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Price Discrimination Markets in Merger Cases: Practical Guidance from *FTC v. Sysco*

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IN HIS ACCLAIMED BOOK, *THE RULE OF LAW*, Tom Bingham[1] quotes Lord Mansfield, who, over 250 years ago, wrote describing the need for businesses to have clearly established rules: "The daily negotiations and property of merchants ought not to depend upon subtleties and niceties; but upon rules easily learned and easily retained"[2] and that "[i]n all mercantile transactions the great object should be certainty; and therefore, it is of more consequence that a rule should be certain, than whether the rule is established one way or the other."[3]

Merger enforcement is a fact-dependent exercise due to the need to predict the risk of future competitive injury in the relevant market using artificially constructed "but-for-worlds" or simulations. Nevertheless, effective rule of law requires that courts and enforcers follow a common understanding of the standards used in analyzing antitrust cases—and preferably analysis that has become settled and supported by sound economic theory. The focus here is on narrow "price discrimination markets" that enforcement agencies are asserting in a growing number of merger investigations and enforcement actions, based on the merged firm's alleged ability to target vulnerable customers with post-merger price increases that other customers buying the same products or services will not face.

The discussion below offers practical guidance on the factual predicates for analyzing price discrimination markets in government merger enforcement. The FTC's challenge to the proposed Sysco/U.S. Foods merger serves as a case study where, in the authors' view, the requisite factual predicates did not exist and the court departed from settled standards and economic theory to accept the FTC's narrow price discrimination market as a basis to block the transaction.

Settled Standard for Price Discrimination Markets and the Departure in Sysco

In *R.R. Donnelley & Sons Co.*,[4] the FTC stated factual predicates for when it is proper to define a narrow relevant market ("price discrimination market" or "targeted customer market") that is limited to customers who may be "vulnerable" to selective post-merger price increases: the merged entity must be able to correctly identify customers to target with price increases and segregate them from other customers. If the merged entity is unable to identify those customers, there is the possibility the entity will miscalculate and suffer a net loss of sales and profits by raising prices to customers who can switch to competing suppliers.[5] Consistent with this logic, the FTC required proof that: (1) customers are purchasing the "same" product (price discrimination by definition applies when the products are the same or similar, otherwise the seller cannot be said to be discriminating between purchasers); (2) the merged firm can identify a segment of targeted customers with "sufficiently inelastic demand" for that product; and (3) the merged firm will actually be able to "selectively and profitably increase prices" to those targeted customers.[6] In *R.R. Donnelley*, the FTC required proof that the inelastic customers could be accurately identified and that a post-merger price increase targeted to those customers "likely would be profitable,"[7] and ruled that complaint counsel had failed to meet this burden.[8]

The 2010 Horizontal Merger Guidelines track the factual predicates for a price discrimination market that the FTC applied in *R.R. Donnelley*. The Guidelines require evidence that customers vulnerable to a discriminatory post-merger price increase must be identifiable based on "observable characteristics."[9] This is an objective standard that the court can apply to analyze evidence submitted by the government to support a segmented price discrimination market in a merger challenge. The Guidelines provide an example to illustrate the type of observable characteristics that may meet this requirement:

> Suppliers can distinguish large buyers from small buyers. Large buyers are more likely than small buyers to self-supply in response to a significant price increase. The merger may lead to price discrimination against small buyers, harming them, even if large buyers are not harmed. Such discrimination can occur even if there is no discrete gap in size between the classes of large and small buyers.[10]

The FTC relied on a price discrimination market in *FTC v. Sysco Corp.*[11] to support its challenge to the Sysco/U.S. Foods merger. Each company is a "broadline" foodservice dis-

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tributor that "sells and delivers a 'broad' array of food and related products to just about anywhere food is consumed outside the home," including restaurants, hotels, hospitals, and group purchasing organizations (GPOs).[12] The FTC initially asserted a price discrimination market of "national broadline customers" whose nationwide footprint meant the customer preferred nationwide delivery from the same food-service distributor.[13] These customers ostensibly were vulnerable to a post-merger selective price increase due to their inability to switch to regional or local suppliers. The FTC argued that the merger parties' internal classification of "national customers" was an observable characteristic, but the parties showed that a number of these customers were not national or even multi-regional in scope, and others who were national in scope chose to use a mix of local or regional distributors.[14]

The FTC then argued that the merged firm could use "individualized negotiations" to identify customers that were vulnerable to a price increase. Although the FTC in *Sysco* did not follow *R.R. Donnelley*'s guidance that it provide a "methodology [that] allows an accurate identification of inelastic end uses and, thus, [predicts] that a price increase within the identified category likely would be profitable,"[15] the district court was satisfied that some group of national broadline customers could be harmed and granted a preliminary injunction.

This approach for determining a narrow price discrimination market was a marked departure from the standard and from the underlying economic theory applied in *R.R. Donnelley* and articulated in the Horizontal Merger Guidelines. The basic tenets of economic theory on price discrimination, as used to define relevant markets, require that price differences apply to the same products and services sold to both vulnerable and non-vulnerable customers, and that the vulnerable customers can be identified in advance. If the first condition is not met, price differences do not show that customers who are charged "higher" prices for different products are in fact "vulnerable." If the second condition is not met, attempted price increases may be defeated by customers who shift to other suppliers.

The Rigorous Analysis Required by *R.R. Donnelley*

Price discrimination occurs when a seller can increase profits by selectively increasing prices (for the same product) to an identifiable segment of its customers. In *R.R. Donnelley*, the Commission recognized that "[i]t is an economic truism that buyers do not have homogeneous preferences or demand elasticities for a given product within a relevant market."[16] But the Commission did not abandon price discrimination theories of harm altogether. Instead, the Commission reasoned that: "Th[e] risk [inherent in defining markets under a price discrimination theory] requires [(1)] a particular rigor in examining the conceptual basis for distinguishing the allegedly inelastic customers and [(2)] the factual basis for the prediction that price discrimination with respect to those customers is likely."[17]

Donnelley was the largest supplier of commercial printing services, and sought to acquire one of its largest rivals. Complaint counsel alleged that the relevant price discrimination market was "high volume publication gravure printing,"[18] and described the "core" of this market as "gravure print jobs with at least ten million copies, more than thirty-two pages, and fewer than four four-color versions."[19] According to complaint counsel, "[A] hypothetical gravure printing monopolist could profitably impose a discriminatory price increase on customers whose printing demand fit these parameters."[20] The Commission ruled that the market was not as narrow as complaint counsel alleged because customers could—and often did—turn to alternative printing methods, such as offset printing.[21] Thus, complaint counsel failed to prove that the merged party could profitably target customers in its proposed market.

The Commission examined evidence offered to show the "conceptual basis for distinguishing the allegedly inelastic customers"[22] (i.e., customers with sufficiently "inelastic demand for gravure printing" who would not switch to offset printing in response to a 5 percent price increase).[23] Complaint counsel introduced a "breakeven analysis" that estimated the production volume at which offset printing becomes a less viable alternative to "inelastic" customers as the number of copies increases, and used this analysis to argue that the merged firm could identify and target these customers with a discriminatory price increase.[24] The Commission, however, found that the break-even analysis was a poor means of differentiating customers based on elasticity of demand because "increased productivity and efficiency" of offset printing made it difficult to tell at what point (if at all) offset printing became a less viable alternative to gravure printing.[25] As a result, the Commission noted it would be difficult if not impossible for the merged firm to identify and thus target customers based on this data alone.[26]

The Commission similarly determined that the number of "versions" of a particular print job was actually "an important variable of competition between gravure and offset," not a fixed observable characteristic as complaint counsel alleged.[27] Examining actual market conditions, the Commission found that "[a]s the relative prices of gravure and offset printing change[d]" based on different variations of the job (including the number of versions), "printing customers can and d[id] substitute from gravure to offset."[28] Thus, by defining the market as "fewer than four four-color versions," complaint counsel ignored a great deal of substitution that was already occurring prior to the merger. Complaint counsel argued that customers should be treated as having exited the relevant market if they increased the number of versions of a print job and switched from gravure to offset printing to avoid the greater cost of versioning in gravure printing. The Commission found that this argument overlooked print volume and page counts that were "not only within complaint counsel's proposed relevant market," but also "well within the 'core'" of allegedly targeted customers—customers who, in

reality, had no problem substituting to an alternative print method and thus were not vulnerable to a price increase.[29]

As a result of these findings, the Commission rejected complaint counsel's prediction that price discrimination with respect to the "targeted" customers was likely, noting that substitution between gravure and offset printing currently taking place in the market "provide[d] the strongest evidence that additional marginal substitution is likely to occur in response to a supracompetitive price increase."[30] Again, the parties could point to several large print customers who were currently using offset printing for jobs falling within the exact specifications of complaint counsel's alleged market.[31] Because complaint counsel offered "[n]o evidence in the record . . . to suggest that high volume customers using offset are inframarginal, economically irrational, or otherwise irrelevant to market definition,"[32] there was nothing to rebut the strong evidence that substitution was occurring and would likely increase in the face of a price increase.

Sysco's Departure from the Principles of *R.R. Donnelley*

The 2015 decision in *FTC v. Sysco* does not reflect the language in *R.R. Donnelley* that a special "rigor" must be applied when determining a market based on evidence of potential post-merger price discrimination: the court did not find that the targeted and non-targeted customers all purchased the same or similar products; the court did not closely scrutinize evidence on how the merged firm could identify inelastic customers based on observable characteristics; and the court faced shifting positions on the identity of targeted customers (i.e., first national customers identified in internal documents, then a subset of those customers identified through trial and error in individualized post-merger contract negotiations).

In its complaint, the FTC attempted to establish a market consisting of "national customers," i.e., those that "require or typically contract with a broadline distributor that offers consistency of pricing, service, ordering, and products across all of their geographically dispersed locations."[33] The complaint further noted that "[a]s a result, many National Customers are most effectively served by a broadline foodservice distributor that has the capability to provide nationwide coverage" and that "Defendants are the only two single-firm broadline distributors that meet these requirements."[34] Once it became clear that national customers were already sourcing from alternatives, including regional distributors and specialty distributors, the FTC changed its definition to suggest that national customers were those who could be targeted through individual negotiations with the parties.[35]

Despite these shortcomings and evidence that some national customers may have preferred to use a single national distributor but would have the practical ability to substitute regional/local distributors in the event of attempted post-merger price increases, the court ultimately embraced the FTC's position on a narrow price discrimination market and blocked the proposed merger.[36]

Using *Sysco* as a case study, the discussion below provides guidance on issues that may arise on each of the factual predicates for using a narrow price discrimination market in merger cases.

Same or Similar Products. Fundamental to the definition of price discrimination is that price increases for targeted customers relative to others are for the same product.[37] Hotel rooms offer a prototypical example. A hotel may have identical rooms next to each other; the occupant in 107 paid $200, and the occupant in 108 paid $350. The guest in 107 booked a month in advance (revealing himself likely to be a bargain-hunting leisure traveler); the guest in 108 booked two days prior to her stay (revealing herself likely to be a less price-sensitive business traveler). Thus, there is an identical product, two customers with different elasticities of demand, and a seller who can tell the two apart based on the observable characteristic of when the purchaser made the reservation in relation to the period of the accommodation.

The Horizontal Merger Guidelines track this reasoning: "When examining possible adverse competitive effects from a merger, the Agencies consider whether those effects vary significantly for *different customers purchasing the same or similar products*. Such differential impacts are possible when sellers can discriminate, e.g., by profitably raising price to certain targeted customers but not to others."[38] The products must be the same (or at least similar) because price differences on different products would not reveal differences in the customer's elasticity of demand and, in turn, the vulnerability of those with inelastic demand to post-merger price increases. While it is possible to look at margins rather than prices to identify differential treatment of customers, that approach is frequently infeasible in practice:

> [W]hen the product differs . . . estimating marginal cost can often be an extremely difficult task. It is well known among economists that estimating true marginal cost from a firm's accounting cost data is, at best, extremely difficult. Any error in the marginal cost estimate could lead to the incorrect conclusion that price discrimination existed.[39]

The Commission's recent *McWane* decision further illustrates that the same product must be involved to infer inelastic demand from evidence that targeted customers may be charged higher prices than others.[40] McWane was the only domestic ductile iron pipe fittings manufacturer, while two other companies sold imported fittings in the United States. When fittings buyers issued bid specifications, they specified either domestic or open-source (imported or domestic) fittings. When McWane priced a bid, it knew whether the customer required domestic fittings or would also accept imported products. McWane filled bids with identical U.S.-made fittings to both groups of buyers. But because it was the only domestic fittings manufacturer, McWane targeted buyers who specified domestic fittings with prices that were 20 to 95 percent higher than it charged for identical fittings when the contract was open-source. "This price differentiation reflected McWane's ability to target customers with domestic-only

project specifications who could not avoid the higher prices by substituting imported fittings . . . even though the fittings themselves are functionally identical."[41]

Unlike the identical fittings in *McWane*, the products and delivery services sold by the merger parties in *Sysco* were highly differentiated. The FTC acknowledged that individual customers purchased "a different basket of goods and services," but argued that evidence "does not require defining separate markets for each product and service, particularly where such 'distinctions would be 'impractical' and 'unwarranted.'"[42]

The court accepted the FTC's narrow market definition in *Sysco* despite evidence of dissimilarity in the products and services purchased by different customers. The *Sysco* court stopped the merger because it found that "Defendants engage in individual negotiations with their national customers" and that "[p]rice discrimination can occur in such a marketplace."[43]

But even under the individualized negotiations rubric, product differentiation can undermine the application of a price discrimination theory of harm. Consider this example: a flower grower may negotiate individual contracts with two seemingly similar flower shops. Shop A negotiates for weekly deliveries, and buys long-stemmed roses. Shop B requires daily deliveries and buys tulips. The shops receive different services and buy different products, so their prices will necessarily be different. The reason, however, is not due to price discrimination stemming from these individual negotiations but rather the different services and products required by each shop. Similarly, if Shop A had engaged in past negotiations for daily deliveries of tulips but now requires weekly deliveries of roses (for some reason unknown to the distributor that the distributor could not predict), prices would again be different, but the price change would be due to changes in the services and products that Shop A now purchases, not the distributor's individual negotiations with Shop A as a "vulnerable" customer.

The *Sysco* decision does not mean that this factual predicate—establishing the same or similar products—is no longer important to justify defining narrow price discrimination markets. The way in which the parties debate that issue may vary. As in *Sysco*, merger parties may attempt to rebut these allegations with evidence that the *products*—in addition to the customers—are different. In short, even if suppliers engage in individual negotiations with some or all customers in the broader market, the merger parties may show that these contracting practices do not allow suppliers of highly differentiated products and services to identify in advance the customers who will turn out to be vulnerable to discriminatory price increases, and in turn that the resulting uncertainty of lost sales may deter potential post-merger price discrimination.

Observable Characteristics of Targeted Customers. The Commission in *R.R. Donnelley* noted that "[i]t is an economic truism that buyers do not have homogeneous preferences or demand elasticities for a given product within a relevant market,"[44] which means that pockets of less elastic demand will exist in virtually any market. If normal dispersion in customer preferences was enough to establish a narrow price discrimination market, even for a small subset of customers, that evidence could "swallow up the market definition principles established by the federal courts and the Commission . . . ."[45] The Commission in *R.R. Donnelley* eschewed this outcome, ruling instead that rigorous analysis is required to find evidence that supports a narrow price discrimination market: "The Commission will recognize the possibility of price discrimination as a means of defining a relevant market if there is *a conceptually sound methodology, supported by the record*, by which a hypothetical monopolist can identify the alleged inelastic customers."[46]

In *Sysco*, the FTC initially asserted that the observable characteristic that identified target customers was the merger parties' internal classification of national customers (i.e., customers on Sysco's "corporate multi-unit" (CMU) customer list and U.S. Foods' "parent multi-unit" (PMU) customer list). However, rebuttal evidence showed that being on the list was merely an administrative label (i.e., the customer would deal with corporate headquarters staff rather than a regional unit),[47] and that many customers with multiple (and often widely dispersed) outlets were not on these lists, among other discrepancies.[48]

Rebuttal evidence also called into question whether national customers had inelastic demand indicative of vulnerability to a price increase. The FTC's theory depended on the assertion that national customers had to purchase from distributors with a nationwide footprint, but rebuttal evidence showed that customers with truly national footprints were already sourcing from regional and local suppliers.[49] There was nothing to indicate that other similarly situated national customers could not follow suit if faced with an attempted price increase.[50] Thus, there was nothing to separate the customers who bought regionally from the customers who bought nationally,[51] and the observable characteristic needed for a price discrimination theory proved indeterminate.

The FTC then changed course and asserted that the merger parties negotiated individually with national customers, and therefore they could single out the vulnerable customers through negotiations.[52] The FTC also argued (and the court accepted) that because both firms have a "know-your-customer" business method and substantial information about their customers, the parties would be able to predict which customers have inelastic demand.[53]

Federal courts, however, have rejected the know-your-customer approach to market definition in the past. In *Sungard* the Department of Justice sought to enjoin a merger that it claimed would lead to a 71 percent combined share in the market for shared hotsite services,[54] "a widely-used disaster recovery system sold by vendors to companies that depend on mainframes and other high-end platforms."[55] As in *Sysco*, "the government's market contain[ed] an extremely hetero-

The rebuttal evidence used in *Sysco* provides guidance for merger parties challenging narrow price discrimination markets based on internal customer classifications.

geneous group of customers,"[56] some of whom could switch to alternatives other than shared hotsites in the event of an attempted price increase, and some of whom could not.[57] Also, as in *Sysco*, the government did not segregate the elastic customers (who could switch) from the inelastic ones (who could not). The government also argued that the parties knew their customers well enough to identify those vulnerable to a price increase: "[P]laintiff has demonstrated that shared hotsite providers invest a great deal of time and money in gathering information about their customers and are typically aware of those clients that could switch to an alternative solution."[58]

In *Sungard*, in contrast to *Sysco*, the court "found that plaintiff ha[d] failed to meet its burden of establishing the relevant product market."[59] Without more, the fact of individualized negotiations does little to establish that individual customers will have inelastic demand, and that negotiations will allow the merger parties to identify this inelastic demand with sufficient precision to make a price increase profitable.

The rebuttal evidence used in *Sysco* provides guidance for merger parties challenging narrow price discrimination markets based on internal customer classifications. These classifications often reflect internal business processes more than the customers' elasticity, and historic records may be used to show differences in how similarly classified customers make purchase decisions as well as differences in prices and other contract terms, all of which may rebut the inference that these classifications show inelastic demand.

Ability to Profitably Implement Price Increases to Targeted Customers. Both economic literature and case law confirm that what ultimately matters with price discrimination conduct is not merely whether merging parties can identify vulnerable customers but whether they can actually increase profits by targeting them with a price increase. In other words, the targeted customers must truly have inelastic demand, rather than a malleable preference for a particular method of procurement.

Jerry A. Hausman,[60] Gregory K. Leonard, and Christopher A. Vellturo succinctly stated the issue in a 1996 article: "[T]he hypothetical monopolist will generally not be able to perfectly identify the inframarginal customers who have high willingness to pay" and "[a] sufficient number of wrong guesses can make the attempt to price discriminate unprofitable."[61] These predictions may be made with high accuracy when there is an observable characteristic that reliably and consistently predicts inelastic demand and vulnerability to a price increase. "Situations in which the condition is met usually involve different end uses by the customers."[62] Relying on "customer knowledge" gained from prior individualized negotiations to accurately predict demand elasticity is more difficult, and thus risky for the supplier. Customers "have the incentive to disguise their preferences precisely because they want to avoid becoming targets for higher prices."[63] Customers' ability to negotiate strategically is particularly relevant where the customers are large sophisticated companies with buyer power and business acumen.

These concerns animated the district court in *Oracle*,[64] where the court analyzed evidence through the lens of "differentiated products unilateral effects"[65] rather than price discrimination, but the analysis translates easily to the price discrimination context. As in *Sysco*, the plaintiffs in *Oracle* proposed a market definition that was based on both product and customer characteristics: "HRM [Human Resource Management] and FMS [Financial Management Services] integrated [software] suites sold to large complex enterprises ('high function FMS and HRM market')."[66] The theory of harm also bore a close resemblance to that in *Sysco*: customers within the defined market would supposedly be vulnerable to a post-merger price increase because the merging parties' offerings were sufficiently differentiated from other alternatives and sufficiently preferable to those alternatives that the customers would rather pay more than switch. Nevertheless, the court ruled that mere preference for the merging parties' products was not enough: "'Customer preferences towards one product over another do not negate interchangeability . . . . [T]he issue is not what solutions the customers would *like or prefer* for their data processing needs; the issue is what they *could* do in the event of an anticompetitive price increase by a post-merger Oracle.'"[67]

The missing element in proof of the relevant market was that "other products must be sufficiently different from the products controlled by the merging firms that a merger would make a small but significant and non-transitory price increase profitable for the merging firms."[68] Defining the market based on customer preferences risks an unjustifiably narrow market definition: "There will almost always be classes of customers with strong preferences . . . but to reason from the existence of such classes to a conclusion that each is entitled to . . . a separate narrow market definition grossly overstates the market power of the sellers."[69] An overly narrow market definition makes resulting market shares an unreliable predictor of harm: "The inability clearly to define a market suggests that strong presumptions based on mere market concentration may be ill-advised."[70]

R.R. Donnelley again is instructive. The Commission identified the question of whether "the hypothetical monopolist can selectively and profitably increase prices to [allegedly vulnerable] gravure customers" as an explicit precondition for finding a price discrimination market, above and beyond the requirement that the merging parties are capable of identifying the vulnerable customers.[71] Complaint counsel per-

formed a break-even analysis quantitatively to identify the threshold volume at which offset printing would cease to be an economically feasible substitute for gravure printing.[72] Although this evidence had a logical tie to underlying economic theory, it was not consistent with real-world observations.[73] The Commission reasoned that, if substitution to offset printing was already occurring at current prices, additional substitution would likely occur if the merging parties tried to raise prices on high volume gravure printing, which implied that complaint counsel "ha[d] not accurately identified inelastic uses of gravure."[74]

In *Sysco*, the merger parties presented expert evidence inconsistent with inelastic demand, showing historical substitution in response to price increases based on the detailed transaction databases that the parties actually use in the ordinary course of business. Where third-party data was available on the totality of a customer's location—in the case of restaurants, hotels, and some group purchasing organizations (GPOs)—comparing these locations to the locations where they bought from the merger parties painted a picture of substitution on a regional basis that was inconsistent with a narrow market comprised of some large national accounts. Comprehensive location data was not available for some customers (some GPOs and foodservice management companies (FSMs)), but the merger parties showed that for every customer that was not currently sourcing on a regional basis, there was a similarly situated customer that did so.[75]

Timothy Bresnahan, an expert for the defendants, also investigated substitution over time. Specifically, he identified each national customer location in the Sysco data and checked whether at any point the particular location stopped being served by Sysco. He determined whether the location had permanently or seasonally closed, or whether it had moved its business to U.S. Foods. By process of elimination, if the location still operated but was not buying from U.S. Foods, then it must be buying its foodservice items from a different distributor.[76] This substitution analysis showed that customers within the "national broadline" customer segment could and did substitute away from the merging parties at current prices.

As in *R.R. Donnelley*, this evidence suggested that customers who were sourcing partially from suppliers other than the merging parties could increase their purchases from alternative regional suppliers if faced with a price increase, and also that similarly situated customers who were not yet sourcing from alternative suppliers at current prices could also switch sufficient volume to other suppliers to make an attempted price increase unprofitable. Given this evidence, it should not matter that some "national" customers procured the majority of their foodservice distribution needs from the merging parties at current prices.[77] Substitution at current prices among would-be targeted customers does not have to be universal to show that demand is elastic. In *R&R Donnelley*, for example, the Commission credited evidence that "[s]everal," not most or all, large print buyers used offset printing for high volume jobs,[78] and that "offset accounted for 13.5%," far from a majority, of print jobs in "the 'core' of complaint counsel's proposed market."[79]

Connection Between Defined Market and Theory of Harm. The decision in *Sysco* reflects an issue concerning the connection between the defined market and the theory of competitive harm that may not be inherent in the use of price discrimination markets in merger cases, but, nevertheless, warrants consideration. The court ruled that "broadline distribution to national customers" was a relevant product market based on application of *Brown Shoe* factors[80] and what it describes as a SSNIP test,[81] although the court conceded that within this market "there [was] great variety in the customers' servicing needs and requirements."[82] Customers that the court found to be vulnerable to post-merger discriminatory price increases in the course of individual negotiations were presumably a part of the relevant market, but the court made no finding as to the identity, number, or relative share of the market comprised of those customers. This lack of direct connection between the relevant market and the risk of competitive harm that the court found due to targeted post-merger price increases presented both theoretical and practical issues for the merger parties in *Sysco* that parties in future merger cases should address.

The theoretical issue is that economic evidence the FTC submitted was based on quantitative models that were not specified to focus on the subset of targeted customers within the relevant market. Absent these specifications, defense experts may not be able to test whether assumptions and predictions in the model used by the FTC's expert conform with real world observations of the marketplace, in particular on whether the targeted/vulnerable customers had viable options with regional and local distributors to fall back on if faced with post-merger discriminatory price increases. As stated by the Commission in *R.R. Donnelley*, the best test of persuasiveness is whether the factual/historical evidence agrees with predictions from theoretical models used by economic experts. Where the model is based on a broader market that does not specify the subset of targeted customers who may be vulnerable to post-merger price increases, the model's predictions may become virtually unrebuttable.

The practical issue in *Sysco* arose from specifications in the English Auction model used by the FTC's economic expert as the basis to predict competitive harm. The major input data for the model was each foodservice distributor's national market share. The model guessed at how customers ranked potential suppliers in "Request for Proposal" (RFP) competitions: the winner was known, but the model ranked the rest of the firms based on national market shares.[83] These rankings were crucial to the analysis: the purpose of the model was to identify situations where the merging parties were the top two options, with the supposed harm occurring when the second-best option was removed by the merger and a less desirable third-place option became the new runner-up, putting less competitive pressure on the auction winner.

The practical issue with the model was that rankings of distributors based on national market shares essentially assumes the desired conclusion, by placing one of the merger parties in second position regardless of whether a mix of regional and local distributors would be a viable and acceptable option for each customer analyzed by the model. For example, assume four equally sized regions: Alpha has 20 percent share in each region, and thus 20 percent national share, while Beta has 40 percent share in the East region, and 0 percent share in the other three regions, for a 10 percent national share. Using the premise that a supplier's ranking in an auction is based on its market share, if a customer is sourcing regionally and soliciting bids in the East, in the real world, Beta has twice the market share of Alpha and thus would earn a higher ranking in the English Auction model. In the world that presupposes that national market shares drive customer selection of suppliers, the situation is reversed and Alpha is assumed to be twice as strong a competitor, even if the RFP is limited to the East region.

With the merging parties having a national presence and many of their competitors having a more regional focus, the expert's model had a built-in bias. The model placed one of the merger parties rather than regional distributors in second position in the auction model (based on national market share). This placement was used to predict a threat of competitive harm if the merger eliminated this option, even though many (perhaps most) customers, in the individual negotiations ultimately used as a basis for the finding of competitive harm, would be willing and able to substitute regional/local suppliers and thus defeat a threatened post-merger price increase.

The *Sysco* court found a threat of competitive harm based on the merged firm's perceived ability to selectively identify and target an unspecified subset of large national customers through individual contract negotiations. Merger parties that face similar theoretical and case-specific issues to those that arose in *Sysco* must, as the *Sysco* parties did, present rebuttal evidence and expert analysis (within the confines of compressed discovery and hearing schedules for merger cases) to show that the models used by the agency's economic expert do not fit the proposed relevant market (and thus are unreliable to predict competitive harm), and that evidence of previous and potential future substitution to alternative suppliers refutes the factual predicates for the agency's expert analysis.

Price Discrimination Markets in *Staples*: A Cautionary Tale on Return to the Standards Applied in *R.R. Donnelley*

In *FTC v. Staples, Inc.*,[84] the FTC sought to enjoin the merger of two suppliers of office consumables on the theory that the merging parties would target large business-to-business (B-to-B) customers post-merger with discriminatory price increases. The FTC argued, as in *Sysco*, that regional and local suppliers were not viable options for large B-to-B customers. The court did not resort to the individualized negotiations approach used in *Sysco*, but rather defined the targeted customer market in terms of objective observable characteristics: "large B-to-B customers who spend $500,000 or more on office supplies annually."[85] This approach still presents issues on whether customers who meet these specifications have inelastic demand, but it is a step in the right direction to define a market composed of customers who are all deemed to be vulnerable to a discriminatory post-merger price increase, rather than a broader market that includes an unidentified subset of vulnerable customers.

The *Staples* court's use of *Brown Shoe* factors to define a price discrimination market, however, is a cautionary tale in its own right. *Brown Shoe* identified a general set of "practical indicia" that courts frequently reference in defining the relevant market: "industry or public recognition of the submarket as a separate economic entity, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors."[86] In the context of price discrimination markets, the main (perhaps sole) analytical question on which these practical indicia should focus is whether customers in the proposed market have observably inelastic demand that will allow the defendant to successfully target these customers with a post-merger price increase. Data for empirical analysis is not always available, and economic experts are often at odds on the implications of this kind of analysis, so these practical indicia may serve as a useful backup or confirmatory tool. But scholars have long been concerned that "practical indicia sometimes have been applied blindly, without reference to the goals of identifying buyer and seller substitution possibilities,"[87] which can lead to inappropriately narrow markets or markets gerrymandered to fit plaintiff's case. As with empirical analysis of data, focused analysis is warranted to assure that the practical indicia from *Brown Shoe* address the core issue of inelastic demand that is the theoretical basis for narrow price discrimination markets.

On this point, the decision in *Staples* is decidedly mixed. The court found that "B-to-B customers require specialized vendors that offer value-added services,"[88] which could be indicative of inelastic demand if backed by sufficient evidentiary support. Other factors, however, appear to be less useful in serving the ultimate analytical task to support a narrow price discrimination market. For example, the court identified "sensitivity to price changes" as one of the practical indicia it used to define the targeted customer market,[89] finding that "large B-to-B customers are extremely price sensitive" and using this finding as support for the conclusion that these customers could be successfully targeted for a price increase post-merger.[90] On its face, a finding of high elasticity of demand is not an observable characteristic of customers whose inelastic demand would make them vulnerable to selective price increases.

Staples serves as a hopeful sign that agencies and courts will return to the standard of using observable characteristics,

and the other factual predicates in *R.R. Donnelley* and the Horizontal Merger Guidelines, to define price discrimination markets. However, it is also a necessary reminder that the mere invocation of the correct framework is no guarantee for sufficient analytical rigor in the application of that framework.

Conclusion

Price discrimination markets may be a useful analytical tool in merger analysis, but as the Commission cautioned in *R.R. Donnelley*, if this tool is used without the proper restraint and safeguards, there is "potential for this approach to swallow up the market definition principles established by the federal courts and the Commission."[91] Tying the concept of price discrimination to observable characteristics allows for a straightforward approach where litigating parties join issue in determining whether (1) a subset of customers share an observable characteristic, (2) that characteristic is indicative of inelastic demand, and (3) the merged company will be able to profitably raise prices to the subset of customers sharing that characteristic.

Shifting from the observable characteristic approach to the individualized negotiation standard, particularly as applied in *Sysco*, creates a real risk that enforcement will be unencumbered by a limiting principle, as most business-to-business markets are characterized by individualized negotiations and customers who have varying degrees of preference for the merger parties' products. The elasticity of our antitrust common law is commendable, but it should not and need not come at the expense of well-established and predictable enforcement standards that are necessary to guide business decisions and a proper analysis of complex market information in merger enforcement. ■

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[1] Tom Bingham, The Rule of Law (2010). Bingham was the only person to have served in office successively as Master of the Rolls, Lord Chief Justice of England, and Senior Law Lord.

[2] *Id.* at 38 (quoting Hamilton v. Mendes (1761) 97 Eng. Rep. 787 (PC) 795).

[3] *Id.* (quoting Vallejo v. Wheeler (1774) 98 Eng. Rep. 1012 (KB) 1017.

[4] R.R. Donnelley & Sons Co., 120 F.T.C. 36 (1995).

[5] *Id.* at 158. For a good discussion of the economic conditions necessary for price discrimination, including price discrimination based on "observable customer characteristics," see B. Douglas Bernheim & Michael D. Whinston, Microeconomics 626–59 (2d ed. 2014).

[6] *R.R. Donnelley*, 120 F.T.C. at 158.

[7] *Id.* at 159–60.

[8] *Id.* at 137–38.

[9] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines 6 (2010) [hereinafter Guidelines], https://www.ftc.gov/sites/default/files/attachments/merger-review/100819hmg.pdf.

[10] *Id.* Some may read the Guidelines as endorsing a price discrimination market definition based not on observable characteristics that allow the identification of inelastic customers but on nothing more than the fact that parties may conduct individualized negotiations with customers and thereby obtain some information about the customers' elasticities. Whether or not such an interpretation was intended by the Guidelines' authors, it is wrong both as a matter of precedent and policy. *R.R. Donnelley* requires "a conceptually sound methodology, supported by the record, by which a hypothetical monopolist can identify the alleged inelastic customers." 120 F.T.C. at 159 n.66. Reliance on nothing more than the potential for individualized negotiations to reveal "targeted" customers (through trial and error) falls far short of that test, and allows the government to establish a price discrimination market in most industries involving business-to-business sales, which are typically accompanied by individualized negotiations.

[11] FTC v. Sysco Corp., 113 F. Supp. 3d 1 (D.D.C. 2015).

[12] *Id.* at 15.

[13] *Id.* at 37–38.

[14] Defendants' Proposed Findings of Fact and Conclusions of Law at 23–24, 65–67, FTC v. Sysco Corp., 113 F. Supp. 3d 1 (D.D.C. 2015) (No. 1:15-cv-00256-APM).

[15] *R.R. Donnelley*, 120 F.T.C. at 159–60.

[16] *Id.* at 159.

[17] *Id.* (footnote omitted).

[18] *Id.* at 160. Gravure printing is "typically used for long runs of magazines, newspaper inserts and catalogs." *Id.* at 38.

[19] *Id.* at 157.

[20] *Id.*

[21] *Id.* at 176.

[22] *Id.* at 159.

[23] *Id.* at 158.

[24] *Id.* at 160.

[25] *Id.* at 164.

[26] *Id.* at 164–67.

[27] *Id.* at 169.

[28] *Id.* at 168 (footnote omitted).

[29] *Id.* at 168–69.

[30] *Id.* at 172 (footnote omitted).

[31] *Id.*

[32] *Id.* at 175.

[33] Complaint for Temporary Restraining Order and Preliminary Injunction at 5, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[34] *Id.*

[35] Transcript of Evidentiary Hearing Proceedings at 912–13, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[36] *Sysco*, 113 F. Supp. 3d at 24, 46, 48.

[37] *See, e.g.*, Daniel J. Gifford & Robert T. Kudrle, *The Law and Economics of Price Discrimination in Modern Economies: Time for Reconciliation?*, 43 U.C. Davis L. Rev. 1235, 1237 (2010) (defining price discrimination as "[t]he practice of selling the same good at different prices"); *R.R. Donnelley*, 120 F.T.C. at 157 n.57 ("Price discrimination consists of obtaining different economic profits from different customers for similar products." (quoting testimony by FTC's experts)).

[38] Guidelines, *supra* note 9, at 6 (emphasis added).

[39] Jerry A. Hausman et al., *Market Definition Under Price Discrimination*, 64 Antitrust L.J. 367, 372 (1996) (footnote omitted). It bears noting that the parties disputed the correct calculation of marginal cost in *Sysco*. *See, e.g.*, Transcript of Evidentiary Hearing Proceedings at 1954–56, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[40] *McWane, Inc.*, 2014 WL 556261, FTC Docket No. 9351 (Jan. 30, 2014).

[41] McWane, Inc. v. FTC, 783 F.3d 814, 829 (11th Cir. 2015).

[42] Plaintiffs' Corrected Proposed Findings of Fact and Conclusions of Law at 267, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM) (citations omitted).

[43] *Sysco*, 113 F. Supp. 3d at 46.

[44] *R.R. Donnelley*, 120 F.T.C. at 159.

[45] *Id.*

[46] *Id.* at 159 n.66 (emphasis added).

[47] The evidence showed that there were "National" customers who shared the same characteristics as "Local" customers and vice-versa. Transcript of Evidentiary Hearing Proceedings at 1158–73, 1565–66, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[48] *Id.* at 1158–73, 1568–69.

[49] *See, e.g.*, *id.* at 1173–78, 1199, 1210–12, 1218–25, 1405–12.

[50] *See, e.g.*, *id.* at 2114–19.

[51] *See, e.g.*, *id.* at 2119 ("Yes, this is the substitution by regionalization. These customers could have chosen to buy the way the FTC describes, to buy from one national vendor, and they did choose, at least in some places, to buy from Sysco or USF. Everywhere else they made another choice.").

[52] *See* Plaintiffs' Corrected Proposed Findings of Fact and Conclusions of Law at 272–73, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM) (citations omitted).

[53] *Sysco*, 113 F. Supp. 3d at 45–46.

[54] United States v. SunGard Data Sys., Inc., 172 F. Supp. 2d 172, 181 (D.D.C. 2001).

[55] *Id.* at 175.

[56] *Id.* at 182.

[57] *Id.* at 191.

[58] *Id.* at 190 n.21. In *Sysco*, the court accepted the government's "know-your-customer" theory based on limited evidence: "Here, the evidence is clear that Defendants engage in individual negotiations with their national customers and possess substantial information about them. Indeed, the fact that Defendants employ substantially more sales representatives than other broadliners . . . and assign full-time dedicated employees to some of their largest customers is indicative of the 'know-your-customer' philosophies of both firms." *Sysco*, 113 F. Supp. 3d at 46 (internal citations omitted). The *SunGard* court, 172 F. Supp. 2d at 190 n.21, actually found that the parties "are typically aware of those clients that could switch to an alternative solution," but the *Sysco* court, in contrast, merely observed that the parties employ a large sales staff and practice a know-your-customer philosophy, findings that are likely applicable to a high percentage of well-run business-to-business companies in the United States.

[59] *Sungard*, 172 F. Supp. 2d at 193 n.25. The *Sysco* court distinguished *SunGard* by arguing that, while *SunGard* entailed "'conflicting evidence relating to customer perceptions and practices,'" in *Sysco* "the industry . . . perceive[d] broadline to be a separate mode of food distribution." 113 F. Supp. 3d at 32 (quoting *Sungard*, 172 F. Supp. 2d at 182–83). Even if there was evidentiary support for this conclusion, the distinction applied only to the broadline foodservice distribution market, not to the narrower national broadline customer market asserted by the FTC.

[60] Professor Hausman was an expert witness for the merging parties in *Sysco*; the cited article was published years before the litigation.

[61] Hausman et al., *supra* note 39, at 373.

[62] *Id.* at 372.

[63] *Id.* at 373.

[64] United States v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004).

[65] *Id.* at 1117.

[66] *Id.* at 1125.

[67] *Id.* at 1131.

[68] *Id.* at 1117–18.

[69] *Id.* at 1131 (quoting *R.R. Donnelley*, 120 F.T.C. at 54 n.65 (quoting Robert Pitofsky, *New Defninitions of the Relevant Market and the Assault on Antitrust*, 90 Colum. L. Rev. 1805, 1816 (1990))). The logical connection between *Oracle*'s differentiated product unilateral effects analysis and price discrimination markets is corroborated by *Oracle*'s citation of a price discrimination case, *R.R. Donnelley*, for the key proposition that mere preference for the merging parties' products does not make a customer a part of a separate market, whether that market be termed a targeted customer market or a differentiated product market.

[70] *Oracle*, 331 F. Supp. 2d at 1121.

[71] *R.R. Donnelley*, 120 F.T.C. at 158 (footnote omitted).

[72] *Id.* at 161. Complaint counsel argued that the gravure printing process is characterized by high fixed costs and low variable costs; the converse is true for offset printing. Hence, theoretically, as printing volume gets higher, offset printing becomes less and less economically attractive in relation to gravure printing.

[73] Complaint counsel's theory was contradicted by the "substantial historical and existing use of offset printing within the proposed market," *id.* at 160, and evidence that "[s]everal of the largest print buyers in the United States use the offset process for high volume publication printing." *Id.* at 172.

[74] *Id.*

[75] *See* Transcript of Evidentiary Hearing Proceedings at 2125, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[76] *Id.* at 2135–39.

[77] *Sysco*, 113 F. Supp. 3d at 46–47.

[78] *R.R. Donnelley*, 120 F.T.C. at 172.

[79] *Id.* at 153.

[80] Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962).

[81] *Sysco*, 113 F. Supp. 3d at 40. The FTC's economic expert conceded that he did not perform a SSNIP on the national customer lists, which were used to define the national broadline customer market. Transcript of Evidentiary Hearing Proceedings at 1155–56, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[82] *Sysco*, 113 F. Supp. 3d at 46.

[83] Transcript of Evidentiary Hearing Proceedings at 1251, *Sysco*, 113 F. Supp. 3d 1 (No. 1:15-cv-00256-APM).

[84] FTC v. Staples, Inc., No. 15-2115, 2016 WL 2899222 (D.D.C. May 17, 2016).

[85] *Id.* at *8.

[86] *Brown Shoe*, 370 U.S. at 325 (footnote omitted).

[87] Jonathan B. Baker, *Stepping Out in an Old Brown Shoe: In Qualified Praise of Submarkets*, 68 Antitrust L.J. 203, 206 (2000) (footnote omitted) (citing previous literature on the subject).

[88] *Staples*, 2016 WL 2899222, at *12.

[89] *Id.* at *9.

[90] *Id.* at *10.

[91] *R.R. Donnelley*, 120 F.T.C. at 159.