THE INFLUENCE OF SUNK COSTS IN SUPPLIER-CUSTOMER RELATIONSHIPS WITH LARGE RETAILERS

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Abstract

This paper discusses the issues of retailer's listing fees and look at them through the prism of sunk costs. As large retailers enjoy a privileged position in the negotiations with its suppliers, with their market power, they lead the commercial cooperation through dominance of contractual relations. It also explains the reasons why suppliers agree to renegotiate mutual contracts, accept less favorable terms and continue to cooperate with the retailer, even though this seems to be disadvantageous. The paper explains by behavioral theory the reasons why suppliers behave irrationally and which parameters are entering in their decision model. Listing fees are seen in this paper as irrecoverable investment, which influences future investments, getting affected by the effect "throwing good money after bad".

Key words: retail, listing fees, sunk costs

JEL Code: JEL G32, JEL L81, JEL M10

Introduction

The purpose of this present paper is to attempt to explain economic behavior, which is partly based on irrationality. The issue of sunk costs is one of the main factors that is "feeding" the significant market power of the large retail companies. The sunk costs can be assigned to a number of financial transfers, which the supplier provides to the retailer in order to make business with.

If we look at alternatives to the overall set of economical transfers from the supplier to the retailer, they can be divided into three categories: Commercial, Financial and Logistic. Table below sets out the different categories and specific subcategories in which we define the transfer tool.

Table 1: economical transfer instruments of commercial cooperation

Commercial	
	Listing fee
	Special placing fee
	Promotion fee and leaflets
	Returning goods
	Quantity discounts
	Specials and discount prices
	Discounts at the opening of new POS
Financial	
	Payment terms
	Electronic Data transmission (EDI) fee
	Fees for processing payments
	Remodeling fee
	Contributions to the construction and reconstruction of the stores (remodeling)
	Discount for early payment of suppliers
	Compensation fee for undelivered goods
Logistic	
	Charges for undelivered goods
	Logistics costs and logistic charges
	Logistics bonus (fee)
	The cost of inventory and supplies "just-in-time"
	merchandising fees

Source: Author

For the purposes of this work, we will focus on the analysis of the listing fees and see how they influence the managerial decision during the commercial relation between a large retailer and its supplier.

First, we will overview retailer´s market power, than define the concept of listing fees, its purpose and method of use, and then we move to the analysis of sunk costs and determine, how a listing fee can be perceived as a sunk cost. And finally we will determine how sunk costs interfere into managerial decisions.

1. Dominance of contractual relations

Large retailers enjoy a privileged position in the negotiations with its suppliers. They lead the commercial cooperation through dominance of contractual relations. If market forces are reasonably applied to the supplier, it leads to a balanced state of mutual trade. In fact a large retailer has predominantly a preferential position in the negotiations and is able to enforce the contract ex-ante, with retroactive effect, and also modify the terms of the contract ex-post, means that the retailer is able to assert its own contract and conditions and to assess the level of cooperation, the activity of the supplier and monitors whether the parties have complied with their obligations and imposes sanctions and penalties. The retail company has superiority over its supplier, similar to a hierarchical arrangement.

Follows from the above, the retailer enforce, at some stage of the negotiations, in a relatively simple way, his commercial, financial and logistic requirements. The reason is not only the vision of the supplier of big turnovers, but later on the third stage, the fact that the supplier has become a victim of its sunk costs in its decision process. The market power of the retailer allows him at anytime to renegotiate the terms of cooperation. More the supplier has invested in the cooperation, more he will be burdened by sunk costs during this renegotiating stage.

We can stratify the negotiations between the large retailer and its supplier into 3 distinct stages:

1. Entry talks (listing)
2. Negotiations on the terms and conditions
3. Annual meetings

Every stage has his specificity. Knowing, that a supplier cannot start selling his products through the distributor´s network without payment of entry fees, called listing fees, the supplier goes through stage 2 and stage 3 after having agreed the total listing fee amount.

2. Listing fees

Any commercial company has the right to carefully select and choose their supplier, that is one of the fundamental freedom of trade and exchange, becoming the main driver of competition and a means stimulating manufacturers and suppliers to increase their own productivity and improve the quality of their products, service level and also leads to a long-term price reduction.

If the supplier wants to sell its products through the distribution channel of a large retailer, it must undergo a process of listing, which means that its products will be added to the assortment of goods offered in the retailer´s commercial network. Listing a product a product is a process that consists in the negotiations between the retail chain and the contractor, the chain will sell products through its entire network with just a single, centralized negotiation. The supplier will save costs that would incur by contacting every single retail point of sales or business organization independently. For this service the retailer requires a payment. The essence of the existence of listing costs is clear: the growth of competition on the supply side and strengthening retail market concentration. Almost every vendor wants to use the extensive distribution channels and thereby potentially gets his goods to many households and in the consciousness of the general public. Supplier, convinced of the quality of its products, is capable to undergo many concessions to achieve listing of his products.

On the opposite side, there is the termination of purchasing selected products (delisting) or termination of cooperation with the supplier, where the retailer does not allow any more to access his business network and terminates the collaboration with the supplier. Delisting a product is a unilateral act, which is fully decided by the retailer and can occur without giving any reasons. Despite the fact that the supplier pays for listing his products a fee to the retailer, he can be delisted at any time without cause and without any financial compensation. Some chains even require the removal of delisted product and a take back inventories from retail outlets. According to the available information, it is an unwritten rule in Czech republic, that the retail chain preserves the product in his network, for two years after the payment of listing fees.

It is clear that in a market economy, where exists an excess of supply over demand of consumer goods, it is suitable for the retailer to choose a strong partner which offers not only financial support, but will also be able to promote new listed products and to dynamically adapt to new market requirements. This also leads to a concentration of suppliers who are able to handle the financial burden, such as suppliers of international caliber who offer globalized products.

Listing fees are single and unilateral transfer payments made to a retailer to encourage him to carry supplier´s products. The listing fee accounts for one-time setup costs for commercial administration. Listing fees are also a kind of insurance for the retailer, as he wants his costs back, if the offered product is not successful. As already said, listing allowance does not guarantee permanent placement. It can be also considered as a test made by the large retailer in order to check the competitiveness of the offered product. Listing fees are also a guarantee that the supplier will be involved and deeply interested in the common business, as he has to recover and amortize the investment.

Listings are usually negotiated during the stage of entry talks, when the vendor presents to the retailer: the product, its potential, estimated demand, price structure, expected innovations. In most cases, the listing fees (I_{List}) are fixed and calculated for each product category separately and refers to a Stock-keeping unit SKU (V_{SKU}) and for one store (POS), which is multiplied by the number of products and stores.

$$I_{List} = V_{SKU} \times Q_{POS}$$

I_{List} = total listing fee

V_{SKU} = number of individual products intended for listing

Q_{POS} = number of stores in which the product will be listed

Can be said, the cooperation between the parties starts with an investment from the supplier.

3. Sunk costs and loss aversion

In economics and business decision-making, „sunk costs are unrecoverable past expenditures. These should not normally be taken into account when determining whether to continue a project or abandon it, because they cannot be recovered either way. It is a common instinct to count them, however"[1].In the classical economical theory, built on rationality, sunk costs should not been taken into account when making rational decisions. But behavioral economists led by Daniel Kahneman, point to the fact that in practice, decision makers are very influenced by the sunk costs in their decision-making (for future development) and take them into account when deciding. "*Behavioral economics recognizes that sunk costs often affect economic decisions due to loss aversion: the price paid becomes a benchmark for the value, whereas the price paid should be irrelevant… Economic experiments have shown that the sunk cost fallacy and loss aversion are common; hence economic rationality—as assumed by much of economics—is limited. This has enormous implications for finance, economics, and securities markets in particular*"[2]

Risk aversion distorts the effectiveness of decision making. Individuals in the willingness to take risks differ significantly and despite to be a natural behavior of individuals

[1] http://economics.about.com/od/economicsglossary/g/sunkcosts.htm
[2] KAHNEMAN Daniel, http://ciks.vse.cz/Edice/nobel/Kahneman/kahneman_biogr.aspx

who fear the economic losses, sunk costs are firmly associated to risk aversion. When making decisions, subject prefers to risk a higher future loss, than an immediate lower loss. Taking in account the fact that an individual has to voluntary surrender a certain financial amount would be unacceptable for most people as they have strong misgivings about "wasting" resources.

4. Listing fees as sunk costs

Listing fees belong to the category of sunk costs, as they show all characters of sunk costs. „The sunk cost effect is manifested in a greater tendency to continue an endeavor once an investment in money, effort, or time has been made.“[3]

We were mentioning the ability of the retailer to renegotiate already concluded contracts, which happens during the third stage of negotiation (annual meetings). Coming from the initial situation – the second stage –in which they were all agreements already concluded and the supplier acknowledges and work with a specific business model, calculating costs and revenues.

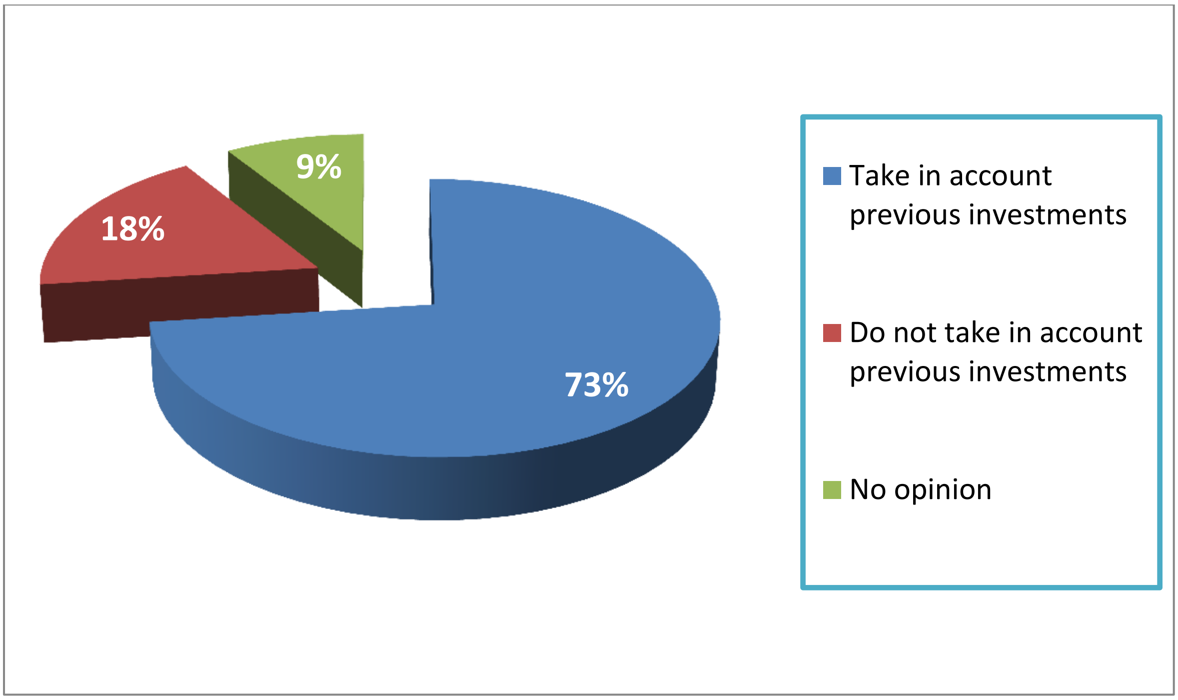
Renewing contract conditions (dynamic contracting process) means that after evaluating the results of the cooperation for the previous period (year), the retailer´s purchasing manager is submitting to the supplier his new requirements, and the essential is that new requirements are based on previous agreed conditions, what means that supplier will have to give more concessions to the retailer. The retailer´s purchasing manager will try to conclude the new agreement as soon as possible and will affect the supplier to accept the conditions immediately.

It is not unusual that a supplier working already for a many years with a retail channel has no more possibility to draw on his own economical profit, as he is already working with minimum margins. The supplier has already invested a considerable amount into the cooperation, both in terms of financial resources and in terms of energy.

According to the findings of our field research, 73% of suppliers are taking in account, during decision making, their previous investments, mainly listing fees, as they are not anyhow directly linked to the profit of the supplier. In those cases, we can talk about sunk cost fallacy, what refers to an irrational behavior that misallocates resources by depending on information that is irrelevant to the decision being made.

[3] HAL R. ARKES AND CATHERINE BLUMER, The Psychology of Sunk Cost, ORGANIZATIONAL BEHAVIOR AND HUMAN DECISION PROCESSES 35, page 120, Ohaio University. http://commonsenseatheism.com/wp-content/uploads/2011/09/Arkes-Blumer-The-psychology-of-sunk-cost.pdf

Chart 1: distribution of suppliers' survey – managerial decisions in supplier-retailer relationship.



Source: Author, suppliers' survey 2011.

As retailers use those annual meetings to obtain better conditions, the supplier may be in a situation of point of no return, what is a psychological point, beyond which the supplier feels that he must continue in the established actions and there is no way back. This is a typical situation, when marginal revenues of the common collaboration are converging zero and the supplier still hopes for better.

One of the reasons why the retailer asks the supplier to the immediate acceptance of new terms is that he knows that the first wave of emotion often overtakes subsequent rational consideration. The retailer´s purchasing managers are very well trained on negotiation skills.

Sunk cost can also reflect a nonmonetary effect: when the supplier has invested a lot of energy building the relationship with the retailer. Again subconscious logic applies as he spent a lot of times to create or trying to create a relationship of mutual trust. If the supplier does not agree to the terms, there is serious concern that the parties end cooperation, which may cause a serious annoyance to the supplier´s agent. He will also have to justify to his employer the termination of cooperation with the retailer, which means some kind of personal failure.

Conclusion

A specific feature of business cooperation with retail chains is precisely the multileveled negotiations, constantly adjusting the conditions of cooperation. Business meeting in the first stage and in the second stage have clearly defined rules and predictable result, as the supplier is able to calculate his future earnings. The third stage of negotiation called “annual meeting” has a specificity in re-negotiation commercial terms between the supplier and the large retailer. Using his market power, the retailer influences his supplier to accept any strict conditions that may increase retailer´s economic profit. Listing fees are part of the deal, starting the business procedure; they become a major investment of the supplier which demonstrates the intention of cooperation with the retail chain. We have to perceive those fees as an investment in future cooperation even if they become a sunk cost immediately after signing the collaboration contract. Those sunk costs will considerably influence the supplier decisions during a large part of the cooperation (at least up to its full amortization). We also have noted that more than 70% of interviewed contractors are taking in considerations sunk cost when deciding on future cooperation.

We can observe that retailer´s awareness of supplier´s sunk costs strengthens the effect of distributor´s market power. We can also note that suppliers are often taking in account sunk costs for their future decisions, which can put a very powerful bargaining instrument in the hands of the retailer.

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