

chapter

3

The Environment of Marketing Channels

Learning Objectives:

After reading this chapter you should:

- Understand the impact of environment in a marketing channels context.
- Be aware of some of the major economic forces affecting marketing channels.
- Recognize that even “normal” economic conditions require attention in terms of how they might influence marketing channels.
- Be cognizant of the international or global nature of the competitive environment as it affects marketing channels.
- Be able to delineate the major types of competition in the context of marketing channel structure and strategy.
- Appreciate some of the major sociocultural developments taking place with respect to their implications for marketing channels.
- Be alert to rapid changes in technology and be sensitive to how such changes can affect market channels.
- Gain a general knowledge of the basic antitrust laws as they apply to marketing channel strategy.
- Be familiar with the key legal issues relating to marketing channels.



FOCUS ON CHANNELS

This Opera Is About Price Fixing in a Channel of Distribution

The so-called Three Tenors—Luciano Pavarotti, Plácido Domingo, and José Carreras—became the “rock stars” of the opera world after a live concert and recording session at the 1990 World Cup soccer finals in Rome. The CD from this Three Tenors concert sold over 3 million copies in the U.S. alone—a spectacular sales level for an opera CD. Polygram, a division of Vivendi Universal, had the exclusive rights for worldwide distribution of the 1990 concert.

The great success enjoyed by the first World Cup opera concert led to a repeat concert at the 1994 World Cup in Los Angeles; this time Warner Music, a division of AOL Time Warner, garnered the exclusive distribution rights. The second Three Tenors World Cup CD did not do as well as the first, but with sales of over 1.5 million CDs in the U.S., it was still considered successful.

For the third Three Tenors Concert, which took place in Paris in 1998, both Vivendi and Warner agreed to jointly distribute the CD. But the two record companies decided to do something else besides putting out a maximum promotional effort to gain the widest possible distribution for the CD. Worried that the third CD might not do as well as the first

two, they decided to take some action to “help it along.” Specifically, Vivendi and Warner explicitly agreed not to discount or even advertise the two earlier CDs from August 1 through October 15, 1998—the period during which the third CD was to be released and promoted.

When the Federal Trade Commission (FTC) got wind of this after discovering the scheme in an internal Warner memo, it charged Warner and Vivendi with attempting to thwart competition and fix prices. The FTC argued that this agreement amounted to an illegal moratorium on competition, because it artificially propped up the third CD by limiting access to the first two. Warner, though not admitting guilt, settled with the FTC, while Vivendi decided to fight the FTC in court if necessary, claiming that the agreement made with Warner didn’t violate antitrust laws.

The Three Tenors themselves claimed to know nothing about the alleged illegal agreement. But if the FTC’s action against Vivendi ends up in court, the Three Tenors may very well be asked to “sing” from the witness stand instead of the stage.

Source: Based on John R. Wilke and Martin Peers, “Price Fixing Is Alleged on CDs of Three Tenors,” *Wall Street Journal* (August 1, 2001): B1, B4.

Marketing channels operate in a continually changing environment.¹ Therefore, the channel manager needs to be sensitive to the environment and the changes occurring in order to plan effective marketing channel strategies for meeting these changes successfully. To do so, the channel manager needs to understand the environmental factors that can affect marketing channel systems.

In this chapter, we examine the environment within which marketing channels operate in the context of the implications for channel strategy, structure, and management.

The Marketing Channel and the Environment

The environment consists of all external uncontrollable factors within which marketing channels exist. Thus, a myriad of variables can affect channels. To give some semblance of order to this huge array of external uncontrollable variables, we will categorize them in this chapter under the following five general headings:

1. Economic environment
2. Competitive environment
3. Sociocultural environment
4. Technological environment
5. Legal environment

Obviously, this is not the only way to categorize environmental variables. Numerous other category systems (taxonomies) exist.² We have used this taxonomy simply because it provides a convenient and workable basis for discussing the environment of marketing channels. It should also be noted that the order in which the categories are listed and discussed does not imply any order of importance. Moreover, for any given channel, the importance of particular environmental factors will vary over time. As we proceed through this chapter, numerous examples of the diverse effects of environmental factors on different channels and at different times will be presented.

Before discussing each of these environmental categories and their influence on the marketing channel, a peculiarity of the influence of environment in a marketing channels context should be noted. Because the marketing channel includes independent firms such as retailers and wholesalers, channel managers must also be concerned with the impact of the environment on these channel members. Furthermore, because channel effectiveness is also influenced by the performance of nonmember participants, such as facilitating agencies, channel managers must also take into account how the environment affects these nonmember participants. Thus, channel managers must analyze the impact of environment not only on their own firms and ultimate target markets, but also on *all* of the participants in the marketing channel. Figure 3.1 illustrates this by showing the environment affecting all channel participants and the target markets. The locus of channel management (not necessarily con-

1. See, for example, Jon M. Hawes and Thomas L. Baker, "Type of Exchange and Environmental Uncertainty within a Marketing Channel," in *Proceedings of the Annual Educators' Conference of the American Marketing Association*, eds. Robert P. Leone and V. Kumar (Chicago: American Marketing Association, 1992), 496–500; Jeffrey C. Dilts, "Perceived Environmental Uncertainty and Perception of the Channel Relationship," in *Developments in Marketing Science, Proceedings of the Academy of Marketing Science*, Vol. XIV (Coral Gables, Fla.: Academy of Marketing Science, 1991), 96–99; F. Robert Dwyer and N. Ann Welsh, "Environmental Relationships of the Internal Political Economy of Marketing Channels," *Journal of Marketing Research* (November 1985): 397–414.

2. See, for example, Ravi S. Achrol, Torger Reve, and Louis W. Stern, "The Environment of Marketing Channel Dyads: A Framework for Comparative Analysis," *Journal of Marketing* (Fall 1983): 55–67.

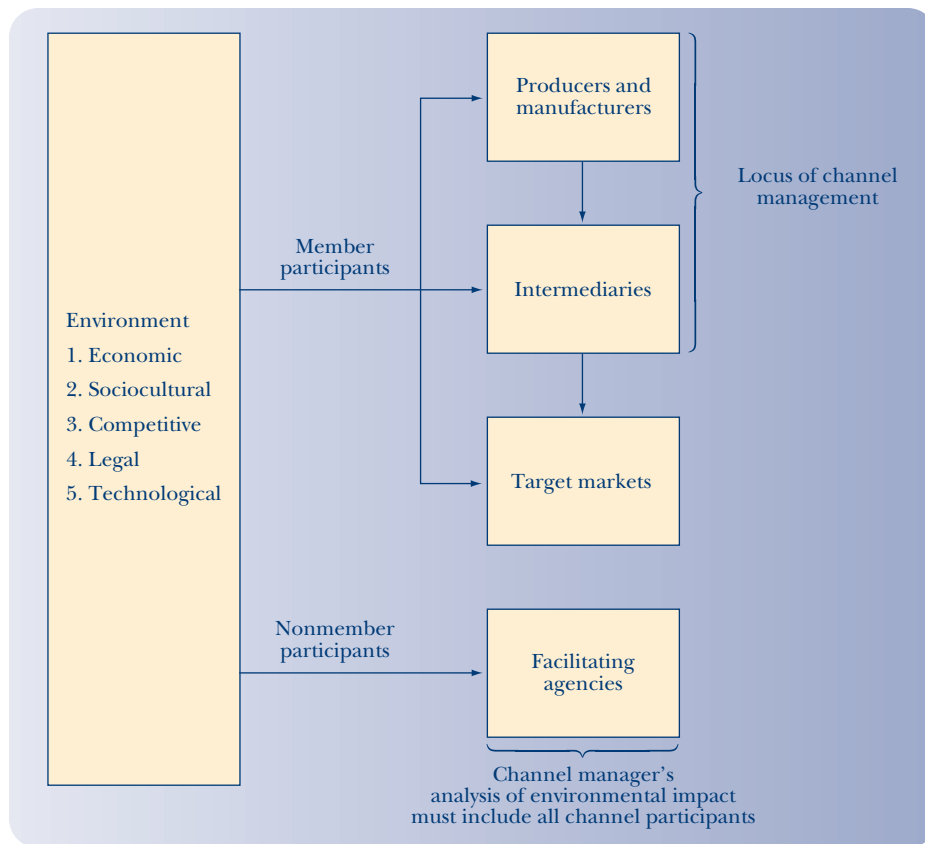


Figure 3.1
The Impact of Environ-
ment in a Market-
ing Channels Context

trol) may lie in producing and manufacturing firms or in intermediary firms such as large wholesale or retailing organizations that are capable of administering the channel. The bracket at the bottom of the figure indicates that management's analysis of environmental effects must consider all of the channel participants.

This view of the impact of environment in a marketing channels context represents a key distinction between channel management and management of the other major variables in a firm's marketing mix (product, price, and promotion). In short, when the channel manager considers environmental influences on channel strategy, he or she has a lot more to think about. This extended view of environmental analysis to include *all* channel participants should be kept in mind throughout this chapter and, for that matter, for the remainder of the text.

We now turn to a discussion of each of the major environmental categories. The discussion will focus on some of the key issues for each category and how they influence the marketing channel.

The Economic Environment

The economy is probably the most obvious and pervasive category of environmental variables affecting all members of the marketing channel. Hardly a day goes by without the state of the economy drawing the notice of consumers and executives in manufacturing, wholesaling, and

retailing firms. All of these parties must pay careful attention to what is happening in the economy. From a manufacturer's raising capital for a long-term investment to a consumer's buying a pound of coffee in the supermarket, all are affected by economic variables.

In a channel management context, economic factors are a critical determinant of channel member behavior and performance. The channel manager must therefore be aware of the influence of economic variables on the participants in the channels of distribution. In this section we discuss several major economic phenomena in terms of their effects on various parties in the marketing channel and their implications for channel management.

Recession

While the "official" definition of a recession among professional economists is two consecutive quarters of decline in the Gross Domestic Product (GDP), any period in which the GDP is stagnant or increasing very slowly is often referred to as "recessionary" or at least as an "economic slowdown."

During the booming decade of the 1990s, many pundits were talking about the "end of the business cycle" and a "new economy" where recessions would be a thing of the past. They argued that information technology was so good that businesses would be forewarned of any potential slowdowns in the economy and would be able to make the necessary adjustments, such as reducing inventories, so as to forestall the onset of a recession. By the dawning of the new millennium in 2000, and with the last recession of 1990–1991 almost a decade in the past, it looked as if the pundits would be right. Well, their hopes were short-lived, as the U.S. did indeed experience a recession in early 2001. The business cycle, with its periodic recessions and economic slowdowns, was still very much alive.

As a recessionary period unfolds, consumer spending (especially for such durable goods as automobiles, major appliances, and personal computers, which consumers can postpone purchasing) usually slows down, sometimes drastically.³ The 2001 recession diverged from this typical pattern. Instead, business investment spending slowed to a much greater extent than consumer spending. Because interest rates were low, thanks to action taken by the Federal Reserve Bank, consumers were able to finance major purchases such as houses, appliances, and automobiles. The corporate sector, however, cut back spending drastically on the information technology hardware and software they had purchased so abundantly during most of the 1990s. In retrospect, they realized that they had overspent on this technology and consequently had massive excess capacity to use up before they could spend any more. This "business investment recession" put a major damper on the economy as it rippled through and drove up the unemployment rate to levels not seen since the recession of the early 1990s.

All members of the marketing channel may feel the effects of recession in the form of substantial reductions in sales volume and profitability. Firms caught with heavy inventories that they cannot sell may be more drastically affected, even to the point of bankruptcy. Unfortunately, in the business-to-business sector little was done by major manufacturers (especially of information technology products) to help channel members weather the recession and economic slowdown. Because this type of business investment recession had not occurred before, the business sector had no experience base for developing a strategy to help channel members.

On the other hand, consumer products manufacturers, particularly the automobile manufacturers, had learned from previous bad experience how to help channel members in recessionary periods. During the previous recession of 1990–1991, low sales coupled with the high costs of carrying inventory made it extremely difficult for automobile dealers to survive, let

3. Carrie Mollenkamp, Don Morse, Tommy Craggs, and Jay Krall, "Uncertain Consumers Scale Back Spending," *Wall Street Journal* (July 19, 2002): A2.

alone earn a profit in the face of the slow economy. Confronted with these serious problems, auto dealers turned to the auto manufacturers for help. According to many of the dealers, however, the help offered was too limited and not directed at the dealers' main concern of financing high inventory costs. Indeed, many dealers felt that manufacturers were indifferent to this problem. No significant program was offered to ease the dealers' financial burden of carrying huge inventories during the economic slowdown and, needless to say, many auto dealers were extremely disappointed and angry over the auto manufacturers' failure to do more to help them solve their inventory financing problem.

The major domestic auto companies—General Motors, Ford, and Daimler-Chrysler—did not make the same mistake again during the 2001 recession. Before the slowdown was even recognized as a recession, they supported their dealers with extremely attractive financing arrangements that, in many cases, enabled the dealers to offer 0 percent financing of automobile purchases. This kept customers streaming into the showrooms and driving off the dealers' lots in new cars, pickup trucks, and SUVs. Such aggressive channel member support in the form of highly attractive financing fostered a boom in auto sales rather than a bust, an outcome unprecedented in previous recessions.

Inflation

Since 1981, the rate of inflation as measured by the Consumer Price Index (CPI) has stayed in the single digits, as shown in Table 3.1. In fact, over the 21-year period between 1981 and 2002 the rate of inflation has averaged just 3.3 percent. Compared to the late 1970s, when double-digit annual rates of inflation were common, inflation has remained moderate for two decades.

Years	Annual Consumer Price Index Increases (percent)
1981–1982	5.6
1982–1983	3.1
1983–1984	4.3
1984–1985	3.7
1985–1986	2.0
1986–1987	4.0
1987–1988	4.7
1988–1989	4.8
1989–1990	5.4
1990–1991	4.2
1991–1992	3.0
1992–1993	3.2
1993–1994	2.7
1994–1995	2.5
1995–1996	3.3
1996–1997	2.2
1997–1998	1.7
1998–1999	1.6
1999–2000	2.7
2000–2001	3.4
2001–2002	1.6

Table 3.1
Inflation Rates in the United States as Measured by the Consumer Price Index (CPI), 1981–2002

Source: Economic Indicator (Washington, D.C.: G.P.O., May 2002).

Even though inflation rates have been relatively low in recent years, there is no guarantee that they will remain at these levels in the future. Some respected economists argue that inflation rates could increase significantly if, for instance, the economy were to grow too rapidly, if the money supply were loosened excessively (thus encouraging the economy to grow too rapidly), or if a world crisis were to create energy shortages leading to spiraling energy prices.⁴ In light of these possibilities, then, it is prudent for the channel manager to become acquainted with the implications of higher inflation for marketing channel strategy.

The reactions of channel members at the wholesale and retail levels to high rates of inflation are in large measure determined by the reactions of consumers or other final users. Unfortunately, reactions of consumers (or other final users) during inflationary periods are not easy to predict. High spending may continue even in the face of growing inflation, as consumers and other users follow a “buy now before the price goes higher” psychology. This, of course, further fuels the inflationary spiral. On the other hand, this psychology can be suddenly replaced by a “hold on to your money” psychology if consumers and other final users see a recession just around the corner. Paradoxically, such precipitous drop-offs in spending can help to bring on and aggravate the very recession they had feared.⁵

In addition to the dramatic shifting in consumer spending that can occur during inflationary periods, many other more subtle changes in consumer buying patterns may occur. For example, in the supermarket industry, during inflationary periods consumer buying patterns increasingly reflected such tactics as:

- » Going to the supermarket without bringing along extra money
- » Putting items back before checking out
- » Buying only the amount needed
- » Buying less meat
- » Stocking up on bargains
- » Buying lower-quality brands
- » Buying unplanned items only if they are on special sale

Such patterns of consumer shopping behavior obviously reflect an attempt by consumers to cope with inflation.

From the perspective of the channel manager in the producing or manufacturing firm, such changes in consumer buying behavior should be viewed in the context of how they might affect channel member behavior and what the implications might be for channel strategy. For example, in the face of slower and more prudent consumer spending, supermarkets (and most other retailers) become increasingly cautious about what products they will handle. Moreover, because of higher interest rates, they generally try to reduce their inventory levels to the minimum. Finally, they will seek more special price deals from manufacturers and a higher level of promotional support. In the face of such increased channel member demands, an effective channel strategy must be developed to satisfy the channel members. Such a strategy might stress a change in emphasis on the manufacturer’s product mix from higher-price to lower-price products. Scott Paper Company, for example, began offering lower-priced paper products to supermarkets so as not to lose shelf space in the face of strong price competition. Reducing the inventory burden on channel members through a streamlined product line, faster order processing and delivery, and higher inventory turnover through stronger promotional support may also have to be incorporated into a channel strategy for meeting the demands of channel members who are attempting to operate profitably under the intense cost pressures imposed by inflation.

4. See, for example, Rudi Dornbusch, “The Inflation Beast Is Asleep—Not Slain,” *Business Week* (June 5, 1995): 24.

5. James C. Cooper, “In the New Economy, the Old Rules Still Live,” *Business Week* (July 28, 1997): 34.

Deflation

Deflation on a wide scale resulting in a decline in prices across a broad spectrum of goods and services has not occurred in the United States since the Great Depression of the 1930s. If deflation similar to that experienced during the Depression were to occur in the future, the Consumer Price Index on which the data in Table 3.1 are based would show negative numbers rather than positive ones.

Most economists do not expect a deflationary environment broad enough to cause an actual decline in the Consumer Price Index to emerge in the foreseeable future. Nevertheless, inflation in recent years has become low enough (see Table 3.1) that such a development is not unthinkable. But what *has* already happened and what is very likely to continue in the future is deflation in certain *sectors* of the economy and in some *product categories*. Automobiles, consumer electronics, computers, telecom equipment, some types of apparel, food products, and many other commodities have experienced deflation recently. Almost certainly other sectors of the economy and other products will experience deflation in the future.

Deflation, static prices, or even very low rates of price increases can create serious channel management difficulties. The problem is one of trying to pass cost-induced price increases through the channel in the face of deflation or very low inflation rates. Why? Even with a very low inflation rate or even with actual deflation in some sectors of the economy, manufacturers, wholesalers, and retailers often face built-in cost pressures, particularly from labor contracts that might have been negotiated several years earlier when the inflation rate was higher. But increasing prices to offset these cost pressures becomes very difficult when inflation is low, because each member of the channel is highly sensitive to higher prices. Thus, although it is relatively easy during periods of inflation to pass on price increases to the next level of the marketing channel all the way down to the final buyer, it becomes anything but easy when the inflation rate is low, and virtually impossible in a period of actual deflation.

Other Economic Issues

Recession, inflation, and deflation are not the only variables in the economic environment. The federal budget deficit (which had started to return by the second year of the new millennium, after a surplus during the last couple of years of the twentieth century), the huge national debt, and the trade deficit have also been widely discussed economic issues and will no doubt be of continuing concern in the twenty-first century. These phenomena are not “bad” in and of themselves, but they can aggravate recession and inflation. The budget deficit and the national debt make huge demands on capital and hence raise interest rates. This in turn adds to the level of inflation. The trade deficit, resulting from greater levels of imports than exports, can mean loss of jobs for U.S. workers, which can exacerbate recessionary forces by reducing the level of income.

Although the U.S. enjoyed very low interest rates during the early part of the twenty-first century, there is no guarantee that high interest rates will not return. High interest rates can be a problem even when the inflation rate is moderate and the economy is not in a recession. This is particularly true of the **real interest rate**, which is the nominal rate of interest minus the inflation rate. Given the same nominal interest rate, the real interest rate will actually be *higher* when inflation is lower. This is illustrated in Table 3.2. As shown in the table, at a nominal interest rate of 10 percent, when the inflation rate decreased from 6 to 3 percent, the real interest rate (nominal rate less inflation rate) increased from 4 to 7 percent. What this means, of course, is that the true cost of borrowing money will actually increase when inflation moderates if nominal interest rates do not decrease sufficiently to offset the decrease in the inflation rate.

Table 3.2
Nominal and Real Interest Rates Compared at Different Rates of Inflation

Nominal Interest Rate (percent)	Inflation Rate	Real Interest Rate
10	6	4
10	3	7

High interest rates can affect all members of the marketing channel. Even though consumers may be slow to recognize the effects of high real interest rates, eventually they do catch on and their spending slows down. This in turn affects sales for retailers, wholesalers, and manufacturers. Moreover, because manufacturers, wholesalers, and retailers also often need to borrow money, high real interest rates have a direct impact on their costs of doing business. So, even during what appear to be good economic conditions—when inflation is low and the economy is not in recession—high real interest rates can still cause problems by decreasing demand and increasing costs.

Another economic factor that can affect channel management, even in good economic times, is the value of the U.S. dollar relative to foreign currency. Ironically, a strong U.S. dollar can actually create channel management problems for U.S. manufacturers by making it more difficult to sell their products through channel members. When the value of the dollar is high, the price of U.S. products increases relative to foreign-made products because it takes more foreign dollars to buy U.S. products and fewer U.S. dollars to buy foreign goods. Hence, U.S. products can become less competitive. When this happens, it becomes much more difficult for U.S. manufacturers selling in international markets to move their products through overseas channels. But even in domestic channels, it becomes more difficult to move products because retailers and wholesalers find it attractive to buy more of the cheaper foreign products.

In terms of the economic environment, then—regardless of the state of the economy—the channel manager needs to pay careful attention to the implications of economic factors on channel management. For even when “good times” are at hand, some subtle, even insidious forces may create enough problems to make the “good times” actually look bad.

The Competitive Environment

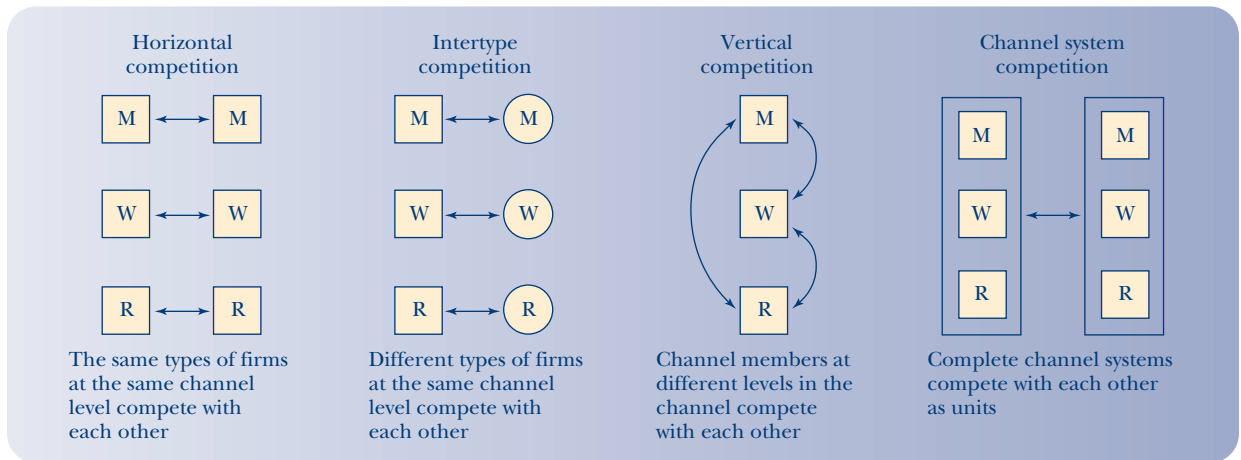
Competition is always a critical factor to consider for all members of the marketing channel. This is especially the case in recent years as competition has become global in scope. No longer is it realistic for domestic firms to focus only on rivals within the boundaries of their own country. In addition, they need to pay close attention to existing and emerging competitors from all over the world. The terms *global marketplace*, *global arena*, and *global competition* are not just international business jargon but realistic descriptions of the competitive environment as it exists today in an increasing number of industries.

Types of Competition

Along with the broadened scope of competition, channel managers must also consider the major types of competition that can affect channel strategy. In particular, they need to focus on the following four types, depicted in Figure 3.2.⁶

6. These classifications of competition are based on the work of Joseph C. Palamountain, *The Politics of Distribution* (Cambridge, Mass.: Harvard University Press, 1955).

Figure 3.2
Types of Competition



1. Horizontal competition
2. Intertype competition
3. Vertical competition
4. Channel system competition⁷

Horizontal competition is competition between firms of the same type; for example, an automobile manufacturer versus another automobile manufacturer, a plumbing supply wholesaler versus another plumbing supply wholesaler, or one supermarket versus another. This is the most visible and frequently discussed form of competition. In economic theory, much of the treatment of competition deals with this horizontal type, although it is usually referred to simply as “competition,” and often the firms involved are producers or manufacturers rather than wholesalers or retailers.

Intertype competition is competition between different types of firms at the same channel level; for example, the off-price store versus the department store or the merchant wholesaler versus agents and brokers.⁸ A development in the competitive structure for the office supplies industry shows how intertype competition can dramatically transform marketing channels. The office supply industry had maintained its traditional channel structure for decades: Manufacturers sold to large national wholesalers, who in turn sold to local retailers, who then sold to local businesses and consumers. The appearance of the “office superstore” originated by Staples changed all this. Modeled after large supermarkets and home centers, the office superstores provide a wide variety of products in huge stores, are open for long hours, and sell at rock-bottom prices. As more and more office superstores appeared, the small neighborhood stationery stores (and the traditional channel structure that supplied

7. This mode of competition is derived from the work of Bert C. McCammon, “The Emergence and Growth of Contractually Integrated Channels in the American Economy,” in *Marketing and Economic Development*, ed. P. D. Bennett (Chicago: American Marketing Association, 1965), 496–515.

8. For additional background on intertype competition, see F. Robert Dwyer and Sejo Oh, “The Consequences of Intertype Competition on Retail and Interfirm Behavior,” in *Proceedings of the Annual Educators’ Conference of the American Marketing Association*, ed. Susan P. Douglas (Chicago: American Marketing Association, 1987), 23–28.

them) virtually disappeared. Clearly, in the intertype competition between traditional stationery stores and office superstores, the “big guys” such as Staples, Office Max, and Office Depot overwhelmed the “little guys.”⁹

Another recent example of intertype competition has come from the dot-com online retailers. During the latter part of the twentieth century, many pundits believed that these “pure-play” e-tailers such as Amazon, Etoys, and Webvan, would spell the demise of “bricks and mortar” retailers. As we now know, of course, this did not happen. Internet-based E-commerce turned out to be a much less significant form of intertype competition than had previously been thought. Indeed, many of these pure-play dot-coms (including Etoys and Webvan) have gone out of business.¹⁰

Vertical competition refers to competition between channel members at different levels in the channel, such as retailer versus wholesaler, wholesaler versus manufacturer, or manufacturer versus retailer. The competition between manufacturers of national brand jeans—for example, Levi Strauss Company’s Levi’s and VF Corporation’s Lee and Wrangler versus retailer private brands such as The Gap’s own brand, JCPenney’s Arizona label, and Sears’s Canyon River Blues—provides a good example of vertical competition. The huge \$15 billion jeans market, which was dominated for decades by the famous national brands, is now getting some serious competition from retailers’ own brands. Using hip marketing campaigns with famous rock bands, Web sites, and exciting imagery, retailers have captured 25 percent of the market with their own brands.¹¹ The retailers love to sell their own brands not only because gross margins are higher but because they can control their own destiny rather than be beholden to powerful manufacturers. As this competition between manufacturers and retailers for the jeans market intensifies, this vertical competition could become vertical conflict whereby one channel member acts to directly impede another channel member’s attempt to achieve its objectives. This possible conflict aspect will be discussed in detail in Chapter 4.

Finally, **channel system competition** refers to complete channels competing with other complete channels. In order for channels to compete as complete units, they must be organized, cohesive organizations. Such channels have been referred to as **vertical marketing systems** and are classified into three types: (1) corporate, (2) contractual, and (3) administered.¹² In **corporate channels**, production and marketing facilities are owned by the same company; Firestone Tire & Rubber Company and Sherwin-Williams Company (paints) are examples. In the **contractual channel**, independent channel members—producers or manufacturers, wholesalers, and retailers—are linked by a formal contractual agreement. Wholesaler-sponsored voluntary chains, retailer cooperatives, and franchise systems are the three major forms of contractual marketing systems. ServiStar in hardware, Independent Grocers Alliance (IGA) in food, and Drug Guild are examples of such contractual marketing channels. **Administered channel systems** result from strong domination by one of the channel members (frequently a manufacturer) over the other members. This dominant position is a function of the leverage that the dominant channel member can achieve based on a monopoly of supply, special expertise, strong consumer acceptance of its products, or other factors. Companies such as Scott (lawn products), Ethan Allen (furniture), Samsonite (luggage), and Coors (beer) are examples of firms that operate administered marketing channels.

Although little precise data exist, it is generally recognized that vertical marketing systems have grown dramatically during the past decade, with the most growth occurring among con-

9. For a related discussion, see Mitchell Pacelle, “Vermont Opens the Door to Megastores,” *Wall Street Journal* (November 26, 1996): B1, B10.

10. Bert Rosenbloom, “The Ten Deadly Myths of E-Commerce,” *Business Horizons* (March–April 2002): 61–66.

11. Ellen Neuborne and Stephanie Anderson Forrest, “Look Who’s Picking Levi’s Pocket,” *Business Week* (September 8, 1997): 68–72.

12. McCammon, “Emergence and Growth,” 498–504.

tractual systems, particularly franchises. As these vertical marketing systems take a larger and larger share of the total distribution system, the extent of channel system competition is also expected to grow.

From the preceding discussion we can see that channel managers face a rather complex competitive environment. Not only do they have to think in terms of a broad global perspective of competition, they also need to worry about horizontal, intertype, vertical, and channel system competition. Fortunately, it is unlikely that they will face all of these types of competition simultaneously. Nevertheless, they should be sufficiently familiar with the four types to be able to recognize and distinguish among them.

Competitive Structure and Channel Management

From the producer's or manufacturer's standpoint, an understanding of competitive structure and the changes taking place in that structure are crucial for successful channel design and management.¹³

In designing the marketing channel, the channel manager needs to determine which kinds of distributors and/or dealers can provide the most efficient and effective distribution of the firm's products. But given that the competitive structure of distributors and dealers changes—sometimes rapidly—conventional ideas about the kinds of dealers or distributors that should sell particular products can quickly become obsolete. For example, it was not too long ago that most automotive parts and supplies were sold in automotive stores, sporting goods in sporting goods stores, and hardware in hardware stores. In recent years, however, one can find all of these products in mass merchandisers, discount department stores, home center stores, warehouse clubs, and even in many drugstores and supermarkets. Such **scrambled merchandising**, the selling of products through nontraditional outlets, has drastically changed the competitive landscape. Whereas once a manufacturer of, say, auto parts would realistically think only in terms of designing a channel that used auto parts distributors and dealers, the options available have become much broader. The same is true for manufacturers of many other kinds of products. It seems that almost any kind of store or other mode of sale such as the mail or the Internet can be an outlet for any kind of product. While this is not 100 percent true, of course, it does suggest that conventional wisdom about who should sell what products does not hold in this new competitive environment. One need only look at the wide variety of products being sold on the Internet to get a glimpse at how conventional wisdom about who should sell what and who competes against whom is being challenged.¹⁴

This changing competitive environment also means that producers and manufacturers attempting to manage marketing channels now face a far more complex management task because they are dealing with more different types of channel members. The auto parts manufacturer, for instance, that was accustomed to dealing mainly with independent auto parts stores now has to contend with mass merchandisers, home centers, drug chains, supermarkets, warehouse clubs, and possibly online distributors as well. Needless to say, the management policies and strategies for dealing with the independent auto parts stores may not be effective in dealing with other kinds of channel members.

The foregoing discussion suggests that an understanding of the various types of competition affecting the channel provides the channel manager with a sharper focus to discern what is happening in the competitive environment. As we proceed through the text we will deal with many types of decisions that the channel manager must face. Many of these decisions will require a consideration of the competitive environment faced by a firm or complete channel.

13. For the most complete and thorough analysis of competitive structure and strategy, see Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).

14. For a related discussion, see Anna Wilde Mathews, "Music Distribution on the Web Revives Antitrust Concerns," *Wall Street Journal* (August 7, 2001): B6.

The ability to recognize and distinguish among horizontal, intertype, vertical, and channel system competition as well as an appreciation of the often global scope of competition are crucial for developing an on-target analysis and strategy.

The Sociocultural Environment

The sociocultural environment pervades virtually all aspects of a society. Marketing patterns (and particularly the structure of marketing channels) are therefore also influenced by the sociocultural environment within which they exist. Indeed, some channel analysts argue that this is a major force affecting channel structure.¹⁵

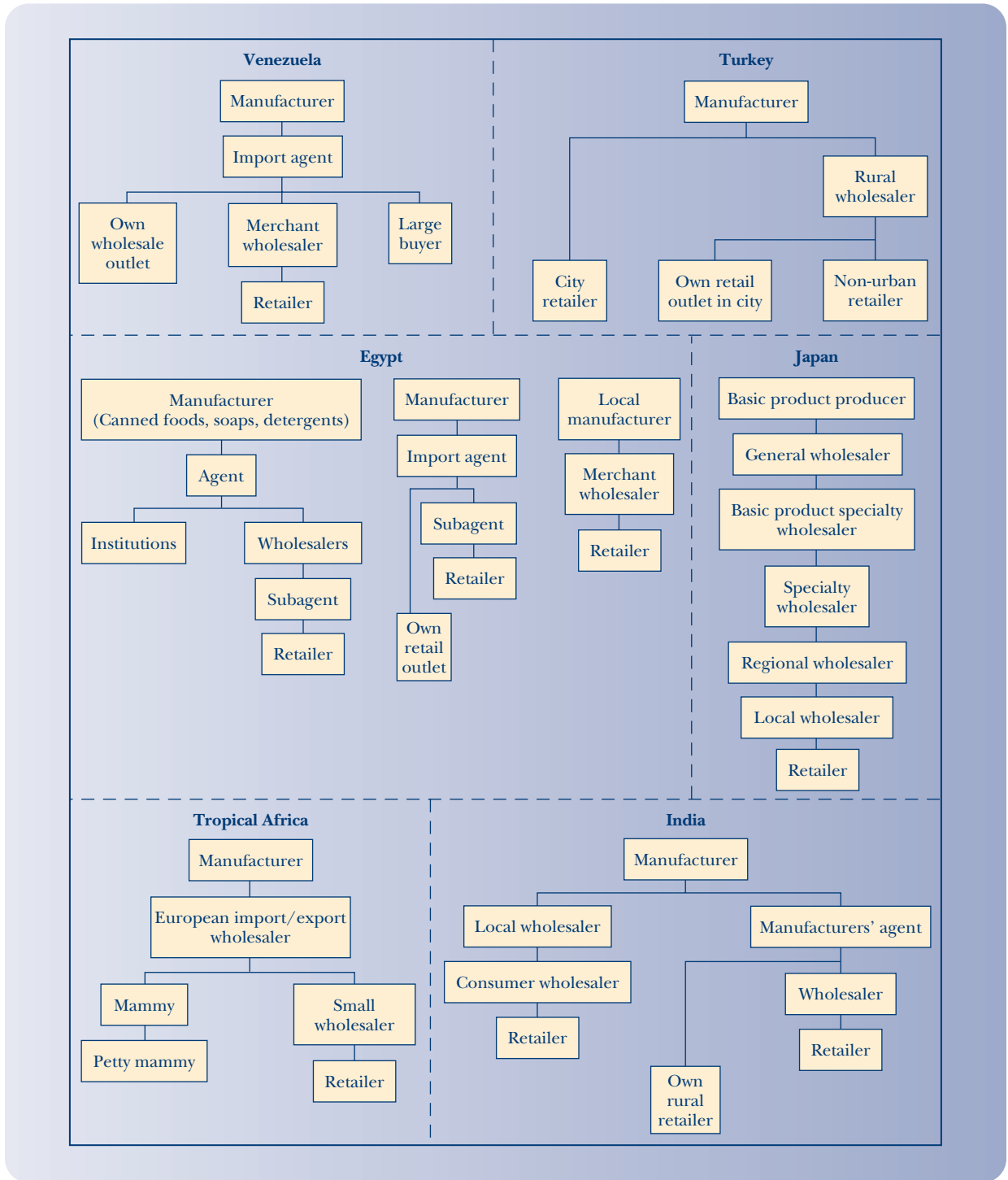
Over the past several decades, a number of studies in many countries around the world support this view. For example, Wadinambiaratchi studied channels for consumer goods in several developing countries as well as in Japan, and found wide variations in channel structures, which he attributed to their different “social, psychological, cultural, and anthropological climates.”¹⁶ Figure 3.3 shows these variations in channel structure. A major study of distribution channels in Great Britain and North America by Hall, Knapp, and Winsten; others by Guirdham in Western Europe; Galbraith and Holton in Puerto Rico; Baker in tropical Africa; and several others also lend support to this proposition.¹⁷ Take, for example, the case of tropical Africa. In some of the countries it is not unusual to find as many as ten levels of channel structure for imported consumer goods. Most of the very small retail intermediaries, often referred to as “mammy traders,” deal in tiny quantities of products, such as a handful of salt, half a bar of soap, or two or three cigarettes. Western observers, as well as some government officials in tropical African countries, are often appalled at this, believing it to be a highly irrational and inefficient channel structure. These observers, however, make the mistake of failing to consider the sociocultural context within which this channel structure exists. In actuality, the seemingly archaic channels with layer upon layer of tiny middlemen are quite rational when due allowance is made for the sociocultural factors involved. In terms of tropical Africa, these factors include a wide geographic dispersion of the population, extremely limited consumer mobility, and a necessary tradition of hand-to-mouth buying. Given these conditions, a modern Western-style supermarket would actually be highly irrational and inefficient.

15. Janeen Olsen and Kent L. Granzin, “Vertical Integration and Economic Development: An Empirical Investigation of Channel Integration” *Journal of Global Marketing* 7, no. 3 (1994): 7–39; Soumave Bandyopadhyay and Robert A. Robicheaux, “The Effects of Culture on Interfirm Communications,” in *Proceedings of the Annual Educators’ Conference of the American Marketing Association*, eds. Robert P. Leone and V. Kamar (Chicago: American Marketing Association, 1992), 100; and Janeen E. Olsen and Kent L. Granzin, “A Conceptualization of the Relationship between Economic Development and the Structure of Marketing Channels,” in *Proceedings of the Annual Educators’ Conference of the American Marketing Association*, eds. Russel Belk et al. (Chicago: American Marketing Association, 1987), 307–311. For an earlier but seminal discussion of this topic, see Jac L. Goldstucker, “The Influence of Culture on Channels of Distribution,” in *Marketing and the New Science Planning*, ed. Robert L. King (Chicago: American Marketing Association, 1968), 468–473.

16. George Wadinambiaratchi, “Channels of Distribution in Developing Economies,” *Business Quarterly* (Winter 1965): 74–82.

17. Margaret L. Hall, John Knapp, and Christopher Winsten, *Distribution in Great Britain and North America* (London: Oxford University Press, 1961); Maureen Guirdham, *Marketing: The Management of Distribution Channels* (Oxford: Pergamon Press, 1972), 91–99; J. K. Galbraith and Richard H. Holton, *Marketing Efficiency in Puerto Rico* (Cambridge, Mass.: Harvard University Press, 1955); and Raymond W. Baker, “Marketing in Nigeria,” *Journal of Marketing* 29 (July 1965): 40–48. Also see, for example, the selections in Reed Moyer and Stanley C. Hollander, eds., *Markets and Marketing in Developing Economies* (Chicago: American Marketing Association, 1968).

Figure 3.3
Marketing Channel Structures in Developing Countries and Japan



Source: Reprinted from Business Quarterly 3 (Winter 1965): 80, published by the School of Business, University of Western Ontario, London, Canada.

Yet even in highly industrialized Japan, with the world's second largest economy and some of the most advanced technology, marketing channels for many goods are very long and cumbersome, with layers of middlemen and enormous numbers of tiny stores. Researchers who have examined Japanese marketing channel structure point to a number of sociocultural factors that tend to perpetuate such channels of distribution there.¹⁸ One of these is the Japanese penchant for developing close business relationships among cooperating firms—a system known as *keiretsu*, which in the context of distribution links together a manufacturer and many wholesale and retail sales outlets. Such linkages protect the many small, inefficient distributors and retailers who participate in the *keiretsu* from competition from the larger, more efficient firms that are effectively kept out of the system. Several other sociocultural factors also contribute to the complex and inefficient channel structure in Japan. Some of the most frequently cited of these are a societal attitude that favors small business (particularly small retailers) in the distributive sector of the economy; the Japanese consumer's preference to shop in his or her own neighborhood; a desire for fresh food, good personal service, and social contact during sales transactions; a priority on maintaining low unemployment rates by encouraging the existence of many small stores where people can work; and a wish for "something to do" during retirement.¹⁹ But these traditional channel structures are beginning to change as younger Japanese consumers who have traveled and seen other cultures are starting to demand more modern and efficient marketing channels in their own country.²⁰

Clearly then, the channel manager must be sensitive to the sociocultural environment of the marketing channel when the channel extends into foreign cultures.²¹ But the channel manager does not have to extend the marketing channel overseas or into developing countries to find "strange" environments.²² Change and the accelerating pace of change in sociocultural variables at home can make what once seemed a tried and true domestic environment appear almost equally as strange as a foreign one.

An in-depth discussion of these changing sociocultural patterns is beyond the scope of this chapter. Our discussion, therefore, will be limited to some of the more fundamental developments occurring in the United States and their possible implications for channel strategy.

Age Patterns of the Population

By 2000, the U.S. population grew to over 275 million, up from approximately 249 million in 1990, an increase of almost 10.5 percent. What these general population statistics do not show, however, is that the U.S. population was becoming both younger and older at the same time.

With regard to the younger population, in 1990 some 71.8 million Americans, or almost 29 percent, were under 19 years old. Moreover, since 1980 the number of U.S. births has been rising, ending the so-called baby-bust years of most of the 1960s and 1970s. From 1989 through 1993, U.S. births exceeded 4 million annually for the first time since the early 1960s.

18. See, for example, Jeroen C. A. Potjes and Roy Thurik, "Japanese Supermarket Chains and Labor Costs—Part 2: A Comparison with French Variety Stores, Supermarkets and Hypermarkets," *Journal of Marketing Channels* 1, no. 3 (1992): 97–113.

19. Michael R. Czinkota and Jon Woronoff, *Japan's Market: The Distribution System* (New York: Praeger, 1986).

20. Yumiko Ono, "Bargain Hunting Catches on in Japan, Boosting the Fortunes of Discount Stores," *Wall Street Journal* (May 19, 1992): B1, B12.

21. David A. Griffith, "Cultural Meaning of Retail Institutions: A Tradition-Based Culture Examination," *Journal of Global Marketing* no. 1 (1998): 47–59.

22. See, for example, Bert Rosenbloom, "The Department Store and Mass Merchandiser: Marketing Challenges and Strategic Responses," in *Competitive Structures in Retail Markets: The Department Store Perspective*, eds. Ronald W. Stampfl and Elizabeth Hirschman (Chicago: American Marketing Association, 1980): 168–177.

By 2000 there were 58.4 million Americans under age 15, with almost 20 million between the ages of five and nine.

At the other end of the age spectrum, there were more than 34.5 million Americans 65 and over in 2000, accounting for almost 13 percent of the population. During the prior ten years, the growth rate for this older age group was more than double the rate for the general population.

This combination of a new baby boom, producing new baby boomers sometimes referred to as Generation Y,²³ and the simultaneous growth in older senior citizens will need to be watched closely by marketers in general and channel managers in particular. While there may be some elements of commonality in consumer preferences between Generation Y and senior citizens, there are likely to be far more divergencies. For example, Generation Y has grown up with personal computers, whereas for many senior citizens, computers are a strange and inaccessible technology. Thus, shopping via the Internet is much more likely to be in the comfort zone of the Generation Y segment than of the seniors.

Changing Ethnic Mix

Of the 275 million people in the United States in 2000, 35.3 million (13%) were African American; Asian and Pacific Islanders numbered 11.1 million (4%); and 32.4 million (12%) were of Hispanic origin. The U.S. population is expected to be even more diverse in the future. By the year 2050, with a total population projected to reach some 394 million, the non-Hispanic white share of the population, currently at 71 percent, is expected to fall to 53 percent. But people of Hispanic origin are expected to increase from today's 12 percent to 24 percent of the population. Asian and Pacific Islanders are projected to climb from the current 4 percent to 9 percent of the population. The percentage increase in African Americans is expected to be smaller, from 13 percent to just 15 percent.

The emergence of these ethnic groups has been reflected in more economic and political power for both minority consumers and minority entrepreneurs. It is projected that minority businesses will grow dramatically in the twenty-first century. Many of these new minority-owned businesses will specialize in serving minority markets. The manufacturer that wants to reach minority group target markets is therefore likely to find that an increasing number of the channel members needed to distribute products to these markets will also be members of minority groups. Thus, to an increasing extent, a manufacturer's ability to sell products in minority markets will be dependent on developing a strong relationship with minority group channel members. Old patterns of prejudice and discrimination (which may still be practiced by some firms, even if inadvertently) make less sense than ever. Astute manufacturers realize that minority channel members provide a unique and valuable resource for understanding the needs of minority consumers and for developing marketing strategies to meet those needs. In short, minority channel members increasingly will hold the key to securing strong distribution in minority markets.

Educational Trends

In 2000, 25.6 percent of Americans age 25 and older held a bachelor's degree or higher. Almost 89 percent of people between the ages of 35 and 44 had at least a high school diploma, and 27 percent of this age group had attained a bachelor's degree or beyond. Only among the older age group were the patterns of high levels of educational attainment significantly lower, with just over 34 percent of people over age 75 holding a high school diploma and only 13.4 percent having a bachelor's degree or higher.

Currently over 15 million students are enrolled in institutions of higher learning in the United States. Thus, the U.S. population is highly educated as measured by enrollment in

23. Melinda Beck, "Next Population Bulge Shows Its Might," *Wall Street Journal* (February 3, 1997): B1, B5.

institutions of higher learning. This large college population includes an increasingly higher proportion of older students, who have returned to school to prepare for or to further their careers, or who attend for the sense of personal growth and enrichment provided by a college education.

The large numbers of people of all ages exposed to higher education raises the level of sophistication and broadens the range of tastes of the U.S. population. In their role as consumers, people will be sharper and more demanding of those who make and sell the products they buy. Specifically, consumers will demand more information and more services from all of the channel members. They will, for example, want to know more about the quality of products, the ingredients or components used in them, how they can be used for maximum benefit, and what kinds of warranties are offered. They will want the products to be easily and quickly available, attractively displayed, and sold through channel members who stand behind and service the products. In short, to meet the demands of an increasingly educated and sophisticated consumer market, all channel members will have to become more effective and efficient in performing distribution tasks.

Family or Household Structure

By 2000 there were almost 105 million households in the United States. Some 69 percent of these households contained families. Married couples accounted for 53 percent of all families, while women with no husbands present maintained 12 percent of all households.

Roughly half of the nation's 72 million families contained children. Twenty-five million of the families with children included both a mother and a father, while some 8 million had a mother only and 1.7 million contained only a father.

The American family has undergone some other significant changes in recent years that have changed the lifestyles of many people. Among the most important of these are the following:

1. Families have become smaller, with the average couple now having only two children.
2. The period of child rearing has been shortened by about three years, and the period after the last child leaves home has increased on average by about 11 years. A married couple can thus expect to live as a child-free twosome for about 14 more years than couples of a generation ago.
3. The number of people living with nonrelatives (including unmarried couples and friends sharing apartments) grew more than any other household type—up by 31 percent from 1990 to 2000.

These changing patterns in the life cycle of American families will significantly influence patterns of consumer shopping behavior which, in turn, have implications for channel management strategy.²⁴ For example, the growth of smaller families, childless couples, single people, and unrelated people living together means higher levels of discretionary income and more freedom for people to purchase and use sophisticated and expensive consumer goods. Such products as personal computers, compact disc players, home gym equipment, roller blades, and cellular telephones are making a strong impact on consumers who have the discretionary income to afford such products as well as the time and lifestyles to make use of them. While most of these products are still distributed through traditional channels, new types of specialized distributors and retailers may be needed to market such products successfully in the future. Specialized stores that appeal to more sophisticated consumers have

24. See, for example, Ronald Alsop, "As Same-Sex Households Grow More Mainstream, Businesses Take Note," *Wall Street Journal* (August 8, 2001): B1, B4.

appeared, such as computer stores, electronics superstores, video stores, upscale supermarkets, mail order catalogs, TV shopping shows, and the Internet, all offering a wide array of sophisticated and expensive merchandise.

At the same time, the new emphasis on low price products by more and more consumers means that the marketing channels for such products are shifting to those channel outlets that can provide the best value.²⁵ To many consumers, this means seeking the lowest possible price consistent with an acceptable level of service. Thus, if mass merchandisers, outlet stores, mail order firms, or the Internet can meet consumers' demands, consumers will be eager to make use of them.

Changing Role of Women

During the 1990s, the number of working women continued the dramatic increase that was begun in previous decades. Labor force participation rates increased for all women under age 25, but the highest rates were for women in their 30s and 40s. For example, by 2000, 77.3 percent of all women between the ages of 35 and 44 were working, as compared to 65 percent of that age group in 1980.

This increase of women in the labor force is just part of the larger and more fundamental change in the role of women in the United States. The 1970s and 1980s probably represented the period of most rapid change, but changes are expected to continue well into the twenty-first century. Women now have far more choices available to them. New opportunities have emerged in recent years for women to become better educated, to obtain employment outside the home, to limit the size of the family, and to end an unsatisfactory marriage.

This increasing range of options for women will continue to have very important implications for distribution. In particular, the increase in career-oriented women may lessen the role of women as primary buyers for the family unit. Hence, retailers will be called on to make it much easier and quicker for women to shop, and in-home or at-work shopping, particularly online, may enjoy a much larger role than at present. Channel managers may want to rethink their channel strategies for reaching the career and working women market segments by emphasizing retail participants or methods of retailing that are particularly well-suited to serving the needs of this market.

The Technological Environment

Technology is the most continuously and rapidly changing aspect of the environment. Everyone could probably recite long lists of technological advances that have occurred in his or her lifetime or, for that matter, just during the past decade. The widespread use of personal computers, DVDs, electronic scanners, fiber optics, cellular telephones, and the Internet are some of the most obvious examples.

In the face of this rapidly changing and accelerating technology, the channel manager has to sort out those developments that are relevant to his or her own firm and the participants in the marketing channel and then determine how these changes are likely to affect the channel participants. This is not an easy task or one that can be precisely programmed. Technological changes, though continual, do not occur evenly or predictably over time.

While it is not possible to present a comprehensive list of technological developments impinging on the marketing channel, several are indicative of the kinds of technological developments that should be watched carefully.

25. For a related discussion, see David Leonhardt, "Two-Tier Marketing," *Business Week* (March 17, 1997): 82–90.

The Internet and Electronic Marketing Channels

The Internet, the worldwide network of smaller computer networks linking millions of individual computer users, provides a highly efficient means for gaining access to, organizing, and sharing virtually unlimited amounts of information.²⁶

The Internet has been in existence for several decades, but initially it was used mainly by scientists and academics. But by the mid-1990s, the popularity of the Internet exploded and it became by far the most celebrated technological phenomenon of the decade. While a number of reasons can be offered for the dramatic growth of the Internet, probably the major factor was the introduction of the World Wide Web (www), an Internet system that enables users to navigate the Internet using a simple point-and-click interface similar to those of Macintosh and Windows software. This mode of interface with the massive information available on the Internet is referred to as a **browser**. The most widely used browsers are Netscape Navigator and Microsoft Internet Explorer. By the latter 1990s, millions of individuals, firms, and organizations from around the globe had access to the Internet. Major online service providers, especially America Online, helped to fuel this rapid growth of the Internet by adding many thousands of users daily.

Although the Internet was conceived primarily as an information exchange mechanism, it has now become an established “electronic marketing channel” on which consumers and organizations can “go shopping.” Online (B2C) retail sales grew dramatically during the late 1990s and the early part of the twenty-first century, from approximately \$12 billion in 1999 to over \$53 billion in 2001. Still, however, this amounts to less than 2 percent of total retail sales via all channels of distribution.²⁷ At the wholesale or business-to-business (B2B) level, online sales are much higher than for B2C. While estimates and projections vary, in 1999 B2B sales had reached almost \$135 billion, or about 5 percent of wholesale sales. Growth in B2B over the next decade is expected to be very high, with projections reaching several trillion dollars by 2010. We will return to a discussion of the Internet in much greater depth in Chapter 15, “Electronic Marketing Channels.”

Scanners, Computerized Inventory Management, and Portable Computers

Electronic scanners are laser devices that “read” prices and other information from product labels and record them much more quickly and accurately than humans can manually. When coupled with the Universal Product Code (UPC) now appearing on virtually all packaged goods, the speed and efficiency of electronic scanners in processing consumer transactions are formidable.

But electronic scanners are now going well beyond simple reading of product labels. They can be used to replenish inventory electronically without having to rely on manually produced purchase orders. Using the checkout sales data from scanners, the computer can tally items sold and then automatically subtract those items from inventory records. A computer-generated order list of items falling below minimum inventory levels can then be transmitted to wholesalers and manufacturers. Electronic scanners are thus enabling retailers to improve their productivity by making it possible for them to process larger volumes of transactions with less labor input. Moreover, Federal Express and United Parcel Service have made extensive use of scanners to track packages anywhere in their worldwide

26. For an excellent background article on the Internet in a marketing context, see Thomas L. Ainscough and Michael G. Luckett, “The Internet for the Rest of Us: Marketing on the World Wide Web,” *Journal of Consumer Marketing* 13, no. 2 (1996): 36–47.

27. Ann Grimes, “What’s in Store—Retailers Are Bringing the Clicks to the Bricks,” *Wall Street Journal* (July 5, 2002): R6.

networks. This enables their customers to learn about the order status of shipments at any time either via phone or online.

Closely related to electronic scanning is the use of computerized inventory management. Computerized inventory systems based on data received from point-of-sale terminals have created a revolution in inventory management and control at the retail level and, to a growing extent, at the wholesale level as well.²⁸ Additionally, the growing use of portable computers has further enhanced the capability of this technology. Portable computers are not only getting smaller, lighter, and more powerful, they are also becoming increasingly useful for providing the kind of information needed to manage product and information flows in marketing channels. When coupled with cellular phone technology, which enables the portable computers to be efficiently linked to remote central processing computers, the speed and efficiency provided by these devices can be awesome.

The system used by McKesson Drug Company, a giant drug wholesaler, provides a case in point. In its Delran, New Jersey, warehouse, McKesson employees called “robo-warehousemen” roam the aisles using the portable computers to manage the inventory as it moves in and out of the warehouse. The computer, worn on the worker’s waist, receives signals from a central computer telling him or her which merchandise needs to be gathered next. A message informing the worker where the merchandise is located appears on the computer screen, which is strapped to the worker’s arm. When the worker reaches the proper shelf, a laser scanner worn on the fingers is used to read each item. The computer then tallies all the merchandise, verifies that the correct number of items has been picked up, and updates the master inventory. One of the largest users of handheld computer technology is Frito-Lay, which owns over half of the \$15 billion salty-snacks market. Virtually all of the company’s 12,800 delivery people are equipped with handheld computers, enabling them to transmit sales and inventory data instantly back to headquarters when they visit stores on their routes. The effective use of this technology has played a major role in making Frito-Lay what competitors call an “invincible foe.”

Electronic scanning and computerized inventory management, enhanced by portable computers, cellular phone technology, and the Internet have created a new world in retailing and wholesaling not only by drastically reducing the amount of labor and paperwork involved in inventory management, but also by making available to managers a vast array of timely and valuable information for making better merchandising decisions.²⁹ Information that might have taken weeks to obtain with a manual inventory system can be called up on the computer in seconds. Retailers and wholesalers of all sizes are now able to monitor the success or failure of products they handle much more closely than was possible just a few years ago. If a newly introduced product is not catching on, they know about it—and quickly. When the rate of sales growth of a successful product begins to slow down, they are able to spot this pattern at a very early stage. And products whose sales are stagnant are not likely to go unnoticed. On the other hand, hot-selling products can also be spotted more quickly by retailers and wholesalers, and reordering can be equally rapid. Thus the new technology is something of a mixed blessing for manufacturers. On one hand, quicker responses by retailers and wholesalers to fast-selling products can allow the manufacturer more time to plan ahead to increase production. But on the other hand, faster responses by these channel members to slow sellers can mean a sudden halt in orders as they use their up-to-the-minute, computer-generated inventory data to reduce their risk and protect their profit positions. The superior inventory management and improved marketing management made possible through sophisticated scanning and computer-based inventory systems used by retailers

28. See, for example, James A. Narus and Tor Guimaraes, “Computer Usage in Distributor Marketing,” *Industrial Marketing Management* 16 (February 1987): 43–54.

29. See, for example, Miguel Helft, “Fashion Fast Forward,” *Business 2.0* (May 2002): 61–66.

and wholesalers along with the Internet can be a double-edged sword from the manufacturer's point of view.³⁰

Electronic Data Interchange

Electronic data interchange (or EDI) refers to the linking together of channel member information systems to provide real-time responses to communication between channel members. For example, a retailer's computerized inventory management system is connected with and monitored by the supplier's (manufacturer's or wholesaler's) computers. Ordering of merchandise can then take place automatically when the retailer's inventory level of that supplier's products reaches certain minimum reorder points. Thus, the retailer's computer orders the products from the manufacturer's or wholesaler's computers without human intervention or paperwork of any kind. The more sophisticated EDI systems can also forecast demand based on sales history. In this case, the manufacturer's or wholesaler's computers will *initiate* the order for the retailer by, in effect, predicting what amount of the items in question the retailer will need during a particular period. EDI systems can also be linked directly to production scheduling, allowing the factory's production to be determined by sales patterns taking place in retail outlets. In other words, the merchandise that is being sold on a given day in retail outlets all over the country will provide the information to guide the manufacturer's production process taking place on that same day. VF Corporation, the manufacturer of Lee and Wrangler brand jeans, used EDI to help unseat the famous Levi's as the jeans market share leader, as measured in unit sales. By the mid-1990s, VF's Lee and Wrangler brands combined to hold 30 percent of the U.S. jeans market compared to Levi's, which slipped to 17 percent, in part, according to retailers, because of Levi's slowness in replenishing stock. The quick response made possible by VF's sophisticated EDI technology enabled stores to replenish stock in two days, compared to two weeks or longer for Levi's.³¹

The emergence of the Internet in recent years has enhanced the potential of EDI because the Internet enables firms to be connected and communicate in a fashion similar to EDI but with considerably less investment in computer hardware and software.³² Thus, firms linked via the Internet will increasingly be able to enjoy the benefits associated with EDI at a "bargain basement" price.

There is little question that EDI technology enhances distribution efficiency, resulting in substantial benefit to all channel members as well as final customers.³³ The manufacturer benefits through more accurate and timely production scheduling, while wholesalers and retailers save on order processing and inventory carrying costs. The final customer benefits from the reduced distribution costs made possible by EDI and by the higher probability of finding the particular items he or she is seeking on retailers' shelves.

The main negative is that the channel members must share information openly for the EDI system to work. So, for those channel members who feel they need control of what they believe to be sensitive or confidential information about the sales of their products, EDI can lose much of its appeal.³⁴

30. Bert Rosenbloom, "Retailers' Growing Power in Marketing Channels," in *Proceedings of the Sixth World Conference on Research in the Distributive Trades* (The Hague, Netherlands: Dutch Ministry of Economic Affairs, 1991), 560-570.

31. Joseph Weber, "Just Get It to the Stores on Time," *Business Week* (March 6, 1995): 66-67.

32. For a related discussion, see Otis Port, "The Next Web," *Business Week* (March 4, 2002): 96-102.

33. Liss R. Williams, "Understanding Distribution Channels: An Interorganizational Study of EDI Adoption," *Journal of Business Logistics* 15, no. 2 (1994): 173-203.

34. For an excellent and thorough discussion of the implications of EDI on channel relationships, see Ramon O'Callaghan, Patrick J. Kaufmann, and Benn R. Konsynski, "Adoption Correlates and Share Effects of Electronic Data Interchange Systems in Marketing Channels," *Journal of Marketing* (April 1992): 45-56.

Other Technological Innovations

Accelerating technology seems to produce new advances almost every day in all types of fields. Those that follow are just a few of the more exciting developments that could have a major impact on marketing channels.

Many retailers—from auto dealers to general mass merchandisers, home centers, office supply stores, and other big box stores—are using or experimenting with “computer sales-people.” Some prototypes being tested in auto dealerships, for example, can do nearly everything a human counterpart can do—and perhaps more. The computer can greet customers, compare features of competitive models, calculate the operating costs of a customer’s car versus the cost of owning a new one, add the cost of options, and compute the monthly payments. An advanced version of the computer can even write up the order and phone it in to the factory!

A somewhat similar technological development is the “computerized design consultant” used by Weyerhaeuser, a manufacturer of wood products for the do-it-yourselfer. A point-of-purchase computer display called the Weyerhaeuser Design Center enables consumers with no computer training to design a deck and view it from any angle on the full-color screen. The Design Center can also provide a printed list of materials, a construction plan for the project, and the costs involved.

Mobile robots such as those being produced by iRobot Corp. could become as common as the personal computer over the next decade or two.³⁵ These robots are already delivering drugs and meals to patients in hospital rooms, providing mail delivery in large office buildings, and giving guided tours in museums. They may soon be used as shopping guides or even personal shoppers for consumers in retail stores and as stocking clerks and order processors in back-office warehouse operations.

The technology of 3-D modeling, such as that being developed by Linden Labs, can turn a computer screen into a three-dimensional landscape that looks so much like a real-world environment, it can make the user want to “jump into the computer.”³⁶ With such incredible graphic capabilities combined with state-of-the-art surround-sound technology, the virtual world of the computer may appear to be almost indistinguishable from the real world. This could greatly enhance the appeal of online shopping because the products and the “store environment” would have the same kind of three-dimensional feeling as if the consumer were shopping in the physical world.

Ultra-wideband technology, being developed by such high-tech innovators as Multispectral Solutions, Inc. and XtremeSpectrum, Inc., is enabling wireless technology to work for a huge range of applications with near-perfect reliability and security because its signals are virtually impossible to detect.³⁷ Such highly efficient and secure technology will enable networks of office products to communicate with each other and allow consumers to have virtually unlimited flexibility to communicate, whether with other individuals, their cars, or even an appliance! So, before leaving work a consumer could press a few buttons on her cell phone or use voice recognition to start the heater in the car and turn on the microwave oven and coffeemaker at home. Such seamless wireless communications could also create opportunities for marketers to stay in touch with consumers in all different kinds of locations, situations, and contexts.³⁸ Consequently, instead of requiring customers to take some action to gain access to marketing channels, the marketing channel would “reach out” to customers to satisfy their needs in a particular situation. For example, if a customer’s car breaks down, she

35. Joseph Pereira, “The Robot Maker,” *Wall Street Journal* (May 13, 2002): R4, R10.

36. Don Clark, “The World Builder,” *Wall Street Journal* (May 13, 2002): R4, R10.

37. Yochi J. Dreazen, “The Wireless Pioneer,” *Wall Street Journal* (May 13, 2002): R6, R16.

38. See, for example, Stephen H. Wildstrom, “Wi-Fi Tips for Wayfarers,” *Business Week* (May 6, 2002): 22.

would not have to call for service. Instead, a monitoring device at the dealership or service agency established by the manufacturer would immediately take note of the breakdown, call the customer's cell phone, diagnose the problem, send a service representative to the scene, and perhaps arrange for a loaner car to be delivered. All literally without the customer having to lift a finger.

The Legal Environment

The legal environment refers to the set of laws that impact marketing channels. The legal structure resulting from these laws is not a static code. Rather, it is a continually evolving structure affected by changing values, norms, politics, and, of course, precedents established through court cases. The varied and numerous court interpretations of laws impinging on channel management may appear to the channel manager to be a morass of legal hodgepodge. Fortunately, the marketing channel manager need not be an expert on the legal aspects of marketing channels. Nor, given the technical nature of the subject, should he or she aspire to such a position, as this would be a full-time job in itself. Only trained legal experts are in a position to deal competently with the legal complexities relevant to the marketing channel. Nevertheless, the channel manager still needs a general knowledge of some legislation pertaining to channels and familiarity with some of the legal issues relevant to channel management. This general background and awareness of the legal side of channel management will help the manager to communicate better with legal experts and perhaps help avoid potentially serious and costly legal problems that can arise in the management of marketing channels.

Legislation Affecting Marketing Channels

While there are many federal, state, local, and even international laws that can affect marketing channels, five pieces of federal legislation underlie most of the major channel management legal issues we will discuss later in this chapter. They are the Sherman Antitrust Act, the Clayton Act, the Federal Trade Commission Act, the Robinson–Patman Act, and the Celler–Kefauver Act.

Sherman Antitrust Act

The Sherman Antitrust Act, passed in 1890, is the fundamental antimonopoly law of the United States. The philosophy underlying this piece of legislation is that public welfare is served best through competition. Thus, the act was aimed at prohibiting practices that would restrain competition in the marketplace. Section 1 of the Sherman Act forbids contracts or combinations that restrain interstate or foreign commerce. The act provides federal courts with the power to break up or dissolve monopolies and also provides for criminal penalties against individuals involved in the creation of illegal monopolies.

Clayton Act

The Clayton Act was passed in 1914 to strengthen the Sherman Antitrust Act. The Clayton Act supplements the Sherman Act by specifically prohibiting such practices as price discrimination, tying clauses, exclusive dealing, intercorporate stockholding, and interlocking corporate directorates among competing firms if these practices tend to substantially lessen competition or tend to create monopolies in any line of trade.

Federal Trade Commission Act

This act, also passed in 1914, established the Federal Trade Commission (FTC). The FTC, as a federal agency, was granted the power to investigate and enforce, through the use of injunctions, unfair methods of competition in interstate commerce. Such "unfair methods of com-

petition” include not only those specifically stipulated in the Sherman and Clayton acts, but also any other practices that might be injurious to competition. Thus, the Federal Trade Commission Act significantly expanded the scope of the federal government in the regulation of interstate commerce.

Robinson–Patman Act

This act was passed in 1936 as an amendment to the Clayton Act. The Robinson–Patman Act was aimed at prohibiting a variety of forms of price discrimination that tended to lessen competition but which were inadequately covered by the Clayton Act.

Sections 2a and 2b of the act prohibit persons engaged in interstate commerce from discriminating in price or terms of sale for goods of like grade and quality if the effects of such discrimination are to substantially lessen competition or foster monopolies in any line of commerce; or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discriminations, or with customers of either of them. The act does, however, allow for price differentials to different customers, under the following circumstances:

1. When the differentials in prices charged to different customers do not exceed the differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such goods are sold or delivered to purchasers
2. When price changes that result in price differentials are necessary to meet changing market conditions, to avoid obsolescence of seasonal merchandise, to dispose of perishables, or to conduct legitimate closeout sales or court-imposed distress sales
3. When the price differentials quoted to selected customers are offered in good faith to meet competitors' prices and are not intended to injure competition

Section 2c of the act covers another form of price discrimination—unearned brokerage fees. Unearned brokerage fees are a device used by buyers to gain a lower price from the seller. Under this arrangement a buyer would set up a phony brokerage firm that was actually part of its own organization and bill the seller for the “cost” of the brokerage fee. The result of this, of course, is to reduce the effective price paid by the buyer to the seller. Those buyers who did not set up such brokerage schemes would thus pay a higher price. Since typically those buyers who were able to set up such phony brokerage schemes were large-scale businesses, smaller businesses were at a significant disadvantage. Such practices were common before passage of the Robinson–Patman Act.

Sections 2d and 2e of the act cover what is perhaps the most nebulous area of price discrimination in marketing channels—that of promotional allowances and services. Promotional allowances and services refer to various forms of assistance from the seller to the buyer. These are often in the form of cooperative advertising allowances, payments for display of the supplier's products, point-of-purchase materials, catalogs, display equipment, training programs, management assistance, and a variety of other services (see Chapter 12). In order to offer such promotional allowances and services to customers legally, sellers must do so on a proportionally equal basis to all other customers distributing their products.

Celler–Kefauver Act

This act, passed in 1950, was an amendment to Section 7 of the Clayton Antitrust Act, which prohibited acquisitions or mergers that tended to lessen competition or create monopolies. The Celler–Kefauver Act broadened the scope of the Clayton Act so that the prohibitions against acquisitions and mergers that tended to lessen competition and foster monopolies as a result of horizontal mergers between firms would also apply to vertical mergers and acquisitions. Thus, the act is particularly relevant to situations involving vertical integration through

acquisitions and mergers. In essence, such vertical integration is prohibited if it tends to substantially lessen competition or foster monopolies.

Legal Issues in Channel Management

Having discussed some of the basic federal legislation underlying the legal environment of marketing channels, we now turn our attention to some of the major legal issues in channel management that are affected by this legislation. What should be kept in mind as we proceed through our discussion of legal issues is the potential for conflict that exists between the objectives of an individual firm's channel management strategies and the interests of society at large. Thus, when a producer or manufacturer imposes vertical restrictions on its distributors or dealers (for example, by using exclusive dealing arrangements, territorial restrictions, or price controls, as will be discussed in this section), such practices may be strategically sound for the firm imposing them but anticompetitive for society as a whole.

Dual Distribution

Dual distribution refers to the practice whereby a producer or manufacturer uses two or more different channel structures for distributing the same product to his target market. The selling of the same or similar products under different brand names for distribution through two or more channels is also a form of dual distribution.

Dual distribution, which in recent years is increasingly being referred to as **multi-channel distribution**, is a common practice, and is certainly not illegal per se under federal antitrust laws. Antitrust controversies have emerged, however, when a firm distributes through its own vertically integrated channel in competition with independent channel members at the wholesale or retail levels, a quite common distribution arrangement in the marketing of petroleum products, tires, shoes, paint, and drugs. Under such an arrangement, the manufacturer may gain an unfair competitive advantage by using company-owned outlets to undercut prices charged by independents. For example, automobile dealers have often complained about what they see as unfair competition from auto manufacturers when the manufacturers sell directly to large fleet buyers such as auto rental companies. Dealers claim that the fleet buyers get a better price than they do. Hence, the fleet buyers attain an unfair competitive advantage in the new- and used-car markets when they sell many of these cars after a year of use at very attractive prices in the same local markets as the automobile dealers. Such practices make it very difficult for some independent dealers to compete and indeed may threaten their very existence. Carried to an extreme, a dominant manufacturer could gain a monopoly position by driving independent distributors or dealers out of business. In recent years, therefore, the courts have taken the position of requiring a manufacturer with a dominant role in a particular product line to seek to preserve the independent distributors or dealers of that product if such independent distributors or dealers exist. Dual distribution arrangements that work to eliminate the independent distributor (or dealer) are inconsistent with this position. Consequently, they may be viewed by the courts as tending to lessen competition and as such may be in violation of the antitrust provisions of the Sherman and Clayton acts.

Exclusive Dealing

Exclusive dealing occurs when a supplier requires its channel members to sell only its products or at least to refrain from selling products from directly competitive suppliers. The case of *Ben & Jerry's v. Häagen-Dazs* ice cream is a typical example of exclusive dealing. Häagen-Dazs stipulated that distributors selling its ice cream were not permitted to sell directly competitive brands, so that all of the distributors' attention would be focused on Häagen-Dazs. Ben & Jerry's argued, in a suit brought against Häagen-Dazs, that this policy severely limited its ability to compete with Häagen-Dazs because these distributors provided the main chan-

nel for getting Ben & Jerry's products into supermarket freezer cases. Without these distributors to carry its products, Ben & Jerry's claimed it would have no marketing channels for reaching consumers. Thus, the exclusive dealing policy that Häagen-Dazs was trying to implement represented an attempt to eliminate competition, argued Ben & Jerry.

With an exclusive dealing arrangement the supplier gains a substantial degree of market protection from competitive products in the market areas covered by its channel members. If a channel member refuses to abide by the exclusive dealing arrangement, the supplier can cut off the channel member from selling its products.

Exclusive dealing arrangements are in violation of the antitrust provisions of the Clayton Act if their effect is to *substantially* lessen competition or foster monopolies. For example, Anheuser-Busch Inc., the nation's largest brewer, was investigated by the Justice Department after the company launched a new channel strategy called "100% Share of Mind."³⁹ This program is effectively an exclusive dealing policy because it seeks to get beer distributors to carry Anheuser products only. Products from other brewers, especially the small micro-brewers and smaller national brands, cannot gain access or are being forced off the shelves of the nation's 2,700 wholesale beer distributors.

The substantiality test has usually been based on three conditions: (1) whether the exclusive arrangement excludes competitive products from a substantial share of the market (Justice Department guidelines stipulate that if a manufacturer has less than a 10 percent market share it will not bother pursuing the case); (2) whether the dollar amount involved is substantial; and (3) whether the dispute is between large suppliers and a smaller distributor or dealer where the supplier's disparate economic power can be inherently coercive.⁴⁰ If any or all of these conditions exist, the exclusive dealing arrangement may be open to attack as anticompetitive under both the Sherman Act and the Federal Trade Commission Act.⁴¹

Full-Line Forcing

Full-line forcing occurs when a supplier requires channel members to carry a broad group of its products (full line) in order to sell any particular products in the supplier's line. Full-line forcing is practiced to varying degrees in a wide range of industries. It represents, up to a point, a legitimate effort by the manufacturer to see that a broad range of its products is carried by channel members and to discourage "cherry picking" by channel members of only the "hottest" items in the manufacturer's product line. The antitrust issue emerges when full-line forcing occurs to such an extent that it prevents other suppliers from selling competitive lines through channel members who are "loaded up" with the products of the supplier practicing full-line forcing.

An example of a case of full-line forcing that did step over the legal boundary involved Levi Strauss & Company. The Federal Trade Commission issued an injunction to cease and desist from the practice that Levi Strauss was using to force department and specialty stores to buy a broad range of apparel in order to obtain the hot-selling Levi's jeans. Much of this other apparel was not desirable merchandise that the retailers would have stocked of their own volition. Some of it, for example, consisted of clothing that had gone out of style. But the retailers were, in effect, forced to buy this merchandise if they wanted access to the jeans, which constituted a very important merchandise category. The forced stocking of this other merchandise resulting from Levi's full-line forcing policy meant that the retailers had less capacity to

39. John R. Wilke and Bob Ortega, "Anheuser's Sales Practices under Probe," *Wall Street Journal* (October 2, 1997): A3, A10.

40. William L. Trombetta and Albert L. Page, "The Channel Control Issue under Scrutiny," *Journal of Retailing* (Summer 1978): 55; and "Easier Rules on Exclusive Dealing," *Business Week* (February 4, 1985): 40.

41. In some industries, exceptions to these provisions are often made. See Marianne M. Jennings, "Exclusive Distributorships in Soda Pop Industry Exempted from Antitrust Laws," *Marketing News* (January 23, 1981): 12.

stock apparel from other manufacturers. The effect was to lessen the competition to Levi Strauss from competing manufacturers by limiting available retailer shelf space. This in turn reduced consumer choice in the marketplace.

Price Discrimination

Price discrimination, which is covered specifically under the Robinson–Patman Act, refers to the practice whereby a supplier, either directly or indirectly, sells at different prices to the same class of channel members to the extent that such price differentials tend to lessen competition. For example, small independent book retailers represented by their trade association, the American Booksellers Association, filed an antitrust lawsuit against five book publishers. The retailers allege that these publishers regularly favor giant chain stores with secret discounts and promotional deals that are not made available to smaller bookstores.⁴²

Discriminatory price differentials can take a variety of forms, some of which can be quite subtle. The classic case of the Simplicity Pattern Company illustrates just how subtle such price discrimination can be. The Federal Trade Commission charged the Simplicity Pattern Company with violating section 2e of the Robinson–Patman Act. The FTC argued that Simplicity, a manufacturer of sewing patterns, had practiced discrimination in offering promotional services to retailers. Specifically, Simplicity offered a large chain of retail variety stores free catalogs and display cases but did not offer them to small, independent fabric stores. The FTC found Simplicity guilty of violating section 2e of the Robinson–Patman Act. Simplicity appealed to the circuit court, which reversed the FTC’s decision. On appeal by the FTC, the Supreme Court upheld the original FTC decision. In finding for the FTC, the court argued that since the variety stores and independent fabric stores were in competition, the granting of free catalogs and display cases was a discriminatory promotional allowance favoring the variety stores, resulting in a competitive disadvantage to the independents. Simplicity argued that the variety stores and independent fabric stores were not actually in competition because their motives for selling patterns were different. In the case of the variety stores, the patterns were sold on a volume basis as an important merchandise item on which the stores intended to make a profit. For the fabric stores, however, Simplicity argued that patterns were sold on a limited basis as an accommodation to customers and were not a significant merchandise category on which the stores intended to make a profit. Hence, Simplicity argued, if the stores were not actually in competition then the actions of Simplicity with respect to promotional allowances could not be viewed as impeding competition *because such competition had never existed*.

This case actually hinged on the competitive structure issue of whether the two types of stores actually were in competition with each other in the sale of sewing patterns. Subsequent observers of this case believe that if Simplicity had had a better documented case for its argument of no competition between the variety and fabric stores, it might have won the case.

It is, of course, debatable as to whether the outcome would have been different if the competitive structure issue had been better articulated. But the case does point up the kinds of subtle issue and interpretive difficulties that often emerge when dealing with the issues of price discrimination in channels of distribution as governed by the Robinson–Patman Act. It is no wonder, then, that confusion and inconsistencies have been common in court interpretations involving the Robinson–Patman Act throughout its history. Consequently, accurate generalizations about whether specific channel pricing policies and practices constitute price discrimination are difficult to make.⁴³ A study by Marks and Inlow, however, found that the

42. Meg Cox, “Booksellers Say Five Publishers Play Favorites,” *Wall Street Journal* (May 27, 1994): B1, B5.

43. For an analysis of some court cases and interpretations of price discrimination involving the Robinson–Patman Act, see Ray O. Werner, “Marketing and the Supreme Court in Transition 1982–1984,” *Journal of Marketing* (Summer 1985): 99–101.

courts have focused mainly on more obvious and flagrant violations involving price discrimination.⁴⁴ Moreover, large firms (sales exceeding \$1 billion) constituted almost 40 percent of the defendants, who came most frequently from the food, tobacco, oil, gas, and petrochemical industries.

Price Maintenance

Price maintenance refers to a supplier's attempt to control the prices charged by its channel members for the supplier's products. The supplier, in effect, dictates the prices charged by channel members to their customers. Thus, prices at which products are sold by channel members are not based on the discretion of the channel members in response to market forces, but rather on the requirements of the supplier. Such price maintenance arrangements can help manufacturers to gain greater control over the distribution of their products.

Strangely enough, this type of anticompetitive price fixing (which is really what such practices amount to) was exempted from federal antitrust legislation through passage of the Miller–Tydings Act in 1937 and the McGuire Act in 1952. These acts exempted retail price fixing by manufacturers in states that permitted vertical pricing arrangements between manufacturers and retailers. Such vertical price fixing agreements were typically referred to euphemistically as **fair trade laws**, and most states enacted various forms of these laws.

With the passage of the Consumer Goods Pricing Act in 1975, which repealed the Miller–Tydings and McGuire acts, the legal basis for exempting state fair trade laws from federal antitrust legislation no longer existed. Consequently, most state fair trade laws were no longer legal.

Although the demise of fair trade laws removed the legal underpinnings for the practice of price maintenance in the marketing channel, the practice has by no means disappeared. Many manufacturers still try to influence the prices charged by their channel members. They do so for a variety of reasons, such as to protect the image of their products, to reduce the likelihood of price wars, and to provide channel members with sufficient profit margins to enable them to offer adequate pre- and post-sale service. Channel members who provide little service themselves and sell at low prices by “feeding” off the service provided by full-service channel members could be dropped as so-called **free riders**, as sometimes occurs when full-service channel members complain about the adverse effects the low-price free riders are having on their businesses.⁴⁵

Until recently, a manufacturer's dropping of price-cutting channel members based on the complaints of high-price channel members was viewed by the courts as a vertical price-fixing conspiracy and was considered to be a per se violation of the Sherman Act. In 1988, however, a Supreme Court decision in the case of *Business Electronics Corporation v. Sharp Electronics Corporation* gave manufacturers much greater leeway in enforcing price maintenance agreements by removing the per se illegality of price-fixing arrangements involving a conspiracy between the manufacturer and high-price channel members to get rid of low-price channel members. This is precisely what happened in the *Business Electronics v. Sharp* case.⁴⁶

44. Norton E. Marks and Neely S. Inlow, “Price Discrimination and Its Impact on Small Business,” *Journal of Consumer Marketing* (Winter 1988): 31–37.

45. For two excellent analyses of the issues involved in price maintenance, see Patrick J. Kaufmann, “Dealer Termination Agreements and Resale Price Maintenance: Implications of the Business Electronics Case and Proposed Amendment to the Sherman Act,” *Journal of Retailing* (Summer 1988): 113–124; and Mary Jane Sheffet and Debra L. Scammon, “Resale Price Maintenance: Is It Safe to Suggest Retail Prices?” *Journal of Marketing* (Fall 1985): 82–91.

46. For additional background on this case, see Aaron Epstein and Barbara Demick, “Supreme Court Decision a Blow to Discounters,” *Philadelphia Inquirer* (May 3, 1988): 15C; Paula Dwyer, “A Red Flag for Red Tags,” *Business Week* (May 16, 1988): 38; and “A Big Win for Price Fixers,” *Consumer Reports* (August 1988): 492.

Hartwell's Office World, a Houston-based full-service retailer selling Sharp Electronics calculators, threatened to stop buying them unless Sharp stopped selling calculators to Business Electronics Corporation, a competing retailer that sold Sharp calculators at significantly lower prices than Hartwell. Sharp, not wanting to lose Hartwell's business, dropped Business Electronics. An antitrust suit was then filed by Business Electronics alleging that Sharp was in violation of the vertical price-fixing provision of the Sherman Act. The case reached the Supreme Court, which in a 6 to 2 decision found in favor of the defendant, Sharp Electronics. The court argued that in the absence of hard evidence of an actual price-fixing agreement between the manufacturer and the dealer, there was no violation of the Sherman Act. Hence, Sharp's decision to terminate Business Electronics to maintain prices was *not* *per se* illegal.

It would appear, then, that based on the precedent established in this case, manufacturers have quite a bit of freedom in enforcing *de facto* price maintenance. All they need do to avoid violating the law is not make specific price-fixing agreements with channel members.

Refusal to Deal

In general, suppliers may select whomever they want as channel members and **refuse to deal** with whomever they want. This right is based on the precedent established in a classic Supreme Court case of 1919 (*United States v. Colgate and Company*) and is often referred to as the "Colgate doctrine." The court argued as follows:

The Sherman Act does not restrict the long recognized right of a trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to the parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to deal.

Thus, there are no legal barriers to sellers using their own criteria and judgment in the selection of channel members and announcing in advance the conditions under which they will refuse to deal.

In the case of existing channel members, however, there are legal restrictions on the seller's use of refusal to deal. Specifically, refusal to deal cannot be used coercively to cut off channel members who will not conform to policies stipulated by the seller that may be illegal or in restraint of trade. Such would be the case, for example, if a manufacturer dropped a channel member who refused to abide by a set of specific prices or price ranges that were dictated to it by the manufacturer. Thus, even in light of the precedent established in the *Business Electronics v. Sharp Electronics* case, which allows suppliers much greater leeway in the use of price maintenance policies, the Sherman Act could still limit the manufacturer's freedom to drop a price-cutting channel member.

Resale Restrictions

Resale restrictions refer to a manufacturer's attempt to stipulate to whom channel members may resell the manufacturer's products and in what specific geographical market areas (territories) they may be sold.

Such restrictions can be very advantageous to both the manufacturer and the channel members. From the manufacturer's standpoint, the capacity to stipulate to whom products may be resold enables the manufacturer to retain and reserve certain accounts as **house accounts** (customers to whom the manufacturer sells directly) by prohibiting channel members from selling to those customers. Moreover, it enables the manufacturer to control the kinds of outlets from which final customers for its products will buy. If, for example, a manufacturer that uses wholesalers wants only high-service retailers to sell its products to final

consumers, the manufacturer could specify the types of retailers to whom the wholesalers are permitted to sell. Further, by delineating the particular territories in which channel members are allowed to resell the manufacturer's products, the manufacturer can maintain a high degree of control over the distribution of products. From the channel members' standpoint, the territorial restrictions minimize **intra-brand competition** (competition between distributors selling the same branded product of a particular manufacturer) because each channel member is in effect given a "protected" geographical market area in which to sell the manufacturer's products. Other channel members selling the same products are then prohibited from selling in a geographical market area other than their own.

In deciding whether such restrictions constitute an illegal restraint of trade, the courts had, for decades, used the so-called **rule of reason**. Under this rule, the courts weighed the intentions of the supplier and the effects of the supplier's resale restrictions on the market. If the restrictions were not intended and did not appear to result in a restraint of trade, they were generally allowed to stand.

In 1967, however, the landmark Supreme Court case of *United States v. Arnold Schwinn and Company* radically changed this rule of reason approach.⁴⁷ The Supreme Court ruled that under the Sherman Act, resale restrictions imposed by suppliers on their channel members are illegal *per se*. The court argued as follows:

Under the Sherman Act, it is unreasonable . . . for a manufacturer to seek to restrict and confine areas or persons within which an article may be traded after the manufacturer has parted with dominion over it. . . . Once the manufacturer has parted with title and risk, he has parted with dominion over the product, and his effort thereafter to restrict territory or persons to whom the product may be transferred, whether by explicit agreement or by silent confirmation or understanding with the vendee, is *per se* a violation of Section I of the Sherman Act.

The effect of this ruling was to severely limit the legality of resale restrictions. Restrictive distribution policies, which had for so many years been practiced routinely by many firms, were now open to attack as violations of the Sherman Act. Yet some ten years later, in 1977, another landmark Supreme Court case (*Continental TV Inc. et al. v. GTE Sylvania Inc.*) overturned the Schwinn case "per se" doctrine and essentially restored the rule of reason doctrine to govern the use of resale restrictions. The court ruled that resale restrictions are not necessarily anti-competitive if competition is viewed in a broader perspective. The court argued that resale restrictions can have "redeeming virtues" by promoting **interbrand competition** (competition between distributors in the sale of branded products of competing manufacturers), including fostering new companies and new products. Further, by inducing competent and aggressive retailers to undertake new efforts and offer special services and promotions, marketing efficiency can be improved and smaller firms can be aided in competing with larger ones. In essence, the court's position was that while resale restrictions might limit intra-brand competition, they could foster interbrand competition.

Even with the ruling in *GTE Sylvania*, however, the legality of resale restrictions is still up in the air. The court left the door open for antitrust action against resale restrictions if such resale restrictions have a "demonstrable economic effect."⁴⁸

47. *United States v. Arnold Schwinn and Company*, 388 U.S. 365 (1967).

48. For an in-depth analysis of the territorial restriction issue based on empirical research, see Shantanu Dutta, Jan B. Heide, and Mark Berger, "Vertical Territorial Restrictions and Public Policy: Theories and Industry Evidence," *Journal of Marketing* (October 1999): 121–134.

Tying Agreements

Agreements whereby a supplier sells a product to a channel member on condition that the channel member also purchase another product as well, or at least agrees not to purchase that product from any other supplier, are known as **tying agreements**. Full-line forcing, discussed earlier, is a special case of tying agreements.

Tying agreements put the supplier in a very advantageous position with respect to the channel members with whom the arrangement has been made. Since the channel member must accept tied products in order to obtain other products from the supplier, and since the channel member is not free to purchase the tied products on the open market, the supplier has a great deal of pricing leverage over the channel member. In effect, the supplier is in a position to virtually dictate the terms of sale to channel members. By far the most high-profile case of a tying arrangement that ran afoul of antitrust legislation involved Microsoft's Internet browser software.⁴⁹ Microsoft tied or "commingled" its Internet Explorer browser software into its Windows operating system. So, computer manufacturers such as Compaq, Dell, Hewlett-Packard, IBM, and virtually all other personal computer makers that used the Windows operating system (with the exception of the Apple Macintosh) would have to take Microsoft's Internet Explorer. Because Microsoft's Windows operating system was used to run 95 percent of the world's PCs, it clearly had a monopoly in operating systems. By inextricably tying its Internet Explorer browser as a part of Windows, Microsoft had an unfair advantage over competitive browsers such as Netscape Communicator, which many experts argued was the originator of the point-and-click interface that made surfing the Internet so practical. Netscape argued in a lawsuit against Microsoft (which was later joined by the Federal Trade Commission and the Justice Department), that Microsoft's tie-in of Internet Explorer to Windows severely limited Netscape's ability to include its browser in PC operating systems. Indeed, Netscape argued and the Justice Department concurred that Microsoft did everything in its power to limit competition from Netscape, such as making it difficult to access Netscape via the Windows operating system even when the PC manufacturers included Netscape in the software bundle built into the PC.

After going through the courts for over three years, the Justice Department found that Microsoft was operating as a monopolist by tying its Internet Explorer browser so closely to Windows and was therefore in violation of antitrust laws.⁵⁰

Vertical Integration

Vertical integration occurs when a firm owns and operates organizations at other levels of the distribution channel (for example, a manufacturer owning and operating its own wholesaling facilities and retail stores). Vertical integration is practiced by a number of manufacturers in a variety of industries, such as Goodyear and Firestone in tires and Sherwin-Williams in paints.

Vertical integration can occur as a result of growth and evolution of the firm, whereby the firm decides to expand its organization to include wholesale and retail facilities. The reasons for doing so are often based on the firm's desire to gain scale economies and a high degree of control, which it believes vertical integration can offer. For example, Walt Disney Company recently bought Capital Cities/ABC Inc. in order to "lock up" a secure distribution system for the shows it produced.⁵¹

49. John R. Wilke, "Microsoft Antitrust Case Heads Back to Trial Court," *Wall Street Journal* (August 3, 2001): A3.

50. John R. Wilke, Rebecca Buckman, and Gary McWilliams, "Microsoft Lets PC Firms Remove Browser," *Wall Street Journal* (July 12, 2001): A3, A8.

51. Bruce Orwall and John Lippman, "Lawsuit Casts Tim Allen TV Series as Victim of Synergy," *Wall Street Journal* (March 17, 1997): B1, B8.

Vertical integration can also occur, however, through acquisitions of and mergers with other firms at different levels of the channel. A manufacturer, for example, may acquire or merge with a wholesale or retailing organization.

Under the Celler–Kefauver amendment to the Sherman Act, such vertical integration by acquisition and merger is subject to antitrust actions if the acquisitions or mergers tend to substantially lessen competition or foster monopoly. This can happen when the vertical integration occurs in a highly concentrated industry, thus eliminating an important source of supply to independent firms or significantly reducing the opportunity for competitive firms to reach the market. For example, a merger between Brown Shoe Company, a major shoe manufacturer, and Kinney Shoe Corporation, a former independent chain of retail shoe stores in the United States, was ruled illegal by the Supreme Court because the merger might have prevented other shoe manufacturers from selling through Kinney.⁵²

52. Louis W. Stern and Adel I. El-Ansary, *Marketing Channels* (Englewood Cliffs, N.J.: Prentice-Hall, 1977), 344.



SUMMARY

Marketing channels develop and operate in a complex environment that is continually changing. Channel managers must therefore be sensitive to environmental changes in order to plan effective marketing channel strategies for meeting these changes successfully. To do so, they must have an understanding of the environment and how it can influence channel management.

While there are many ways to categorize the myriad of environmental variables, the following five-category taxonomy was used in this chapter: (1) economic environment, (2) competitive environment, (3) sociocultural environment, (4) technological environment, and (5) legal environment.

When dealing with any or all of these environmental categories, channel managers need to consider the effects of environmental variables not only on their own firms and on their firms' target markets, but also on *all* the channel members and participants.

The economic environment is probably the most obvious and pervasive category of environmental variables affecting all members and participants in the channel. Especially important are the effects of recession, inflation, and possible deflation, but even so-called normal economic conditions can create problems. The fundamental challenge confronting channel managers in the face of these economic developments is to help channel members weather difficult economic conditions. Advance planning to develop channel strategies for dealing with economic changes is the basis for successfully meeting this challenge.

The competitive environment must include global as well as domestic competition. Moreover, four major types of competition need to be addressed: (1) horizontal competition, where similar firms at the same level of the channel compete with each other; (2) intertype competition, where different types of firms at the same level of the channel compete; (3) vertical competition, where firms at different levels in the same channel compete with one another; and (4) channel system competition, where entire channels compete with each other. Channel managers must watch all of these types of competition in order to determine how the competitive structure in which their channels operate is changing and what implications these changes may have for channel management strategy.

The sociocultural environment has an impact on marketing channels because the structure of marketing channels reflects the sociocultural environment within which they exist.

So, channel managers must carefully observe changing sociocultural patterns in order to discern what implications these pattern changes will have for marketing channel strategy. Because of their profound influence in recent years, certain developments should be especially noted. These include age patterns of the population, ethnic mix, educational trends, family or household structure, and the changing role of women.

The technological environment must be monitored carefully to evaluate the effects of technological changes on marketing channels. Developments such as the Internet, computerized inventory management with handheld computers, EDI, robotics, and ultra-wideband wireless technology should be watched.

Finally, channel managers cannot ignore the legal environment, with its complex laws and continually changing precedents. While channel managers cannot be expected to be experts in the technicalities and nuances involved in the complex and changing legal environment affecting channel management, general knowledge and awareness of some of the basic laws and legal issues are needed. In particular, channel managers should be familiar with the basic provisions of the Sherman Act, Clayton Act, Federal Trade Commission Act, Robinson–Patman Act, and the Celler–Kefauver Act and how they affect such legal issues in channel management as (1) dual distribution, (2) exclusive dealing, (3) full-line forcing, (4) price discrimination, (5) price maintenance, (6) refusal to deal, (7) resale restrictions, (8) tying agreements, and (9) vertical integration through acquisitions and mergers.

Review Questions

1. How does the impact of the environment on channel strategy differ from the other major strategy areas of the marketing mix?
2. In dealing with the effects of environment on channel strategy, the channel manager has a lot more to think about. Discuss this statement.
3. Discuss the fundamental channel management issues associated with recessionary, inflationary, and deflationary periods in the economy.
4. Why might even “normal” economic conditions pose channel management problems?
5. Explain the four types of competition discussed in the chapter. Why is it important to recognize these different forms of competition?
6. Marketing channels reflect the sociocultural environments within which they exist. Explain this statement.
7. Technological changes, though continual, do not occur evenly or predictably over time. Discuss the implications of this statement for channel management strategy.
8. How and why might the Internet become an important electronic marketing channel?
9. Discuss the channel management implications of such technological developments as electronic scanners, high-tech point-of-sale displays, computerized

inventory management systems, EDI, robotics, and ultra-wideband wireless technology.

10. What is the underlying philosophy of the Sherman Act with respect to the role of competition versus monopoly in promoting public welfare? Discuss.
11. Discuss the basic provisions of the (1) Sherman Antitrust Act, (2) Clayton Act, (3) Federal Trade Commission Act, (4) Robinson–Patman Act, and (5) Celler–Kefauver Act.
12. Exclusive dealing, full-line forcing, and tying agreements all have something in common. What is it? Discuss the antitrust implications of this common element.
13. Price maintenance, refusal to deal, and resale restrictions all represent attempts by the supplier to exercise control over its channel members. What are the legal limits on the degree of control the supplier can exercise through these three approaches?
14. Discuss the basic legal implications associated with the policies of dual distribution, price discrimination, and vertical integration through acquisitions and mergers.

Issues for Discussion

1. James Johnson, vice president of marketing for a major manufacturer of fiberglass home insulation aimed at the DIY market, was elated after reading an article in the *Wall Street Journal* about the recent steep rise in energy prices. “This will be great for us—our sales could double next season,” he exclaimed to his general sales manager, Bill Allan, who had just walked into the office. “Tell your district sales managers to instruct their field salespeople to push home center retailers to double their inventory and floor space for home insulation,” continued Jackson. Bill Allan dutifully responded, “I’ll do it right away, but the last thing the home centers are going to want is to stock up heavily on inventory when this energy price spiral might cause a recession.”
 Comment on this situation in terms of the different perspectives of the manufacturer and the retailers about this environmental development.
2. Home Depot, Toys “Я” Us, Staples, CompUSA, Circuit City, and many other giant retailers (often referred to as “category killers” or “big box” retailers because of their dominance in particular merchandise categories and the sheer physical size of the stores) are fierce competitors and are frequently accused of driving small retailers out of business. Indeed, the very reason the small retailers go out of business is that they “can’t compete” with these giants, say observers who have watched this competitive struggle take place over the past decade. The verdict in most cases has been “no contest” between the retail giants and

the little guys because the little guy so seldom wins or even gets to stay in business.

From a competitive standpoint, is such an outcome inevitable? Discuss. Is it really the “big guys” driving the “little guys” out of business or is there something more fundamental at work here?

3. Many people are dissatisfied with the regular radio programming on local stations. In fact, many local stations are owned by national companies that have homogenized programming, thus limiting consumer choice. New technology in the form of satellite broadcasting could provide an alternative for consumers. XM Satellite Radio (<http://www.xmradio.com>), for example, offers 100 program channels nationwide, many with no commercials, for a \$10 monthly fee. Sirius Satellite Radio (<http://www.siriusradio.com>) offers a similar service for \$12 per month. Both services require an XM receiver, which costs about \$300. Sony offers a convertible model that, while primarily designed for use in a car, can also be used with a home audio system. Both General Motors and Ford are also making XM receivers available as an option in a number of their models.

Do you think the technology of satellite broadcasting will revolutionize radio in light of the generally poor consumer response given to radio Webcasting—music and the programming streamed over the Internet? In your answer be sure to address not only the technological issues associated with satellite broadcasting but the economic and possible legal issues as well.

4. Streaming video over the Internet as a mainstream technology for delivering entertainment such as movies, concerts, and sports to millions of consumers has been a major disappointment. The quality of streaming videos has been unsatisfactory for most consumers, plus the technological and legal issues involved in streaming to mass-market audiences have been major obstacles. “Old-fashioned” television still seems to be much better suited for the mass entertainment market. However, streaming video over the Web has so far been very successful for *businesses* who are using it to communicate with employees, stockholders, international partners, and other constituencies. These business applications include sales training, employee education, new product announcements, customer service, and many others where quick yet extensive communication is needed. Businesses view this technology as a way of dramatically reducing travel costs compared with bringing people together at a physical location. Jupiter Media Metrix projects that businesses will spend almost \$3 billion on streaming video by 2005, up from \$290 million in 2001.

Do you think streaming video would be an effective tool for communicating with channel members? How might it be employed to enhance marketing channel management?

5. Microsoft Corp’s newest version of its Windows software, Windows XP, introduced in the fall of 2001, offered many new functions bundled with the basic

software, including instant messaging, digital media, photography, and video-editing software. Microsoft argues that these additional functions are of great benefit to the consumer because they are getting a significant added value. However, competitive software producers argue that this type of bundling is anticompetitive because it inhibits their ability to get consumers to use *their* versions of the software that Microsoft includes. Because Microsoft Windows is used in 95 percent of the world's personal computers, other software makers believe Microsoft, in effect, controls 95 percent of the "shelf space" for alternative software products. This makes it extraordinarily difficult if not impossible for competitors to get their software onto the "shelves" of millions of personal computers around the world. The federal courts largely agreed with the competitors' views, leading to federal lawsuits against Microsoft. Early rulings did indeed find that Microsoft was a monopolist that had violated antitrust laws. The penalty against Microsoft, which ranges from possibly breaking up the company to substantial fines, still has not been finalized by the courts.

What do you think about the merit of Microsoft's argument vs. that of competitive software makers?

6. Toys "Я" Us has been cited by the Federal Trade Commission for pressuring manufacturers to refuse to sell popular toys to warehouse club discount retailers. The pressure was so intense that major toy manufacturers Mattel Inc. and Hasbro Inc. stopped selling toys altogether to warehouse clubs while other toy manufacturers would sell only discontinued toys and special large packages to the clubs. Toys "Я" Us claims that it is against sales to warehouse clubs in principle because the warehouse clubs want to "cherry pick" just a small number of hot toys around the Christmas season and then get a "free ride" on the marketing and advertising of Toys "Я" Us. Toys "Я" Us, however, denies that it exerted any pressure on the manufacturers to force them to refuse to deal with the warehouse clubs and is appealing the FTC ruling.

What legal issues in marketing channels appear to be involved here? Discuss.