Antitrust Impact in Indirect Purchaser Class Actions: The Need for Rigorous Analysis of Pass-Through

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I. Introduction

In indirect purchaser class actions, economic analysis of whether the alleged anticompetitive behavior had a common impact is more complicated than in direct purchaser class actions. In both direct and indirect purchaser class actions, a fundamental question that economic experts must investigate is whether common evidence and common methods can be used to measure reliably the damages allegedly imposed on direct purchasers of the product (for example, due to an overcharge). However, in indirect purchaser cases, experts must then also show that common evidence and common methods can be used to measure reliably the extent to which the overcharge paid by direct purchasers is passed through to each member of the proposed indirect purchaser class. Recent court decisions appear to increase the level of rigor required in analyses at the class certification stage. Most notably, two recent high-profile rulings by the U.S. Supreme Court – Wal-Mart Inc. v. Dukes (2010) and Comcast v. Behrend (2013) – have raised the bar for expert analysis at the class certification stage by explicitly emphasizing (1) the importance of “rigorous analysis,” and (2) the need to causally link the theory of harm to the measure of alleged damages suffered by class members.1

In this article we discuss the implications of the new “rigorous analysis” standard for the critical question of pass-through of alleged anticompetitive harm in indirect purchaser class actions, with a particular focus on retail pricing. We start in Section II with a short overview of the basic economics of pass-through. In Section III, we then explore three important considerations in retail pricing that can complicate the question of whether an alleged overcharge is passed through to the end consumers (putative class members). Specifically, we examine: (1) discounting pricing strategies like “loss leader,” “everyday low pricing,” and “high-low” pricing; (2) the strategic use of scale and size to negotiate lower prices (i.e., the Wal-Mart effect), as well as the use of private label brands; and (3) “sticky” pricing due to focal point pricing and menu costs.

II. The Economics of Pass-Through

In economics, the pass-through rate is defined as the rate at which a change in an input cost is passed through to a change in an output price. In the context of a consumer class action in which there is an alleged overcharge by a manufacturer or distributor, any measure of damages will generally depend on pass-through at all layers of the industry – from distributor to retailer (if retailers do not purchase directly from manufacturers) and from retailer to consumer2. A key finding in the economic literature on pass-through is that if there is “perfect competition” at the intermediate levels of an industry, then any upstream increase in price will be passed through to consumers.3 Plaintiffs’ experts often rely on this finding to justify an assumption of common pass-through at all layers of the market and on all products at issue.

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1 Wal-Mart Inc. v. Dukes, 131 S. Ct 2541, 2551 (2011) ("We recognized in Falcon that ‘sometimes it may be necessary for the court to probe behind the pleadings before coming to rest on the certification question,’ and that certification is proper only if ‘the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied.’ Frequently that ‘rigorous analysis’ will entail some overlap with the merits of the plaintiff’s underlying claim.") (internal citations omitted).

Comcast Corp. v. Behrend, 133 S. Ct. 1426 (2013) ("[A]t the class-certification stage (as at trial), any model supporting a ‘plaintiff’s damages case must be consistent with its liability case, particularly with respect to the alleged anticompetitive effect of the violation. And for purposes of Rule 23, courts must conduct a ‘rigorous analysis’ to determine whether that is so.’") (internal citations omitted).


Economists, however, have long recognized that real-world markets rarely follow the simple paradigm of “perfect competition” and that firms do not always increase their prices dollar for dollar with each increase in costs. Thus the extent of pass-through, if any, is generally an empirical question. Indeed, academic research has found that deviations from perfect competition are particularly common amongst retailers, who regularly implement complex pricing strategies related to optimizing their profits across many different products and consumer types. The remainder of this article addresses several common examples of such strategies, and explores how these strategies can affect the frequency and magnitude of pass-through in certain circumstances.

III. Common Retailer Pricing Strategies That Mitigate Pass-Through

A. Discounting Strategies

A common strategy amongst retailers for driving sales and increasing profits is to offer targeted discounts on key products. Such discounting strategies can lead to different price patterns for the exact same product across different stores. These differences in price trends can, in turn, affect whether (and by how much) an overcharge imposed on a direct purchaser is passed through to an indirect purchaser. In this section, we walk through a few examples of such strategies, and explain how they can affect pass-through rates.

One prevalent discounting strategy is the “loss leader” strategy. In the “loss leader” strategy, the retailer advertises a deep discount on a popular product (sometimes even below cost) in order to attract consumers to its store(s). Once the customers are attracted, the retailer anticipates that they will buy other items, some of which are sold at more profitable margins, leading to an overall increase in profits for the retailer. Retailers can change which products they use as loss leaders over time, and different retailers can use different products or product categories for this purpose. So how does this dynamic affect the likelihood of pass-through? If the product for which the overcharge is being alleged is sold by the retailer as a “loss leader,” then it is possible that none of the overcharge would be passed through. The retailer sets the price of the “loss leader” product not based solely on the costs of procuring that product, but instead based on a strategy to increase profits across a wide number of products.

Retailers also set their marketing strategy with respect to the overall level of prices and general frequency of discounting. Some retailers attempt to build a reputation (or brand) of offering low prices at all times across all (or most) of the products they stock (e.g., Wal-Mart). Other retailers choose to maintain a slightly higher price level in general, but then offer periodic, deep discounts on particular products, with prices varying week to week. Depending on which strategy a retailer chooses, the price patterns that arise for a specific product over time can look very different. The literature refers to these discount strategies respectively as the “everyday low price” and the “high-low” model. Both pricing strategies are widely used, with each strategy meeting the needs of different consumers.

For example, so-called “large basket shoppers” may prefer the steady pricing offered by the “everyday low price” stores, as it allows them to lower their

4 Id.
7 Chevalier, supra note 6
8 Id. at 27.
total spending across a large number of products and categories. In contrast, “small basket shoppers” may prefer the increased price volatility of the “high-low” stores, as it allows them to take advantage of good deals on particular products of need while holding off on purchasing higher-priced items. Adding to the complexity, depending on the occasion, the same consumer may behave as a large or shopper or a small basket shopper.

What complications do these two different pricing strategies create for pass-through analysis? First and foremost, an “everyday low price” store may be less likely to pass through a wholesale cost increase if its customers are expecting it to maintain relatively consistent and low prices. For example, customers may return to an “everyday low price” store each week expecting to purchase a particular food item for $3.99. Retailers recognize that expectation among customers and, moreover, incur costs when changing prices. Thus retailers may choose to keep their retail prices stable in order to keep costs down and maintain customer satisfaction and repeat business, especially in the case of a small increase in wholesale cost. On the other side, a “high-low” store with more volatile pricing may find it easier to pass through a small wholesale cost increase during “high” periods, but it may not be passing the wholesale cost increase through in the periods in which its prices are “low.”

The figure below illustrates this example. Suppose that an alleged price fixing conspiracy causes the wholesale price of a product to increase from $2 to $2.20 (10 percent increase) during the period between the dotted lines, and suppose that this increase is alleged to affect all retailers in a common fashion. Suppose further that, prior to the overcharge, Retailer 1 adhered to an “everyday low price” strategy and set a retail price

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11 Aila wadi, supra note 9; Teck-Hua H4, Christopher S. Tang, and David R. Bell, Rational Shopping Behavior and the Option Value of Variable Pricing, 44(12, 2) Management Science S145 (1998).

of $3.99 and that Retailer 2 adhered to a “high-low” strategy and had a regular price of $4.99 with occasional discounts to $3.49. During the overcharge period, Retailer 1 (the solid red line) chooses to maintain its price at $3.99 in order to protect its reputation as the “everyday low price” choice for its loyal customers. However, Retailer 2 (the solid green line), which employs a “high-low” strategy of occasional discounts, decides to pass through part of the overcharge during “high” periods when it is not discounting the product by raising its price to $5.09 during such periods (rather than keeping it at $4.99, which it was prior to the overcharge). Given such patterns, it would be difficult to use common data to establish common impact of the overcharge on a class of indirect purchasers that includes customers who shopped at Retailer 1 and Retailer 2. Whether these customers were impacted or not depends not only on which retailer they shopped at, but on individualized factors like when they purchased the product.

B. Retailer Size and the Use of Private Label Brands

Another factor that affects retailers’ pricing strategies, and thus the possibility of pass-through, is their size. There are several factors associated with size that can complicate the issue of whether large retailers pass through cost increases (particularly small cost increases): (1) negotiating power with suppliers, (2) ability to provide a wide range of products, and (3) ability to sell private-label products.

Wal-Mart is the classic example of a large retailer that has developed a strong reputation for leveraging its size and scale to increase its negotiating power and maintain its consistently low prices for consumers. Part of Wal-Mart’s negotiating power comes from its sheer size, but part of it comes from the fact that it purchases a wider array of products. For a supplier, having very large retail customer like Wal-Mart, who buys a wide range of your products, can create pressure to keep prices low in order to retain the account. This pressure can help insulate large retailers like Wal-Mart from modest increases in their suppliers’ costs. In other words, an alleged overcharge at the wholesale level would not necessarily be realized by all retailers (if some are able to push back against the price increase), and therefore would not necessarily lead to any change in retail prices.

Private-label products provide another avenue for large retailers to insulate themselves from modest cost increases that their external suppliers might experience. Private-label products are those that are produced for and carried only in a particular retail chain. Retailers with stronger private-label brands tend to have greater bargaining power in their negotiations with external suppliers. Whether a retailer has private label products that compete against the product for which an overcharge has been alleged may impact whether that retailer would accept a cost increase from the supplier at issue. For example, if a firm is able to make larger margins on their private label products (while still maintaining low prices), they may be more willing to hold the line on popular branded products, and not pass on cost increases.

These well-documented facts about large retailers strongly suggest that one cannot simply assume that all retailers uniformly pass through small increases in their wholesale costs. In particular, in an indirect purchaser class action that includes substantial volume of product flowing through large retailers, it would not be realistic for an expert to assume that pass-through rates are the same for small and large retailers. Instead, careful empirical analysis of the available data, and careful review of the

15 See, e.g., Bloom, supra note 13; Mottner, supra note 13.
relevant contracts at issue, would be needed to evaluate whether the alleged overcharge was passed through in a common way to all indirect purchasers.

C.  Focal Point Pricing and Menu Costs

Focal point pricing is another pricing strategy that can affect pass-through rates. Focal point pricing refers to the tendency of many retailers to set prices at “focal points” – often prices ending in the digit nine.\(^\text{18}\) Consumer research has found so-called “left-digit” effects whereby a price just below a round price (which leads to a smaller “left digit”) results in higher sales than if the product was priced at the round price.\(^\text{19}\) In order to take advantage of this aspect of consumer behavior, many retailers choose to maintain prices at certain “focal points” (i.e., just below round numbers).\(^\text{20}\) A retailer’s desire to maintain a price at a focal point, or at a level such that it has the same left digit, can lead a retailer to not pass through a small increase in wholesale cost. For example, if a retailer experiences an increase of $0.50 in the wholesale cost of a product that it was pricing at $9.99, that retailer may choose to leave the retail price unchanged even after the wholesale cost increase rather than raising the retail price to $10.00 or higher because the resultant decrease in sales would reduce the retailer’s profit.

Menu costs also factor into a retailer’s decision as to whether to pass through a small change in wholesale costs. “Menu costs” simply capture the idea that prices cannot be adjusted continuously.\(^\text{21}\) In bricks and mortar retail outlets, menu costs can be driven by the cost of physically reprinting price labels for each price change. For Internet retailers, menu costs can be driven by the cost of changing an entry in a price database, either manually or programmatically. Depending on the magnitude of menu costs, it can be optimal for a retailer to leave a retail price unchanged even in the face of an increase in the wholesale cost of a product. For example, one study of large U.S. supermarkets found that menu costs averaged $0.52 per price change.\(^\text{22}\) This study found that such large menu costs imply that some supermarkets choose not to pass through small increases in wholesale cost so as not to bear the cost of changing the retail price.\(^\text{23}\) Other studies have found evidence that Internet retailers have smaller menu costs than bricks and mortar outlets and therefore tend to make smaller retail price adjustments.\(^\text{24}\) Therefore, whether and how much of a small increase in wholesale cost is passed through to retail consumers depends on the particular retailer from which the consumer purchases the product.

Both “focal point” or “left-digit” pricing and menu costs affect whether an alleged overcharge in wholesale prices is passed through in a common way to indirect purchasers at retailer outlets. These are yet more reasons why one cannot simply assume pass-through to retail prices even if one is able to establish an alleged overcharge.

IV. Conclusion

The push by Courts for more “rigorous analysis” at the class certification stage has direct implications for indirect purchaser class actions, and, in particular, for the question of pass-through. It is not uncommon for experts to assume 100 percent pass-through by pointing to the simplified economic paradigm of “perfect competition.” As we have detailed above, this

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\(^\text{20}\) Schindler, supra note 18.


\(^\text{23}\) Id. at 814.

assumption is not always valid when analyzing pricing at the retail level. Retailers commonly employ a variety of pricing and negotiation strategies to try to maximize profits across a wide variety of products, many of which can diminish pass-through for particular products (particularly in the face of modest cost increases). Such complexity in pricing strategies raises the possibility that the pass-through rate can vary substantially across different retailers and products as well as over time.

As a result, whenever possible, one should conduct an empirical analysis of pricing data in the market of interest to determine how frequently, and with what magnitude, each retailer passes through costs for each product at issue. Further, qualitative research on each retailer's contract terms with relevant wholesalers and on their overall pricing/marketing strategy (e.g., high-low, everyday low price) can help to explain observed retail pricing patterns.

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