EVERYDAY LOW PRICING (EDLP) AS BEHAVIOR-BASED CONTROL: AN INTEGRATION OF AGENCY THEORY WITHIN THE STRUCTURE OF CHANNEL RELATIONSHIPS

By

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This study examined, within the context of the packaged-goods industry, a two-mechanism governance structure for channel relationships through the integration of agency theory and the role of dependence. This framework is to guide manufacturer decision-making through an understanding of the factors that determine the most efficient incentive strategy (agency contract control) and the relationship with retailers required to maximize strategy effectiveness (social integration control). The social control that emerges from the relationship is based on relational exchange theory. Everyday low pricing (EDLP)

and high levels of trade allowances are offered as behavior-based and outcome-based incentive strategies, respectively.

The role of monitoring was examined as an indicator of the inverse relationship, reflecting the primary control component, between governance mechanisms. The influence of manufacturer and retailer dependence on both governance mechanisms was also evaluated in this study.

The results of this study indicated partial support for the assumptions of the hidden action model of agency theory as determinants of the control mechanisms. The risk accepted or tolerated by the manufacturer for generating consumer demand was found to influence the selection of incentive control strategy. The use of EDLP increased with risk acceptance.

Goal compatibility and task programmability were found to influence the control of social integration. Increased levels of the assumptions resulted in a greater level of relational exchange. This finding indirectly supported the value-added movement of efficient consumer response.

A direct correspondence between the two governance mechanisms was not found in this study. Gaps in mechanism correspondence may indicate a less efficient and effective

governance. A transition phase, such as when an incentive strategy leads or follows social integration, was offered as an explanation for the results. Additionally, manufacturers who were more socially integrated with retailers monitored less.

Asymmetrical dependence was found to influence the type of exchange relationship. Packaged-goods manufacturers perceived a more relational exchange when there existed higher levels of retailer dependence and lower levels of manufacturer (their own) dependence.

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This dissertation is dedicated to my wife, Linda, whose love and support was always there.

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INTRODUCTION

A manufacturer depends on a retailer to perform an activity central to its existence -- the exchange with the consumer. The manufacturer's ability to control the consumer exchange lies in its exchange with retailers. The governance of channel exchange has recently attracted considerable attention from marketing scholars (i.e., Gundlach and Achrol 1993; Heide 1994; Robicheaux and Coleman 1994). Their research seeks to provide an ordering of construct relationships and an understanding of the processes for market and alternative forms of governance. The management of these governance forms, based on the relationship between firms, is rapidly emerging as the central research paradigm in the marketing channels literature (Heide 1994).

Within the context of the packaged-goods industry, this study offers manufacturers a governance framework that is based on the incentive contract control of agency theory

(Harris and Raviv 1979; Jensen and Meckling 1976) and the social integration control of relational exchange theory (Macneil 1980). Through an understanding of the factors that determine the most efficient incentive strategy and the relationship with the retailer required to maximize strategy effectiveness, this framework guides manufacturer decision-making in the use of the contractual control mechanisms of everyday low pricing and trade allowances. Incentive strategy should not be determined in isolation from the relationship of the exchange. Within the context of the packaged-goods industry, the relationship between manufacturer and retailers, in and of itself, may act as a control mechanism. Gundlach and Achrol (1993) suggest that an understanding of how firms govern their exchange relationship is of paramount concern to public policy.

In agency theory, the assumptions of goal compatibility, risk taking, environmental uncertainty, and task programmability offer context-specific direction for the most efficient contractual incentive mechanism. This mechanism ranges from an outcome-based to a behavior-based incentive system. Traditionally, packaged-goods manufacturers have offered trade promotion allowances, which

at the extreme can be described as high list price and high temporary trade allowance (Hi-Promo), intending to control for the store-level outcome of a featured product at a temporarily lower price to the consumer. The overall goal for the manufacturer is an increased market share and a strengthened consumer franchise.

Unfortunately for packaged-goods manufacturers, the retention of trade allowances by retailers (as well as the increased level of trade allowances) has weakened this mechanism of control. An industry estimate contends that up to 35% of a supermarket retail chain's profits and up to 75% of a distributor's income is derived from retaining trade allowances and not passing the savings on to the consumer (MacClaren 1992). Manufacturers face a loss of influence in their exchange with the consumer through the uncertainty of the store-level outcome of a featured product at a temporarily lower price.

In response, some manufacturers have introduced an incentive system of everyday low pricing (EDLP). EDLP at its extreme can be described as that of low list price and low temporary trade allowance, and is intended to reward behaviors (processes) and allow the retailer to present a

consistently lower price to the consumer. The EDLP price is above the lowest price available under Hi-Promo, but significantly below the everyday price outside of a featured promotion period. Although there exists a directly related and desired store-level outcome of a consistently lower price, the behaviors of the retailer are anticipated to be instrumental to the overall goal of the manufacturer.

Hi-Promo and EDLP range on a continuum and are proposed to function, respectively, as outcome-based and behavior-based control mechanisms of agency theory. High and low list price reflects the variance that may occur in the shelf price consumers pay for the product; high and low temporary trade promotion reflects the range of temporary trade promotions offered to retailers.

The contractual control mechanism predicted by the tenets of agency theory (specifically, the assumptions of the hidden action model) is proposed to correspond to a level of social integration control that should emerge from the relationship itself. Relational exchange theory offers a set of social norms or shared expectations for regulating behavior (Gundlach and Achrol 1993), reflecting the integration of the firms within the relationship. Norms

serve to control proper and acceptable behavior (Macneil 1980, p.38) in ways not provided by legal contracts (Gundlach and Achrol 1993). The level of social integration control ranges from discrete to relational, as manifested in the norms. Relational exchange can be viewed as an erosion of discreteness (Macneil 1978), where the relationship becomes increasingly interdependent, cooperative, and complex (Macneil 1981).

This study proposes that the continuum of agency contract control, outcome-based Hi-Promo to behavior-based EDLP, corresponds to the continuum of social integration control, discrete to relational exchange. Although positively related in correspondence, agency control and social control are proposed to be inversely related as the primary control mechanism. Relational exchange becomes increasingly more important under higher levels of EDLP; conversely, discrete exchange is prevalent under higher levels of trade allowances (Hi-Promo).

The control of agency and social integration is proposed to form the base governance structure of an exchange reflecting economic and psychosocial components, respectively. As proposed in the political economy

paradigm, these components or forces influence behavior and performance (Stern and Reve 1980). Thus, structure serves to define the exchange form.

The range of corresponding mechanisms provide an array of plural governance structures to manufacturers. Given the tenets of agency theory, context-specific direction is offered to manufacturers for both control forms. Heide (1994) suggests that non-market governance is a diverse phenomenon and the appropriateness of relationship strategies vary with exchange conditions.

A manufacturer selecting EDLP as a strategy must recognize the relationship conditions required to be effective, such as a long-term view, a degree of fairness in the distribution of channel profits, and a need for flexibility and information sharing. An inconsistency between control forms may mean a greater need for the enforced contractual provisions of trade allowances (as when the exchange is less relational than contractually specified) or an opportunity to increase EDLP efficiency through a reduction in monitoring (as when the exchange is more relational than contractually specified).

This study integrates agency theory within the structure of channel relationships by offering incentive contracts as the economic component and predictive assumptions of the hidden action model as determinants of the social control mechanism. This theoretical integration seeks to advance an understanding of exchange governance by holistically viewing the two forms of control. This view is particularly important as boundaries become increasingly blurred between firms.

Proposed contributions to the field include: (1) the offering of agency as a theoretical basis for explaining exchange governance, (2) the recognition that the incentive contracts of agency control should not be used in isolation in structuring relationships, (3) the recognition that determinants of the agency mechanism are also antecedent to the norms of the exchange (given the relationship between control forms), (4) the recognition that non-market governance of hierarchy can be structured other than as a bureaucratic mechanism, and (5) the inclusion of dependence in the relationship as a predictor of both the agency and social control mechanisms.

From a managerial perspective, packaged-goods manufacturers are offered context-specific direction in the use of Hi-Promo and EDLP as control strategies and relationship conditions necessary to be effective. The design of exchange relationships is a critical strategic decision variable (Heide 1994). Related strategies, contingent on the type of structure, such as communications (e.g., Mohr and Nevin 1990), negotiations (e.g., Dabholkar, Johnston and Cathey 1994), and influence (e.g., Boyle et al. 1992) can be additionally integrated into the manufacturer's decisions.

This study sets its foundation and builds a governance framework from the works of Bergen, Dutta and Walker (1992); Bradach and Eccles (1989); Eisenhardt (1989); Gundlach and Achrol (1993); Heide (1994); Jarillo (1988); Macneil (1980); Mohr and Nevin (1990); and, Robicheaux and Coleman (1994).

STUDY CONTEXT

Packaged-goods manufacturers, fueled by leveraged buyouts and a continuing demand for growth in mature markets, escalated the levels of trade promotions and

enabled retailers to become gatekeepers to the consumer. This shift in power allowed retailers to increasingly act in their self-interest, while manufacturers continued to push trade allowances from 7% of advertising and promotion expenditures in 1970 to over 44% in 1992 (Schiller 1992). One major firm estimates that trade allowances account for over 17% of revenues totaling $2.6 billion (Sellers 1992).

The high level of trade allowances enabled retailers to pursue the practice of forward buying and diversion. Retailers began to purchase product during a trade promotion beyond the quantity they could expect to sell during the featured period. The excessive quantity was then sold to consumers at the normal price (the retailer retaining the allowances) or sold (diverted) to another retailer typically outside of the promotion area. Buzzell, Quelch, and Salmon (1990) estimate that the added cost of forward buying and diversion practices in the non-perishable food section alone is nearly $3 billion or 2% of retail sales. Furthermore, the year round average inventory for the retail channel is 80% greater with these practices.

Manufacturers, in an effort to offset operational inefficiencies and escalating levels of trade allowances,

raised prices to retailers; retailers then passed the increases on to the consumers. As prices increased on their favorite brands, consumers became more price sensitive and concerned with value. The percentage of packaged-goods consumers who knew what brand they would purchase prior to entering a store dropped from 56% in 1988 to 46% in 1991 (Liesse 1991).

The rise in consumer prices also presented retailers with the opportunity to develop store brands or private label products as a viable low-cost alternative to manufacturer branded products. Private label sales of grocery products rose to 18.3% of unit volume and 14% of dollar volume in 1992 compared with 16.4% and 12.5%, respectively, in 1989, with retailers enjoying nearly twice the gross margin than realized on manufacturer brands (Deveny 1992).

As manufacturers continue to experience a loss of influence in the exchange with the consumer (and the resulting erosion of market share and consumer franchise), the selection of a control strategy with the retailer becomes a decision of major importance.