

# Proposed Merger Between Staples and Office Depot Leads to Concerns of Higher Prices

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Michael Baye and Patrick Scholten prepared this case to serve as the basis for classroom discussion rather than to represent economic or legal fact. The case is a condensed and slightly modified version of the public copy of the FTC's motion for a temporary restraining order and preliminary injunction against the proposed merger between Staples and Office Depot dated April 10, 1997. No 1:97CV00701.

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## OFFICE SUPPLY SUPERSTORE MARKET

Staples and Office Depot pioneered the office superstore concept within months of each other in 1986. Over the next ten years, they and a number of other firms seized on the same strategy of providing a convenient, reliable and economical source of office supplies for small businesses and individuals with home offices. These firms competed aggressively, developing office superstores as a one-step destination, carrying a full line of consumable office supply items as well as assorted other products. Staples and Office Depot have been immensely successful: today, Staples has almost 500 stores and Office Depot has more than 500 stores nationwide; they compete head-to-head in 42 metropolitan areas across the country. On September 4, 1996, Staples and Office Depot entered into an agreement whereby Staples would acquire the stock and assets of Office Depot for \$4 billion. The merged company would have combined annual sales that exceed \$10 billion. Absent the merger, both companies planned to continue growing for the foreseeable future, and areas of head-to-head competition between the two firms would have increased significantly by the year 2000.

Their success has redefined the retailing of office supplies in the United States, driving thousands of independent stationers out of business and eliminating by acquisition or bankruptcy some rivals who sought to compete in the office superstore market. In the process, they have created a unique competitive arena where these two and the only other surviving office superstore -- OfficeMax -- do battle. This intense competitive rivalry -- particularly between Staples and Office Depot -- has redounded to the benefit of consumers. Each has slashed prices, driven costs down, developed innovative approaches to marketing, distribution and store layout, and expanded into new areas of the country, bringing increasing numbers of consumers the convenience of one-stop shopping at low prices. Office Depot has been the most aggressive and lowest-price competitor, in turn forcing Staples and OfficeMax to compete more aggressively. This merger would end this competitive battle and leave the merged firm free to raise prices significantly.

In evaluating the legality of a merger, the antitrust laws essentially require a prediction as to whether the deal is likely to lead to less competition and, consequently, higher prices for consumers. Usually, that prediction is by necessity based on inferences derived from market concentration levels. Here, the court need not rely on market share

based predictions alone. There is real world direct evidence -- based on the defendants' pricing behavior -- showing that this merger will likely lead to substantially higher prices for consumers. Staples and Office Depot today charge higher prices in those parts of the country where they do not compete against each other and lower prices where they are rivals.

Staples' office supply prices are lowest in cities where all three of the national office superstores (Staples, Office Depot and OfficeMax) compete. Prices are higher in markets where the only other competitor is OfficeMax and higher in those areas of the country where Staples faces no other superstore rival. Similarly, Office Depot -- the low-price competitor -- charges significantly higher prices where it faces little or no superstore competition. As shown in Figure 1, consumers in Orlando (where all three office superstores compete) pay \$17.99 for a box of copy paper at Office Depot, while shoppers in nearby Leesburg, Florida (where Office Depot faces no competition) pay \$24.99 for the same item.

**Figure 1: Comparison of Office Depot's Advertised Prices Cover Page of January 1997 Local Sunday Paper Supplement**

	Orlando,FL (3 firms)	Leesburg, FL (Depot only)	Percent Difference
Copy Paper	\$17.99	\$24.99	39%
Envelopes	2.79	4.79	72%
Binders	1.72	2.99	74%
File Folders	1.95	4.17	114%
Uniball Pens	5.75	7.49	30%

Of course, other retailers sell some office supplies, but none of them offers the one-stop shopping convenience of the office superstores. Most importantly, these retailers do not prevent superstores from charging anticompetitive prices. By contrast, superstores do. In city after city, the level of competition between superstores determines the prices consumers will pay for office supplies.

Staples fully appreciates the significance of superstore competition. As all three superstore chains have expanded, Staples has found itself competing head-to-head in a growing number of markets and facing increasing pressure to cut prices. While neither of those past efforts was successful, it now proposes merging with Office Depot, the low-price leader.

Staples has long recognized Office Depot as its chief competitive threat. Staples' prices and profit margins are lowest in markets where it competes with Office Depot. This merger thus threatens to injure both consumers who benefit from today's rivalry between Staples and Office Depot and those who otherwise would enjoy the future benefits of office superstore competition.

The investment community too sees reduced competition as the inevitable result of this merger. One industry analyst stated that, by merging, "Staples and Office Depot have taken a major step towards avoiding the destructive price competition which would have accompanied approaching market saturation." Another was equally blunt: "The just announced merger of Staples and Office Depot permanently eliminates the lingering fear of intensified competition in three [superstore] markets."

These real world facts paint a clear picture -- this merger will harm consumers. The Commission demonstrates here that the sale of office supplies (sometimes called "consumables") through office superstores offers consumers a unique combination of convenience, selection and price and therefore is the appropriate relevant product market; that the metropolitan areas that are likely to be affected by the proposed acquisition are relevant geographic markets; and that the proposed transaction would combine the only two competitors in many markets and would leave only one other superstore competitor in the others. Even in the absence of direct evidence, anticompetitive effects -- the power to raise prices to consumers -- are presumed where a merger gives a firm such a dominant market position.

### Staples

Staples is the second-largest office superstore chain in the United States. Approximately 52% of Staples' revenues are derived from sales of office supplies; the balance is accounted for from the sale of computers, office furniture and other business related items.

### Office Depot

Office Depot is the largest office superstore chain in the United States. According to Office Depot's 1995 Annual Report, "Office Depot continued to lead the office products industry, remaining first in total number of stores, first in average sales per store, first in average weekly store sales, first in total delivery sales, and most important to our shareholders, first in net earnings." Most importantly, Office Depot is the lowest price competitor among office superstore chains. Office Depot's retail operations mirror those of Staples: it sells a wide range of general office supplies, computers, office furniture and other business related items, and its primary customer base is small businesses and individuals with home offices. Like Staples, Office Depot has grown at a steady and increasing pace since its founding in 1986. Office Depot's total sales for 1996 were approximately \$6.1 billion; 47% of which were accounted for by office supplies.

## **ARGUMENTS AGAINST THE PROPOSED MERGER**

Evidence suggests that the effect of the proposed acquisition "may be substantially to lessen competition or to tend to create a monopoly" in the sale of office supplies sold through office superstores, in violation of Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act. Serious and substantial questions about the legality of the proposed transaction suggest this merger should not be allowed to proceed.

Section 7 of the Clayton Act prohibits any merger or acquisition "where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly." The focus of Section 7 is on arresting anticompetitive mergers "in their incipiency" and thus requires a prediction as to the merger's impact on future competition. In this case, the evidence provides a solid empirical foundation for assessing the likelihood of anticompetitive pricing: office superstores charge the highest prices for office supplies in those markets where they do not face competition from another office superstore, and they charge the lowest prices where they face the two

other superstore competitors. The merger will turn the most competitive triopoly markets into duopolies, and will transform markets where only Staples and Office Depot compete into superstore monopolies.

Defendants understand the anticompetitive potential of the proposed transaction. Indeed, eliminating competition is a primary motivation for the deal.

To show the anticompetitive motive and the likely anticompetitive effects of a transaction requires the determination of (1) the product market in which to assess the transaction; (2) the geographic market in which to assess the transaction; and (3) the transaction's probable effect on competition in the product and geographic markets. In view of Staples' current pricing practices and its clear intent to diminish competition by acquiring its chief rival, it is not surprising that an analysis of the market's structure and characteristics confirms that Staples' acquisition of Office Depot will lead to less competition and higher prices.

### **RELEVANT PRODUCT MARKETS: OFFICE SUPPLIES THROUGH OFFICE SUPERSTORES**

The lawfulness of an acquisition turns on the purchaser's "potential for creating, enhancing, or facilitating the exercise of market power -- the ability of one or more firms to raise prices above competitive levels for a significant period of time." The leading antitrust treatise states that "finding the relevant [product] market and its structure is not a goal in itself but a surrogate for market power." The tools for defining a product market "help evaluate the extent competition constrains market power and are, therefore, indirect measurements of a firm's market power."

Product markets are defined by "the reasonable interchangeability of use or the cross elasticity of demand" between the product itself and possible substitutes for it. The relevant product market "must be drawn narrowly to exclude any other product to which, within reasonable variations in price, only a limited number of buyers will turn . . . ." In other words, if prices go up, will so many consumers switch to substitutes that the price increase becomes unprofitable? If not, those possible substitutes are properly excluded from the relevant market.

A relevant product market is a market where "sellers, if unified by a hypothetical cartel or merger, could raise prices significantly above the competitive level." The 1992 Horizontal Merger Guidelines provide an analytical framework for finding the relevant product market by taking the smallest possible grouping of competing products or distributors, here office superstores, and asking whether a "hypothetical monopolist over that [product or] group of products would profitably impose at least a 'small but significant and non-transitory' [price] increase." United States Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines, (hereinafter "Merger Guidelines") use five percent as the usual approximation of a "small but significant and non-transitory" price increase.<sup>1</sup> The term "profitably impose" simply asks whether, in the face of a price increase,

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<sup>1</sup>Commentators have noted that, for retail markets characterized by high volume of sales but low profit margin per dollar of sales, a hypothetical price increase lower than 5% is appropriate. Harris & Jorde, Market Definition in the Merger Guidelines: Implications for

enough customers will continue to buy from the monopolist to offset any sales lost to other sellers. So long as the additional profit from the price increase exceeds the profits lost from those consumers who turned to substitutes, the price increase would be profitable overall and the particular grouping of products is deemed to be a separate market for antitrust purposes.

In this case, the exercise need not be hypothetical. The defendants' own current pricing practices show that an office superstore monopolist has the ability profitably to raise prices above competitive levels. When Staples, Office Depot and OfficeMax all compete in a city, prices are lowest. In two firm markets where Staples faces only its arch rival Office Depot, it charges slightly higher prices. But where Office Depot is not in the market and just Staples and OfficeMax are present, Staples raises its prices. Where Staples faces no office superstore competition, prices are higher than in three-firm markets. If Staples became a superstore monopolist, it would find it profitable to raise prices by much more than 5%.<sup>2</sup>

This real world application of the Merger Guidelines market definition test demonstrates that the demand cross elasticity between office superstores and other retail sources of office supplies is low: that is, that, even in the face of significantly higher prices, not enough customers consider these other sources to be adequate substitutes for office superstores to force prices down to the competitive levels found in geographic areas where all three superstore chains compete. This evidence that customers do not, and will not, switch in sufficient numbers to other sources of office supply products to defeat an anticompetitive price increase establishes that office superstores constitute a relevant product market.

While other retailers also sell some office supplies, no other type of retail format offers the breadth of product line, inventory on hand, and convenience that office superstore customers require. Indeed, these retailers confirm the defendants' own assessment that superstores offer a unique combination of office products and services.<sup>3</sup>

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Antitrust Enforcement, 71 Calif. L. Rev. 464, 482 (1983) ("In the high volume grocery business . . . net income typically represents 0.5% of sales, so a 5% increase in price would represent a 1000% increase in profit . . . Surely, a sizable number of competitors not now in the market would enter if profits were running at that exorbitant level. Just as surely, the managers of any recently merged grocery firm would know better than to try to raise prices by 5% across the board.") Here, as we will show, the office superstore market is supported by even a 5% test.

<sup>2</sup>"There are no other office supply retailers that offer such a broad array of office supply merchandise at comparably low prices."); " . . . the only competitors to office superstores are the other office superstores").

<sup>3</sup>[ . . . ] (warehouse clubs stores offer very limited line of office supplies compared to superstores);[ . . . ] (office superstores offer much wider breadth of product compared to [ . . . ] does not offer full range of items, variety, convenience, and focus on office supplies as do the superstores);[ . . . ] has different customers, lacks breadth of product of office superstores); [ . . . ] product line not competitive with office superstores on general consumable office supply items); [ . . . ] office supply line too limited to attract broader customer base of office superstores); [ . . . ] office supply offering is limited and does not attract superstore customers); [ . . . ] limited offering of office supplies as a convenience, not as a destination point for office supplies customers); [ . . . ] buying group of 200

Courts recognize that such a "cluster" of products and services may be a relevant product market, based on the benefit to consumers accruing from the convenience of purchasing complementary products from a single supplier. Supermarkets and commercial banking services (providing a combination of checking, savings and loan services) are but two examples.

Staples and Office Depot have argued that a relevant market of office superstores fails to account for office supplies sold by these other retailers. This argument misses the point. The mere fact that two different classes of retail vendors both sell a particular type of merchandise does not mean that they are in the same product market.

The proper focus in product market definition is not on whether other retailers have anything in common with office superstores, but whether a sufficient number of consumers would defect to these alternatives to make a small but significant price increase unprofitable. Here the real world evidence tells the story. Despite the fact that there are other retailers such as Wal-Mart, Target, Sam's Club, Kmart, Best Buy and Computer City in towns and cities such as Fredericksburg, VA, Lynchburg, VA, New Orleans, LA, Portland, ME, Buffalo, NY, Leesburg, FL, Reading, PA, and Jacksonville, FL, where there are no competing office superstores, the office superstore monopolist (be it Staples, Office Depot or OfficeMax) is still able to raise prices above levels in cities where there is superstore competition. Statistical analysis of these price differences by a leading economist confirms that the presence or absence of superstore competition -- not competition from other retailers -- explains these price differences. Because office superstores offer a unique combination of price, convenience and product offerings, not enough customers switch to other retailers to defeat anticompetitive pricing.

Documents from Staples and Office Depot provide powerful evidence in support of a separate product market. Both Staples and Office Depot reveal that significant price differences between geographic areas are based primarily on the level of office superstore competition. Although the companies will point to occasions where they changed price in response to someone else, other retailers do not pose a competitive constraint in any way comparable to office superstores.

Even if the market were broadened to include other office supply retailers that exhibit some limited competitive interplay with superstores, the basic analysis would not change. The ultimate question is not the precise boundaries of the market, but whether the merger is likely to have an adverse impact on competition. If the market is defined broadly, the fact remains that the office superstores within that broad market interact principally with each other. It has been found that "submarkets" -- i.e., narrower relevant markets within broader markets, based on factors such as industry perception or the existence of different channels of distribution that demonstrate a special competitive interaction between some firms or product in the market. As shown above, industry perception, the pricing practices of office superstores, the significant differences between office superstores and other channels of

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independents: other retailers, including independents, are not "realistic alternatives for consumers who shop at the superstores"); [ . . . ] Sworn statements similarly show that mail order and contract stationers cannot constrain the pricing of the superstores. [ . . . ] (mail order has higher prices, does not compete with office superstores); [ . . . ] (mail order and contract business is different from retail operations).

distribution and the parties' own documents provide direct and substantial proof that, even within a broader market, office superstores constitute significant and unique competition for one another.

### **RELEVANT GEOGRAPHIC MARKETS: METROPOLITAN AREAS WHERE STAPLES AND OFFICE DEPOT COMPETE**

In this case, the relevant markets include 42 metropolitan areas where both Staples and Office Depot operate office superstores and the numerous metropolitan areas throughout the country where -- but for this merger -- Staples and Office Depot had planned to be competitors in the near future.

The focus in defining relevant geographic markets is to determine which areas of the country would be affected adversely by an acquisition. The relevant geographic market must "correspond with the commercial realities of the industry . . . ." Relevant geographic markets may be as large as the nation or the world, or as small as a metropolitan area or neighborhood. For all products and industries, the test for assessing the commercial realities is a practical one: can producers within certain geographic boundaries increase prices without triggering an outflow of customers to producers in other areas so as to make the price increase unprofitable overall?

The fact that office superstores actually price higher in metropolitan areas where they face no office superstore competition demonstrates that they can charge supracompetitive prices without causing customers to travel elsewhere for office supplies. They advertise primarily on a local basis, and advertised prices vary dramatically from city to city. The business realities, therefore, demonstrate that metropolitan areas are relevant geographic markets for the purposes of assessing the merger's likely impact on competition.

The geographic markets impacted by the proposed transaction include many of the most populous cities in the United States, across eighteen states and the District of Columbia. In 15 markets, the proposed merger will result in an office superstore monopoly. In another 27 metropolitan areas, the number of superstore competitors will be reduced from three to two. Finally, the merger eliminates future competition in many additional metropolitan areas, including four where Office Depot and Staples planned or had planned to compete with one another in the next few months.

### **EVIDENCE ILLUSTRATING THAT THE ACQUISITION MAY LESSEN COMPETITION**

After the relevant product and geographic markets are established, the next step of the inquiry under Section 7 is evaluating the impact of the acquisition on competition: that is, determining whether the proposed merger may hurt consumers by facilitating anticompetitive pricing in these markets. To aid in this predictive determination, courts look first at market concentration and the increase in market concentration created by the transaction, then examine such other factors as the nature of competition between the merging firms, other market participants, and barriers to entry. The task of predicting the competitive impact of the Staples/Office Depot merger is simplified in this case. Since prices are significantly lower

where Office Depot and Staples compete, eliminating their head-to-head competition will free the parties to charge higher prices.

### Significantly Increased Concentration

Mergers that significantly increase market concentration are presumptively unlawful because the fewer the competitors and the bigger the respective market shares, the greater the likelihood that a single firm, or a group of firms, could raise prices above competitive levels. Market concentration may be measured by determining the market shares of industry leaders or by calculating the Herfindahl-Hirshman Index ("HHI").

The combined shares of Staples and Office Depot in the office superstore market would be 100% in 15 metropolitan areas. In 27 other metropolitan areas, the post-merger market shares range from 45% to 94%, with HHIs ranging from 5,003 to 9,049. These percentages are far in excess of the levels raising a presumption of illegality.

Even were a market defined to include the other retailers of office supplies who both Staples and Office Depot contend compete at least to some degree with office superstores, the combined market share of the defendants raises competitive concern.<sup>4</sup> Concentration is high and would increase significantly because of the merger. In the 42 geographic areas where Staples and Office Depot today compete, the post-merger HHI's average over 3,000, ranging from approximately 1,800 to over 5,000. Increases in HHI's are, on average, over 800 points; ranging from 162 to over 2,000.

### Merger will Lead to Higher Prices

Market shares are not the only concern about the proposed merger. Other evidence shows that, by eliminating Staples' most significant, and in many markets, only rival, this merger will allow Staples to increase prices. Office Depot is and has been the industry maverick, leading prices and costs down (Depot acknowledges its maverick status). Over the years, Office Depot's innovative approaches to office supply retailing -- such as low-price guarantees and high-volume "mega stores". Staples fears Office Depot's innovated approach, and explain why Staples seeks to acquire Office Depot. It has been recognized that the elimination of a particularly aggressive competitor in a highly concentrated market increases the risk that prices will rise after the merger.

Even were a market defined to include other retailers, superstores offer a distinct combination of convenience, product offering and price that differs significantly from other sellers of office supplies. This means that, for consumers, office superstores are particularly close substitutes for each other. The Merger Guidelines describe the potential anticompetitive effects of a merger of two rivals who are closer competitors than most others in the market:

A merger between firms in a market for differentiated products  
[and services] may diminish competition by enabling the

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<sup>4</sup>The firms include: Wal\_Mart, Kmart, Target, Sam's Club, BJ's Warehouse Clubs, Price/Costco, Best Buy, Computer City, and CompUSA. It also includes estimated sales of office supplies by independent stationers in each city.

merged firm to profit by unilaterally raising the price of one or both products above the premerger level. Some of the sales loss due to the price rise merely will be diverted to . . . the merger partner and, depending on relative margins, capturing such sales loss through the merger may make the price increase profitable even though it would not have been profitable premerger . . . . The price rise will be greater the closer substitutes are the products of the merging firms, i.e., the more the buyers of one product consider the other product to be their next choice.

The similarities between Staples and Office Depot and the intense nature of their rivalry are reflected in the pricing behavior of the two firms. Each prices low where the other is present and higher where they are not head-to-head competitors. Indeed, investment analysts view the elimination of close competition between Staples and Office Depot as a "benefit" to this merger. Wall Street recognizes that, if this deal is approved, Staples will do what it has done consistently in the past -- maximize prices wherever it faces reduced superstore competition.

Without competition from Office Depot, Staples evidently concluded that neither OfficeMax nor any other retailer would force it to decrease prices. The elimination of this unique competitive relationship between Staples and Office Depot is what makes the merger so pernicious. If allowed, Staples will acquire significant additional power over price and consumers will be forced to pay millions of dollars in higher prices. In 15 cities Staples will have a post merger monopoly and be free to charge consumers the same high prices it charges today in markets where it faces no office superstore competition. This means prices will rise in those 15 cities alone. In the 27 markets where the merger reduces the superstore presence from 3 to 2, Staples' current pricing demonstrates that the reduction in competition will allow it to increase prices to consumers in those cities.<sup>5</sup> Using Staples' current pricing in one-, two- and three-firm markets as a guide, the merger exposes consumers to substantial annual price increases in cities where Staples and Office Depot compete.

#### Elimination of Future Competition Between Staples and Office Depot

The merger of Staples and Office Depot also threatens to eliminate future competition in the many cities where the two firms had planned to open new stores. Before this merger, Staples and Office Depot were systematically expanding the competitive battlefield, moving into each other's markets, providing consumers with the benefits of heightened competition.

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<sup>5</sup>For example, consumers in Columbus, Ohio (where Staples and OfficeMax compete) pay approximately higher prices for office supplies than in nearby Cincinnati (where Office Depot is present as well). Similarly, consumers in two-superstore Charlotte, North Carolina pay higher prices for office supplies than consumers in nearby Greensboro, a three-superstore market. An outside analyst, Prudential Securities, found the same result on its own: it undertook a similar analysis in March, 1996 and found prices in Totowa, New Jersey, a three-player market, approximately 5% lower than prices in nearby Paramus, a two-player market. In all three instances, the one common characteristic of the markets with the higher prices -- Columbus, Charlotte, and Paramus -- is the absence of competition between Staples and Office Depot.

Recent estimates prepared for Staples and Office Depot showed both companies opening several new stores by the year 2000. Without the merger, Office Depot had planned to become the third superstore chain in Bergen County, NJ; Fayetteville, NC; and Albany, Schenectady, Troy, NY and had planned to become the second superstore chain in Fredericksburg, VA. This merger thus eliminates planned additional competition that would have driven prices down in many more areas.

Given that the superstore market is highly concentrated, the loss of this actual potential competition by the only chains uniquely situated to enter, and with actual plans to enter and provide effective competition, also violates Section 7. The elements of an actual potential competition case are met here. First the markets are highly concentrated. Second, independent entry will result in significant procompetitive effects. Third, Staples and Office Depot are two of only a few equally likely potential entrants. Fourth, Staples and Office Depot would have been likely entrants but for this merger. Finally, entry into these markets by either or both of these firms would occur in the near future.

### **THE RELEVANT MARKET IS INSULATED FROM NEW ENTRY AND EXPANSION OR REPOSITIONING BY OTHER RETAILERS**

The analysis of the conditions of new entry into a relevant market is part of a determination of the likely anticompetitive effects of any acquisition, because if entry is unlikely, the merged entity can raise prices without attracting new competition. In assessing the conditions of entry, the ultimate issue is whether entry is so easy that it "would likely avert anticompetitive effects from [the] acquisition . . . ."

The Merger Guidelines articulate the conditions under which entry would likely avert anticompetitive pricing. Entry is considered "easy" if it would be "timely, likely and sufficient in its magnitude, character and scope to deter or counteract the [anti]competitive effects" of a proposed transaction. Entry is timely if a new entrant would have a significant market impact within two years. Entry is likely if it would be profitable at premerger prices. Entry is sufficient if it would be on a large enough scale to counteract the anticompetitive effects of the transaction.

Staples and Office Depot have argued that entry either by a new superstore chain or by repositioning of an existing retailer will be enough to avert anticompetitive effects from the acquisition. Current market realities indicate otherwise.

Even with prices elevated in many markets across the country, entry is not occurring. On the contrary, firms have been exiting the market: over the past few years, the number of superstore chains has dropped. Office 1, for example, entered in 1991 and grew to thirty-five stores in eleven states by 1996. Office 1 is now in bankruptcy. Several other office superstores have exited the market altogether or have been acquired by one of the market incumbents. The failed entrants in this industry run the gamut of very large, well-known retail establishments from Kmart and Montgomery Ward to Ames and Zayres.

The evidence that so many firms have exited and that no one is attempting to enter the market reflects the significant disadvantages facing a new challenger. De novo entry into the office superstore market is tantamount to starting a marathon when the other runners are in

the last mile. There is too much ground to make up and no one with any sense is likely to try. A new entrant into the office superstore market must enter both at the local and national level to check anticompetitive pricing by market incumbents. Entry at the local level entails establishing a sufficiently large presence in each of the affected markets that the new entrant can achieve economies of distribution and advertising and can effectively constrain pricing by local market participants. But, in order to compete effectively in a given local market, a new firm has to establish the "critical mass" of stores necessary to achieve scale economies of advertising and distribution.<sup>6</sup> In many markets, entry cannot occur at a sufficiently large scale to achieve the requisite critical mass because there is little, if any, room for new stores. Staples, Office Depot and OfficeMax have been expanding into new markets for over ten years, and are in the process of entering more every day. Staples and Office Depot are constantly evaluating the markets they currently participate in, as well as potential new markets. Similar results apply to the Washington, D.C. area where Staples and Office Depot operate 24 and 14 stores, respectively.

In order to match the cost and distribution structures of the market incumbents, a new entrant would not only have to establish a presence in each of the local markets affected by the transaction, but would also have to enter on a nationwide scale. Staples, Office Depot and OfficeMax each have a nationwide network of approximately 500 or more stores. By operating at such a large scale, each of these firms is able to leverage their huge volumes into price concessions from their suppliers. They also are able to distribute most efficiently by setting up regional transshipping centers.<sup>7</sup> In order to match the efficient cost structure of the current office superstore firms, a new entrant would have to open, on a national level, multiple stores in multiple geographic areas. Entry at the national level, of course, entails entry into scores of local markets. The hurdles that must be overcome to enter each of these markets are, therefore, exponentially greater if entry is attempted on a national level.

Staples and Office Depot have argued in the alternative that the functional equivalent of entry would be repositioning by an existing retailer to attract office superstore customers. The likely "repositioners," they assert, are retailers such as Target, Wal-Mart, and Kmart, and computer superstores catering to small businesses, such as Best Buy. But it is instructive that these companies have not repositioned today in markets where Staples and Office Depot charge customers higher prices. It would require a dramatic change to the entire nature of their operations. And, it is unlikely that such changes would be undertaken.

Staples' CEO does not consider Wal-Mart to be a competitive threat. Less than three weeks before the merger with Office Depot was announced, he flatly stated, "In our industry, Wal-Mart has never been a factor." Other retailers and independents have also testified that they could not profitably reposition to attract office superstore business even if Staples increased prices anticompetitively.

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<sup>6</sup>As one Staples official has stated, "it's really tough to steal the customers from a direct competitor when you don't have the economies of advertising leverage." This is particularly true in major markets, where the costs of advertising are extraordinarily expensive.

<sup>7</sup>A successful distribution network is key to offering consumers immediate access to a full stocking of a wide range of products -- a hallmark of a successful office superstore.

Best Buy actually attempted to reposition itself as an office supply retailer in 1994. Best Buy, an electronics retailer that carries a broad range of computers and business machines, sought to capture additional business by creating a separate office supply department. Two years later, Best Buy gave up.

## **EFFICIENCIES WILL NOT OFFSET ANTICOMPETITIVE EFFECTS OF MERGER**

Staples and Office Depot have asserted that the proposed acquisition would generate significant cost savings. They claim that if they are allowed to merge, they may well be able to reduce their costs by using the "best purchasing practices" of each company and by pressuring suppliers to give them bigger discounts. The evidence, however, will show that the claimed efficiencies are not likely to benefit consumers, are speculative, and can be achieved through means that do not have the dramatic anticompetitive effect of the merger. As a result, efficiencies are not a defense to the anticompetitive effects likely to result from this merger. The acid test of efficiencies is whether they benefit competition:

A merger the effect of which may be to substantially lessen competition is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial. A value choice of such magnitude is beyond the ordinary limits of judicial competence, and in any event has been made for us already, by Congress. Alliant Techsystems, Inc., 808 F. Supp. At 23 (quoting Philadelphia Nat'l Bank, 374 U.S. at 371)

Many courts, including this one, have interpreted the Supreme Court's admonitions as effectively precluding an efficiencies defense. Other courts have nevertheless held that, in appropriate circumstances, efficiencies generated by mergers can promote competition, just as the antitrust agencies consider appropriate efficiencies in evaluating a merger's likely competitive effect. Indeed, just this week the Commission and the Justice Department's Antitrust Division revised Section 4 of the Merger Guidelines to articulate how the agencies weigh efficiency claims in merger investigations.

Even under the standard of University Health and the Section 4 of the Merger Guidelines, it is not enough for defendants to show cost savings resulting from the transaction. Defendants must show that competition will not be adversely affected by the merger:

[A] defendant who seeks to overcome a presumption that a proposed acquisition would substantially lessen competition must demonstrate that the intended acquisition would result in significant economies and that these economies would benefit competition and, hence, consumers. University Health Inc., 983 F.2d at 1223; see Rockford Mem. Corp., 717 F. Supp. at 1289.

Here the cost savings cannot be credited for three distinct reasons. First, they will not overcome the injury to competition resulting from this merger. Without the competitive

rivalry provided by Office Depot, the force that has driven Staples to reduce costs and pass on these reduced costs in the form of lower prices will be lost. Once the competitive dynamic between Office Depot and Staples is removed, Staples will be free to increase its prices and retain any cost savings as additional profits. Indeed, if the past history of the two companies is any guide, cost savings tend to be passed on to consumers where there is superstore competition and retained as profit where there is not.

A second limitation on efficiencies is that the claimed efficiencies may not be speculative. Because efficiencies are difficult to verify and quantify, the role that efficiencies play in merger analysis has been carefully circumscribed. Staples and Office Depot's efficiency claims are the essence of the speculative, self-serving assertions that the University Health court cautioned against. Since the proposed merger came under investigation, the Staples and Office Depot's claims of efficiencies have escalated beyond what the defendants estimated when their respective boards of directors approved the transaction last September. Such litigation driven efficiency estimates should be viewed with considerable suspicion.

Third, defendants must also show that the efficiencies are specific to the merger. "[T]he Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects."<sup>8</sup> Staples likely efficiency claims must fail because any cost savings they attribute to a merger with Office Depot can be, and most likely will be, achieved through other means that do not adversely affect competition.

The major sources of defendants' claimed cost savings are possible cost reductions associated with volume purchasing and the utilization of best purchasing practices. Because both Staples and Office Depot are expanding rapidly, as is the office superstore market as a whole, the volume of products these companies purchase will increase with or without this merger. Each party to this merger had previously projected expanding within the next few years. Similarly, improved purchasing practices are achieved by the parties internally every day by searching for lower cost sources of supply. They are also available by hiring talented and proven purchasing representatives, and through the acquisition of other vendors of office supplies. The efficiencies claimed here are likely to accrue with or without the proposed transaction, since in a competitive environment both companies would seek out improved purchasing methods and would continue to increase the volume of products they purchase as they continue their inexorable expansion. Accordingly, defendants' cost savings are not merger specific, and therefore not cognizable under Section 7.

## **NEED FOR INJUNCTIVE RELIEF**

Where, as here, the Commission has raised serious and substantial questions about the legality of a proposed transaction under Section 7, defendants face a difficult task of "justifying anything less than a full stop injunction." The strong presumption in favor of a preliminary injunction can be overcome only if: (1) significant equities compel that the

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<sup>8</sup>Merger Guidelines, § 4.0; see *University Health*, 938 F.2d at 1222 n.30; *United States v. Mercy Health Services*, 902 F. Supp. 968, 987 (N.D. Iowa 1995); *Rockford Mem. Hosp.*, 717 F. Supp. at 1289\_91; *Ivaco*, 704 F. Supp. at 1425\_26.

transaction be permitted; (2) a less drastic remedy would preserve the Commission's ability to obtain eventual relief; and (3) a less drastic remedy would check interim competitive harm.

In this case, the considerations supporting the need for a preliminary injunction are clear, and there are no public or private equities which suggest that a lesser remedy would be more appropriate. One of the principal reasons for enjoining potentially illegal transactions stems from the historic difficulty of effectively splitting a combined operation into viable entities after a merger. The ineffectiveness of divestiture as a remedy, and the need for injunctive relief to maintain the status quo, was demonstrated so frequently that by 1966 it became the subject of judicial notice by the Supreme Court in *FTC v. Dean Foods Co.*, 384 U.S. 597, 606 n.5 (1966). The enactment of Section 13(b) manifests Congressional recognition of this problem.

The proposed acquisition will eliminate a price-cutting competitor and Staples' most fervent rival. Once Office Depot's separate identity is destroyed, it would be virtually impossible to restore competition in the marketplace by re-creating two independent companies after a full trial on the merits.

Another compelling reason to halt illegal acquisitions before they occur is to prevent the interim harm to competition that would result even if a suitable divestiture remedy could be devised. Given the risk of anticompetitive pricing that the merger raises, it is paramount that the benefits of competition not be dissipated during the pendency of an administrative proceeding in this case.

The Commission has not only demonstrated the appropriate product and geographic markets, the unlikelihood of entry, the industry trend toward concentration, and the high post-merger market shares of the merged entity, but has provided evidence from the parties that if the acquisition is consummated prices will increase -- the ultimate issue in any horizontal merger case. The evidence amply demonstrates that the Commission has a substantial likelihood of prevailing in the administrative proceeding and that injunctive relief is necessary to preserve the benefits of free and open competition for the public.

## **CONCLUSION**

For the reasons set forth above, the Court should grant the Commission's request for a preliminary injunction in order to maintain the status quo pending the outcome of the Commission's administrative proceeding.