Merger Analysis at the Federal Trade Commission: Two Recent Retail Cases

by

Aileen Thompson[1]

The Federal Trade Commission ("FTC") and the Antitrust Division of the Department of Justice ("DOJ") are responsible for enforcing Section 7 of the Clayton Act. Section 7 prohibits mergers "where the effect ... may be substantially to lessen competition." According to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, parties to a transaction above a certain size must notify the FTC and DOJ of their intentions prior to the consummation of the transaction. One of the agencies will then investigate the proposed transaction to determine if it is likely to enhance the ability of the parties to increase prices or engage in other types of anticompetitive behavior such as reducing quality.

Reduced competition may occur through coordinated effects or unilateral effects. Coordinated effects occur when a merger increases the likelihood that competitors will coordinate - either tacitly or expressly - to raise prices. A merger may enhance the ability to coordinate by reducing the number of independent competitors. This is more likely to occur if the existing number of competitors is already relatively small. Many other factors also affect the ability to coordinate. For example, all other things equal, it is easier for competitors to reach and monitor agreements if the products are relatively homogeneous and the pricing by individual competitors is relatively transparent.

The merged entity may also have a unilateral incentive to increase the price of one or

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[1] The author is a staff economist at the Federal Trade Commission. The views expressed in this paper are those of the author and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner.

more of the products sold by the merging firms if a significant proportion of consumers view the two merging firms as their first and second choices. In the pre-merger equilibrium, firms have chosen their prices to maximize profits, taking into account their perceptions about consumers' willingness to switch to other products. Thus, a firm would not have an incentive to increase its price independently prior to the merger because it has already determined that the benefit of a higher price would be outweighed by the cost of lost sales to competitors. However, if a large enough proportion of the lost sales by one merging firm would be captured by the other merging firm, then a price increase could be profitable after the merger.

An important step in evaluating the likelihood of anticompetitive behavior - either coordinated or unilateral - is to ask the following hypothetical questions. First, if the merging parties were to raise prices for one of more of their products by a small, but significant amount, are consumers likely to switch to other products? If so, to which products are they likely to switch and would this potential switching be large enough to render the price increase unprofitable? To address these questions, antitrust economists rely on various types of evidence, including documents and economic data provided by the merging parties. The two cases discussed below provide examples of how the likely impact of a merger can be predicted by evaluating the current pricing practices of the parties.

In 1997, the FTC successfully challenged the proposed merger of Staples and Office Depot.[2] At the time of the proposed acquisition, Staples and Office Depot were two of the three large office supply superstore chains, the third being Office Max. Office supplies are also sold by many other retailers, including stationary supply stores, mass merchandisers, warehouse club

[2] David Ashmore and Orley Ashenfelter worked with FTC staff on this case, and Orley Ashenfelter testified as an economic expert for the FTC.

stores, and mail order suppliers. Relative to other types of brick and mortar retailers, office supply superstores tend to offer a greater variety of office supplies and lower prices. A key question in the FTC investigation was whether the differences between office supply superstores and other types of retailers were important enough to prevent these other retailers from significantly constraining the pricing of Staples and Office Depot. In other words, would it be profitable for a combined Staples/Office Depot to increase its prices by a small but significant amount after the merger or would it lose too many customers to other retailers?

Documentary evidence suggested that Staples' average prices at the time of the investigation were higher in geographic areas where there were no other office supply superstores than in areas where Staples faced competition from other office supply superstores. For example, Staples was the only office supply superstore in Charlottesville, VA. Approximately 65 miles away, in Fredericksburg, it competed with one other office supply superstore. As illustrated in the sample ads for these two cities (Figure 1), advertised prices in Charlottesville were lower than the advertised prices for identical items in Fredericksburg. Similar price differences were found between other areas with and without competition from other office supply superstores.

If competition from other office supply superstores was causing prices to be lower than prices in areas without such competition, then this evidence would suggest that prices would increase post-merger in areas where competition between Staples and Office Depot would be eliminated. There are other factors, however, that may have affected pricing. For example, it is possible that areas, such as Charlottesville, where Staples and Office Depot competed were also areas where warehouse club stores tended to locate. If this were the case, then the price differences between Charlottesville and Fredericksburg may have been driven, at least in part, by competition from warehouse club stores in Charlottesville. Similarly, price differences among geographic areas may also reflect differences in labor and land costs.

To determine whether the observed pre-merger pricing pattern was attributable to competition from office superstores rather than to other factors that may have affected prices, the FTC performed econometric analysis of prices charged at individual Staples stores for a basket of 7000 individual items. In particular, the FTC estimated the effect of having an Office Depot located in a metropolitan area on Staples' prices in that area while controlling for cost differences and the presence of other competitors.[3] The results of this analysis indicated that Office Depot was a significant constraint on pricing by Staples, even after taking into account the presence of other types of retailers. This suggests that the acquisition of Office Depot by Staples would have likely led to price increases in the areas where the two companies were competing. The econometric estimates predicted that office supply prices would have increased by 8.6% on average as a result of the merger.

In contrast to the Staples/Office Depot case, the FTC approved the acquisition of May Department Stores by Federated Department Stores in 2005. At the time, both Federated and May owned and/or operated conventional department stores. The term, "conventional department stores," generally refers to large stores that offer a wide variety of products of mid-range price and quality.[4] Federated's stores included Macy's and Bloomingdale's stores, and May' stores included Marshall Fields, Filene's, Kaufmann, Hecht's, Strawbridges, Foley's, Famous-Barr and Robinson's-May. As a result of the transaction, Federated now owns a

[3] For a more detailed discussion, see Ashenfelter, Orley, David Ashmore, Jonathon B. Baker, Suzanne Gleason and Daniel S. Hosken, "Empirical Methods in Merger Analysis: Econometric Analysis of Pricing in *FTC v. Staples*," *International Journal of the Economics of Business*, July 2006, 13:2, pp. 265-279 and Ashenfelter, Orley, David Ashmore, Jonathon B. Baker, Suzanne Gleason and Daniel S. Hosken , "Econometric Methods in Staples," *ABA Antitrust Section*, 2004.

substantial share of the conventional department stores in some parts of the country.

Many other types of retailers sell items similar to those sold by conventional department stores, but they each have a somewhat different format. For example, upscale department stores tend to sell higher-priced brands and provide more service than conventional department stores, while discount department stores and mass merchandisers tend to sell lower-priced brands. There are also numerous specialized stores (e.g., The Gap, Linens ‘n Things) that overlap with conventional department stores in particular categories, but do not sell items in other categories. Thus, these specialized stores do not offer the scope for potential one-stop-shopping that conventional department stores offer.

A central question of the FTC’s investigation of this matter was whether these other types of retailers were significant constraints on the pricing by Federated’s and May’s conventional department stores. As in the Staples/Office Depot case, the pre-merger pricing patterns of the merging parties provided important evidence about the likely competitive consequences of the merger. The FTC obtained pricing documents from the merging parties as well as detailed price data for individual items sold at individual Federated Department stores. The FTC did not find any evidence that Federated’s prices were affected by the amount of competition that it faced from other conventional department stores. Instead, Federated set prices that were uniform over very broad geographic regions despite the fact that competition from conventional department stores varied among the metropolitan areas within these regions. For example, Federated owned and/or operated over 90% of the conventional department stores in the New York/New Jersey metropolitan area, yet its prices in this area were the same as its prices throughout much of the Eastern United States where its share of conventional stores was much lower. Similarly, May

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[4] See “Statement of the Commission Concerning Federated Department Stores, Inc./The May Department Stores

had identical prices over broad geographic regions, despite differences in the amount of competition from other conventional department stores within these regions.

This pricing evidence suggests that conventional department stores were not unique constraints on each other's pricing. Thus, it can be inferred that other types of retailers also constrained the prices of Federated and May stores. The merging parties' documents and consumer shopping surveys also indicated that Federated and May competed with a broad range of retailers. The FTC concluded that the acquisition was not likely to lead to anticompetitive price increases or reductions in quality and, therefore, closed the investigation and allowed Federated and May to merge.

Questions for Discussion

1. What are some characteristics of office supply superstores (and the products that they sell) that might explain why Staples was able to charge higher prices in areas where it only competed with non-superstore sellers of office supplies?
2. What are some characteristics of conventional department stores (and the products that they sell) that might explain why other types of retailers are a significant constraint on their prices?
3. Suppose that the average price of groceries is higher in California than in Kansas. Does this indicate that grocery stores face less competition in California than in Kansas?

Company," www.ftc.gov/opa/2005/08/federatedmay.htm.

Comparison of Staples' Prices in Two Virginia Cities

Charlottesville, VA, *The Daily Progress* Feb. 1997
(Two Superstores)

Fredericksburg, VA, *The Free Lance - Star* Feb. 1997
(One Superstore)