBs sell their programs to retailers on the basis that manufacturer prices will be no higher with the IHB program. Thus, at least initially, there will be pressure to keep manufacturer prices the same.

One wonders whether this can persist in the long run. As long as there is excess capacity in an industry, some companies may be willing to “eat” the increase in selling costs. Eventually, excess capacity will leave an industry and higher costs are likely to be passed on through higher prices.

Effects on Retail Prices of PL Products

This depends, in part, on how the brokerage commission rebate is handled by retailers. Is it treated as a reduction in the cost of PL products or does it go straight to the bottom line as “other income”? From my research, it appears to be solely the latter. Rebate cash or checks are periodically sent to retail accounts and are not traceable to the cost of merchandise. Thus, retail prices are largely determined by manufacturer invoice price, not invoice price minus rebates. In those cases where higher manufacturer selling costs are passed on in higher manufacturer prices, the retail price of these products is also likely to be increased. This is particularly likely for products such as health and beauty aids, breakfast cereals, and gelatin desserts in which PLs have a small share of concentrated markets. There is relatively little price competition within the branded segments of these product markets. PLs sell at substantial discounts from the advertised brands of these products and should have more flexibility to increase prices than is the case for products like milk, bread, and concentrated orange juice. On the latter items, consumers are sufficient-

ly aware of retail prices that cost increases are more difficult to pass on unless competitors make similar price increases.

Effects on Structure of PL Manufacturing

IHBs tend to prefer large manufacturers. Transaction costs are less with one supplier than with two or three. Fewer suppliers requires less negotiation time for IHBs, less uncertainty regarding performance, less time to monitor quality, and less time to manage labels. In addition, there appears to be some multimarket reciprocity between IHBs and manufacturers: you work with me in this market, and I will work with you in that market. Thus, the IHB system appears to favor financially powerful and national manufacturers and may hasten the demise of less financially powerful or regional manufacturers. Hence, IHBs may increase concentration in PL manufacturing and increase entry barriers.

The competitive effects of increasing concentration and entry barriers will vary from product to product. In some products, the PL strategic group is sufficiently concentrated that any increase may be anticompetitive and may lead to higher prices in the long run. In other products, this may not yet be the case. Unfortunately, we have relatively poor information about the structure of most PL strategic groups. We do know that there are several products in which one firm dominates PL manufacturing.

Effects on Structure of Food Retailing

Supermarket chains that use IHBs are likely to realize some decline in PL procurement and management expenses and/or an increase in profitability from commission rebates, despite possibly higher manufacturer prices. Hence, retailers that use IHBs will be at a competitive advantage over those that do not, at least in the short run.

IHBs prefer large chains and wholesalers. According to one estimate, an account with \$1 billion in sales is a marginal account for IHBs. By this estimate, chains smaller than the top 50 US supermar-

ket chains might have difficulty attracting IHBs and hence would be at a competitive disadvantage vis-à-vis larger chains.

If IHBs tend to favor chains or wholesalers with large sales in a metropolitan area or region, they will facilitate the growth in market share of the leading firms. Thus, IHBs are likely to be a factor in the continuing trend toward increased supermarket concentration in local markets. And, in time, it will become more difficult for small retailers (including new entrants) to find suppliers for a PL program. This would mean higher entry barriers into grocery retailing. These consequences would be of less concern if supermarket concentration were not already high and increasing. Any increase in supermarket concentration or entry barriers is likely to result in higher consumer prices.

Effects on Management and Performance of PL Programs

The evidence here is mixed. Some IHBs are apparently successful in improving the management of PL programs. This is particularly the case with retailers that did not have strong PL programs prior to the use of IHBs.

In other cases, particularly those with very high rebates, the IHB is little more than a fee collector and tends, if anything, to weaken the PL program.

There are at least two ways in which IHBs can weaken PL programs in the long run. First, because IHBs represent (deal with) competing manufacturers of the same product, they stifle the flow of merchandising ideas and other information. PL manufacturers and their local brokers may be afraid to share information lest it be passed on to a competitor. Second, at least some manufacturers believe the IHB system encourages complacency in PL procurement and PL manufacturing. Their rationale is that once an IHB and PL manufacturers are selected to serve a particular retail account, incumbency leads to security and complacency. As long as a retail account seems secure, there may be little incentive for an IHB to shop as diligently for the best terms. And for manufacturers who develop a symbiotic relationship with IHBs, they may also be un-

der less pressure to improve products and reduce costs and prices.

Supermarket executives may perceive IHBs as a method of increasing cash flow without increasing prices, at least in the short run. However, the short-run gains in cash flow may be at the expense of long-run competitiveness in their PL program.

Some of these conclusions may appear contradictory. If the IHB system results in higher manufacturer and retail prices in the long run, restricts the flow of information to retailers, and encourages complacency, how can one conclude that the retail chains using IHBs will benefit? After hearing these conclusions from enough industry participants, I finally realized that IHBs may yield consequences in the short run that are very different from those in the long run.

The IHB programs are generally sold to the top management of chains and wholesalers. If top management is under pressure to increase cash flow and earnings in the *short run*, they may not give much weight to the consequences 5 or 10 years from now. And, if the IHB system helps chains using it in the short run, in the long run these chains may have sufficiently strong market positions to pass on higher prices and to prosper even with complacency in their PL programs. Thus, it is entirely plausible that IHBs may provide competitive advantages to participating chains in the short run but may weaken a chain's PL program and the viability of the PL system in the long run.

Effects on Incentives in Food Marketing System

The IHB system tends to pervert some of the incentives in the food marketing system. Manufacturers of a particular product are selected not primarily on the basis of product quality, price, and service, but first and foremost on whether they will sell through a particular IHB. The "best" manufacturer may find himself on the sidelines because he refuses to deal with the "power brokers" as they are sometimes called.

Although IHBs are being paid by manufacturers, they are selected by retailers. Those who "pay the

piper” do *not* call the tune. IHBs have no incentive to build the business of a particular manufacturer. Next month or next year, the IHB may choose a different manufacturer–supplier of a particular product.

PL manufacturers in the IHB system are unable to select brokers on the basis of who does the best job for them. A considerable degree of coercion now influences the patronage of IHBs. The price of admission to some accounts is selling through the selected IHB. Most manufacturers resent being forced to sell through and pay commissions to IHBs when they do not represent the manufacturer’s interests. PL manufacturers that sell through IHBs often retain the use of their own sales force or local broker to have someone who represents their interest.

Concluding Comments

The IHB system for PL products appears to be spreading rapidly. There are also early reports of IHBs expanding to include branded product procurement. If this becomes prevalent, it will compound the problems outlined above.

Independent brokers’ business is threatened. Manufacturers too are concerned. Although there is widespread concern about the IHB system, most manufacturers are reluctant to voice their concerns out of fear that they might lose some accounts.

Emotions are strong, however. Comments from manufacturers included the following:

- “IHBs—if they are not illegal, they should be. They’re just a way of extending the procurement power of chains.”
- “They’re parasites. They perform no significant service to justify their commission.”

There is little question but that IHBs violate the letter and the spirit of Section 2c of the Robinson–Patman Act. However, there has been little enforcement of the Robinson–Patman Act in the last 15 to 20 years. The FTC has apparently adopted a rule of reason approach to the enforcement of Section 2c, and the main question is whether consumers are injured as a result of IHBs. Unfortunately, there is little in the way of hard facts on IHBs. This makes the injury to consumers difficult to assess. There is little evidence that, on balance, the IHB system will serve the public interest. Indeed, IHBs appear likely to have significant negative effects on the US food system.

Slotting allowances that are agreements to exclude competitors may be violations of Sherman, Section 1. At least in some cases, slotting arrangements are used for exclusionary purposes. IHBs, slotting allowances, and similar campaigns to solicit street monies warrant much more attention than they have received by academic researchers and the antitrust agencies.

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