Pricing Policies of Food Retailers

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Food retailers, in pricing their merchandise, want to create the impression of low competitive prices for their customers.

Grocers do not apply a standard price markup or gross margin to all items. Rather, they employ what Nelson and Preston (2) termed "variable-price merchandising" in which margins on individual items are varied consistent with the objective of achieving a specified overall gross margin (markup as a percentage of sales) on all products.[1] The object of variable-price merchandising is to maintain low prices on items that are price-sensitive to consumers and charge high prices on other products.

Consumers are thought to be price-sensitive on about 300-500 items. These items may differ from market to market, but generally include most of the products that consumers buy most frequently, especially those with higher prices— and, therefore, account for a significant share of a store's total sales. Since price specials are as important as low prices, variable-price merchandising is noted for lowering prices of some products (and advertising these price changes) while quietly raising the prices of other products.

A firm that is especially successful at using variable-price merchandising may appear to consumers to have low prices when actually its overall price level is relatively high. The only accurate way to determine which store has high or low prices is to select a large enough list of products to measure overall price levels (this larger list of products may not be relevant to any one consumer). Since this is beyond the practical capabilities of most consumers, variable-price merchandising results in considerable confusion. Retailers within the same city often charge different prices for many of the same products. In fact, if different firms in a city charge identical prices on a large number of items, strong competitive pressures may be lacking. There is even less chance that prices on individual items will be the same in different cities.

Grocery retailers' pricing policies usually fall in one of two categories: "discount pricing" and "deep-cut specials" (including loss leaders). One cannot conclude that a store has high or low prices based upon the choice of pricing policy employed— either one may be used with high or low overall prices. Retailers who employ discount pricing claim to have low gross margins and prices on all items. This represents an attempt to reduce differences in gross margins between products, thus reducing the emphasis on variable-price merchandising. Discount pricing is easier for firms to administer than deep-cut specials.

The object of deep-cut specials is to sharply lower the prices of a few products to attract customers who then (the retailer hopes) will buy a broad selection of products. According to Holdren (1), a product has strong drawing power and is a good candidate to use for deep-cut specials if:

- Consumers are knowledgeable about the product's price level and aware of price changes;
- Consumers buy large quantities of the product;
- The product has no close substitutes; and
- A price change is not viewed as a change in product quality.

Products which have little drawing power include those with low prices, impulse items, produce, condiments and spices, and many nonfoods. Over time, retailers search for new items that can be used for price specials to attract consumers. Items that have strong drawing power but that consumers do not store in quantity are preferred in order to reduce losses that may be incurred on the deep-cut specials.

The Role of Nonprice Promotions

Retailers learned long ago that nonprice features such as store decor, large product selection, and consumer services could be used to attract customers and were more difficult for competitors to duplicate. Trading stamps were popular for many years because one grocer had exclusive rights to a particular stamp. Continuity programs and games also were introduced to attract and hold consumer patronage.[2]

A private label program was found to have several merchandising advantages. Private label products permit a retailer to offer a substitute at a lower price than advertised brands. This practice contributes to a low-price image. In addition, a retailer can promote private label products with the assurance that consumers who like the products cannot buy them from another retailer. Furthermore, since consumers may not view competing retailers' private label products as being perfect substitutes, a firm need not be as concerned that a competitor will have lower prices on a specific item; this is especially important for products whose prices are advertised. Generic, or no-brand products (a type of private label) also were used successfully to attract consumers during the last half of the 1970's. The merchandising advantage of the early adopters probably will be partially lost after most retailers introduce such products. However, generics are popular with many consumers and will continue to be handled by food retailers.

As firms and stores grew, they turned more to those nonprice consumer attractions subject to economies of scale, including increased newspaper, radio, and television advertising, larger product selections, pleasant store decor, and more customer services. Trading stamps do not offer scale economies and have not been popular since the 1960's.

Unless prices are cut drastically, as in no-frills type stores, discount pricing often lacks strong drawing power. This is because consumers do not perceive that a firm has low prices when it spreads price cuts over many items so that the price reduction on any one item is small. Over time, nonprice attractions appear to have made it easier for several firms to switch from deep-cut specials to discount pricing. However, in intensely competitive market situations, firms may be forced to turn to deep-cut specials because they cannot afford to match competitor's deep-cut specials and still maintain low prices on all other items.

Interaction Among Firms and Overall Price Levels

A firm's overall price level is determined by the types of grocery stores it operates (for example, no-frills warehouse stores versus superstores), company philosophy, and competitive market

[1] Numbers in parentheses refer to references listed at the end of this article.

[2] Continutiy programs offer or feature one dish, flatware setting, encyclopedia, or other products each week so that over time a loyal customer can complete a set.

pressures. Some firms aggressively juggle prices while other are relatively unaggressive. Nonaggressive competitors tend to maintain relatively high gross margins and prices unless forced to do otherwise by competitors. They do not initiate cuts in the general level of prices or start major competitive skirmishes. Nonaggressive firms advertise prices in local newspapers but relatively few of the prices represent specials. Most are products that the retailer has agreed to advertise in order to qualify for a manufacturer's advertising allowance. Aggressive competitors also advertise products to qualify for manufacturers' allowances, but relatively more of their advertisements are for products whose prices have been cut.

Moderately aggressive firms initiate price cuts against nonaggressive competitors and continually search for nonprice techniques to increase sales. They resist price increases when wholesale prices rise, but also resist cuts when wholesale prices fall. Aggressive competitors take every opportunity to underprice rivals and let consumers know they will not be undersold.

Competitive pressures vary considerably between markets and, over time within a market. In the absence of a major disruptive force, such as entry of a new firm or a major change in competitive strategy by existing firms (including recent introductions of no-frills, limited-assortment stores), grocery retailers settle into a fairly predictable behavior. Relatively nonaggressive pricing policies often develop. Wholesale prices of many products may need to fall (which has been unusual in recent years) before retailers in such markets cut their prices sharply. In these instances, gross margins get bigger until one firm seizes the opportunity to cut prices and capture sales. Rivals then react, advertising activity increases sharply during these periods.

In some instances, a price war follows. In recent years, this has included double and triple couponing (redemption of manufacturers' cents-off coupons for more than their face value). Declining wholesale prices were reported to be at least partially responsible for price wars in 1975 and 1976. The entry of a new market competitor or a major merchandising change by a large firm already in the market also can trigger more aggressive pricing behavior. Large chains often do not initiate aggressive competitive tactics, but react strongly when competitors seriously threaten their market position.

A market leader seeks to enjoy the benefits of its large market share — economies of scale and the ability to exercise some control over the competitive environment — while at the same time preventing an erosion of that market share.

The behavior of firms in less-than-leading positions could be of critical importance in determining the price structure and competitive environment in metropolitan areas. Leading firms may be expected to charge prices that are above competitive levels unless aggressive less-than-leading firms challenge them with lower prices (after adjusting for any differences in product selection and customer services), or unless they feel threatened by potential market entrants. As long as one or more significant competitors is attempting to gain market share, other firms are likely to anticipate price and merchandising changes and, make changes themselves. This type of behavior can lead to situations where all major competitors behave like followers without clear evidence of a leader. Unless there are sharp differences in store characteristics, different firms may have the lowest overall prices during consecutive weeks. Overall price levels will be very similar, and relatively low, although the firms may charge slightly different prices for many specific products.

In those markets where less-than-leading firms accept their positions in the market, all firms also are likely to charge similar prices after adjusting for differences in product selection and consumer services. However, these markets are characterized by relatively nonaggressive behavior and are likely to have relatively high prices. Competitive techniques emphasize nonprice activities, reducing emphasis on price cuts which might trigger a competitive price battle.

Multimarket food chains have a clear advantage in both gaining and holding market share in any given market. This is because they can subsidize their operations with earnings from other markets. This may reduce the willingness and ability of independents and small chains to compete aggressively with them. In markets which are dominated by a few large chains, strong competitive price pressures may not exist if the firms recognize the futility of cut-throat price competition and turn to nonprice techniques.

However, large chains also have the resources that can enable them to enter or increase their sales in a market that has relatively high prices. Past evidence suggests this is not likely to happen unless the large chain's market share is quite low and/or declining, or unless the firm is encountering financial problems that warrant relatively aggressive (and more risky) behavior. For example, A&P, Grand Union, and First National Stores have increased price competition in several cities by opening no-frills type stores. Other large chains are also likely to encounter financial problems in the future and could continue to be a source of increased competitive pressures in various market areas during the next few years. The introduction of no-frills stores by all-size firms could generate new price competition in other markets as well.

In summary, many firms probably benefit when direct price competition is minimized. A market leader may be expected to set the pace for higher prices if the other firms go along. When two or three leading firms have relatively high market shares, they are more likely to be satisfied with their position and, so, avoid head-to-head price battles. Large healthy chains may most likely resist the urge to use sharply lower prices to challenge the rankings of other firms. This may indicate a recognition that no firms are likely to benefit from lower prices.

The lowest price levels are likely to be found where the leading firms realize economies of scale, but are continually threatened by existing and potential competitors and have little market power, because each believes it lacks the power to be the price leader.

References

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2. Nelson, Paul E. and Lee E. Preston, *Price Merchandising in Food Retailing: A Case Study*. IBER Special Publications, Institute of Business and Economic Research, University of California, Berkely, 1966.