



CUSTOMER GROUPING FOR
COST JUSTIFICATION PURPOSES

by

EARL W. KINTNER *



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In the complex world of Robinson-Patman Act enforcement, no area has been more difficult to understand and less susceptible of practical application than the Act's cost justification proviso which provides that nothing in the Act "shall prevent [price] differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered." This cost justification defense stems from the economic premise that a seller should not be compelled to charge an artificially high price to a particular buyer if the seller can show by facts and figures that it actually costs less to sell to this particular buyer than to other buyers. The cost savings to the seller might result from the buyer's purchasing practices, savings in shipping costs, reduced sales expenses, or a host of other factors.

The burden of establishing that a price differential is cost justified is on the seller, the party that has granted the price differentials. To meet its burden, sellers utilize various distributive cost accounting concepts and techniques; however, as experienced and knowledgeable executives realize, distributive cost accounting is far from an exact science. Moreover, even with sophisticated distributive cost accounting, it would be extremely difficult, if not impossible, for many sellers to individually cost justify each price differential as to each customer. Consequently, sellers will

* Member, Indiana and District of Columbia Bars; practicing attorney, Washington, D.C.; formerly General Counsel and Chairman, Federal Trade Commission. Mr. Kintner is the author of "An Antitrust Primer—A Guide to Antitrust and Trade Regulation Laws for Businessmen", published by the Macmillan Company in 1964.

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often divide their customers into groups whose members are charged the same prices and then attempt to show that the average cost of dealing with the members of each group varies to the extent of the price differentials between the groups. This customer grouping and averaging, however, raises a threshold question as to the acceptability of the groupings for cost justification purposes. The Federal Trade Commission and the courts have rejected a number of cost justification defenses because the customer groupings were improper. Thus, unless businessmen understand how to properly group their customers for cost justification purposes, the cost justification defense will not be available to them except in the unusual situation where the seller can individually justify his price differentials. In this article, we will examine and analyze those Federal Trade Commission and Court decisions that are particularly relevant to the question of the degree of homogeneity that is required for acceptable customer groupings and will attempt to extract from them standards and guidelines that should be followed by sellers in grouping customers for cost justification purposes.

Initially, it will be helpful to briefly review a few of the older FTC and court decisions that deal with this question of proper customer groupings. In 1945 in *Standard Oil*,¹ Standard attempted to cost justify lower prices it had allowed one customer by comparing its cost per gallon of dealing with the one favored customer with the average cost of dealing with all its other customers as a group. The cost study was completely rejected by the Commission and this type of customer grouping and comparison was specifically disapproved of. The Commission observed that such a comparison failed to take into consideration the fact that Standard's customers fell into several different groups and that the cost of doing business would vary between these groups.

Three years later, the FTC considered a cost justification defense in *Minneapolis-Honeywell Regulator Co.*² in which Minneapolis-Honeywell had granted many of its customers graduated volume discounts based on annual purchases. Commissioner Ayres, in approving the general principles of the cost study and the customer groupings, observed that:

"Where [cost studies] are made in good faith and in accordance with sound accounting principles they should

¹ 41 FTC 263 (1945).

² 44 FTC 351 (1948).

be given a very great weight. . . . Respondent's burden under the act is very great and it should have a liberal measure of consideration when it becomes apparent that it has made sincere and extensive efforts to discharge that burden."³

In 1951 two private treble-damage actions involving quantity discounts granted by American Can Co. produced conflicting Circuit Court opinions on the question of customer groupings.⁴ The Fifth Circuit held that the quantity discount schedule and classification of American's customers into three arbitrary groups was unlawful and discriminatory. The court felt that the quantity discounts were not based upon actual differences in the cost of selling to the customers, or classes of customers, and, in addition, that the system did not represent a good faith effort to make the price discounts functionally available to all customers. Since only two customers received the 5% discount and only about 1% of American's customers received any discount at all, the court approved of the District Court's finding that "the discount schedule was tainted with the inherent vice of 'too broad averaging' . . .". The court noted that "any discount system . . . which arbitrarily exclude[d] 98% of the customers involved from qualifying for any discount whatever impose[d] a heavy burden on its proponent to justify its continued existence."

The Eighth Circuit, on the other hand, dealing with the same quantity discounts, reversed a district court determination that the customers had been improperly grouped. Although the Eighth Circuit did not find that American's cost study should be accepted, it held, in effect, that the propriety or validity of American's customer groupings was irrelevant if the cost study had been adopted in good faith, was honestly maintained and reflected with substantial accuracy the differences in selling costs between the customer groups.

Another cost justification defense was considered and rejected by the FTC in *Champion Spark Plug Co.*⁵ because the customer groupings were not acceptable. Champion, which had granted two of its customers lower prices, treated the two as one group and

³ 44 FTC at

⁴ *American Can Co. v. Bruce's Juices*, 187 F. 2d 919 (5th Cir. 1951); *American Can Co. v. Russellville Canning Co.*, 191 F. 2d 38 (8th Cir. 1951).

⁵ 50 FTC 30 (1953)

treated its additional four hundred and eighty-five customers as another group. The average cost of selling an individual spark plug to each group was computed and then compared to justify the price differentials. The Commission noted that this type of customer grouping (2 compared with 485) failed to take into consideration the fact that within the large disfavored group there were some customers upon whom Champion expended a comparatively small amount of sales effort. The Commission ruled that:

"A cost justification based on the difference between an estimated average cost of selling to one or two large customers and an average cost of selling to all other customers cannot be accepted as a defense to a charge of price discrimination." (Emphasis added).⁶

More authoritative pronouncements on the degree of homogeneity required for proper customer groupings for cost justification purposes were forthcoming when the question was presented to the Supreme Court in *United States v. Borden Co.*⁷ Two Chicago dairies, Borden Co. and Bowman Dairy, were charged with violating the Robinson-Patman Act because they had granted grocery store chains lower prices than they had charged the independents. Sales of both dairies during the period in question were handled on plans which gave most of their customers—the independently owned stores—percentage discounts which increased with volume to a special maximum discount. The grocery store chains, however, were granted a flat discount without reference to volume in an amount substantially greater than the maximum discount available to the independents under the volume plans. Both dairies introduced cost studies which purportedly justified the lower prices to the chains.

Borden's cost study divided its customers into two classes—the two chains with a combined total of 54 stores constituted one class and the 1,322 independents, grouped into four brackets based on volume, made up the other. Borden's cost justification was built on comparisons of its average cost per \$100 of sales to the chains in relation to the average cost per \$100 of sales to each of the groups of independent groceries.

⁶ 50 FTC at 43.

⁷ 370 U.S. 460 (1962).

Bowman, which serviced three chains and 2,500 independents, based its cost justification on differences in volume and methods of delivery. It relied heavily upon a study of the cost per minute of the routeman's time. Bowman determined that a substantial portion of the routeman's time was devoted to services which were never performed for the chains. Bowman compared the cost of these services with the price differentials in an attempt to justify the differentials. Bowman estimated that two-thirds of the independents received some of the services and that most independents received others.

Justice Clark, writing for a majority of the Supreme Court, recognized that the only question before the Court was how accurate the cost justification must be in relation to each individual purchaser. A literal construction of the cost justification proviso which would have required that any price discrepancy between any two purchasers be individually justified was specifically rejected by the Court. The Court realized that complete rejection of class pricing as justified by class accounting would have the practical effect of eliminating the cost justification proviso as to sellers having a large number of purchasers and would prevent them from passing their savings on to their customers. Such a result was considered to be at war with the Congressional language and intent. The Court explained:

"But this is not to say that price differentials can be justified on the basis of arbitrary classifications or even classifications which are not representative of a numerical majority of the individual members. At some point practical considerations shade into circumvention of the proviso. *A balance is struck by the use of classes for cost justification which are composed of members of such self-sameness as to make the averaging of the cost of dealing with the group a valid indicium of the cost of dealing with any specific group member. High on the list of 'musts' in the use of the average cost of customer groupings under the proviso of §2(a) is a close resemblance of the individual members of each group on the essential point or points which determine the costs considered.*" (emphasis added.)^a

^a 370 U.S. at 469.

The Supreme Court, applying the standards set forth above, rejected Borden's cost study because (a) Borden had failed to show that the economies relied upon were isolated within the favored class, (b) members of the classes were substantially unlike in some of the cost saving factors relied upon and (c) some of the independents had volumes comparable to, and in some cases larger than, that of the chain stores and the broad averaging created artificial disparities.

Bowman's customer classification system had defects similar to Borden's. Bowman had failed to show that all the independents received the services daily or even on some lesser basis; actually, its study revealed that only a large majority of the independents took the services on a daily basis.

The Court explained that the use of the cost factors across the board in calculating the independent store costs was not permissible because it possibly allocated costs to some independents whose mode of purchasing did not give rise to them. The burden was on the one offering the customer classification to negate such a possibility and this burden was not met here. Thus, the cost justification defenses were rejected because Borden and Bowman had failed to satisfy their threshold burden of showing that the customers in each class were so homogeneous as to permit their being joined together for cost allocation purposes.

Twice within the past year the FTC has considered cost justification defenses based on customer groupings and averaging. In *American Motor Corp.*,^{*} American was charged with discriminating in its sales of electrical appliances to some of its retailers. American had classified its retailers into two groups for pricing purposes; merchandising distributors and regular dealers. The merchandising distributors were charged uniformly lower prices than the regular dealers. Four retailer customers were classified as merchandising distributors. All were multiple outlet retailers and each usually carried American's line exclusively, or along with the line of one other competitor. American treated its additional 6,000 retailer customers as regular dealers. These regular dealers fell roughly into two categories: department stores with appliance divisions, and appliance stores or stores with appliance outlets. Some of the regular dealers had multiple outlets, some were as large as the merchandising distributors and some limited their

*Dkt. #7357 (1965).

line exclusively to American, or carried, at most, only one other competitive line of appliances.

In its cost study American did not differentiate between the customer groups as to their relative size, number of outlets, competitive lines handled or manner of delivery. Rather, American asserted that there were basis differences in the functions which its salesmen performed for its merchandising distributors and its regular dealers which justified their classifications into separate groups and which accounted for the differences in time, and, therefore, in cost, of servicing the two groups.

The Hearing Examiner accepted American's cost study and found that the discounts were cost justified. The Commission, however, rejected the Examiner's findings and held that American had failed to satisfy its threshold burden of establishing a reasonable basis for the classification of its customers upon which it had rested its cost justification defense. The Commission found that the functions relied upon did not, in fact, constitute differentiating factors between the two classes of customers. The record disclosed not only that some of the functions were performed for the favored merchandising distributors, but also that American had failed to show that these functions were substantially performed for all or most of its 6,000 non-favored dealers. The Commission repeatedly stressed that American had made no meaningful showing that the 6,000 regular dealers should be treated as a single group and pointed out that among the regular dealers there were many large multiple outlet dealers who probably could and did perform many of the functions for themselves.

Regarding proper customer classification, the Commission explained that members of a group whose costs are being averaged must "*have a sufficient homogeneity so that averaging the cost of dealing with them as a whole will fairly represent the cost of dealing with each member in the group.*" (emphasis added).¹⁰ Applying the standards set forth in *Borden* the Commission found that American had not shown that the 6,000 retailers grouped together had the requisite self-sameness on the cost determining points to constitute them a single group for purposes of comparison with the merchandising distributors. In its order the Commission explained:

¹⁰ *Id.*

"our decision here is limited to our holding that a respondent failed to establish that some of its 'non-favored customers' were not discriminated against insofar as they, too, may have saved respondent the identical selling expenses that respondent claims it saved in servicing its merchandising distributors."¹¹

The Commission explained that it was not holding that sellers with many purchasers had to individually cost justify each one out in each area he has selected for his cost justification defense, although it did feel that a detailed representative study should be made by the seller.

The most recent FTC decision involving customer grouping for cost justification purposes is *Standard Motors Products*¹² in which, once again, a cost justification defense was rejected because of improper customer grouping and volume averaging procedures. Standard, a seller and distributor of automotive and electrical fuel system replacement parts, employed a rebate plan under which it bracketed its customers according to their annual purchase volume and increased the rebate percentage as volume increased. On their "standard" line of products the rebate was 4% in the lowest volume bracket and went up to 17% in the highest volume bracket. On the "hygrade" line the rebate moved from zero to 12%, depending on volume. Standard contended that the price differentials were cost justified and presented statistical data which purportedly represented the cost of four chosen activities for each volume bracket. The aggregate cost figures for each of the activities were divided by the year's volume of rebatable sales to customers within each bracket to show costs in terms of a percentage of volume.

At the outset the Commission noted that Standard was relying on the purchasing ability of its buyers as the sole criteria of the rebates. Upon observing that Standard had first established the volume brackets and then determined the cost attributable to customers whose purchases placed them within a particular bracket, the Commission stated:

"While the successful establishment of a cost justification defense does not require the profferer to have put his horse first, one who has casually delimited available re-

¹¹ *Id.*

¹² Dkt. #5721 (Dec. 20, 1965).

bates must at least demonstrate that a significant majority of those customers relegated to a particular volume group most likely had costs supporting their inclusion in that group."¹⁰

From Standard's own evidence the Commission concluded that a majority of its customers had computed costs which should have resulted in their being placed in another bracket. Indeed a large number of customers whose purchases cast them into a particular bracket had costs equal to or lower than the average cost computed for the next higher bracket. The Commission observed that the result of the discriminating rebate schedule was that a great number of low cost customers were burdened with the expense of higher cost customers. Because of the "discriminatory" and "arbitrary" nature of the customer groupings, they and the resultant averaging were entirely rejected by the Commission.

In view of its findings the Commission found it unnecessary to rule on the persistent question of whether annual volume rebate allowance programs are *per se* unacceptable. Regarding proper customer grouping, the Commission stated:

"... whenever such programs are employed, the volume rebate groups must be limited to certain types of customers having apparent cost similitude. Before assigning his customers to a particular rebate bracket, the seller should carefully measure their buying characteristics to be certain that those to be bracketed in all probability will have like cost percentages. (*Unanticipated occasional deviations by individual customers would not affect the Commission's evaluation of reasonably constituted brackets.*) The factors used in ascertaining probable cost homogeneity will of course vary with the nature of each seller's business and distributing practices."¹¹

CONCLUSION

Although the above decisions recognize that some customer grouping must be permitted if the cost justification proviso is to be practically available to many sellers, examination of these decisions reveals that guidelines for the businessman and lawyer in

¹⁰ *Id.*

¹¹ *Id.*

this area are, at best, very general. Much of the advice from the decisions is negative in that it tells what is not acceptable. It now appears clear that customer grouping which places two, three or four customers in one group and all others in another will be difficult, if not impossible, to justify. And, the acceptability of quantity discount systems is very much in doubt although they have not yet been held *per se* improper. On the other hand, there is some positive guidance which businessmen and lawyers who intend to rely on the cost justification proviso should be aware of. The general test that will determine the acceptability of customer groupings will be whether there is substantial homogeneity within each customer grouping on the critical cost determining factors. Encouraging in this regard is the FTC statement that occasional unanticipated deviations by individual customers will not affect the acceptability of reasonably constituted customer groups. Furthermore, good faith as evidenced by a pre-litigation, pre-discount cost study, while not a technical requirement, apparently impresses both the FTC and the courts and, very likely, affects the degree of scrutiny given the customer groupings. However, until additional cases arise requiring more specific application of the present general guidelines, proper customer grouping will continue to be a very difficult matter for the businessman and the lawyer.