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Category Management

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Introduction

According to evidence provided to the UK Competition Commission's inquiry into supermarkets, "category management will become the underlying process to the way companies conduct business".[1] This statement underlines the commercial importance of category management, but Robert Steiner, a US writer who has been part of some of the Federal Trade Commission's reviews in this area, has also said that "antitrusters must remain alert to the possibility that category management can produce a number of competitive concerns".[2]

If both of these statements are true, then competition regulators in the United Kingdom and Brussels may need to decide what their approach to category management will be, and quickly. This article has the following aims:

- to explain what category management is and the context in which it is used, with a focus on modern retailing methods;
- to explain what is involved in category management;
- to look at the US experience, through the leading case and a Federal Trade Commission staff report;
- to draw some conclusions as to how our law would tackle category management; and
- to review a few practical issues surrounding category management.

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1 Competition Commission, *Supermarkets: A report on the supply of groceries from multiple stores in the United Kingdom*, Cm.4842 (2000), p.243.

2 Robert L Steiner, "Category Management—A Pervasive, New Vertical/Horizontal Format" [2001] *Antitrust*, Spring, p.77.

What is category management?

Steiner has described category management as "a vertical partnership in which previously confidential information is shared between manufacturers and retailers to cut distribution costs and increase the margins of both parties".[3]

According to Steiner, the precursor of category management was the so-called "channel partnership". Unlike category management, these were "one-to-one" relationships between an individual manufacturer/supplier and an individual retailer, and focused on saving costs in the distribution channel through information sharing and close co-operation between supplier and retailer.

The first channel partnership was between Procter & Gamble and Wal-Mart, in the mid-1980s.[4] The intention was to achieve many of the efficiencies which come from vertical integration without effecting integration. Specifically, the parties to channel partnerships were looking to reduce inventory levels, make production planning more efficient, speed up delivery and so forth. Part of the concept was to replace the traditional adversarial relationship which typically existed between manufacturers and retailers.

By the mid-1990s, category management started to replace channel partnership. In category management, rather than concentrating on a single supplier and product line, consumer demand within an entire market segment or category is studied and shelf space is allocated amongst different, competing, products to best satisfy the demand as a whole. "In effect, it is a way of managing a category of products as if it were a free-standing business."[5] In principle, category management could be undertaken directly by retailers themselves, but in fact suppliers tend to advise retailers in relation to the whole of a market category, in an extension of the channel partnership. Supermarkets cannot effectively do this themselves because, according to the Competition Commission, UK supermarkets tend to have about 2,000 suppliers,[6] a figure which is probably even higher in the US.

The efficiency imperative is also undeniably strong and in one US example, for one category of products, a medium-sized retailer made savings of £12 million in the

3 *ibid.*

4 A short description of the relationship can be found in Brandon Copple, "Shelf-Determination" [2002] *Forbes*, April 15.

5 Federal Trade Commission, *Staff Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry* (FTC, February 2001), p.46.

6 Competition Commission, cited above at n.1, at 230–231.

first year, with sales up by 12.5 per cent and an increase in profits of 9.5 per cent.[7] Warehouse and shelf space were also saved.

The driving force developing category management in the United States was the Food Marketing Institute ("FMI"), the supermarkets' trade association, which created a multi-volume set of category management implementation plans as a model for the retailer/supplier relationship. In the FMI's model, the retailer appoints a "category captain", usually the number one or number two supplier. The category captain gathers data on wholesale and retail prices, sales figures, planned promotions, and other relevant information, from independent sources but also usually from the retailer's EPOS information and occasionally from rival suppliers. Using the data, the category captain prepares a "category plan" including a "plan-o-gram" (a computer-generated image of the shelf space available and of the suggested layout of products on that shelf space). He or she also prepares a range of recommendations on issues such as the number of "facings" which each product should be allotted, which products should be given the most desirable positions—on the centre shelf and in the centre of the display of products in the range concerned—and even recommendations as to listing or de-listing of products.

Manufacturers involved in category management claim, and this is supported by the materials, that the idea is that they will provide trustworthy and objective recommendations, which are not biased by the self interest of the manufacturer acting as category captain. The idea is also that recommendations (only) are provided and that there will be no direct or indirect pressure on the retailer to accept those recommendations.

This concept will inevitably set alarm bells ringing for competition lawyers. We have a strong supplier, often the lead supplier, providing recommendations to the retailer including recommendations as to the way in which other parties' products should be treated, and that manufacturer is being granted access to confidential information regarding the prices and terms offered by its competitors—information which were it to be exchanged between those manufacturers directly would almost certainly amount to a serious infringement of Art.81 of the EC Treaty and/or the Ch.I prohibition of the Competition Act 1998.

On the other hand, it is undeniable that category management improves efficiency and can provide benefits to consumers. Whether the benefits of category management are passed on systematically from retailers to consumers is a moot point.

The US experience—*Conwood v USTC*[8]

This case was an appeal from a lower court in circumstances where triple damages were available. Ultimately, the damages awarded against USTC, the dominant supplier in the market concerned, were $105 million.

The case related to moist snuff, a substance which cannot legally be sold in the United Kingdom. However, US sales in 1999 were $1.68 billion and USTC, the defendant in this case, had a market share of 87 per cent. USTC also reportedly had the highest profit margin of any US quoted company but despite this, and despite the seeming availability of attractive margins for anyone coming into this market, no new entrant had entered this market in the US since 1990.

In the market for moist snuff, point of sale advertising and racking is crucial and shelf space is limited. The product comes in very small tins and customer choice is significantly affected by being able to see and pick up the product concerned.

Seemingly, USTC adopted a systematic policy of excluding and seeking to damage its competitors. The case makes an almost comical read as USTC employees clearly went about destroying its competitors' racks, re-ordering products on those racks so as to put competitors' brands, particularly their cut price brands, at the back and engaged in many other forms of skullduggery aimed at bolstering USTC's position. In a number of extreme cases, they even waited until certain members of staff were otherwise occupied or off duty to attack the racking of competitors and to supplant it with their own.

Against this background, which would amount to classic abusive conduct in any event, USTC was in many cases appointed as category captain. In that role it falsified data relating to category management, exploiting its greater market knowledge of what, for many of its retailer customers, was a very small market segment, in order to promote its own brands and squeeze out its competitors' products.

Conwood is a competitor of USTC. Understandably, Conwood attacked USTC's behaviour under US legislation which is outwardly quite similar to Art.82/Ch.II. However, interestingly, Conwood did not attack category management as such but merely attacked USTC's

7 Steiner, cited above at n.2, at 78.

8 *Conwood v United States Tobacco Co*, Fed. App. 0171 P (6th Circuit) (2002).

abuse of it. There was plenty of incriminating correspondence to back up the evidence showing that USTC was engaged in a long-running attempt to keep its own market share up and damage its competitors. So the case is perhaps not of decisive importance in assessing the attitude of regulators or the courts to category management.

The most that can be said for this case is that it points out some dangers involved in Category Management. The court did say, however, that a supplier engaged in Category Management has a particular responsibility to its retail customer. Ultimately the court concluded that USTC misused its position as Category Captain by providing misleading information to retailers in an effort to dupe retailers.

The US experience—the Federal Trade Commission (FTC) Report[9]

Most of this Report deals with "slotting allowances" (payment for being on a retailer's list and for being allotted shelf space) and so is outside the scope of this article, although some aspects of it did touch on category management.

The Report seems to have come out of a series of workshops run by the FTC, and attendees included not only regulators and academics, but in-house lawyers, lawyers from large law firms and industry executives.

One such workshop looked at category management and concluded that it offers important efficiencies but can raise competitive questions in so far as it involves a supplier making recommendations as to how its competitors should be treated. The workshop concluded that whilst these concerns were not inherently so serious as to call into question the whole practice of using category management, it was thought that care was needed to ensure that there was:

- no "improper" receipt of confidential information regarding competitors' plans;
- no significantly disadvantageous barriers to competitors; and
- no orchestration of horizontal collusion.

The first of these perhaps bears a little further explanation in that it seems that the workshop's focus was on access to information about competitors' future plans for product launches and so forth rather than current price data.

UK/EU competition analysis

The *Conwood* case seems to be a "no-brainer": a clearly dominant business behaving in a manner which we would, even with no knowledge of category management, readily characterise as abusive should not present any problems to the OFT, the Commission or domestic courts.

What about simple involvement in "plain vanilla" category management? Does this involve any risks for the supplier, or indeed the retailer?

The analysis can be divided into three key parts:

- is there an Art.81/Ch.I concern with category management *as such*?
- even if there is not, what potential Art.81/Ch.I issues could arise if category management is used? and
- what is the position of dominant players (remembering that the lead supplier will often be the category captain)?

The basic position under Article 81/Chapter I

What we are asking here is whether the arrangement between supplier and retailer in itself infringes Art.81/Ch.I.

Assuming that the relationship does not involve any agreement to implement the recommendations on future pricing strategy (as any agreement to comply with those recommendations would of course amount to price fixing), there does not appear to be any Ch.I concern *as such* with category management for a number of reasons:

- in the absence of any agreement to implement, the supplier is merely providing a *service*, recommending particular actions, to the retailer. We have no qualms about recommended *prices*, and nor in the author's view should we have any about recommendations on shelving, facing and the other issues involved in category management;
- a more surprising conclusion—category management probably benefits from exclusion or exemption.

9 *Report on the Federal Trade Commission Workshop on Slotting Allowances and other Marketing Practices in the Grocery Industry*, February 2001 (online at *www.ftc.gov/os/2001/02/slottingallowancesreportfinal.pdf*).

It should be recalled first of all that the exclusion/exemption applies to agreements for the supply of *services* as well as *goods*.

In the United Kingdom of course, at least for the time being, we have a general exclusion for vertical agreements. But, you might say, Tesco as an "own-labeller" competes with Heinz as a supplier of baked beans. So can this be a vertical agreement?

Vertical agreements are defined by the Exclusion Order[10] in terms of the role of the parties "for the purposes of the agreement". The agreement on category management involves the supply of services by the category captain to the retailer. For that purpose, the category captain is at a different level in the chain to the retailer. Given the new realism engendered by the *Bayer* case,[11] it seems hard to characterise the category management exercise as part of a broader agreement between the supplier and retailer as it will not be entered into at the same time and is voluntary; it involves making recommendations across a range.

It is probable that the Vertical Agreements Block Exemption[12] applies, up to the 30 per cent market share threshold of course. The same wording as appears in the Exclusion Order ("for the purposes of the agreement") appears in the Block Exemption, and there is a further test in circumstances in which the parties are, in a broader sense, competing undertakings. But there are two potentially relevant let-outs, even if the parties are competitors because of own-labelled products. Those let-outs are:

- Article 2(4)(b): this applies where the buyer is not a manufacturer. Given that, in relation to own-label goods, the retailer will make the decision to produce the products, will design art work and make key decisions about the products, using the manufacturer as a mere sub-contractor, we would conclude that this let-out is not available, because we must impute the position of manufacturer to the retailer.
- Article 2(4)(c): this applies where the supplier supplies services at different levels of trade, but the buyer is not involved in competing services. If we can characterise the agreement concerned as an agreement to provide category management services by the supplier to the retailer, then this exception seems to apply.

10 SI 2000/310.
11 Cases C 2/01 P & 3/01 P *Bundesverband der Arzneimittel-Importeure v Bayer and Commission*, January 6, 2004.
12 Regulation 2790/99.

If the Block Exemption applies, then an agreement to provide information, the making of recommendations about shelf allocation, de-listing and so forth, are not "hardcore" restrictions. There is therefore at least a strong argument that "plain vanilla" category management is exempted from/excluded from Art.81/Ch.I.

Potential Article 81/Chapter I problems with category management

Of course, there are still Art.81/Ch.I traps for the unwary in category management including at least the following:

- Information exchange: if the retailer becomes a conduit (even unknowingly) for the exchange of information between suppliers, there could be an Art.81/Ch.I concern. For this reason, if advising a supplier on acting as category captain, that supplier should be advised to ensure that no competitor is engaged in category management activity on behalf of the retailer at the same time. There should, however, be no problem in the context of Art.81/Ch.I where a supplier obtains pricing and other information from the retailer as part of a category management exercise, where no competitor of the supplier is involved.
- Facilitating collusion amongst retailers: if a group of retailers are all using the same suppliers to provide category management advice, and if they all received, and know they have received, identical recommendations from the category captain, then this could be interpreted as amounting to, or at least facilitating, collusion between the retailers concerned.
- Enforcement of recommendations on price: this would of course fall outside the Exclusion Order and the Vertical Agreements Block Exemption and would amount to a "hardcore" restraint.

In the area between a 30 per cent supplier market share and supplier dominance, it is necessary to go back to basic principles in order to ascertain whether there is an Art.81/Ch.I problem. There is, however, no specific guidance on category management in the Guidelines which accompany the Block Exemption.

In fact, the only sign that category management is on the Commission's radar screen is an appendix to a research paper produced for the Commission by Nottingham economist Paul Dobson.[13]

The position of dominant suppliers

Clearly, "USTC-type" behaviour is, as has already been said, a candidate to be labelled as an abuse of a dominant position, even without knowing anything about category management. The question which remains is whether ordinary category management is capable of being abusive as such.

It is hard to see that the simple making of recommendations can in itself be considered abusive. Retailers will be receiving visits from suppliers on a regular basis, and every supplier will be seeking to push its own products and encourage the retailer to take more of them. Whilst category management puts the supplier in a position to provide detailed recommendations tailored to the retailer concerned and based on real data, in the absence of the type of pressure which we would identify as amounting to an abuse, the provision of category management recommendations should not be viewed as abusive.

However, there are a number of circumstances in which one could characterise behaviour surrounding category management as abusive. These would include at least the following:

- if there is evidence that category management is being used as a means to raise entry barriers;
- if access to category management services is rationed so that the supplier is applying dissimilar conditions to equivalent transactions, using category management assistance as a way of rewarding "loyal" retailers;
- if the supplier secures that it alone will have access to data;
- if there are incentives or disincentives connected with the provision of category management services or if direct or indirect steps are taken to encourage retailers to comply with recommendations;
- if a dominant supplier reacts to information obtained during a category management exercise, for instance, so as to thwart a new product launch by a competitor which it has found out about via the category management process. This is probably caught by Art.82/Ch.II in any event.

13 *Buyer Power and its Impact on Competition in the Food Retail Distribution Sector of the European Union*—European Commission, October 1999 (online at *http://europa.eu.int/comm/competition/publications/studies/bpifrs/*).

So, the advice to a dominant supplier engaged in category management is "proceed with caution".

A final point can be made, in relation to the United Kingdom. Given all the difficulties which regulators might have in "getting at" category management, the system of market investigations (now contained in the Enterprise Act 2002) may seem an attractive tool for the Office of Fair Trading ("OFT"). In particular, it might be appealing to the OFT to have a clear statement from the Competition Commission on category management before using its Competition Act powers.

Given this, it is a pity that the MMC (as it then was) missed the opportunity to say anything definitive on this subject in its report on supermarkets. Admittedly, the MMC recommended originally that the Supermarket Code of Practice should include a non-discrimination provision regarding category management and a provision requiring that shelf space allocation remained the exclusive preserve of the buyer. In the event, neither of these appeared in the final version of the Code, aspects of which are now under review.

Practical pointers

What is the appropriate reaction of competition lawyers to category management? How should we advise clients involved in, or thinking of becoming involved in, category management?

A cautious lawyer would recommend a formal written agreement between retailer and supplier. It should set out some of the key points from this article, such as the non-exclusivity of data provision, a confirmation from the parties that any recommendations made by the supplier will be mere recommendations, assurance from the retailer that it is not engaged in category management activities with any competitor of the supplier at the same time, and confirmation that the relationship is "at will".

Note the watershed regarding dominance and the fact that neither the Exclusion Order in the United Kingdom nor the Block Exemption will have any force as regards Art.82/Ch.II.

Relevant supplier employees need to be alive to concerns about collusion both at the supplier and retailer level and they need to be astute to avoid anything which amounts to, or could even be misunderstood as, pressure on the retailer to accept recommendations. Finally, these employees should understand how to deal with confidential information and how to react if they find out that a competitor is in discussions with the retailer at the same time.

Ideally, well organised suppliers will maintain "firewalls" between their in-house category management consultants and sales staff. Category management consultants should be reminded to watch their language at all times because it is already clear how readily the OFT can misunderstand emails and other communications, even if they are in fact innocuous.

We are waiting for the first real review of category management by the Commission, the OFT or the courts. It can only be a matter of time before this issue arises, even if only as part of a wider allegation of breach of the competition rules.