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PRICE DIFFERENTIALS BASED ON COST DIFFERENCES: Strengthening the Administration of the Robinson-Patman Act

Address of

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I long have thought that one of the main reasons for failure to obtain general compliance with the Robinson-Patman Act, is the mystery and ignorance (both in industry and government) which surround distribution costs.

While savings in cost constitute the primary justification for price differentials under the Act, there has been little advancement in the field of distribution cost accounting during the eighteen years it has been on the books. Manufacturing cost determination has been reasonably well understood and recognized for many years, but this has not been true in the distribution field.

Business concerns, especially those from the small business segment of our economy, have found it very difficult, if not impossible, to determine precisely what cost savings are allowable and how they may be proved. General accounting analyses made for management in the regular course of business seem to be unsuitable for the purpose of supporting price differentials under the act.

The few distribution cost studies that have been developed in litigated cases have been very expensive and have involved detailed functional analyses of the sellers' entire business. Even then the conflicts between respondent's accountants and accountants of the Federal Trade Commission with reference to theory, allocations, procedures and methods often have prevented any reasonable evaluation of the actual savings in serving different customers.

These difficulties have engendered widespread disregard of the prohibitions against price discrimination. This has been so because sellers cannot, in our competitive economy, rely on a one price policy. In order to compete they must be able, when the situation requires it, to pass on to the buyer the savings created by the buyer's method of doing business.

Section 2 of the Clayton Act, prior to the Robinson-Patman Act amendment, permitted price differentials based on differences in quantity. The precise words of the old quantity proviso were that "nothing contained herein shall prevent discrimination in price between purchasers of commodities on account of differences in the ... quantity of the commodity sold."

In the leading case under the old law the Federal Trade Commission charged one of the large tire companies with violation of section 2 by selling tires to Sears Roebuck at discriminatory prices. Respondent contended that its contracts with Sears, which involved lower net prices than those charged independent dealers, were made because of the great difference in the volume purchased by Sears as compared with that of the largest independent dealer.

After some 25,000 pages of testimony, the Commission ruled that it did not consider "a difference in price to be on account of quantity unless it was based on a difference in cost and was reasonably related to and approximately no more than that difference." It concluded that since the price differential in favor of Sears was not justified by differences in cost of transportation or selling, the lower prices were not made "on account of" quantity.

In support of this ruling the Commission relied on various economists who had written or commented on the subject of quantity discounts. These economists had said that insofar as the purchasing habits of the customer contribute to savings, it is sound to carry the discount to the point where the customer receives the benefit of the savings he created; that the proper basis for quantity discounts is to make them commensurate with the economies that are effected in handling and shipping the respective quantities of merchandise. Such discounts are equitable, they said, in that the buyer who purchases in large quantities is compensated for the carrying or handling charges he assumes when he buys the large lots.

Based on this reasoning it was concluded that quantity discounts which exceeded such savings were a device for catering to large buyers and amounted to price cutting.

The respondent tire company, in refutation, pointed to the language of the statute and asserted that it permitted a discrimination that would measure the economic advantage of quantity sales beyond mere savings in cost. It pointed to such economic benefits as the value of Sears' volume in removing manufacturing hazards, the avoidance of profit fluctuation, the assumption by the buyer of certain risks and drops in raw material prices.

While the Commission remained unconvinced, the court, on appeal, agreed with respondent. "It seems clear," the court said, "that [old] section 2 of the Clayton Act permits discrimination in price on account of quantity without relation to savings in costs."

In the meantime - in fact, while the matter was pending before the Court of Appeals - Congress was asked to clarify the situation. The result was the controversial cost proviso of the Robinson-Patman Act. This reads:

> "... nothing herein contained shall prevent 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."

It was believed at the time that the new proviso was little more than a legislative restatement of the Commission's interpretation of the old proviso, namely, that price differentials should be "reasonably related" to cost differences. It was designed to preserve for the consumer and the public the benefits of more efficient marketing methods, while at the same time protecting small buyers from "unearned" discounts which were not related to savings in cost in serving the large buyer.

However, within a few years after the passage of the Robinson-Patman Act the Commission abandoned this rule of reason approach and put respondents to strict cost-accounting proof. While there were some lingering protestations that mathematical precision would not be required, the cost proviso was applied so as to require detailed showings of actual distribution costs - sometimes to the point of measuring separate items of expense by variances in mileage, time spent in travel, or the number of typed lines per invoice.

This technical approach was sought to be justified on the ground that the distribution activities of practically every company differ from those of every other company and what is suitable for one company in the way of distribution cost analysis may not fit the situation of another company. This, of course, is true. But instead of justifying rigid and mechanical approaches it merely emphasizes the need for elasticity and the development of overall techniques by which to measure price differentials based on cost differences.

Cost accounting is by no means an exact science. Methods of allocation and proration of distribution costs are in the evolutionary stage. Several equally acceptable techniques will no doubt be developed, as has been the case in the more traditional field of manufacturing cost analysis.

In any event the fact remains that the cost defense has proved largely illusory. In only three formal cases, one of which was decided less than two weeks ago, has the cost justification been entirely successful. In three more cases cost studies were accepted in part as justifying some portion of the price differential. In all the remaining cases of public record the cost studies were rejected as inadequate.

There have been, of course, a large number of cases in which the cost defense was explored on an informal basis. Such cases included some in which the proposed respondent was able to convince the Commission's staff that the cost defense would be successful, and so the formal complaint was not issued. They also included cases in which respondents became convinced that the cost defense would not be successful or that it was too complex and expensive to be undertaken. By and large, however, the rigid standards of proof required by the Commission have resulted in very few decisions on the merits in favor of respondents.

In none of the cases, with the possible exception of the recent Sylvania case, which I will discuss later, has the Commission established guiding principles or precedents for cost analysis. The fact that there are no rules of the game is illustrated by one case where there was not even an agreement as to the prices to be compared. The respondent wanted to compare prices after the deduction of cash discounts, to which all buyers were entitled, but the staff thought that gross prices, before cash discount, should be compared in measuring the price difference.

Sellers attempting to defend price discrimination charges in treble damage actions have been equally unsuccessful. One federal court rejected the cost defense because of its failure to show the seller's cost in dealing with each individual buyer; another district court rejected cost studies not based on individual transactions with individual customers.1/

The sole comment of the Supreme Court on this subject occurred in the recent Automatic Canteen case where the Commission contended that the buyer had the burden of proving his sellers' costs. In rejecting this contention Mr. Justice Frankfurter said:

> "We have been invited to consider in this connection some of the intricacies inherent in the attempt to show costs in a Robinson-Patman Act proceeding. The elusiveness of cost data, which apparently cannot be obtained from ordinary business records, is reflected in proceedings against sellers. Such proceedings make us aware of how difficult these problems are, but this record happily does not require us to examine cost problems in detail. It is sufficient to know that, whenever costs have been in issue, the Commission has not been content with accounting estimates; a study seems to be required, involving perhaps stop-watch studies of time spent by some personnel such as salesmen and truck drivers, numerical counts of invoices or bills and in some instances of the number of items or entries on such records, or other such quantitative measurement of the operation of a business."

All of this led me to suggest, after I was named Chairman of the Commission, that the problem should be reexamined in order to strengthen the administration of the Robinson-Patman Act.

1/On appeal one decision was reversed and the other affirmed in opinions which admittedly were in disagreement with each other.

An Advisory Committee on Cost Justification was appointed and Professor H. F. Taggart of the University of Michigan was designated Chairman. The Committee was asked to ascertain whether it is feasible for the Federal Trade Commission to develop standards of proof and procedures for costing which can be adopted by the Commission as guides to businessmen desiring to comply with the law.

To the extent that such standards of proof and reliable guides to satisfactory costing procedures are susceptible of development, and are consistent with good business practices, sellers who wish to facilitate a determination of compliance with the Act would be able to organize their records accordingly.

We are not naive enough to believe that either the Advisory Committee or the Commission can devise a universal system of cost accounting which can be adopted by a seller and from which he can derive, merely by turning to the proper ledger account, the answer to any particular Robinson-Patman Act problem.

However, I do feel that the Advisory Committee can and will make a significant contribution to improved cost accounting methods and techniques which will be useful not only to the Commission but to business generally. Most businessmen will agree, I believe, that regardless of the Robinson-Patman Act they need to know much more about distribution costs.

I don't know just when the Advisory Committee will report or what it will recommend. The appointments to the committee were made and accepted with the understanding that the members were to take their time, that the problem was not one that lent itself to quick or easy solution.

While, as I say, I cannot preview the report, I am told it will probably discuss such problems as:

1. Definitions of price and price differences.
2. Definitions of other terms at both the manufacturing and distribution level.
3. Manufacturing costs as affected by methods and quantities of sale.
4. Selling and transportation costs as affected by methods and quantities of sale and delivery.
5. Techniques of allocation and proration.
6. Customer classification.
7. Use of budgeted costs, standard costs, actual costs.
8. Functional approach to distribution cost analysis.
9. Uses of sampling in making cost studies.
10. F.T.C. accounting staff organization and procedures.

In the recent Sylvania case decided two weeks ago, the Commission may have anticipated one of the many problems the committee will consider. There were divergent points of view in that case as to whether the price differential, which was the subject of the complaint, was the difference between the prices of each of 600 types of radio tubes, or whether it was permissible to ascertain a weighted average price. The Trial Examiner decided in favor of the contention that the true differential to be justified was that between each individual type of tube.

On appeal this holding was reversed by the Commission. The Commission held that it was proper in this instance to compare the aggregate price difference on the entire complement of tubes and the aggregate cost difference.

Any other holding would, it seems to me, make a mockery of the "due allowance" proviso. Obviously it would not be feasible, by any known accounting method, to compare individual prices and individual distribution costs of 600 different types of radio tubes, where the demand was determined not by price or customer choice, but by the size and kind of radios owned by the customers needing new tubes.

Whatever the cost justification committee may propose, it will fall to the ground unless the Commission goes back to first principles and approaches the problem with a desire to give full credence to the intent of Congress. This intent, as I interpret it, was to make a fair adjustment between the protection of small buyers and the welfare of the consumer - to preserve for the consumer the benefits of mass production and low cost distribution while prohibiting price favors to large buyers that were unrelated and not reasonably attributable to savings created by more economical methods of manufacture, sale or delivery.