

GHQ Weekly

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This month at GHQ

- March 2005 Highlights
- Current Cover Story
- Industry Issues
- Tech Solutions
- Focus On Fresh
- Center Store
- Nonfoods for Profit
- Equipment, Design & Operations
- Distribution & Logistics
- From the Publisher

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March 2005



TECH SOLUTIONS

- > Easing the pain of cashless sales
- > Grocers have a gift (card)

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Easing the pain of cashless sales

By Deena M. Amato McCoy

With no relief in sight from the transaction fees that come with card-based payments, supermarkets are exploring less costly options.

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Last year marked the first time that cashless transactions exceeded cash-based retail purchases, according to the U.S. Department of Commerce. While cashless options give shoppers more choices, supermarkets still struggle with how to handle these payments' ever-rising interchange rates and transaction fees.

In search of more cost-effective tendering options, grocers are evaluating the benefits of solutions that include electronic check conversion (ECC) and stored-value cards. Yet a retailer's secret weapon could be to evolve his own loyalty program to reward customers for using lower-cost products.

As the volume of cash purchases continues to decline, card-based transactions are on the rise. Reliance on card products is so strong that \$2.1 trillion of the \$6 trillion in consumer spending in 2004 was made by using credit, debit and prepaid cards, the Commerce Department says. According to the Nilson Report, a Carpinteria, Calif. firm that researches consumer payment systems, nearly 50% of all consumer spending will be cashless by 2008.

While they appeal to shoppers, products like credit and offline debit cards are taking their toll on the economics of the retail industry. The settlement fees posed by these specific cards can exceed the net profit on a typical grocery order.

"There continues to be a battle in the retail space between the interchange rate and fees charged to retailers to accept plastic payment options," says Lynn Kerchner, product manager, payment terminals at NCR. "At the same time, however, credit cards have helped to push new technologies into the retail space."

As new methods emerge, retailers gain more opportunities to promote new, less costly payment options. One of these options is ECC, a process that converts paper checks into electronic items.

While grocers have been accepting paper checks for years, chains have not yet perfected the verification process. "A check is basically a promissory note or an IOU. As a result, they need to verify it as best they can," says Paul Palmer, senior account executive for US Dataworks, a Houston-based provider of software that handles retailers' electronically converted items and presents them for payment.

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"Once a check is accepted, retailers are also challenged by getting the item to the bank," Palmer adds. "It is a laborious effort plagued with human error. Collections on returned items is also a tedious task, and retailers toil with not upsetting their customer base with harsh collections."

By deploying ECC, retailers can eliminate these manual, often erroneous processes. The electronic process begins as the customer's blank check is inserted into a dedicated printer/reader that electronically reads and transmits all necessary data into the payment collection stream. The voided check is handed back to the customer with a receipt, and the data is converted into an automated clearinghouse (ACH) debit entry.

### **Picking up the pace**

Ultimately, ECC can help grocers speed up checkout lines and reduce the cost of accepting and processing checks. Further, ECC gives chains quicker access to their funds and reduces the acceptance of fraudulent and not-sufficient-funds (NSF) checks.

"Recent studies show that the customer experience is faster and more favorable than traditional paper check acceptance," says Stephen Craig, vice president of business development for LML Payment Systems Corp. The Vancouver-based company is a leading provider of check conversion technology.

"Our clients who use ECC are increasing recovery rates, while reducing fraud and check losses," he adds. "In fact, ECC can reduce [grocers'] check fraud by as much as 40% through our ECC service."

Price Chopper Supermarkets, based in Schenectady, N.Y., unofficially the first supermarket chain to use ECC, launched it to stop check processing costs from eating away at revenue. Price Chopper piloted ECC and imaging in June 2002, and today the entire enterprise is using it. Since adding the program, Price Chopper has gained labor savings, reduced bank fees and bad checks, and increased funds availability, according to a recent interview with the chain's CIO Tom Nowak.

Price Chopper is not alone in its ECC journey. Thirty-seven percent of all retailers are currently using ECC in some way, according to the Martin Akel & Associates Retail Market Study released in December. More than half of the remaining retailers said they would evaluate ECC and were likely to add it in the future.

There are many drivers currently speeding up the industry's acceptance of ECC. One is new legislation called Check 21. This law, which took effect last fall, allows check images to be exchanged instead of paper.

Also impacting retailers' ECC decisions are the recent paper fee increases posed by the Federal Reserve. While companies may shun this as a financial industry issue, retailers should keep their eyes open. For example, chains' paper-based deposits could be subject to these new bank fees.

"We've encouraged our clients to reexamine their current paper check model and compare ECC programs," says LML's Craig.

Supermarket operators have their homework cut out for them. "There are many changes taking place in check processing, and grocers are deciding how they can implement ECC in their stores," says Bud Weist, vice president of sales and marketing for Epson System Device Group.

### **Stored value turns heads**

While ECC is clearly on grocers' radar screens, it is the growth of stored-value cards that is truly gaining supermarkets' attention. Similar in size and shape to credit and debit cards, the prepaid units also have a magnetic stripe. Each time the stripe is swiped at the point-of-sale terminal, the tender amount is electronically deducted from the card.

Originally seen as a payment option for customers who did not have bank accounts, stored value cards quickly fit into other niches. They became a natural replacement for labor-intensive paper gift certificates. In some cases, companies even upload their employees' earnings onto the units in lieu of issuing paper checks. Regardless of the model, prepaid cards are gaining

traction across the retail industry and evolving into a strong payment method for the masses.

The cards' flexibility has made them valuable to shoppers. For example, there's the flexibility of spreading card balances across multiple purchases. Shoppers can also reload value onto the card once a balance is depleted.

Consumers are showing their approval by carrying them regularly, according to the fourth annual *Consumer Insights Survey* conducted by ValueLink, Denver. ValueLink, a First Data company, is an industry leader in gift and spending card programs.

For example, 14% of survey participants carry between six and nine plastic cards--including gift cards--at all times. Ten percent of shoppers carry 10 or more cards in their wallets.

Prepaid cards also benefit retailers. First, the cards do not impose transaction fees, making them a viable, cost-effective option for supermarkets to accept. Further, the cards are creating larger shopping baskets: 55% of gift card recipients spend more than the card's initial value during their shopping trip, the study says.

### **Stunned by the numbers**

"For what is still a relatively young product, consumer awareness, use and satisfaction figures continue to stun those of us in the industry," says Karen Larsen, ValueLink's vice president of product marketing and evolution.

"Gift and spending cards are applicable in nearly every facet of our lives," she adds. "As shoppers purchase [prepaid] cards in thousands of locations across the globe and through the Internet, they continue to offer tremendous benefits [to purchasers and retailers] throughout the year."

As customer demand for prepaid items increases, grocers are feeling the pressure to make products readily available to shoppers. Coinstar is one company that helps them achieve this goal.

"Grocers need to offer a value proposition by being a one-stop-shopping experience," says Steve Verleye, Coinstar's general manager of electronic payments services. "Consumers need choices. They need to be able to buy products in a manned lane during a shopping trip or at a self-service kiosk. Our belief is shoppers have different needs, so grocers need to offer both options."

As grocers try to encourage shoppers to use these new payment choices, chains must create innovative programs that will promote this consumer behavior. One way for retailers to lower processing expenses and build customer loyalty is to tie new payment options to existing loyalty programs.

"Loyalty programs tend to be relatively immature. Simultaneously, new and costly payment options abound," Verleye says. "By tying loyalty programs with [payment] products of choice, grocers can reward shoppers for using specific products while they save money in transaction fees."

The most common practice in this arena is co-branded credit cards, which allow customers to pay for merchandise and earn reward points toward future purchases.

The most notable co-branding examples are the Starbucks Visa, or Duetto, card, and the Target Smart Visa Card. In October, Kroger Co. and Royal Bank of Scotland Group introduced the 1-2-3 Rewards MasterCard, which enables holders to earn free groceries, as well as save on thousands of brands and products, at select Kroger stores in Ohio.

"We recognize that our customers have a lot of choices in where to shop, and we're happy to reward them for choosing Kroger," Bob Hodge, president of Kroger's Cincinnati/Dayton division, said in a statement.

Each time shoppers use the card, which also doubles as a Kroger Plus loyalty card, they earn reward points at Kroger-owned stores and locations that accept MasterCard. For every 1,000 points earned, shoppers receive a \$10 reward that can be spent in Kroger stores. Rewards are mailed to shoppers quarterly.

### **Low-cost loyalty option**

Co-branded credit cards are clearly gaining traction in the industry; however, they do not help grocers move away from high-cost credit options. Instead, supermarkets may choose to exploit the power of their basic loyalty cards.

For example, grocers can encourage loyal shoppers to register their preferred payment products and loyalty account number either at POS or customer service. As the loyalty card is swiped at POS, the payment terminal lists their personal payment options.

"The loyalty card is used as authorization to ensure identity of the shopper," says Larry Friedman, principal of EasyCheck, a consulting firm based in Clifton Park, N.Y., and a former vice president of Price Chopper.

By swiping this card, consumers can authorize payment from their checking account, as well as debit, credit, even gift cards. Shoppers choose their payment method at the terminal, but never have to reach for their wallet.

While these new payment options may seem appealing, supermarkets should not jump into programs without weighing their options. Before committing to any payment product, grocers are urged to analyze their current and potential expenses.

"Grocers should use a profit-and-loss statement to analyze all of their electronic and manual payment costs," Friedman says. "They may be shocked to see where their costs really are and how they are growing."

This internal research could reveal data that will help them make a decision and ultimately deploy the right payment technologies for their chain. "A company that takes time to understand what they need to better serve customers and improve the bottom line will be successful in implementing new solutions," adds Epson's Weist.

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