

# Economic Commentary

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## Anatomy of a Price-Fix

by Michael F. Bryan

On February 19, 1982, the three largest retail food chains in the Cleveland area were fined \$4.2 million by a federal court for criminal price-fixing, after entering pleas of no contest to the charges against them. Four supermarket executives were given three-year suspended sentences and fined \$200,000 each for their participation in the price conspiracy.<sup>1</sup> In related civil actions, the federal court accepted a \$20-million coupon repayment plan from the local food stores, payable to the approximately one million households that the retailers serve. This is the largest consumer settlement in U.S. history.

Although there are harsh penalties against attempts to fix prices, experience suggests that such efforts are relatively commonplace. Under the antitrust laws, it is the attempt to fix prices that is the crime, even if the attempt should not result in any impact on actual prices and pricing behavior. In theory, inherent forces in a free market should limit the effective life of most price conspiracies. History is replete with soured price-fixing schemes, as illustrated by testimony in a U.S. Senate investigation into

1. The court suspended \$2.5 million of the corporate fines and \$125,000 each of the individual fines. See "Supermarkets Fined for Price-Fixing," *The Cleveland Press*, May 12, 1982. For additional information see Margaret Yap, "Three Grocery Chains in Cleveland Face Trial on Charges of a Price-Fixing Plot," *The Wall Street Journal*, August 13, 1981; and *United States v. First National Supermarkets, et al.*, No. CR 80-175 (N.D. Ohio) (Bill of Particulars in Response to Request of Defendant Charles Rini, filed April 16, 1981).

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price agreements in the electrical manufacturing industry.<sup>2</sup>

**Senator Hruska:** By and large, Mr. Ginn, you have had considerable experience in the business of meetings with competitors. How effective were those meetings to get the job done that they purported to have as an objective?

**Mr. Ginn:** Senator, this is the way I will put it. If people did not have the desire to make it work, it never worked. And if people had the desire to make it work, it wasn't necessary to have the meetings and violate the law.

**Senator Hruska:** So that your preliminary discussions and meetings with competitors—

**Mr. Ginn:** Were worthless.

**Senator Hruska:** Were not necessarily controlling?

**Mr. Ginn:** Were worthless . . . I think that the boys could resist everything but temptation. No sir, I'll tell you frankly, Senator, I think if one thing I would pass on to posterity, that it wasn't worth it. It didn't accomplish anything, and all you end up with is by getting in trouble.

That the retail-food industry often operates in a viciously competitive environment provides an incentive for tampering with the marketplace. Indeed, food retailers might rationalize price conspiracies as a means of survival rather than a strategy for reaping unwarranted profits. However, the large number of goods sold by food retailers, in addition to the competitive dynamics of the markets they serve, makes this industry an unlikely candidate for a successful price-fix. The retail-food price conspiracy in Cleveland is a case in point.

### Economic Environment of the Retail-Food Industry

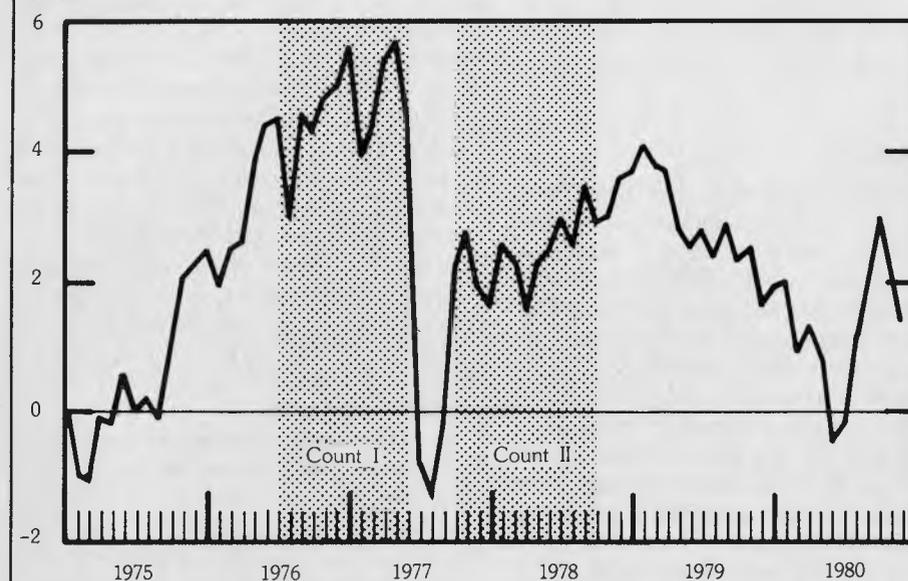
Food stores are limited in the ways they can successfully compete by the standard nature of the products that they sell.

2. Mr. Ginn was vice president and general manager of the turbine division for General Electric. *Price-Fixing and Bid-Rigging in the Electrical Manufacturing Industry*, hearings before the U.S. Senate Committee on the Judiciary, Parts 27 and 28, 87th Cong. 1 Sess. April, May, and June 1961, pp. 17069-17070.

Chart 2 Food Price Differential

Cleveland vs. U.S. Average

Percent



NOTE: Shaded areas represent periods of indictment for price-fixing.

METHODOLOGY: The food price differential represents the percentage difference between Cleveland's CPI-measured food price index and the food price index for the U.S. city average.

SOURCE: Bureau of Labor Statistics.

gests that, even without explicit agreements, retail-food prices in Cleveland probably would have risen above the U.S. average as a result of individual firm growth in the market. Further, the study concludes that the market concentration/retail-food price relationship is strengthened in three-firm concentration markets, as in Cleveland, where growth in the second leading firm's market share is greatest. Between 1975-76, the three-firm market concentration of Cleveland's retail-food industry jumped from 51.0 percent to 65.4 percent; Fisher's showed the largest single firm growth, rising from a second-place 20.4 percent share to a first-place 26.3 percent share. Generalizing from the evidence in the USDA study, the 1975-76 increase in Cleveland's market concentration would have resulted in a 2.5 percent increase in its retail-food prices above the U.S. average. In sum, a covert price-fixing arrangement is not a definitive explanation for local food-price increases above national averages.

Another approach for measuring the price conspiracy's damage to Cleveland's consumers used data relating to firm gross margins, an important control mechanism for the pricing policies of food retailers.<sup>7</sup> The gross margin evidence yields a substantially lower total consumer damage estimate, between \$20.0 million and \$21.3

million. Economic experts for the defense offered a net-profit approach to estimate consumer damage, arguing that actual damages would most accurately be reflected in additional profits accruing to the conspiring retailers. According to these estimates, the conspiracy was not nearly as lucrative as one would imagine; the damage was estimated at \$2.4 million for the first count of the indictment, while no damage was found for the second count. The primary objection to this analysis is the source of the profit data—the defendant price-fixing firms themselves.

The problems associated with the estimation of consumer damages are complex, as evidenced by the wide range of estimates presented during litigation. Finally, the federal court negotiated a settlement between plaintiff consumer advocates and the food retailers to provide \$20 million in food coupons to be distributed throughout the Cleveland area. The civil settlement, touted as "fair and reasonable" by all of the participants directly involved, serves as another expensive lesson on the imprudence of interfering in the marketplace.

7. Gross margins are derived by subtracting the cost of goods sold from total sales. As with the CPI, gross margin comparisons are very sensitive to product-mix differences, which tend to distort the signals from margin movements.

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civil liabilities that apply to the price conspirators. That is, what damage did the price-fixing scheme inflict on consumers in Cleveland? The plaintiffs in the civil actions sought substantial reparations against the food retailers, who repeatedly maintained their innocence.

Cleveland's food prices rose above the U.S. average in each count of the indictment against the three food retailers (see chart 2). On the basis of these price differentials and after adjusting for differences in relative labor costs, economic experts for the plaintiffs contended that price collusion cost Cleveland's consumers \$37.9 million—\$28.5 million in count I of the indictment (pre-price war collusion) and \$9.4 million in count II (post-price war collusion).

Conceptually, it is difficult for one to draw conclusions from price differences measured with the Consumer Price Index (CPI) because of product-mix inconsistencies between regional and national market bas-

kets.<sup>6</sup> Cleveland's retail-food prices often have risen above the U.S. average as measured by the CPI. Specifically, they did so between 1960-62, 1968-71, and 1972-73 (although never rising above the U.S. average as much as in the first count of the price conspiracy). Moreover, the acceleration in Cleveland's food prices began at least eight months prior to any formal price discussions and continues today, almost four years after the ill-fated price scheme supposedly ended. The relative price differential between Cleveland's retail foods and the U.S. average is influenced by a number of factors, not all necessarily linked with illegal agreements. For example, the USDA study of retail-food concentration and prices sug-

6. Attempting to disaggregate the local market basket to conform with a national measure is also problematic, since the relatively small size of specific local samples makes price movements statistically difficult to interpret.

Standardized (or homogeneous) products make it difficult for a store to develop a unique image and maintain customer loyalty, making prices the most powerful competitive tool of retail-food sellers. Food sellers have long recognized the cost advantages of centralizing operations and increasing store sizes to accommodate larger sales volumes. Cost or efficiency gains enable retailers to lower unit-selling costs, thereby lowering prices. The retail-food industry typically operates within razor-thin profit margins, usually between 0.6 percent and 0.9 percent of total sales.<sup>3</sup> For the return on equity to be high enough to attract investors, retailers must turn over their merchandise stocks quickly.

Investing in retail-food facilities was attractive in the 1960s and early 1970s, as swelling populations indicated market growth for years to come. The U.S. retail-food industry, however, has undergone some difficult transitions. Since 1960, the percentage of personal income spent on food prepared at home has been declining. In 1960, 17.5 percent of disposable income was allocated to retail-food purchases; by 1970, the retail-food share of income had fallen to 15 percent, and in June 1982 it was slightly under 13.5 percent. Clearly, the increasing number of single persons and the growing prominence of women in the labor force are primary contributors to this trend, as more and more persons eat meals away from home.

As consumer buying habits have shifted, the retail-food industry has been restructured. Convenience-food stores have proliferated, offering late hours and location advantages over supermarkets. These stores skim customers from supermarket traffic, particularly for the purchase of high-turnover items such as milk, bread, and beer. Consequently, supermarkets have had to make up for the reduction in stock turnover by bolstering profit margins and increasing store traffic through other means. For example, many supermarkets have opened extensive check-cashing systems, which in some cases have led to in-store banking facilities. Goods from in-store bakeries, delicatessens, and health and beauty

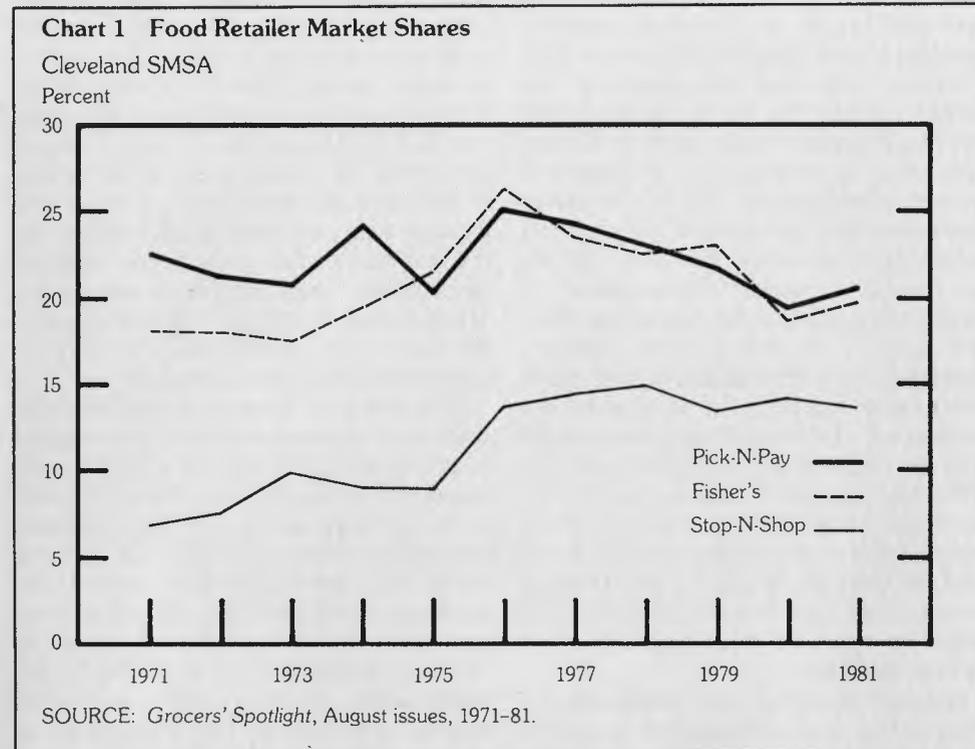
sections are higher profit items that some supermarkets carry to increase traffic and improve earnings.

In addition to consumer behavior and structural changes, rapid and unforeseen fluctuations in food prices have had serious repercussions on the financial health of supermarkets because of their relatively high proportion of fixed expenses (e.g., union wages, capital rents, and energy usage). These food price fluctuations have been particularly alarming during the last decade. In 1973 Cleveland's food prices increased at a 21.7 percent rate, but in less than three years that pace slowed to 1.7 percent. Labor, rent, and energy expenses have accounted for roughly 60 percent of the industry's total marketing costs over the last decade, and these continued to register strong price advances, thus squeezing profit margins and forcing marginal firms from the market. As a firm's market share in an area shifts, pressure builds in the marketplace for lowering prices even further.

### Scene of the Crime

The retail-food industry is a textbook example of a competitive market, having a large number of sellers of standardized products, none with sufficient market share or power to control prices. Yet, urban markets are often dominated by a few retail-food sellers. In the 1970s two food retailers—Fisher Foods (Fisher's) and First National Supermarkets (Pick-N-Pay)—accounted for 40 percent or more of Cleveland's total retail-food market.<sup>4</sup> Pick-N-Pay was the dominant food seller in Cleveland prior to 1975, commanding 21 percent to 24 percent of total retail-food sales, while Fisher's maintained a competitive second place with 18 percent to 20 percent (see chart 1). However, a number of factors were at work in the early 1970s that would affect the profitability of the Cleveland market. For example, the 1970s witnessed a shrinking of Cleveland's retail-food market, caused not

4. Pick-N-Pay is the Cleveland operating name for the national food chain of First National Supermarkets, Inc. Fisher Foods Inc. sells in the Cleveland area under the names of Fisher's and Fazio's. A third firm has more recently risen to a position of market strength in the Cleveland area as part of the national food chain Association of Stop-N-Shop Supermarkets.



only by a change in life-styles but by a persistently declining local population. In 1970 the retail-food industry in the Cleveland SMSA served a population of slightly over 2 million, and that population has since declined approximately 16,000 persons per year.

The competitive atmosphere for Cleveland's retail-food dollars was heightened by additional structural changes in the local industry. The first was the rise in popularity of convenience-food stores. Lawsons, a major convenience-food seller, operated 100 stores in Cleveland in 1971, growing to 163 stores in 1975. At the same time, Convenient Food Mart was emerging as a competitor: a virtual unknown prior to 1970, this seller operated 68 stores by 1976.

Whether because of this additional competition or because of internal reasons, two national food chains—A&P and Kroger's—opted to withdraw from the Cleveland market in the 1970s. Together, these two food sellers represented 15.5 percent of Cleveland's food market in 1971 and 8.0 percent in 1976; by 1979 they were virtually nonexistent. The "void" created by the pull-out of supermarket competition explains a

large part of the increase in market shares enjoyed by the surviving major food sellers in Cleveland between 1974 and 1976, as the remaining participants aggressively repositioned themselves. As Pick-N-Pay and Fisher's were exchanging leads for market-share superiority over the two-year period, the third-place firm, Stop-N-Shop, added nearly 6 percent to its market share. In 1976, this trio of food sellers accounted for over 65 percent of Cleveland's total retail-food sales.

Market concentration can be an important determinant of industry prices and, consequently, industry profits. A recent analysis by the U.S. Department of Agriculture (USDA) of the price-concentration linkage in the food-retailing industry reports that increased concentration in some cases yields higher retail-food prices.<sup>5</sup> This linkage is particularly strong in urban markets dominated by three firms or less, as in the Cleveland market. In pricing theory, as

5. R. McFall Lamm, "Prices and Concentration in the Food Retailing Industry," *Journal of Industrial Economics*, vol. 30 (September 1981), pp. 67-78.

firms recognize their joint dominance of a market, they tend to develop collusive pricing strategies. Simply said, they set prices with the *unspoken* understanding that lowering prices would reduce profitability for all of the participating firms, while collectively raising prices would benefit all the firms.

### The Price-Fix

According to the U.S. Department of Justice, the retail-food industry in Cleveland ceased operating as a competitive market halfway through 1976. The government alleged that executives of Pick-N-Pay and Fisher's met to discuss the below-cost advertising and selling of certain food items and agreed to eliminate price competition and raise prices—a criminal violation of antitrust law. Shortly after the initial meeting, a Stop-N-Shop executive was contacted and a meeting arranged, supposedly to secure an agreement from that food retailer to join the price conspiracy.

Two major roadblocks underlie the success of any price-fixing scheme. The first involves the difficulty in securing a price commitment supported equally by the members of the conspiracy. Parties to the agreement may have different marketing approaches that result in inconsistent preferences for the pre-established prices of particular food items. Once prices have been established, there also exist incentives for conspiracy participants to cheat. Firms with relatively small market shares stand to improve their individual positions by drifting below agreed-to price levels. This strategy, however, depends on the ability of the price cheat to improve market share without being detected by its conspirators. Once exposed, the cheater is likely to be the target of retaliation, as other conspirators also lower prices and the price-fix dissolves. Simply, the competition that fosters thoughts of price-fixing also serves to undermine the success of such agreements.

Indeed, the court evidence suggests that the cheating incentives in Cleveland's retail-food price conspiracy surfaced very early in the price-fix, particularly with respect to the cartel's smallest conspirator. Stop-N-Shop allegedly was either offering lower prices on certain food items or not raising prices quickly enough to

agreed-to levels. One conspirator supposedly complained that another of the conspirators had resorted to nonprice competition, another popular cheating technique, in this case by offering trade stamps. Almost without exception, cheating complaints were met with an exchange of price information and a reaffirmation of the conspirators' support for raising prices.

According to the Justice Department, meetings between retail-food executives continued throughout 1977, and price lists were being exchanged on a regular basis. Despite the efforts of the conspiracy to resolve its differences, and possibly because of cheating, a retail-food price war broke out in Cleveland in the summer of 1977. The event is a testimony to the frailty of price-fix schemes.

As the pricing conspiracy fell apart, food retailers sustained severe losses, providing an incentive to reactivate illegal price manipulations. The government argued that the three food retailers reaffirmed their support for price uniformity and conspired to raise prices again in the fall of 1977. By year-end 1977, price lists allegedly were being exchanged often, occasionally being used to prepare identical advertising campaigns. Weekly price "bulletins" apparently were distributed for a period in excess of nine months, with the basic purpose of coordinating the timing of price movements. Once again, a common conspiracy topic during the second price-fixing period was the charge that one of the conspiring retailers was cheating against agreed-to prices. Meetings were arranged to sort out the accusations, each time ending in a reaffirmation of conspiracy solidarity. Cleveland's food cartel came abruptly to an end late in 1978. While it is not known why the price-fixing scheme ended, economic theory indicates that most price-fixing arrangements are highly unstable, often breaking down because of the unwillingness of the participants to abide by price agreements.

### The Damages

Inasmuch as the food retailers pleaded no contest, the criminal evidence against them was never formally contested. Beyond the criminal violations of the law, however, remain questions concerning any

3. *Progressive Grocer*, 49th Annual Report, vol. 61, no. 4 (April 1982), p. 47 and pp. 100-101.