United States General Accounting Office

GAO

Report to the Ranking Minority Member, Committee on Small Business and Entrepreneurship, U.S. Senate

December 2002

DEFENSE COMMISSARIES

Additional Small Business Opportunities Should Be Explored

GAO

Accountability * Integrity * Reliability

GAO-03-160

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Highlights

Highlights of GAO-03-160, a report to the Ranking Minority Member, Committee on Small Business and Entrepreneurship, U.S. Senate

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DEFENSE COMMISSARIES

Additional Small Business Opportunities Should Be Explored

Why GAO Did This Study

Some grocery supermarket companies have been charging food product manufacturers "slotting fees" to place products in stores and have involved large product manufacturers in making decisions about what products to sell. These practices have raised concerns about anticompetitive behavior and may be adversely affecting small businesses. GAO was asked (1) if the Defense Commissary Agency is using these practices in managing military commissaries; (2) what proportion of products sold by commissaries are produced by small businesses; and (3) if small businesses face barriers in selling products through commissaries and how opportunities for small business could be improved.

What GAO Recommends

GAO is recommending that the Department of Defense study the benefits and costs of developing private label products for sale through commissaries. GAO also suggests that the department consult with the Small Business Administration on the removal of a legal hurdle that that may deter some small businesses from dealing with commissaries.

www.gao.gov/cgi-bin/getrpt?GAO-03-160.

To view the full report, click on the link above. For more information, contact Lawrence Dyckman at 202-512-9692 or dyckmanl@gao.gov.

What GAO Found

The Defense Commissary Agency does not charge slotting fees, and agency staff, not product manufacturers, decide which products to sell and where they will be placed on commissary shelves.

GAO estimates that slightly more than half of the companies producing products that the agency sold are small businesses. According to GAO estimates, these businesses produced about 24 percent, or about 10,900 of 45,200 products sold by commissaries from August 2000 through May 2001, generating about 7 percent of commissary sales during the period.

Federal law requires that a name brand product must have been sold on a regional basis through grocery stores or other retail operations before the agency may purchase it for resale without competition. This requirement apparently poses a legal hurdle to small businesses whose name brand product distribution may be limited because the agency cannot accept their products for resale.

GAO identified two ways in which opportunities for small businesses might be increased. First, the legal hurdle to purchasing name brand products that have limited distribution could be removed. Agency officials are capable of deciding which products to sell without this requirement.

Second, the agency could sell private label products, such as the Kroger Company's "Big K" brand or Safeway Stores' "Safeway Select" brand and obtain these products from both large and small businesses. In 2001, private label products constituted over 20 percent of industry unit sales and 16 percent of dollar sales. Private label products are sold at lower prices than brand name products and could potentially increase savings for commissary customers. Agency officials recognize there could be some potential benefits if the agency were to offer private label products. However, the officials said it would be difficult to initiate and operate a private label program. Further, they are concerned that if the agency attempted to sell private label products, its current suppliers would increase their prices and withdraw some of the support they now provide commissaries, perhaps reducing the overall benefits of commissary shopping. GAO noted that the agency has not done a thorough study of the potential for private label products to serve commissary customers. The agency's Director agreed with GAO that a study of the benefits and costs of developing private label products would be reasonable to undertake to determine if such a program could enhance the commissary benefit.

The Department of Defense concurred with GAO's recommendations and plans to implement them.

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Abbreviation

DeCA	Defense Commissary Agency

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Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

December 12, 2002

The Honorable Christopher Bond
Ranking Minority Member
Committee on Small Business and Entrepreneurship
United States Senate

Dear Senator Bond:

For well over a decade, the U.S. retail grocery industry has increasingly required grocery store suppliers to pay a variety of fees to place their products in stores. These fees, called "slotting fees" or "slotting allowances," help determine which products supermarkets will sell and where they will place those products on their shelves. Proponents of slotting fees maintain that the fees help pay the costs of introducing new products to the marketplace, such as the costs of reallocating shelf space and reprogramming scanner equipment and that the fees help allocate the risk of product failure between suppliers and retailers. Some retailers view slotting fees as a way to reduce their risk in trying a new product and say that a manufacturer's willingness to pay slotting fees indicates the manufacturer's confidence in a product's success. Opponents of the practice, including some product suppliers and small business groups, maintain that it can prevent smaller manufacturers from competing if they cannot afford the fees.

Many large grocery retailers have also adopted a business technique called "category management" for assessing the sales potential of products within a particular category, such as ice cream or other frozen foods, selecting the products with the best potential and allocating shelf space to these products. Retailers may manage product categories themselves, with recommendations from suppliers; select various "category captains" (usually the leading manufacturers for each product category) to help them manage the categories; or turn over management of the categories to the category captains. While proponents of category management view it as having potentially significant benefits for suppliers, retailers, and consumers, others are concerned that when a retailer relies heavily on a category captain, anticompetitive behavior may arise.

The Department of Defense operates supermarket-type stores called commissaries for the use of active and retired military personnel and their families. Managed by the Defense Commissary Agency (DeCA), these commissaries number about 280 worldwide, with sales totaling about

$5 billion per year. DeCA's overall goal is to provide quality products at the lowest possible cost. Like commercial supermarkets, commissaries sell name brand products and nonbranded products such as produce, fresh fish, and ground beef. DeCA encourages small businesses to sell products through commissaries. Even so, to assure that DeCA can supply the name brand products its customers desire, federal law allows DeCA (as well as other federal agencies) to purchase name brand products without competition and without setting aside a portion of this business for small businesses. The Small Business Administration generally considers businesses with 500 or fewer employees to be small businesses.[1]

You asked us how DeCA is managing its product purchases. Specifically, you asked us to determine the extent to which (1) DeCA requires grocery suppliers to pay for shelf space in commissaries, (2) DeCA's large suppliers select the products that are sold by commissaries, (3) products sold by commissaries are produced by small businesses and foreign businesses, and (4) small businesses face barriers to selling their products in commissaries as well as whether opportunities for small businesses could be improved.

Results in Brief

The Defense Commissary Agency does not require its suppliers to pay for shelf space in commissaries; the agency accepts and stocks products for sale without charging slotting fees. However, in recent years the agency participated in a small number of promotional arrangements, called "performance-based agreements," under which its suppliers paid a negotiated fee for preferred product display space. In calendar year 2001, for example, the Defense Commissary Agency had 14 performance-based agreements covering products sold by 10 of over 2,700 of its suppliers. These agreements were negotiated separately from decisions to stock products, according to agency officials. The revenue from these performance-based agreements—about $1.2 million in 2001—has been used to fund commissary construction. The agency discontinued offering its suppliers performance-based agreements for 2002 to assure that revenue obtained through these agreements was not limiting vendors' capability to reduce product prices and because the Congress had provided for funding commissary construction.

[1] Exceptions, among others, include breakfast cereal manufacturing, fats and oils refining and blending, and specialty canning—1,000 employees or fewer; and cookie and cracker manufacturing, and cane sugar refining—750 employees or fewer.

The Defense Commissary Agency's large suppliers do not select the products that the commissaries sell; instead, agency officials have sole responsibility for category management decisions. When the agency assesses the performance of a category of products, such as frozen dinners or ice cream, it relies on market data that it obtains from an independent source. The agency also obtains product sales data and selection and display recommendations from suppliers within that category. These suppliers include both leading manufacturers—such as Kraft Foods, Inc., and General Mills, Inc.—and other companies selling and distributing products in that category that decide to participate in the review. The agency reconsiders its selections if requested to do so by suppliers.

Based on a statistical sample, we estimate that 53 percent of businesses producing products which the agency sold were small businesses and that these businesses produced about 24 percent or about 10,900 of 45,200 products sold by commissaries, during the period we sampled. We also estimate that the sale of these products totaled about $214 million, or about 7 percent of the dollar sales of commissaries during the period. In addition, we estimate that about 13 percent of the businesses producing products which the agency sold are foreign businesses and that these businesses produced about 6,500 products, or about 14 percent of the products sold by commissaries during the period. We also estimate that the sales of products produced by foreign companies totaled about $551 million or about 17 percent of the dollar sales of commissaries over the period. These estimates are based on a statistical sample of 700 of approximately 45,200 products sold by commissaries during the 10-month period from August 2000 through May 2001.

Businesses face a legal hurdle in selling brand name products to the Defense Commissary Agency for resale. Federal law requires that a name brand product must have been sold on a regional or national basis through grocery stores or other retail operations consisting of multiple outlets before the agency can purchase a product for resale without competition. Agency officials do not know precisely how often companies may be affected because companies do not inform the agency when they decide not to propose products for acceptance. Also, some small businesses may not sell to the commissary system because it appears to present less opportunity than other large grocery supermarket companies since the assortment of products which commissaries stock is smaller in comparison, the distances between commissaries is greater, and the costs of distributing products to commissaries may be increased. Nevertheless, agency officials said that they are eager to add products from small businesses and are looking for products with positive sales records, as well as companies with the financial capability to sustain operations and the production capacity to meet demand for their products if accepted. Because the legal requirement apparently limits the consideration of products proposed by small businesses, the agency may wish to consult with the Small Business Administration on whether to suggest to Congress that the provision be modified or removed from the law.

There also would be opportunities for small businesses if the agency were to sell private label products. Major grocery retailers, except for the agency, have developed successful private label products—private label products have grown to account for over 20 percent of industry unit sales and a 16 percent share of dollar sales in 2001, according to industry data. Private label products have low prices compared to name brand products and have also provided retailers with higher profit margins according to industry information. Agency officials recognize that private label products are successful and that commissary customers are very likely to buy private label products if they are offered at commissaries. Yet, agency officials also commented that a private label program could be difficult for the agency to initiate and implement. They said that introducing private label products could cause the agency's current suppliers to raise prices and withdraw the labor support they now provide and thereby raise the possibility that the overall benefits of commissary shopping may be reduced. We believe these issues would need to be carefully considered to determine if private label products are in the best interest of commissary customers. The agency's Director agreed that it would be reasonable to perform a study to determine if a private label product program could enhance the commissary benefit. Because the sale of private label products is a significant and successful competitive trend in grocery retailing, provides products at the lowest possible cost, and offers opportunities for small businesses, GAO is recommending that the Department of Defense assess the benefits, costs, and implementation issues associated with selling private label products through commissaries.

The Department of Defense reviewed a draft of this report, concurred with our recommendations and stated that it will implement them.

Background

DeCA commissaries are in business to provide a significant non-pay compensation benefit to military families; they sell food and household items tax free at cost plus a 5 percent surcharge. Military servicemen, retirees, and their families consider the opportunity to shop and save through the commissary a highly important benefit of military service. DeCA is striving to achieve an overall savings of 30 percent for its patrons compared to retail supermarket prices. DeCA's operating expenses are paid primarily through an annual appropriation of about $1 billion. DeCA was formed in 1991, and its headquarters are at Fort Lee, Virginia.

Under federal law, DeCA may purchase name brand products without competition and thereby supply its customers with products they prefer.[2] Also, when purchasing products without seeking competition, requirements regarding purchases from small businesses become inapplicable.[3] For the remainder of the products which commissaries sell for which there is not demonstrated customer preference for a specific brand, DeCA follows federal procurement requirements, seeking competition and striving to purchase a portion of its products from small businesses.

The Federal Trade Commission has been reviewing slotting and category management practices as part of its responsibility for preventing business practices that may have a harmful effect on competition.[4] Within the commission, the Bureau of Competition is responsible for investigating such illegal practices, and for taking enforcement action if it finds illegal activity. The Bureau of Competition views slotting allowances as covering a very broad range of business conduct, some of which—such as

[2] 10 U.S.C. 2304(c)(5).

[3] Although not required, DOD sets a goal for the portion of DeCA resale dollars that small business suppliers are to receive—based on the companies with DeCA resale agreements. These companies include brokers and distributors (who represent multiple manufacturing companies both large and small) and the individual manufacturers who deal directly with DeCA. For fiscal year 2002, DeCA's goal was that 14.5 percent of sales would be attributable to the resale agreements with small businesses, and 14.9 percent was achieved.

[4] Federal Trade Commission, *Report on the Federal Trade Commission Workshop on Slotting Allowances and Other Marketing Practices in the Grocery Industry* (Washington, D.C.: Feb. 2001). The report stated that commission staff prepared it and said "It does not necessarily reflect the views of the Commission or any individual Commissioner." The commission's workshop report contained little information about the amounts of the fees and their frequency of use and concluded that much more information needs to be obtained about slotting practices.

commercial bribery[5]—are unlawful. Other slotting practices are legal in competitive markets, according to the Federal Trade Commission, such as ordinary price discounts that are passed through to consumers. The Deputy Director of the Bureau of Competition has testified that slotting allowances are unlikely to harm competition when there are payments of reasonable amounts to compensate a retailer for stocking a new unproven product. On the other hand, the Deputy Director also advised that slotting practices may be of competitive concern if they involve the exclusion of rivals.[6] The following fees illustrate those in use in the industry according to the Federal Trade Commission's workshop report on slotting practices and industry studies:

- *Slotting allowances*—lump-sum, up-front payments from a manufacturer or producer to a retailer to have a new product carried by the retailer and placed on its shelves.
- *Pay to stay fees*—fees paid by a manufacturer to keep existing products on retailers' shelves.
- *Display fees*—fees paid by a manufacturer for shelf space and for placing products in particular locations within a store, such as on eye-level shelves or on displays at the end of shelves. There are concerns that some payments may limit or disadvantage a rival's access to shelf space.
- *Failure fees*—fees paid by a manufacturer to a retailer in the event that a product does not sell as well as expected and must be removed from store shelves and inventory.

DeCA Does Not Use Up-Front Slotting Fees

DeCA does not as a matter of course require companies supplying grocery products to make payments to obtain shelf space in commissaries. DeCA accepts and stocks products for sale without charge and in so doing has not joined in the grocery industry practice of requiring up-front slotting fee payments for shelf space.

[5] Commercial bribery occurs when an under the table payment to a retailer's purchasing agent for placing a product on a store shelf goes into the agent's pocket.

[6] Federal Trade Commission, *Slotting Allowances and the Antitrust Laws*, Testimony of Willard K. Tom, Deputy Director, Bureau of Competition, before the Committee on the Judiciary, U.S. House of Representatives (Washington, D.C.: Oct. 20, 1999). In addition, the Federal Trade Commission staff report indicates that, among other things, the exclusion of competitors is cause for antitrust concern only if it impairs the health of the competitive process and that the exclusion of individual firms is not a competitive concern if the relevant market as a whole remains competitive. The staff report also states that this perspective flows from the principle, often repeated by the Supreme Court, that antitrust laws are intended to protect "competition" rather than "competitors."

Although DeCA does not use up-front slotting fees, DeCA has entered into promotional arrangements, called "performance-based agreements," under which suppliers paid DeCA fees for allowing specific promotional activities. DeCA used these agreements to increase the funds available for commissary construction. The agreements were based on suppliers' proposals and negotiations with DeCA, and the agreements authorized suppliers to place products on special merchandizing racks, on end-of-aisle displays, and on in-aisle display cases. The agreements were negotiated separately from decisions to stock products, according to DeCA officials. DeCA entered relatively few performance-based agreements, and they provided modest income as table 1 indicates.

Table 1: DeCA's Performance-Based Agreements for 2000 and 2001

Year	Number of agreements	Product categories	Estimated DeCA revenue
2000	18	Candy, pet supplies, breakfast foods, butter, margarine, baked goods, cheese, drinks, snack foods, and home care products	$1.7 million
2001	14	International products, snack foods, baked goods, drinks, frozen foods, health foods, kitchen aids, and insecticides	$1.2 million

Source: GAO's analysis of DeCA information.

In addition, our review showed the following:

- Only one company had performance-based agreements in both years.
- In calendar year 2001, the 14 performance-based agreements covered products sold by 10 of over 2,700 of DeCA's suppliers.
- DeCA's performance-based agreements were not structured in a manner that excluded the sale of other suppliers' products. Appendix II contains examples illustrating the performance terms and the basis for payments that DeCA received through its performance-based agreements.

While there have been relatively few performance-based agreements, the concept has raised some concerns. In a 1998 report on DeCA contracting activities, the Department of Defense expressed concern that (1) DeCA's agreements were a form of selling space in commissaries, which is not authorized, and (2) that the agreements were a cost to the suppliers who may pass on those costs to military customers through increased product prices.[7] While DeCA officials disagreed with these perspectives, DeCA decided not to enter additional performance-based agreements for 2002. DeCA officials stated that they took this action to assure there was not any possibility that the agreements were limiting their suppliers' capability to reduce product prices, and because revenue needed for commissary construction had been secured through congressional action.[8]

DeCA Officials Are Responsible for Product Selection Decisions

DeCA officials select the products that commissaries sell—the agency does not use its large suppliers to select products for commissaries. DeCA officials do use category management techniques when selecting products, and DeCA officials have sole responsibility for category management decisions. DeCA adopted category management in the mid-1990s because this technique was being recognized as a significant improvement in grocery industry management practice. DeCA's category managers and buyers who are assigned to DeCA's Marketing Business Unit, located primarily at Fort Lee, Virginia, implement these techniques. DeCA has divided its grocery business into about 170 categories of like products, and it completed 164 reviews of individual product categories from January 2001 through August 2002. Appendix III identifies the general steps in DeCA's category management process, and DeCA's role within this process.

DeCA category managers and buyers have the lead role in DeCA's category management process. DeCA category managers and buyers told us that they use data from Information Resources, Inc.,[9] as a foundation for making grocery product selection decisions. Information Resources, Inc., supplies DeCA with sales data for each product in a category for the commissary market, as well as comparative sales data from other grocery retailers. This information allows DeCA's category managers and buyers to have an overview of the performance of each product over several time periods. In addition, DeCA category managers and buyers meet individually with their suppliers during a category review and are provided with product presentations and sales data developed by the supplier or purchased by the supplier, along with the suppliers' product selection and

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[7] Department of Defense, *Procurement Management Review: Defense Commissary Agency* (Washington, D.C.: Nov. 10, 1998).

[8] National Defense Authorization Act for fiscal year 2002.

[9] Information Resources, Inc., is a leading source of statistical data on supermarkets and their products. It purchases point of sale data for analysis from industry retailers.

display recommendations. Suppliers who make presentations to DeCA during a category review typically include both leading manufacturers such as Kraft Foods, Inc.; General Mills, Inc.; and PepsiCo, Inc.; and distributors, brokers, and other companies selling and distributing products in a category that decide to participate in the review. According to DeCA officials, they do not discuss or share the content of meetings with individual companies with the representatives of other companies that participate in a category review. After DeCA announces the results of a category review including any changes in its selections and the distribution of its products, DeCA will reconsider its selections if requested to do so by suppliers.

Commissaries Sale of Products from Small Businesses and Foreign Companies

Based on a statistical sample, we estimate that 53 percent of businesses producing products that DeCA sold are small businesses and that these businesses produced about 24 percent of the products (about 10,900 products, plus or minus 1,500) sold by commissaries from August 2000 through May 2001. We estimate that the sale of these products totaled about $214 million, or about 7 percent of commissary sales, and we are 95 percent confident that the total lies between $76 million and $352 million. In addition, we estimate that about 13 percent of the businesses producing products that DeCA sold are foreign businesses and estimate that these businesses produced about 14 percent or about 6,500 of the products sold by commissaries during the period. We are 95 percent confident that the total lies between 5,300 and 7,800. We also estimate that the sales of products produced by foreign companies totaled about $551 million, or about 17 percent of the dollar sales of commissaries, and we are 95 percent confident that the total lies between $287 million and $815 million. For our statistical sample, we selected 700 of approximately 45,200 products sold by commissaries during the 10-month period.[10] Table 2 provides additional details.

[10] We identified the parent company, if any, for 669 of the products we sampled. Some 138 small companies, 164 large companies, and 40 foreign companies supplied these 669 products.

Table 2: Estimated Percent of Small and Foreign Businesses and Sales of Products by DeCA Commissaries, August 2000 through May 2001

Dollars in millions

Business type[a]	Percent	95-percent confidence interval	Total	95-percent confidence interval
Small	53	44 to 54		
Products	24	21 to 27	**10,900**	9,400 to 12,400
Dollar sales of products	7	2 to 11	**$214**	$76 to $352
Foreign	13	10 to 17		
Products	14	12 to 17	**6,500**	5,300 to 7,800
Dollar sales of products	17	9 to 25	**$551**	$287 to $815

[a]While we could estimate the proportion of small and foreign businesses, we could not reliably estimate the total number of businesses. To do so would require knowledge of the number of products in the population associated with each parent company identified in the sample. The list from which the samples were drawn included product, but not company, identification, and the population of companies that produce products sold by DeCA is not known. Commissaries sales from August 2000 through May 2001 totaled $3.278 billion dollars.

Source: GAO's analysis of DeCA data.

We developed estimates of this business activity because this data was not available from DeCA. DeCA collects data on its suppliers with which it has resale agreements. These suppliers include a mix of companies, some of which produce products and others that are the distributors of products produced by other companies. DeCA's database identifies the companies that supplied it with each product, and its data includes either the producer or the distributor, but not both.

We could not compare commissary sales of the products of small business with private sector grocery supermarkets because the data that are available are too limited. While scanner data on industry sales are available, this information does not identify the size of the companies that supply the products, according to industry officials. Also, the U.S. Census Bureau, which conducts economic surveys of manufacturing, does not collect data on the extent that the products of small businesses are sold through individual commercial grocery retailers. Census Bureau data shows that grocery manufacturing is diversified, with over 22,000 companies participating in the sector, and that over 21,000 of these companies had 500 or fewer employees. Yet, the industry is more concentrated at the top—the 50 largest companies in the sector accounted for about 51 percent of the $422 billion in shipments attributed to this sector of the economy in 1997 (the latest data available).[11]

Barriers Small Businesses May Face in Doing Business with DeCA

Businesses face a legal hurdle in selling brand name products through commissaries—a provision of law requires a minimum level of sales before DeCA can consider a brand name product for purchase. In addition, the commissary system has certain physical characteristics that limit the number of products that commissaries sell and increase the costs of distributing products to commissaries. These characteristics affect the opportunities of businesses, including small businesses, to present and sell products through commissaries.

In general, federal policy concerning small businesses is to (1) foster their development and (2) to eliminate barriers to their growth. As indicated by the Small Business Act and the U.S. Small Business Administration, the United States is committed to preserving full and free competition that leads to free entry into business to keep capitalism efficient and foster innovation. Also, according to the administration, the growth of small businesses is vital to preserve competition, and its Office of Advocacy was created to help discourage barriers to small business development and growth. Furthermore, according to the administration, policymakers should find ways to level the playing field for all businesses without compromising statutory or agency specific goals.

In considering products for sale in commissaries, DeCA is bound by a provision of federal law that requires a name brand product to have been sold on a regional or national basis through grocery stores or other retail operations consisting of multiple outlets before DeCA may purchase these products on a non-competitive basis for resale.[12] This limitation was enacted in 1997, and a congressional committee considering this legislation specifically stated in referring to this provision that discount

[11] The 1997 data is from the U.S. Census Bureau's 1997 *Economic Census: Manufacturing Subject Series*, the latest economic census performed (Washington, D.C.: 1997). The next economic census of U.S. businesses is being conducted by the Census Bureau starting in January 2002 and will be reported starting in 2004.

[12] 10 U.S.C. 2486 (e).

brands that are not sold by major commercial grocery or retail store chains would not qualify as brand name products.[13]

DeCA officials said that the provision has, in part, had the effect of limiting their consideration of products that have not yet achieved a regional distribution, including products produced by small businesses. DeCA officials do not know precisely how often companies may be affected because companies do not inform DeCA when they are discouraged from proposing products for acceptance by DeCA for this reason. DeCA seeks products with positive sales records and companies with the financial capability to sustain operations and the production capacity to meet demand for their products if accepted for sale. DeCA does not accept a product with an indifferent sales record or a product that may not be as attractive to customers as those that are already in DeCA's assortment. Nevertheless, DeCA officials said that they occasionally accept products that appear to be popular in regional and local areas even with relatively limited distribution—they are looking for and eager to add products from small businesses that are innovative or distinctive. In addition, DeCA officials said each product accepted for sale must earn its place on the shelf and continue to sell well to maintain its place in a commissary store and the commissary system. When a product is added to DeCA's assortment, a competing product may need to be removed to make shelf space available.

In addition, other factors affect whether or not a small business sells products through commissaries. The commissary system differs, in part, from some large grocery supermarket companies in the following respects: the assortment of products, the distances between stores, and the costs of distributing products to stores. According to DeCA information, DeCA's assortment of products is limited by the physical size of commissaries—commissary stores are about one fourth smaller on average than typical commercial grocery supermarkets. Also, commissaries are shopped intensively twice per month on days after military paydays, and DeCA plans its stock assortment to assure that commissaries have sufficient quantities of the items in highest demand to meet these bimonthly shopping peaks. Due to these characteristics, an average commissary stocks about 11,500 items—as much as 40 percent fewer grocery items

[13] Committee on National Security, House of Representatives, *House Report 105-132*, *National Defense Authorization Act for Fiscal Year 1998* (Washington D.C.: June 16, 1997).

than large grocery supermarkets, according to DeCA information. In addition, the wide spacing of commissaries limits their sales in regional and local markets compared to other large supermarkets chains in metropolitan areas that have high concentrations of supermarket stores. Nearly half of all DeCA sales occur at about 55 of the largest commissary stores distributed across the continental U.S. at major military bases. Moreover, DeCA does not have centralized warehouses or a product distribution system within the United States, as do other large supermarket chains. Therefore, DeCA requires that its suppliers deliver or arrange to deliver products for sale, and these deliveries must be frequent enough to assure that at least a minimum quantity of each product is on the shelf each day. To meet these requirements, many of DeCA's suppliers pay a distributor to warehouse and deliver products to commissaries. These increased distribution costs may affect the decision of a small business to sell products through commissaries.

Private Label Products Might Reduce Commissary Prices and Provide Small Business Opportunity

Private label products are successful in the supermarket industry, providing quality products at low cost, but DeCA does not now offer private label products.[14] DeCA officials recognize the strength of the industry trends in selling private label products, and that commissary customers would likely purchase significant quantities of private label products. The sale of private label products would also provide some opportunity for small businesses. According to officials of the Private Label Manufacturers Association, as many as half of the association's membership of 3,200 companies may have 500 or fewer employees.[15] However, DeCA officials identified operational issues that they believe may undercut the benefits of having commissaries sell private label products. DeCA's Director's said that a study may clarify whether a private label program would be in the best interests of commissary customers.

Private label products have become a major form of retail trade in the grocery industry. Private label products, such as those sold by the major grocery retailers Kroger Co.; Albertson's, Inc.; Safeway Stores; Wal-Mart;

[14] Private-label products are goods produced by a manufacturer under contract with a retailer, which distributes them exclusively under its own label. Also known as house brands, private-label products let a supermarket offer products that can only be found in its stores.

[15] Some large companies that produce name brand products also produce private-label products to use excess capacity in their plants.

and Ahold USA have captured 20.7 percent of supermarket unit sales, and 16.2 percent of dollar sales according to industry data.[16] These and other grocery retailers now use their own private labels to sell thousands of products. Examples of private label brands include the Kroger Company's "Big K" brand, Wal-Mart's "Sam's American Choice" brand, or Safeway Stores' "Safeway" and "Lucerne" brands. In addition, reports[17] on the supermarket industry indicate that private-label products

- may capture 24 percent of grocery industry sales by 2006;
- make business sense because they offer a 20 to 40 percent price advantage over national brands and, in addition, provide retailers a 35 to 40 percent margin compared to the 27 percent margin of national brands; and
- are perceived within the industry as promoting customer loyalty to a retailer.

Sales of private label products vary significantly by product category, and in some categories exceed 30 percent of the sales of a category. The top 20 categories of private label product sales are listed in appendix IV.

DeCA officials have been considering the industry trend toward private label sales. In 1997, a limited evaluation of the private label concept by DeCA staff suggested, at that time, that (1) DeCA customers appeared to be demographically ideal purchasers of low cost private label products, (2) a private label program would be impractical for DeCA because it may not reduce overall prices and would require significant operations changes; and, (3) it may be necessary for DeCA to respond to industry trends by selectively carrying low cost alternative products.[18] In July 2000, DeCA started its "Best Value Items" program, which offers name brand products at the lowest prices DeCA can obtain. The Best Value Items program responds, in part, to a commissary customer's request to DeCA's director for private label products, and the recognition by DeCA that commissaries were at a competitive disadvantage compared to private label programs in serving some customers, such as its younger service members who desire the lowest priced products. As of September 2002, DeCA's Best Value Item program contained about 400 items and

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[16] Information Resources, Inc., as reported by the Private Label Manufacturers Association for 2001.

[17] Standard and Poor's, *Supermarkets and Drugstores* (New York, N.Y.: Aug. 2001).

[18] Analyses of the financial issues and alternatives for implementing a private label concept were not included.

accounted for about 2.3 percent of DeCA annual dollar sales, according to DeCA information.

In discussing the potential for private label products, DeCA officials raised concerns about the effects of a private label program that require serious consideration. DeCA officials said that the private label concept may not increase customer traffic from current levels, nor succeed in reducing product costs overall. More specifically, DeCA officials noted that the private label concept could be difficult for DeCA to initiate, and the DeCA's major suppliers may respond by raising prices on products now sold through commissaries and withdraw the labor support that they now provide to commissaries. According to DeCA officials, there would also be implementation issues such as (1) the pricing of products, which may require a change in DeCA's legal authority if variable pricing would be helpful; (2) the expense of advertising DeCA private label products; and (3) controls over product quality. Due to these concerns, DeCA officials have not performed a thorough study of the potential for selling private label products.

On the other hand, the Department of Defense has stated that it is important for the future of the commissary system to focus on the emerging trends in the supermarket industry and for commissaries to be positioned to retain their appeal. In addition, the department has in the past expressed concern that discount retailing could lead to strong competition for military members' business in common markets. In discussing the potential offered by private label products, as well as the issues that would be involved, DeCA's Director concluded that although there may be difficulties associated with the application of the private label concept to commissaries, it would be reasonable to perform a study to determine whether the sale of private label products could enhance the commissary benefit overall.

Conclusions

The legal requirement that name brand products must first be introduced through multiple retail operations on at least a regional basis may preclude DeCA from purchasing some small business brand name products that it may desire to purchase. In addition, this requirement may thereby have the effect of lessening the opportunities to implement the federal policy of fostering the development of small businesses. We recognize that even if this provision is removed from the law or some other adjustment is made to the requirement to open the door to the consideration of all small business products offered to DeCA, it is uncertain whether there will be a positive effect on the sales of small business products in commissaries because commissary shelf space is limited and open to competition. Nevertheless, a change in the requirement could at least open the opportunity for small businesses to make the case that their products deserve a place on commissary shelves.

Private label products may provide further opportunities for DeCA to offer its customers good alternatives in low-cost grocery retailing. The growth of private label products in the grocery supermarket industry appears to be a compelling trend, with thousands of private label products capturing a portion of sales in major national supermarket chains, and significant portions of particular product categories. Unless the potential for private label products is examined more thoroughly than it has been thus far, along with a review of implementation alternatives and the issues that can be expected to arise if further steps in that direction were to be taken, the potential for applying this successful retailing to the benefit of commissary patrons will remain in question.

Recommendations for Executive Action

Because of the potential limitation on small businesses opportunity, GAO recommends that the Secretary of Defense consult with the Administrator, U.S. Small Business Administration, on the provision of law restricting DeCA's consideration of products that have not yet achieved regional distribution, and together inform the Congress if small business opportunity could be improved by removing or modifying the provision.

In addition, to evaluate the potential to better serve commissary customers, GAO recommends that the Secretary of Defense perform a study to examine the benefits, costs, and implementation issues associated with the sale of private label products through commissaries, and act on study results, as appropriate.

Agency Comments and Our Evaluation

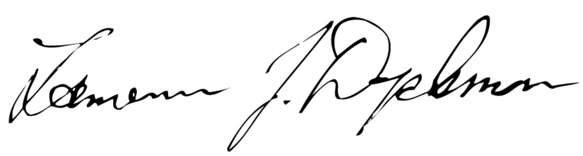
We requested comments from the Department of Defense on a draft of this report. The department concurred with our recommendations and its comments are presented in appendix V. Specifically, the department stated that (1) it would consult with the Small Business Administration on whether to suggest that the provision of law restricting the consideration of products be modified or removed from law; and (2) that it will conduct a study in 2003 to assess the potential benefits, costs and implementation issues associated with selling private label products through commissaries, and act on the results, as appropriate. In addition, DeCA officials told us that they agreed with the contents of the draft report and they also provided some technical corrections and clarifications to the draft report that we incorporated as appropriate.

We conducted our review from January 2000 through October 2002 in accordance with generally accepted government auditing standards. Details of our scope and methodology are discussed in appendix I.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. We will then send copies to other appropriate congressional committees; the Secretary of Defense; the Director, Defense Commissary Agency; and the Director, Office of Management and Budget. We will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions about this report, please call me at (202) 512-3841 or Charles Adams at 202-512-8010 or e-mail us at dyckmanl@gao.gov or adamsc@gao.gov. Key contributors to this report are listed in appendix VI.

Sincerely yours,



Lawrence J. Dyckman
Director, Natural Resources and
the Environment

Appendix I: Objectives, Scope, and Methodology

To determine the extent to which DeCA requires grocery suppliers to pay for shelf space in commissaries, and DeCA's large suppliers select the products that are sold by commissaries, we reviewed U.S. Federal Trade Commission documents and industry studies concerning slotting practices and category management, reviewed DeCA documents, and interviewed DeCA and industry officials. More specifically, we reviewed DeCA's basic contract with its suppliers, DeCA's performance-based agreements for fiscal year 2000 and fiscal year 2001, DeCA category management documentation, and studies and reports about DeCA's history, organization, and operations[1]. At DeCA headquarters at Fort Lee, Virginia, we met with DeCA's Director, and interviewed DeCA officials including among others, DeCA's General Counsel, category management officials, category managers, buyers, and accounting and contracting officials. We also interviewed several of DeCA suppliers including large distributors as well as individual companies. We also visited commissaries located in Texas and Virginia to discuss commissary operations and the use and management of commissary shelf space. To determine whether small businesses face barriers in selling their products in commissaries, we interviewed officials of DeCA's Office of Small and Disadvantaged Business Utilization; reviewed DeCA correspondence on complains from small businesses; interviewed DeCA's regional officials involved in deciding whether the products of small businesses would be attractive additions to DeCA selection of regional and local products, and officials of small businesses supplying DeCA. We contacted over 50 companies and discussed DeCA's use of category management, slotting fees, and sales of products from small businesses. In addition, we interviewed officials of the Food Marketing Institute, several industry trade associations, and the Private Label Manufacturers Association.

To estimate commissary sales of the products of small businesses and foreign businesses, we obtained a database from DeCA containing 45,200 products sold through commissaries over the 10-month period August 2000 through May 2001. For each product, the file contained the product's brand name, a commodity description, unit and dollar sales, and the Universal Product Code. Also, at our request, DeCA officials classified each product as being supplied by either a large or a small business based

[1] For example, we reviewed reports pertinent to DeCA operations, relationships with its suppliers, and operations including: SRA International et al., *Category Management Survey Final Report*, (Arlington, Va.: May 7, 1997) prepared for DeCA's Marketing Business Unit; and the Jones Commission, Office of the Assistant Secretary of Defense, *DOD Study of the Military Commissary System*, (Washington, D.C.: Dec. 18, 1989).

on its knowledge of its suppliers and the industry. We drew a random sample of 700 products from DeCA's population of products.[2] To assist in verifying the identity of each company that produced or distributed each product in our sample, we obtained information from the Uniform Code Council, Inc., that enabled us to identify the company that obtained a product's Universal Product Code. We then matched DeCA's product information with the corresponding information from the Uniform Code Council database. In some cases, the matching procedure was unsuccessful, and we used the product brand name to identify the company that produced or distributed the product. For the products in our sample, we verified the parent companies, the size of each company, and identified foreign companies. Our verification of the number of employees of each company was based on data obtained from business sources available on the Internet and phone calls we made to company representatives. We were able to determine the size of the company[3] and its parent company, if any, and whether it was foreign or domestic for 669 of the 700 products we sampled. The proportions of small and foreign companies were estimated by determining the number of products in the sample associated with each firm and then using the collection of relative frequencies of each company to estimate the percent of small and foreign companies in the population. We also used this information to estimate the numbers of products produced by these companies and sold by commissaries, and the dollar sales of their products.

[2] Because we followed a probability procedure based on random selections, we are 95 percent confident that the confidence intervals in this report include the true values in the population. All percentages we derived have confidence intervals that extend no more than 10 percentage points away from estimates, as do our numeric estimates, unless otherwise noted. We used a resampling technique to derive the 95 percent confidence intervals around the estimated proportions of small and foreign parent companies. To do this, we generated 1,000 repeated samples (resamples) of the same size as the original sample (669), each time selecting products with replacement from our original sample of products. The proportion of small and foreign parent companies was calculated for each resample, generating a distribution of 1,000 resampled percentages. We computed the 2.5% and 97.5% percentile points of this distribution and used them as the endpoints of our 95% confidence interval. Estimates and associated confidence intervals for (1) the proportion of products from small and foreign parent companies, (2) the total number of products from these companies, and 3) the percent and total sales dollars of products sold were derived using standard statistical estimation procedures.

[3] Our classification of the size of companies was based on information from the U.S. Small Business Administration.

Appendix II: Examples of the Terms of DeCA's Performance-Based Agreements

Agreement number	Length of agreement	Performance of promotion activities	Basis for payments to DeCA
1	7 months	1. DeCA to expand bulk sales sections where practical. Space to remain unchanged where previously expanded. Specific displays to be added in the two largest store categories for 6-month period. 2. Company will continue to have a dedicated sales section in stores that excludes others products. 3. Two other sets of products to be promoted for 3 months each.	Company to pay a specified amount for achievement of base annual sales volume. In addition, as sales increase above the base annual volume, company to pay an increasing percent of additional sales (up to 8 percent) to DeCA.
2	1 year	DeCA to provide display of specific products at specified commissaries.	Company to make minimum specified quarterly payments. Above minimum target sales, company to increase total payments based on pounds of product sold.
3	16 months	Company to place freezers in specified number of commissaries for display of company products.	Company to make specified payment at end of performance period.
4	1 year	DeCA to promote and display specified products on various timetables such as once per quarter, and two times over one year period.	Company to pay specified amount for each primary display plus a bonus based on percent of invoiced dollar sales, with the percent increasing at specified sales amounts.
5	1 year	1. Off shelf displays to occur in each of 24 display periods. DeCA to allocate space for company to build and maintain displays. Only company brands to be placed on company display equipment. 2. DeCA to provide a minimum of 1 endcap or shop-around display in specified stores. In other specified stores, DeCA to provide a table, rack, or other display space for company use. 3. DeCA to promote two specific brand products. 4. Competitors to have "proper allocation" of shelf space. Company shelf space to be based on sales volume and agreed formula.	• Company to pay specified quarterly cash payment. • Company to provide various promotions of a specified value in coordination with DeCA's category manager.
6	1 year	DeCA to execute specified number of primaries/power buys in various product categories.	Company to make specified payments to DeCA per agreement based on performance. Also, incentive payments added when sales reach or exceed 105 percent of base.
7	1 year	1. DeCA to allow racks for display of company products. Rack types specified in agreement. 2. Specific products to be displayed in off the shelf locations a specified number of times per year.	Company to pay a specified amount per rack.
8	1 year	DeCA to use company display rack at all commissaries for company product. DeCA to follow company specified annual promotion plan.	Company to make specified payments to DeCA for each rack placed in use.

Source: GAO's analysis of DeCA's performance based agreements.

Appendix III: Steps in DeCA's Category Management Process

The basic steps in DeCA's category management reviews, based on GAO's analysis of DeCA documents and interviews with DeCA officials, are as follows:

1. DeCA announces a category review including the goals of the review, and invites companies supplying products to supply information and analyses of product sales and trends within the category.

2. DeCA conducts individual meetings with interested companies, including manufacturers, brokers, and broker-distributors, at Fort Lee, Virginia. DeCA receives information developed by participating companies and listens to company presentations and recommendations for the category.

3. DeCA's category buyer obtains market information from Information Resources, Inc., on the performance of products within the category. This information is gathered from cash register scanner data, and it shows for each product such data as number of items sold, dollar value of sales, and changes from prior periods. The data provides a basis for comparative analyses of sales patterns.

4. DeCA's buyer analyzes data provided by Information Resources, Inc., along with data and recommendations submitted by participating companies. Based on the buyer's analysis, the buyer prepares a schedule of its category decisions indicating which products will be added, which will be retained with or without distribution changes, and which will be deleted from inventory.

5. DeCA officials develop and sign-off on shelving plans called "plan-o-grams" illustrating how nationally distributed products are to be arranged and that provide shelf space for products that have been specifically selected to meet regional and local demand. These plans are used as guides for resetting products on the shelves of individual commissary stores. Under DeCA's supervision and with the participation of product distributors, brokers, and manufacturers representatives, products on the shelves of individual commissary stores are periodically reset based on DeCA's display plans.

6. DeCA releases its category review decisions and solicits comments from companies participating in the category.

7. DeCA responds in writing to each company that objects to DeCA's decisions (an objection to a DeCA decision is termed a "reclama"), and usually provides a brief explanation for its decision.

8. After a 90-day period, DeCA removes deleted items from its stock system.

Appendix IV: Top 20 Private Label Product Categories in the Supermarket Industry, 2001

Dollar volume leaders	Dollar value
1. Milk	$6.4 billion
2. Cheese	2.3 billion
3. Fresh bread & rolls	2.1 billion
4. Fresh eggs	1.6 billion
5. Ice cream/sherbet	1.0 billion
6. Carbonated beverages	909 million
7. Juice/Beverages–refrigerated	714 million
8. Vegetables	688 million
9. Frozen plain vegetables	680 million
10. Sugar	629 million
11. Bottled juices	573 million
12. Cold cereal	496 million
13. Cups and plates	486 million
14. Butter	484 million
15. Canned/bottled fruit	446 million
16. Entrée/side dishes	443 million
17. Food and trash bags	433 million
18. Luncheon meats	415 million
19. Breakfast meats	408 million
20. Cookies	407 million

Source: Information Resources, Inc., data as reported by the Private Label Manufacturers Association.

Appendix V: Comments from the Department of Defense

UNDER SECRETARY OF DEFENSE
4000 DEFENSE PENTAGON
WASHINGTON, D.C. 20301-4000

PERSONNEL AND READINESS

DEC - 5 2002

Mr. Lawrence J. Dyckman
Director, Natural Resources and the Environment
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Dyckman:

This is the Department of Defense (DoD) response to the GAO Draft Report, GAO-03-160, "DEFENSE COMMISSARIES: Additional Small Business Opportunities Should be Explored," dated November 4, 2002 (GAO Code 860028).

The DoD concurs with the overall comments and recommendations in the report. Specific comments on the recommendations are enclosed.

Thank you for the opportunity to comment on this report.

Sincerely,

David S. C. Chu

Enclosure:
As stated

GAO DRAFT REPORT – DATED NOVEMBER 4, 2002
GAO CODE 860028/GAO-03-160

"DEFENSE COMMISSARIES: ADDITIONAL SMALL BUSINESS OPPORTUNITIES SHOULD BE EXPLORED"

DEPARTMENT OF DEFENSE COMMENTS TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense consult with the Administrator, U.S. Small Business Administration on the provision of law restricting the Defense Commissary Agency's (DeCA) consideration of products that have not yet achieved regional distribution, and together, inform the Congress if small business opportunity could be improved by removing or modifying the provision. (p. 16/GAO Draft Report)

DOD RESPONSE: Concur. The Department will consult with the Small Business Administration on whether to suggest to the 108th Congress that the provision be modified or removed from the law.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense perform a study to examine the benefits, costs, and implementation issues associated with the sale of private label products through commissaries, and act on study results, as appropriate. (p. 16/GAO Draft Report)

DOD RESPONSE: Concur. The Department will conduct a study in 2003 to assess the potential benefits, costs and implementation issues associated with selling private label products through commissaries, and act on study results, as appropriate.

ENCLOSURE

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact

Charles M. Adams, (202) 512-8010

Acknowledgments

In addition to the name above, Nancy Crothers, Robert Crystal, James Dishmon, Curtis Groves, Frank Papineau, and Sidney Schwartz made key contributions to this report.

(360028)

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