Unit 11: Sysco/US Foods

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Good things come from Sysco

US. FOODS™

KEEPING KITCHENS COOKING.™

Four new concepts

1. *Cluster markets* in product market definition
2. *Targeted customer markets* in product market definition
3. Defining *geographic markets* when suppliers travel to customers
4. *Auction unilateral effects*

The Background

The deal

- Sysco Corporation to acquire US Foods
  - Announced December 8, 2013
  - $3 billion of Sysco common stock (13% of combined company)
  - +$500 million of cash
  - Assumption of $4.7 billion of USF debt
  - Total transaction value: $8.2 billion
  - Agreement expires September 8, 2015 (21 months)

The parties

- Sysco
  - Publicly traded “broadline” distributor
  - 200K customers
  - Sales = $44 billion in food distribution sales 2013
  - #1 with about 17% of total food distribution sales nationally
  - 72 distribution facilities nationwide

The parties

- US Foods
  - Privately owned broadline distributor (Clayton, Dubilier & Rice and KKR)
  - Sales = $22 billion in food distribution sales in 2013
  - #2 with about 8.6% of total sales nationally
  - 61 distribution facilities nationwide

Deal rationale

- Creates a company with $65 billion in sales
  - Sysco (#1 w/17%) + USF (#2 w/8.6%) = Combined (#1 w/25.6% of total sales nationally)
    - Number 3: Performance Group (2.4%)
  - Would employ over 14,000 sales reps
    - No other company employs more than 1600
  - Would operate over 13,000 trucks
    - No other company operates more than 1600 trucks
- Immediately accretive to earnings
- Annual recurring synergies > $600 million (after 3-4 years)
  - Eliminate duplicative overhead
  - More leverage to lower costs of goods (COGS)
  - Optimize distribution facilities and logistics
  - Integrate sales force
  - Bigger platform for enhanced innovation and development of exclusive products

Industry background

- Food service distribution
  - Total industry sales nationwide = $231 billion (2015)
  - Supply a broad range of fresh, frozen, canned and dry food and non-food products to away-from-home food service operations
  - Customers include—
    - Independently owned single-location restaurants, regional and national chain restaurants (majority of sales)
    - Hotels, motels, and resorts
    - Hospitals
    - Schools
    - Government and military facilities
    - Retail locations

Industry background

- Types of food distributors: Product range/channel
  1. Broadline
     - "One-stop" shop—carry everything
  2. Specialized
     - Meat
     - Seafood
     - Produce
     - Baked goods
  3. Systems distributors
     - "Customized" distributors for fast food, casual chain restaurants (e.g., Burger King, Wendy's, Applebees)
     - Small number of SKUs
     - Often proprietary to chain
     - Very small sales forces
  4. Cash-and-carry and club stores
     - E.g., Restaurant Depot, Costco, Sam's Club
     - Do not deliver
     - No sales force dedicated to individual customers
     - Typical customer: independent restaurant

Industry background

- Types of food distributors: Geographical distribution footprint
  - National
  - Regional
  - Local

Industry background

- Largest food distributors in the United States

Distributor	Distribution Footprint	Distribution Centers
Sysco	Nationwide	72
US Foods	Nationwide	61
Performance Food Group	Eastern/Southern U.S.	24
Gordon Food Service	Midwest, Florida, TX	10
Reinhart Foodservice	East, Mideast	24
Ben E. Keith Co.	Texas and bordering states	7
Food Services of Am.	Northwest	10
Shamrock Foods	Southwest, Southern Calif.	4
Local distributors	Local	1-5 each

Industry background

- Distribution centers
  - Key for broadline distribution

- 28-foot clear-height ceilings
- “Super-flat” insulated floor systems to meet strict temperature control standards
- Zoned to accommodate the storage of both perishable and dry goods

Distribution centers

- US Food distribution centers in 2017
  - Only three more centers than in 2013

The FTC investigation and litigation

- FTC investigated for one year
  - Second request issued on February 18, 2014 (a little over two months after signing)
  - Investigation ended February 20, 2015
- Fix-it-first solution:
  - On February 16, 2015, Sysco signed a deal to sell 11 of 61 USF distribution centers to #3 Performance Food Group
    - Announced Feb. 16, 2015
    - Conditioned on closing main deal
  - The centers to be divested largely located in the western U.S.
    - PFG had only one center in the West
    - PFG had 24 centers in East/South
  - Accounted for $4.5 billion in sales
    - About 20% of USF premerger sales
    - Would give PFG a total of $10.5 billion in sales
    - Compare to $60.5 billion for the combined firm post-divestiture
- FTC rejected the fix and brought suit
  - Joined by 11 states seeking relief under Clayton Act § 16 in their sovereign capacity
  - Parties "litigated the fix"

The District Court

- Entered the preliminary injunction blocking the deal
  - Relevant markets
    - Broadline foodservice distribution to national customers
    - Broadline foodservice distribution to local customers
  - Anticompetitive effects (upward pricing pressure)
    - *PNB* presumption
    - Unilateral effects in the national broadline customer market
    - Unilateral effects in local broadline markets
  - Defenses insufficient to put the prima facie case into dispute
    - The PFG "fix"
    - Dealing regionally by national customers
    - Entry/expansion
    - Efficiencies
  - Equities favored the entry of a preliminary injunction

PI entered: June 23, 2015
Deal terminated: June 29, 2015

Parties abandon the merger

- Costs to Sysco
  - $300 million breakup fee to US Foods
  - $25 million breakup fee to divestiture buyer Performance Food Group
  - $265 million to redeem financing
  - $258 million on integration planning and advisers
  - $100 million in historical financing costs, and
  - $53 million in computer systems integration

Total cost to Sysco: $1 billion

The District Court

- Tried in the District Court of the District of Columbia
  - Judge Amit P. Mehta
    - Appointed by President Obama
    - Assumed office: December 19, 2014
    - Assigned case: February 20, 2015

Organization of opinion

- Relevant markets
  - The relevant product market
    - Broadline distribution as a relevant product market
      - Legal principles
      - *Brown Shoe* “practical indicia”
      - Expert testimony
      - Conclusion
    - National broadline distribution as a relevant product market
      - Legal basis
      - Evidence
  - The relevant geographic market
    - National market
    - Local markets

Organization of opinion

- Probable effects on competition
  - *PNB* presumption
    - *PNB* presumption in the national broadline distribution market
    - *PNB* presumption in the local broadline distribution markets
  - Additional evidence of competitive harm
    - Unilateral effects in the national broadline customer market
    - Merger simulation in the national broadline customer market
    - Unilateral effects in local broadline markets
    - Event studies ("natural experiments") in local broadline markets
- Defendants' other rebuttal arguments
    - PFG divestiture
    - Existing competition
    - Entry/expansion
    - Efficiencies
- The equities

The District Court Opinion

1. The Prima Facie Case

A. Relevant Product Markets

Two product markets

- FTC position: Two product markets
  1. Broadline foodservice distribution (as opposed to all food distribution) to all customers
  2. Broadline distribution to “national” customers

All broadline foodservice distribution

1. Broadline foodservice distribution to all customers
   - Characteristics:
     - Vast array of products (“one-stop shop”)
     - Private label offerings
     - Next-day delivery/emergency deliveries
     - Value-added services (such as menu and nutrition planning)

This is an example of a *cluster market*

All broadline foodservice distribution

- Cluster markets: The idea
  - Courts sometimes define relevant product markets around collections of products that are almost always offered for sale at a single location
  - The products in cluster markets can vary widely and typically exhibit little if any cross-elasticity of demand
    - *Examples*: Commercial banking services, supermarkets, broadline foodservice, office supply stores, department stores, sporting equipment, acute care inpatient hospital services

All broadline foodservice distribution

- Two types of cluster markets
  1. Products that share similar shares and demand characteristics
     - Not well defined in the case law
     - Accepted "for analytical convenience" when market shares are likely to be the same across products[1]
     - Typically, analytic similarity is simply asserted rather than analyzed by courts
       - A bit more formally, the idea is that consumers at each store as a whole purchase the same mix of products in the cluster in the same percentages and that this mix is the same across stores and time. Under this assumption, the market share distribution for an individual product in the cluster across stores is identical to the market share distribution of the cluster across stores.
  2. Product groups that exhibit economies of scope
     - There exist substantial economies of scope in purchasing, so customers are attracted by the totality of the products offered at the seller's location
     - In this situation,
       - Sellers tend to offer for sale at a single location the entire collection of products, and
       - Customers tend to select sellers more on the basis of their aggregate offerings and less on the offerings of single products
     - Generally, sellers have some flexibility in setting the prices of individual products without being constrained by competition from partial line or single product sellers, provided that the sellers remain competitive within their product offering as a whole

All broadline foodservice distribution

- Separable demand or supply conditions
  - A cluster market would not be appropriate if customers would respond to a price increase of a single product within the cluster by shifting some or all their purchases to partial line or single product sellers
  - Example
    - In *Staples/Office Depot*, the district court accepted an FTC cluster market that included all general office supplies except toner, ink, and BOSS ("beyond office supplies") products[1]
    - The court found that the excluded products were subject to significantly different competitive conditions than the other products in the alleged cluster market and hence properly excluded

[1] *See* FTC v. Staples, Inc., 190 F. Supp. 3d 100, 122-26 (D.D.C. 2016).

Broadline national accounts

2. Within broadline, there is another product market: Broadline distribution to “national” customers
   - Customer characteristics
     - Nationwide distribution network important to these customers
     - Require national contracts and use RFPs to solicit bids
     - Require a single distributor with geographically dispersed distribution centers
     - Looking for price, product, and service consistency across all facilities
     - Require a single technology platform to interface with distributor
   - Customer examples
     - GPOs
     - National restaurant chains
     - National hospitality chains
     - National foodservice management companies

> This is an example of a *targeted customer market*

Broadline national accounts

- Price discrimination/“targeted customers”: The idea
  - Ordinarily, the SSNIP is applied uniformly to all products in the provisional market
  - However, if the market is or can be subject to price discrimination, the agency may apply a discriminatory price increase on sales to—
    1. particular products in a differentiated products market, *or*
    2. particular targeted buyers
  - Relation to the one-product SSNIP test
    - In one-product SSNIP tests, the products in the candidate market are differentiated in product space. This is Case 1 above.
    - In Case 2, however, the products are the same, but the seller can price discriminate among different buyers
      - This is common where products are sold through bidding or auction processes, and the market does not allow for arbitrage
      - Price discrimination among buyers can also occur when different groups of buyers purchase through separate and distinct distribution channels

Broadline national accounts

- Price discrimination/“targeted customers”: The idea
  - Introduced in the 1992 Merger Guidelines

> *Example*: Consider a merger of two string bean producers. Assume that a hypothetical monopolist could not profitably raise prices because of diversion to carrots, so that carrots must be included in the provisional market. Assume further that spinach is a close substitute for carrots but not as close a substitute for string beans, and that a hypothetical monopolist could not profitably implement a SSNIP to both string beans and carrots.
>
> Under the usual pre-1992 approach, spinach would be added to the provisional market. But under the new approach of the 1992 guidelines, if the hypothetical monopolist finds it maximally profitably to raise string bean prices by a SSNIP but carrots by something less than the same SSNIP (to avoid diversion to spinach), string beans and carrots would be a relevant market.[1]

  - Implications
    - Price discrimination can narrow a market considerably
    - In some years, the FTC aggressively used price discrimination to narrow markets even when there were no historical occurrences of price discrimination

[1] Janusz A. Ordover & Robert D. Willig, *Economics and the 1992 Merger Guidelines: A Brief Survey*, 8 Rev. Indus. Org. 139, 140-41 (1993).

Defendants' position

- *As to broadline distribution generally*: Customers purchase from all channels from national, regional, and local distribution companies—cannot slice and dice market into "broadline" only
  - Examples of other market participants in food distribution:
    - Systems distributors
    - Specialty distributors
    - Cash-and-carry and club stores
- *As to national customers*: Can purchase more regionally or locally, or consortia will form, to protect these customers

Relevant markets

- Why does product market definition matter?

	Combined	Delta	Post HHI
FTC's national broadline market	59%	1500	3809
FTC's local broadline market	63.7% - 90.3%	1410 – over 4000	
Defendants' national market	25%		
Defendants' local market	?? (but small)		

Court

- Accepted: Broadline distribution as a product market
  - *Brown Shoe* "practical indicia" supports FTC's definition
    1. Product breadth and diversity
       - "One-stop shop" for almost any type of customer
       - Number of SKUs carried by other types of distributors pale
       - Offer private label products
       - Customers may buy from other types of distributors on a limited basis
    2. Distinct facilities and operations
       - Massive distribution centers
       - Large sales forces
       - Run channel as a separate business
    3. Delivery
       - Timely and reliable delivery critical
       - Broadline has sufficient fleet of service vehicles to offer frequent and flexible delivery schedules to meet customer needs
       - Including next-day delivery

Court

- Accepted: Broadline distribution as a product market
  - *Brown Shoe* “practical indicia” supports FTC’s definition
    4. Customer service and value-added services
       - For example, offer menu and nutrition-meal planning services
       - Food safety training for customers at distribution centers
    5. Distinct customers
       - Serve a wide range of customers that other channels cannot reach (so what?)
    6. Distinct pricing
       - Typically price only against other broadline distributors
       - Not against higher-priced specialty or lower-priced cash-and-carry
    7. Industry or public recognition
       - Recognizes broadline as a distinct channel

NB: the Court did not strictly look at the specific indicia listed in *Brown Shoe*, but considered any qualitative evidence probative of cross-elasticity

Court

- Accepted: Broadline distribution as a product market
  - Hypothetical monopolist test supports FTC's definition
    - Used aggregate diversion ratio implementation
      - Margin > 10% (using 10% as a lower bound is conservative since it gives a higher critical recapture rate than would the actual margins)
      - SSNIP = 10%
      - Critical recapture formula:

$$R_{Critical} = \frac{\delta}{\delta + m} = \frac{10}{10 + 10} = 0.50 = 50\%$$

    - Data for actual recapture rates
      - For each company, built a tracking database that showed, for each bidding opportunity, the incumbent distributor, the winning distributor, and the competing bidders
      - *Sysco*: Lost 70% of the bids to another broadline distributor as opposed to another type of food distributor
      - *USF*: Over 70% to another broadline distributor
    - Since R_i > 70% for both Sysco and US Foods → $R_i > R_{critical}$ and so broadline distribution is a product market
    - Rejected defendants' challenges to data and application
    - BUT agreed that the flaws in the data reduced the probative value of the test but still corroborative of the result from other evidence

Court

- Accepted: Broadline distribution as a product market
  - Hypothetical monopolist test supports FTC's definition
    - WDC: Some questions you should be asking:
      - The FTC's expert used the formula for a uniform SSNIP recapture test. Is this the correct formula to use?
      - Does the data used to estimate recapture rates suggest a one-product SSNIP or a uniform SSNIP?
      - What would have been the result of the analysis if the FTC's expert assumed that the data estimated one-product SSNIP diversions and used a one-product SSNIP critical recapture formula?
    - The FTC's expert used a *sufficiency test* here. See the appendix for one-product SSNIP critical recapture sufficiency tests

Court

- Accepted: Broadline distribution for national customers
  - *Rule*: A relevant market can be defined by a group of customers if they can be targeted for a price increase (citing the HMG § 4.1.4)
    - Here, national customers can be readily identified
    - Given the nature of the product, there is no arbitrage along purchasers
  - Market supported by *Brown Shoe* "practical indicia"
    - Industry and public recognition of distinct customer needs
      - Regional broadliners have formed cooperatives to bid for national customers (formed specifically to compete again Sysco and US Foods)
      - McKinsey report (done for Sysco) and other industry research studies support national customers as a distinct customer group with distinct requirements
      - Industry trade group (International food Distributors Association) recognizes the distinction
      - Defendants' ordinary course of business documents support distinction
      - PROBABLY KEY: National customers testified that they would not switch to channels to substitute for a broadline supplier
  - Aggregate diversion analysis corroborates the market
    - Analysis identical as in broadline generally
    - EXCEPT look to recapture only by broadline companies with a national footprint

Court

- Accepted: Broadline distribution for national customers
  - Rejects defendants' arguments
    - The distinction between national and local is not arbitrary: reflects a preference by national customers for which they are willing to pay
    - National customers are identifiable—contracts are individually negotiated
      - No arbitration of products, so national customers can be charged different prices
    - Sysco and US Foods earn higher margins on sales to local customers than from sales to national customers, indicating that national customers can constrain the prices
      - *Court*: Customer testimony indicates that the lower margins more likely result from national customers playing Sysco and US Foods off each other

This brings us to—

- The *auction unilateral effects*
- The *power buyer defense*

Auction unilateral effects

- The idea
  - Consider a situation where—
    - Purchases are large, "lumpy," and winner-take-all
      - Say, multiyear requirements supply contracts
    - There a two or more competing suppliers for the purchase
    - The suppliers have different costs to supply the customer
  - The theory predicts that—
    - The customer can "play the customers off one another" to obtain the lowest price
    - The winner of the auction will be the lowest-cost supplier
    - The price the winner will pay will be just below the cost of the second lowest-cost supplier[1]

[1] The idea of a second cost auction equilibrium is closely related to a "second price auction" mechanism. In a second price (Vickery) auction, bidders for a supply contract submit sealed bids. The bidder who submits the lowest bid is awarded the contract but at the price bid by the second-lowest bidder. The second cost auction describes a bidding market equilibrium. The bids need not be sealed, and lowest bidder charges its own bid price. But the equilibrium in our model, at least where information is reasonably complete, is that the wining bidder is the bidder with the lowest cost to supply the contract and that bidder bids a price just below the cost of the second lowest-cost bidder.

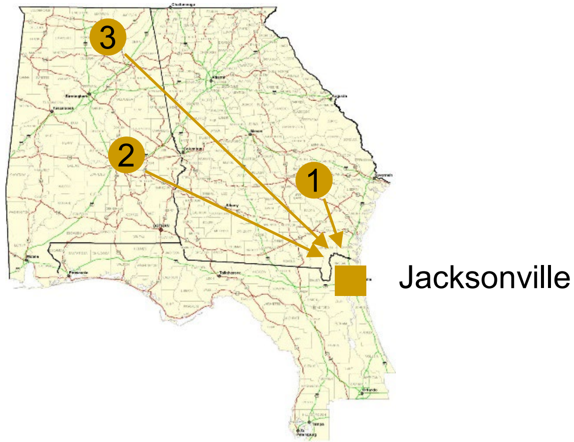
I could also (perhaps more accurately) described this as an "English auction." An English auction for a supply contract is an open-outcry descending dynamic auction. The auctioneer announces some reserve price and bidders openly bid against each other until no more bids are forthcoming. The bids will be bid down until the second-lowest cost bidder drops out because the bid price is at its cost. The lowest-cost bidder then wins the contract at a bid just below the second-lowest bidder's cost.

Auction unilateral effects

- As a theory of anticompetitive harm
  - The theory predicts a unilateral price increase from the merger if—
    1. The merger involves the first and second lowest-cost suppliers to one or more customers
    2. The customers can be targeted for price discrimination
    3. The third lowest-cost supplier has costs to supply the customer that are (materially) higher than the second-lowest supplier
    4. There are barriers to entry/expansion/repositioning that will impede a supplier postmerger from achieving the cost structure of the second lowest-cost supplier

Auction unilateral effects

- Example
  - The City of Jacksonville seeks lime for its municipal water treatment facility
    - The RFP requests a price for lime delivered to the Jacksonville facility
  - Lime is mined and processed at a lime quarry and shipped to the customers
  - The cost of extracting and processing the lime is essentially the same for all suppliers, but shipping costs differ depending on the distance



  - Predicted results:
    - Supplier 1 (the closest lime quarry) will win the contract at a price just below the delivered cost of supply of Supplier 2 (the second-closest quarry)
    - If Supplier 1 and Supplier 2 merge, the price will increase to just below the delivered cost of Supplier 3 (the third lowest-cost quarry)

Auction unilateral effects

- Numerical example

Firm	Cost of production	Transportation	Delivered Cost
1	52	5	57
2	49	12	61
3	50	15	65

  - Predicted results:
    - Firm 1 will win the contract at a price of 60
    - If Firms 1 and 2 merge, the combined firm will win the contract at a price of 64
      - The merger is anticompetitive under an auction unilateral theory of harm
  - A variation
    - If Firm 3 had a delivered cost of 61, the combined firm would win the contract at a price of 60
      - The merger would not be anticompetitive under this theory
  - How can a customer protect itself? Two possibilities (both unlikely to happen)—
    1. The customer induces de novo entry by contracting with another firm to open a quarry and supply the customer's requirements at a price of 60
       - The customer has to purchase from the new entrant, or else the new entrant will not enter
       - The price has to be the premerger price of 60, or else there would be an anticompetitive effect
       - Ideally, the new entrant must be able to supply the customer's entire requirements, or else the residual would be provided by the combined firm at a price higher than 60 (which would not completely negate the anticompetitive effect)
    2. The customer vertically integrates into lime production and supplies itself

Auction unilateral effects

- Important note 1: Definition of "cost"
  - "Cost" here is defined to be the lowest price at which the supplier would be willing to supply the customer
  - Includes, for example—
    - All variable costs of production
    - The cost of transportation (if the product is to be supplied at "delivered cost')
      - An alternative is F.O.B. ("free on board")—product is loaded on the truck or railcar at the supplier's plant, and the buyer pays freight charges
    - A sufficient return on capital to cover fixed costs (including recurring fixed costs)
    - The opportunity cost of the supplier
      - *Example*: Say a supplier has the capacity to supply only one additional customer. The supplier could make a profit of $1 million if it supplies Customer A. The supplier will lose this profit if it chooses instead to supply Customer B. Accordingly, the supplier's cost to supply Customer B will include the opportunity cost of $1 million.

Auction unilateral effects

- Important note 2: Quantifying cost differences
  - In establishing a prima facie case of anticompetitive effect, it is not necessary to precisely quantify the differences in costs
    - All that is necessary are qualitatively material cost differences
    - In the lime example, all that would be necessary to show is that—
      - Supplier 3 is located considerably more distant than Supplier 2 from the Jacksonville facility
      - The transportation cost differences between Supplier 2 and Supplier 3 to deliver lime to Jacksonville are economically significant
      - BUT since transportation cost differences are easy to calculate, they are almost always included as part of the evidence
  - Conversely, in a defense, all that is necessary is to show that the cost differences between the second and third lowest-cost suppliers are immaterial
- Important note 3: Evidence
  - Customer testimony re equivalency of suppliers and the postmerger ability—or lack of ability—to play one off the other
  - If there is a history of bidding, cost differences can be inferred from bid differences
  - Quantitative analysis of cost differences

Power buyers defense[1]

- The idea
  - The upward pricing pressure that otherwise would be created by a merger is negated by the ability of buyers to “force” the combined company to charge premerger prices in the postmerger period
- *Key question*: What is the mechanism by which this “forcing” takes place?
  - The agencies will not assume that large and sophisticated buyers can ensure that suppliers will act competitively postmerger
  - The parties bear the burden of production of evidence of a mechanism that would be sufficient to negate the upward pricing pressure that the merger otherwise would have
    - The defense often fails for the failure of the defense to adequately explain the “forcing” mechanism

[1] *See* U.S. Dep’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 8 (rev. 2010).

Power buyers defense

- Three important caveats:
  1. The standard bargaining models used by the agencies predict that buyers, no matter how large or sophisticated they are, will not be able to negate the entirety of a postmerger price increase if the merger increases the combined firm's market power
  2. Even if some buyers could protect themselves from a price increase in the wake of an otherwise anticompetitive merger, other buyers may not be able to do so, and the merger will be anticompetitive with respect to these other (targeted) buyers
  3. Power buyer defenses work best, if they work at all, against postmerger price increases or output reductions
     - Other types of anticompetitive effects, especially a reduction in the rate of innovation or product improvement, are much more difficult to negate
       - The buyer may not perceive a reduction postmerger
       - Even if the buyer does perceive a reduction postmerger, it may not be able to trace the reduction to an anticompetitive effect from the merger (as opposed to other, nonreaddressable causes)
       - While it is easy (in principle) to direct a seller to maintain premerger prices and other terms postmerger, it is much more difficult to direct the merged firm "to continue to innovative at premerger rates" even if the buyer has significant buyer power

Power buyers defense

- Guidelines' example of an unsuccessful defense:

> *Example 22*: Customer C has been able to negotiate lower pre-merger prices than other customers by threatening to shift its large volume of purchases from one merging firm to the other. No other suppliers are as well placed to meet Customer C's needs for volume and reliability. The merger is likely to harm Customer C. In this situation, the Agencies could identify a price discrimination market consisting of Customer C and similarly placed customers. The merger threatens to end previous price discrimination in their favor.[1]

- This is an auction unilateral effects scenario where—
  - The merging parties have the lowest and second-lowest costs of supplying the buyer
  - The third lowest-cost supplier has higher costs than the second-lowest supplier
- Here, auction unilateral effects model would predict that the buyer's price would increase to just below the third lowest-cost supplier

[1] *See* U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 8 (rev. 2010).

The District Court Opinion
1. The Prima Facie Case
B. The Geographic Markets

Geographic markets

- FTC allegations:
  - National for broadline distribution to national customers
  - Local for broadline generally
- Court: Legal standard
  - "[T]he area in which the goods or services at issue are marketed to a significant degree by the acquired firm" (*Marine Bancorp.*)
  - "[W]here, within the area of competitive overlap, the effect of the merger on competition will be direct and immediate" (*PNB*)
  - The Supreme Court has recognized that an "element of 'fuzziness would seem inherent in any attempt to delineate the relevant geographical market,' " and therefore "such markets need not—indeed cannot—be defined with scientific precision." (*Connecticut National Bank*)
  - WDC: Could have added that the Merger Guidelines give a more precise standard using the hypothetical monopolist test
    - Note: The geographic dimensions of the candidate market are required for every application of the hypothetical monopolist test (implicit in the need to know the identity of every firm in the candidate market)

National broadline market for national accounts

- Court accepts national broadline market for national customers:
  - Defendants plan on a national level and have “national account” teams dedicated to national customers
  - Their contractual pricing and service terms with national customers apply across regions
  - Their competition for national customers is largely other broadliners with nationwide coverage
  - “Although the physical act of delivering food products occurs locally, for national customers the relevant geographic area for competitive alternatives is nationwide”—given how they are:
    - Marketed
    - Sold
    - Priced
    - Serviced
  - These are essentially the same factors that established the national customer product market—No further analysis

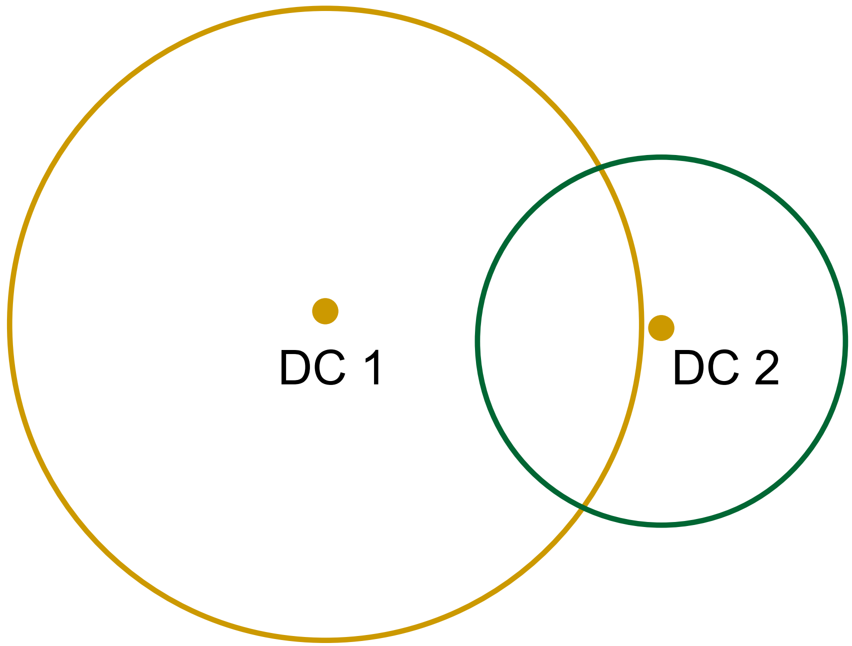
Local broadline markets

- FTC's overlap diagrams
  - *Step 1*: For each distribution center, determine the radius in which the distribution center draws 75% of its revenues ("draw areas")
  - *Step 2*: Determine the "overlap areas"—these customers will have one less alternative supplier as a result of the merger
  - *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)
  - The relevant geographic market is defined by the area encompassing the competitive distributors
    - Aggregate market sales are the total sales made into the relevant geographic market
    - A firm's market share is its sales into the relevant market as a percentage of aggregate market sales

This model applies when suppliers travel to customers and can price discriminate (charge different prices) to customers for the same product or service

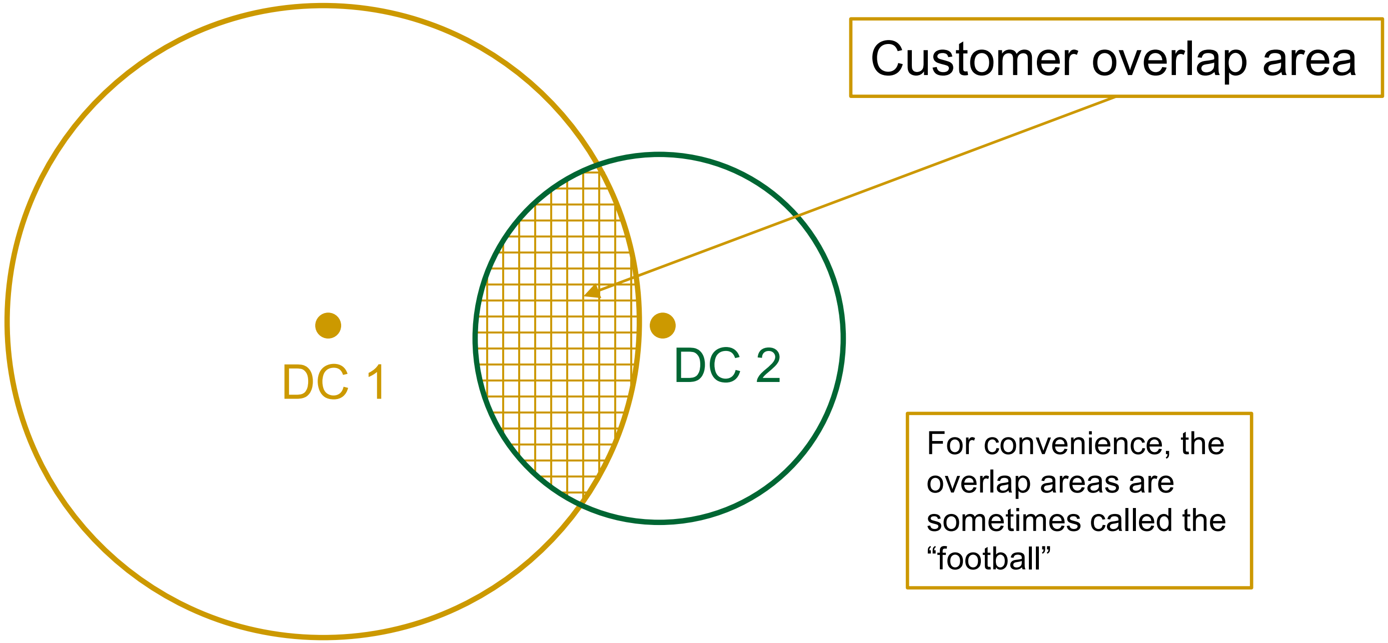
Local broadline markets

- *Step 1*: For each distribution center, determine the radius in which the distribution center draws 75% of its revenues ("draw areas")



Local broadline markets

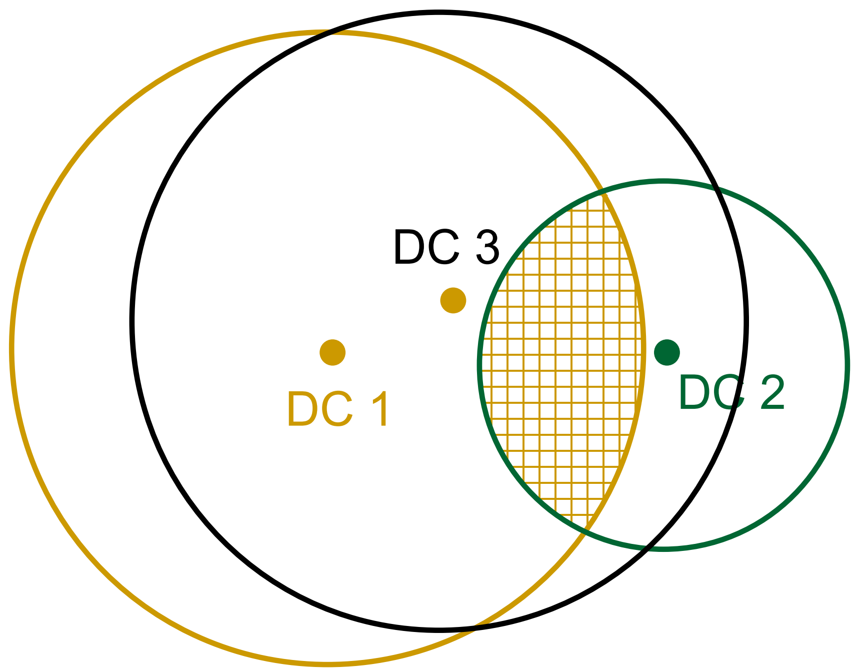
- *Step 2*: Determine the "overlap areas"—these customers will have one less alternative supplier as a result of the merger



NB: The price discrimination condition is critical in this model. It allows a firm to charge higher prices in the overlap area than in the remainder of the firm's service area. If the firm could not price discriminate—as might be the case if customers travel to the supplier's location (e.g., the typical retail situation)—then to increase prices to customers in the overlap area, the firm would have to increase prices to all its customers.

Local broadline markets

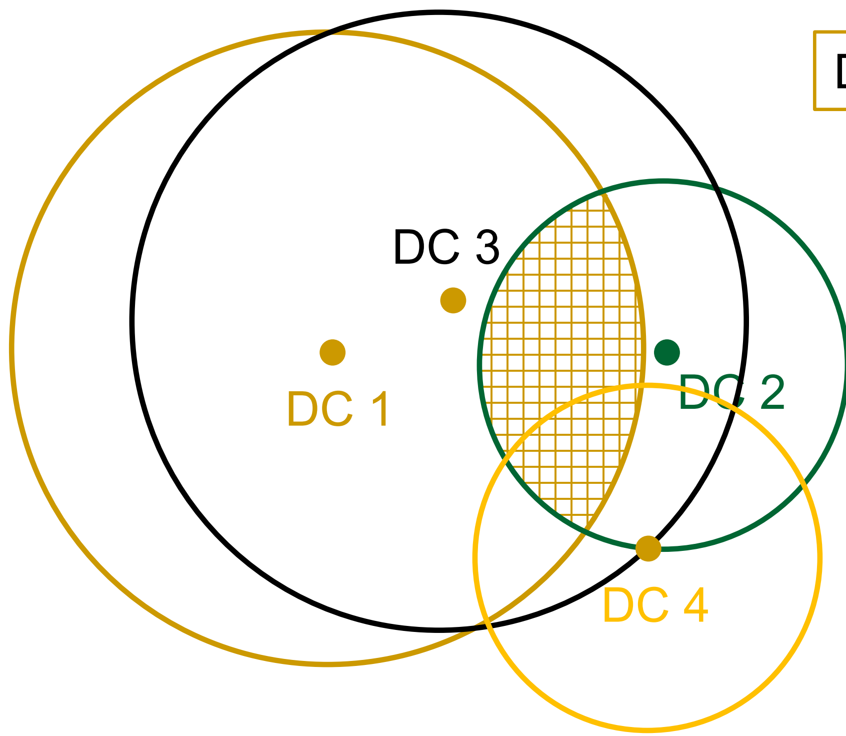
- *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)



DC 3 is in the market

Local broadline markets

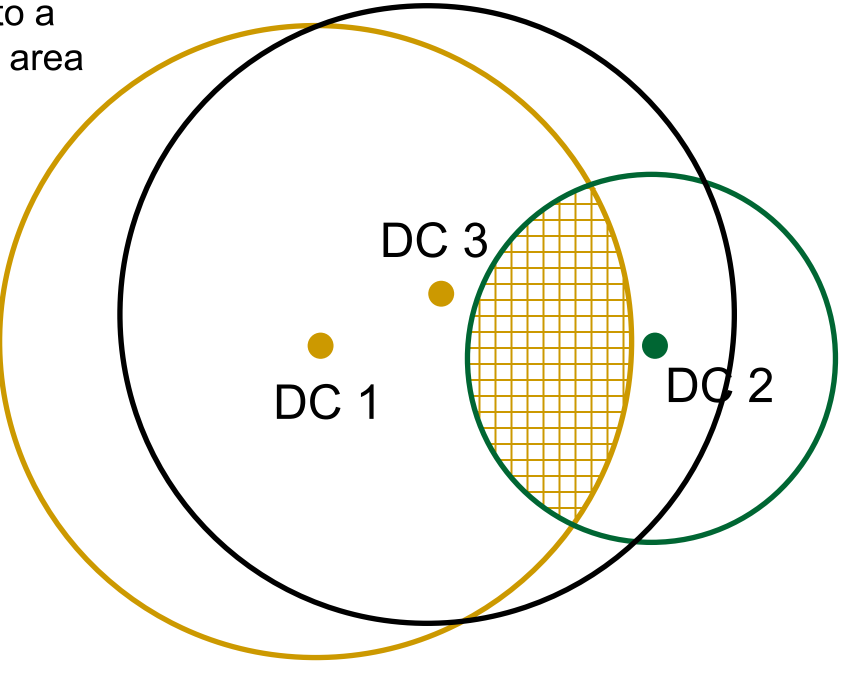
- *Step 3*: Identify the broadline distributors who could compete for the overlap customers (using the distributor's 75% draw radius)



DC 4 is not in the market

Local broadline markets

- So what is the relevant geographic market?
  - In principle, it should just include distributors to the extent they serve customers in the overlap area (i.e., their sales only in the overlap area)
    - That is, the geographic market should be defined by customer location
  - If the data does not permit this isolation, it could be the union of the three draw areas
    - Should still yield good results if suppliers will rapidly shift sales in response to a price increase in part of their sales area



Local broadline markets

- Defendants’ response
  - Markets too small
    - Some suppliers will ship into the overlap area even though it is outside their defined draw area
    - By construction, 25% of a supplier’s shipments will be outside its defined draw area
- Court
  - True, but the FTC’s approach is a practical one that identifies areas that are likely to be competitively affected
  - KEY: Also, no indication in the opinion that expanding markets to meet defendants’ criticism would have materially changed the results

Practice note: This is typical of courts’ reaction. If the merging parties are going to argue that the FTC’s market definition is wrong, to be persuasive they should prove an alternative market and show that within that market the merger will not have the requisite anticompetitive effect. Courts are generally not to persuaded by pure “failure of proof” arguments on market definition.

The District Court Opinion

1. The Prima Facie Case

C. The *PNB* Presumption

National broadline market for national accounts

- FTC's market shares

Table 18

Shares of Sales to National Broadline Customers, After Accounting for the Proposed Divestiture

	Post-Divestiture Shares	Post-Divestiture HHI's	
	Combined Share	HHI	Δ HHI
Baseline	71%	5,119	1,966
(i) National	68%	4,935	1,953
(ii) National + Imputed National	65%	4,549	1,799
(iii) National + Regional	66%	4,614	1,822
(iv) National + Systems	62%	4,217	1,643
(v) National + Regional + Systems	61%	4,087	1,590
(vi) Parties' Ratio of National	59%	3,809	1,500

- Defendants' position
  - Contested methodology and inputs
  - But offered no alternative calculations that showed that the *PNB* presumption was not triggered

National broadline market for national accounts

- Court:
  - "None of these arguments ultimately persuade the court that Dr. Israel's methodology or his market shares and HHI calculations are unreliable. The FTC need not present market shares and HHI estimates with the precision of a NASA scientist. The 'closest available approximation' often will do."[1]
  - Last method was most persuasive:
    - Assumed that all 16 of the top broadliners had the same national-local sales ratio as defendants did.
    - Produced a combined share of 59%, Delta of 1500, and post-HHI of 3809
    - Three times the delta in *Heinz*, which the DC Circuit found sufficient by a "wide margin"
    - Also consistent with estimates suggested by business data
      - Sysco & USF largest customers alone account for more than half of total national broadline sales of $28-$30 billion
      - Also, smaller broadline distributors likely to have a smaller national/local sales ratio than Sysco and USF, which would overestimate the numerator and underestimate the combined firm's share
    - Consistent with only independent market analysis (Technomic)
  - COURT: *PNB* presumption established in national broadline market

[1] Dr. Mark Israel was the FTC's economic expert.

Local broadline markets

- Merger challenged in 32 local markets
- Israel's estimates
  - Metrics
    - Square footage of distribution centers
    - Local broadline sales
    - Number of sales representatives

	Combined	Delta	Post HHI
Local broadline markets (32)	63.7% - 90.3%	1410 – over 4000	

Local broadline markets

- Israel's estimates

Table 21

Examples of Areas with Large Change in HHI despite Divestitures

CBSA	Post-Merger Combined Share	Delta HHI
Omaha-Council Bluffs, NE-IA	90.3%	1,410
Sacramento--Roseville--Arden-Arcade, CA	88.6%	2,974
Durham-Chapel Hill, NC	75.4%	2,807
Charleston-North Charleston, SC	80.2%	2,947
Birmingham-Hoover, AL	57.5%	1,542
Jackson, MS	66.0%	2,155
Memphis, TN-MS-AR	93.8%	4,123
Columbia, SC	72.8%	2,315
Raleigh, NC	71.3%	2,188
Lynchburg, VA	63.3%	1,588
Rochester, NY	63.7%	1,574

- Defendants
  - Same types of arguments as before—contesting methodology and inputs
  - But no alternative calculations showing that the *PNB* presumption is not applicable
- Court:
  - Numbers not perfect, but good enough to make a prima facie showing in the absence of opposition
  - Defendants' challenges not persuasive → FTC has established its prima facie case

The District Court Opinion

1. The Prima Facie Case

D. Additional Evidence of Anticompetitive Effect

Additional evidence of anticompetitive effect

1. Unilateral effects in the national customer market
2. Merger simulation for the national customer market
3. Unilateral effects in local markets
4. Local event studies on unilateral effects in local markets

Unilateral effects in national customer market

- Basic theory:
  - auction model unilateral effects
    - Lowest bidder pays a price just below the cost of the second lowest bidder
    - Not quite the auction unilateral effects model we examined earlier
    - Here, FTC implicitly assumes that the bids are positively correlated with costs and this correlation will continue postmerger
  - Anticompetitive unilateral effect when the two lowest bidders merge unless the third-lowest bidder is very close to the second lowest
- Sysco and US Foods are usually the first- and second-lowest bidders in bidding for national customer accounts
  - Israel's RFP/bidding study (7 years of data) (classic unilateral effects evidence)
    - Sysco lost to USF 2.5x more than to the next closest competitor
    - USF lost to Sysco 3.5x more than to the next competitor
  - Parties' ordinary course of business documents show that they are each other's closest competitors
  - Testimony from industry participants
  - Independent market research reports
- Court: Credited

Merger simulation for national customer market

- Israel: "Second-price auction model"
  - Price determined by second lowest bidder
  - If #1 and #2 merge, then #3 becomes the second bidder
  - Competitive harm: Difference between prices of #2 and #3
- Evidence
  - Company emails recognizing that—
    - Sysco and U.S. Foods are each other closest competitors, *and*
    - The next closest is a very distant third
  - Quantification of model
    - Using market shares and price-cost margins, estimated annual harm to national customers = $1.4 billion (without divestiture)
      - $900 million w/divestiture to PFG
    - Not clear from opinion what Israel exactly did
- Defendants' criticism—bad data
- *Court*: Recognizes data deficiencies, but the model is robust and consistent with other evidence of anticompetitive effect here

Unilateral effects in local markets

- Ordinary course of business documents
  - Show Sysco and US Foods each other's closest competitors for local customers in jointly served markets
- Testimonial evidence more equivocal (each for particular markets)
  - FTC testimony: Uniquely strong competitors of one another
  - Parties: Other equally strong or stronger competitors for local customers
  - Court: "Because of conflicting local market assessments, the court cannot draw firm conclusions about the competitiveness of the local broadline markets from the testimonial evidence."
- Second price auction analysis
  - Same economic analysis as in the national market
  - But evidence is somewhat more equivocal but still strengthens FTC's prima facie case
- Court overall conclusion:
  - "Though the court finds the evidence of unilateral effects in the local markets to be less convincing than in the national customer market, the evidence nonetheless strengthens the FTC's prima facie case of merger harm."

Local event studies

- Israel:
  - Studied the effects of Sysco's opening of two distribution centers on prices paid by USF customers
    - USF operated distribution centers in the same 75% overlap area
  - Long Island, NY—July 2012
    - Regression analysis showed that entry resulted in a 1.4% decrease in USF's prices
  - Riverside, CA—June 2013
    - 0.6% decline
- Not "clean" studies—Sysco already had centers in these areas
- Israel: Interpreting the results
  - The new Riverside center was close to the existing Sysco center—so presumably price effects of Sysco's presence had already occurred
  - By contrast, the new Long Island center was more distant to the existing Sysco center and served more new business than the Riverside facility, resulting in larger price effects

Local event studies

- Court: Not convincing evidence that the merger would harm local customers
  - Even if the Long Island study is taken at face value, the price effect is much smaller than found in other cases
    - *Staples* (1997): 13% difference in markets where Staples was not competing with another superstore
    - *Whole Foods*: WF dropped prices by 5% when another organic supermarket opened
  - "[T]he absence of convincing price effects evidence is the weakest aspect of the FTC's case"
- WDC: Should FTC have presented local event studies?

Anticompetitive effects: Conclusion

- Court: The FTC has presented a “compelling” prima facie case of anticompetitive effects

> In summary, the FTC has bolstered its prima facie case with additional proof that the merger would harm competition in both the national and local broadline markets. Although the FTC’s case would have been strengthened with more convincing pricing effects evidence [the local event study], the court nevertheless finds that the FTC has presented a compelling prima facie case of anticompetitive effects. *See Baker Hughes*, 908 F.2d at 991 (“The more compelling the prima facie case, the more evidence the defendant must present to rebut it successfully.”). The court now turns to Defendants’ rebuttal arguments.

The District Court Opinion
2. Defendants’ Rebuttal Arguments

Four lines of rebuttal

1. Post-divestiture PFG will replace any competition potentially lost as a result of the merger
2. National customers can protect themselves by dealing more regionally
3. The entry of new competition and the repositioning of existing competitors will keep the industry competitive
4. Customers will benefit from efficiencies arising from the merger

1. The PFG "fix"

- The deal
  - Shortly before the FTC complaint was filed, Sysco entered into an agreement to sell 11 USF distribution centers to PFG
  - In addition, PFG's owner, The Blackstone Group, committed to invest $490 million to develop 7 more centers and increase capacity in 16 of PFG's 24 existing centers

1. The PFG "fix"

- Court: Rejected fix
  - Appears to agree that the merger should be analyzed with PFG "fix" in place
    - Determine the anticompetitive effects of the merger in the absence of the fix
    - Ask if the fix negates the anticompetitive effects
  - Does not doubt—
    - PFG management's experience or commitment
    - Blackstone's financial commitment to PFG
  - BUT PFG will not be as nearly competitive post-fix as USF is premerger:
    - PFG 5-year business plan projects that PFG will have less than ½ of the national broadline sales that USF had at the time of the merger
    - Even assuming PFG will be able to integrate the 11 USF centers effectively into its operation, it will start with only 35 centers—compared to Sysco/USF > 100 centers
      - Prenegotiation PFG internal strategy documents indicated that 35 distribution would not be enough to compete effectively with Sysco and USF (court did not provide details)
      - PFG said the same to the FTC in the vetting process (obviously seeking help from the FTC in obtaining more distribution centers, but this failed)
    - New centers and expansions PFG is planning to build, while perhaps they could plug the gap, will not come online for several years at best
    - PFG lacks experience in offering value-added services to some important segments (e.g., healthcare) that both Sysco and USF have premerger
    - Significant reliance on the merged firm for 3-5 years under Transition Services Agreement (cuts against PF as a strong *independent* competitive force)

2. Protection through regional dealing

- Defense: National customers can protect themselves by dealing more regionally
  - Dealing with a single national distributor is merely a preference
  - National customers often deal with multiple sources of supply
- Court: Rejected defense
  - Multiple sources for some national customers often a one-off phenomenon—they still purchase the bulk of their products from national distributors (61% to 100%)
  - Regionalization is available today, but firms are not moving in that direction—the “clear trend” is to move toward centralization in a single supplier
  - Not merely a customer preference—driven by rational business considerations:
    - Management and supply chain costs increase
      - Multiple points of sales and logistics contact
      - Multiple, different order entry/communications/IT systems
      - Multiple billing systems
    - Consistency in products can suffer (especially in private label)

3. Entry/expansion

- Defense:
  - No technological, legal, or regulatory barriers to entry or expansion
  - New firms will enter, or smaller incumbent firms will expand, in the event of a postmerger price increase and compete prices back down to premerger levels

3. Entry/expansion

- Court: Rejected defense
  - Rule: To be a defense, entry must be—
    1. Timely
    2. Likely, *and*
    3. Sufficient to deter or counteract the anticompetitive effect
  - There exist significant barriers to entry and expansion
    - Broadline extraordinarily capital- and labor-intensive
      - New distribution center: $35 million to build
      - + stock
      - + Delivery trucks (including expensive refrigerated trucks)
      - + People to sell the service, maintain and stock the warehouse, deliver the products, handle the back office
    - Reputation barriers
    - Even if barriers could be overcome, it would take years to enter (especially in the national market)
  - Individual ability and incentive:
    - Incumbent distributors testified that they have no plans to expand to serve national customers—dissuaded by time, costs, and risk
    - If incumbent distributors will not expand, de novo entry is even less likely

4. Efficiencies

- Defense:
  - Merger will result in at least $600 million and as much as $1 billion in annually recurring efficiencies
  - Rigorously derived:
    - Developed over 8 months involving over 100 employees at McKinsey and over 170 Sysco and USF employees

4. Efficiencies

- Court: Rejects defense
  - Adopts Merger Guidelines requirements:
    1. Merger specificity
    2. Verifiability
    3. Timeliness and sufficiency to negate the merger's anticompetitive effects
  - Does not question scale, rigor of analysis, or accuracy of the efficiencies estimate
    - Not questioning verifiability
    - NOT the usual approach of attack—verifiability typically plans heavily in rejecting the defense
  - Rather, finds that defendants failed to make a prima facie case that the efficiencies are merger specific

4. Efficiencies

- Court: Rejects defense
  - *Question*: Have defendants "shown that the projected 'merger-specific' cost savings are substantial enough to overcome the presumption of harm arising from the increase in market concentration and other evidence of anticompetitive harm?"
  - Court: Not persuaded
    - Merger specificity
      - McKinsey was not hired to evaluate merger-specific efficiencies
      - McKinsey witness could not say if any of the efficiencies it identified would have occurred in the absence of the merger
        - Sysco, for example, had some projects going to achieve some of the same types of synergies that McKinsey (e.g., savings from "category management")
      - Hausman (a defense expert) reduced efficiencies number to $490 million but performed no independent analysis of McKinsey's results
      - → Failure of proof on which merging parties bore the burden (*Query*: What burden? Production?)
    - Sufficiency
      - Even crediting Hausman's estimate of $490 million, insufficient to offset the likely gross anticompetitive effect
      - <1% merged company's annual revenue
      - So even assuming 100% was passed on to consumers, even a small increase in price could offset any cost savings
      - → Failure of proof on which merging parties bore the burden (*Query*: What burden? Production?)
  - *WDC*: Note that the court did not rely on Israel's quantification of anticompetitive harm to find that efficiencies were insufficient

The District Court Opinion
3. Determining the Net Anticompetitive Effect

Determining the net anticompetitive effect

- Unnecessary to proceed to step 3 of *Baker Hughes* since the defendants failed to produce sufficient evidence to put the prima facie case in dispute

The District Court Opinion
4. Balancing the Equities

The FTC's alleged equities

1. Public interest in effectively enforcing antitrust laws
2. Public interest in ensuring that the FTC can order effective relief if it succeeds at the merits trial—Would have to confront:
   - Consolidation of Sysco's and USF's distribution centers and infrastructure and possible departure of significant personnel (e.g., management, sales, logistics) would make it difficult to restore both parties to premerger condition, AND
   - Sale of 11 distribution facilities to PF, which presumably could not be rolled back
   - PLUS inevitable disruption to the food service industry caused by a postmerger divestiture

The defendants' alleged equities

- Public interest in allowing customers to have the advantage of the efficiencies of the transaction
  - *Court*: Rejected for failure of proof (in the efficiencies defense)
  - *WDC*: Could add that this factor could at most count the harm from the *delay* in the realization of the efficiencies if the defendants succeeded on the merits
- The public and private harm merger that would result if the merger terminates as a result of an injunction, even if the merger is not anticompetitive
  - Court: This is a "private equity" that does not outweigh the public equities in favor of the preliminary injunction
  - WDC: Could add that the election to terminate the transaction and not defend on the merits was made by the parties and was not compelled

The District Court Opinion
5. Conclusion

Conclusion

- Court:
  - FTC proved a prima facie case of anticompetitive effect in two markets:
    - Broadline distribution to national customers
    - Broadline distribution in local markets
  - Defendants failed to discharge their burden of production on any of their defenses:
    - The PFG "fix"
    - Protection through regional dealing (for national customers)
    - Entry/expansion
    - Efficiencies
  - FTC showed a likelihood of success on the merits at a full trial
  - Equities weighed in favor of entering a permanent injunction
  - Preliminary injunction entered June 23, 2015
- Aftermath
  - Parties terminated the merger agreement on June 29, 2015

OPTIONAL

Appendix
One-Product SSNIP Sufficiency Tests

One-product SSNIP recapture tests

- Sufficiency tests
  - The idea
    - In some situations, the data on prices, diversion ratios, or margins may not be complete
    - Depending on the available data, we may be able to create a test that provides an upper bound $\overline{R}^1_{Critical}$ which is always equal or higher than the actual one-product SSNIP critical recapture ratio
    - Then if—

$$R_1 > \overline{R}^1_{Critical} \left(\geq R^1_{Critical} \right),$$

the one-product SSNIP recapture test for product 1 is satisfied and the candidate market is a relevant market under the hypothetical monopolist test

  - Finding an upper bound for the critical recapture ratio?
    - Recall the one-product SSNIP critical recapture formula:

$$R^1_{Critical} = \frac{\delta p_1}{\$m_{RAve}} \left(= \frac{\$SSNIP_1}{\$m_{RAve}} \right).$$

    - We can find an $\overline{R}^1_{Critical}$ either by making the numerator larger or the denominator smaller
    - Usually we know the price of product 1, so we should know the numerator
    - The key is finding ways to make $\$m_{RAve}$ smaller

One-product SSNIP recapture tests

- Sufficiency tests
  - Two cautions
    - Upper bounds are not unique. As long as we know a number provides an upper bound, the number can be used in a sufficiency test.
    - Because there can be a gap between an upper bound $\overline{R}^1_{Critical}$ and the actual critical ratio, just because the actual recapture ratio is below the upper bound does not mean that the candidate market is not a relevant market
      - All we know is that if the actual recapture ratio is greater than the upper bound, it must be greater than the critical recapture ratio
  - Some sufficiency tests
    - Use the minimum dollar margin $\$m_{min}$ of the "other" products as the denominator:

$$\overline{R}^1_{Critical} = \frac{\$SSNIP_1}{\$m_{\min}}.$$

Probably the most useful sufficiency test

    - When the percentage margins of the other products are all the same, use the minimum price p_{RMin} of the other products:

$$\overline{R}^1_{Crtical} = \frac{\delta}{m_o}\frac{p_1}{p_{RMin}}.$$

    - When the prices of all products in the candidate market are the same, use the minimum margin of the other products:

$$\overline{R}^1_{Critical} = \frac{\delta}{m_{RMin}}.$$

You can derive these sufficiency tests by replacing x_{RAve} with x_{RMin} in any of the formulas in Slide 88

One-product SSNIP recapture tests: Examples

- Example: Single-product SSNIP test (same price, different margins)
  - We can use Corollary 3 when the prices of the products in the candidate market are the same at \$3.00 but the margins differ.
    - Product 2 recaptures 2 units at $\$m_2 = 1.75$
      Product 3 recaptures 5 units at $\$m_3 = 1.05$
  - *Answer*:

But assume all we know is that the dollar margin for all other products is at least \$1.05

The products have the same price but different margins. An upper bound on the one-product SSNIP recapture test in this case is that:

$$\overline{R}^1_{Critical} = \frac{\delta}{m_{RMin}} \left(> \frac{\delta}{m_{RAve}} = R^1_{Critical} \right)$$

δ =	5%
$\$m_{min}$ =	1.05
$\%m_{min}$ =	0.35
$\delta/\%m_{min}$ =	14.29%
R_1 =	70.00%

The actual critical recapture ratio (calculated in Unit 9) was 10.34%

Since $R_1 > \overline{R}^1_{Critical} > R^1_{Critical}$, a 5% SSNIP in product G1 would be profitable and gourmet pizzas are a relevant market under the hypothetical monopolist test