Any evidence of prices going follow. departure from mkt?

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FEDERAL TRADE COMMISSION,	Docket No. CA 97-0701
Plaintiff,	Washington, D.C.
	May 20, 1997
v.	9:15 a.m.
STAPLES, INC.,	
and	
OFFICE DEPOT, INC.	
2200 Old Germantown Road	
Delray Beach, FL 33445	
Defendants.	

TRANSCRIPT OF TRIAL
BEFORE THE HONORABLE THOMAS F. HOGAN
UNITED STATES DISTRICT JUDGE

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(Computer-Aided Transcription From Stenotype Notes.)

P R O C E E D I N G S

THE COURT: Good morning, counsel.

THE DEPUTY CLERK: Civil action 97-0701, Federal Trade Commission v. Staples, Inc. et al. Counsel, please identify yourselves for the record, beginning with your names.

MR. CARY: George Cary for the Plaintiff, U.S. Federal Trade Commission. At counsel table with me are Robert Doyle, James Fishkin, Mel Orlans, and our first witness for the morning.

THE COURT: Thank you. Good morning.

MR. KEMPF: Don Kempf for the Defendants. And with me are my partner Gene Assaf, who will conduct the cross-examination of the first witness this morning. And then the usual suspects: Mr. Curran, Mr. Gidley, Mr. Smith, our client Mr. Stemberg and Mr. Fuente. And the young woman back there is Stacy Saponja, who is one of our legal assistants. I think I introduced Mr. Prentice over in the chair, there, who helped with the charts yesterday.

THE COURT: Thank you. I understood there is a preliminary matter. Do counsel want to talk about it at the bench or in open court? Doesn't matter to me.

MR. CARY: I think we can handle it in open court.

THE COURT: As long as you are not getting into some confidential matters.

MR. CARY: It is not confidential. We think we have resolved it. The issue has to do with the econometrician, experts Dr. Hausman and Professor Ashenfelter. As Your Honor might recall, we had a discussion during the course of Professor Ashenfelter's deposition with respect to the distinction between his case-in-chief testimony and his rebuttal testimony.

We received last night -- as part of that discussion, it was represented by counsel that Mr. Hausman was completed with his work and would be doing no further work. Last night we received a computer disk. I have no idea what is on it, because it was in a computer disk form. There was no printout associated with it, but it purported to be some additional work that Professor Hausman had done in response to Professor Ashenfelter.

So what we have is a situation where Professor Hausman did some work and Professor Ashenfelter responded to it, and Professor Hausman responded to that. Professor Ashenfelter said at his deposition he would respond to that. And now, two days before Professor Hausman is to testify, he has come up with some new work.

Counsel and I have discussed it, and we believe that the -- that we have resolved it in the following way. Professor Ashenfelter will be deposed before his rebuttal testimony, which will be on Friday. Professor Hausman will be deposed before his testimony in defense, which will be on Thursday. So that means Wednesday night, and then that material can come in. Now, there is --

MR. GIDLEY: Let's be clear here about why we are at the podium. Last night was a busy night. I received at 10:00 two new analyses from Dr. Ashenfelter, first an update of his so-called pass-through analysis. At the deposition I had examined him on a 30 SKU version of that analysis. Last night I received a brand-new study, a 49 SKU analysis. It is different. It's a different study, and I would like to examine him before he stands up in open court this morning. I have not had a chance to read it through carefully. It's just a bunch of computer runs.

The second thing that I received last night for the first time is another pricing regression, and I have had no opportunity to depose Dr. Ashenfelter.

We did produce last night rebuttal diskettes from Dr. Hausman in response to Dr. Ashenfelter, and how we deal with that I think is a separate issue. We are perfectly willing for Dr. Hausman to stand for deposition, because we don't fear that. And we see that we need some kind of orderly process here, and that is exactly what we contemplated.

But at the deposition last week, we asked very clearly that we be limited in the direct today, and it was only last Wednesday that we were in deposition to the 30 SKU study and the pricing regressions that were done. And I think that is a very reasonable limitation. If they want to bring Dr. Ashenfelter back with some new work later in this week, we can have an intervening deposition.

MR. CARY: Let me provide the Court with a little bit of additional background here. The problem that we have had from the beginning in this case is that the parties control the data. They are the ones that have the numbers in terms of what their prices are, what their sales are, et cetera. And what they have done from the beginning of this process is to dribble it out in a way that is self-serving, in a way that controls -- that supports their conclusions.

Now, what has happened here is that Professor Hausman originally gave us some data. We looked at that and figured out the problems. He said, no, no; here is some more data we got from the parties. These 46 SKUs, for example, is a perfect example of that. All Professor Ashenfelter did was say, Just give me the data, and I will pump through and do what I can do with it. They have provided this data very recently; and he said, Okay, I will run the same analysis that I ran before.

With respect to the other study, again, Professor Hausman came up with this thing and Professor Ashenfelter said, Fine, bring on the data and I will run my analysis.

Trouble is, there is always a lag between when we get the data and when he can complete the analysis. And that's what's driving the process.

MR. GIDLEY: In my country, Your Honor, and I think it was your ruling at the deposition, we should have the opportunity, given the complexity and seriousness of the manner here before us, to depose an expert before he testifies to a study.

THE COURT: Let me make sure I understand the problem first. The first, we had a problem with Hausman, and that will be attempted to be reconciled, for producing this material yesterday sometime.

And now the Defendants are saying that they have a problem with today's witness. Is he on today?

MR. GIDLEY: Yes.

THE COURT: Because he produced a new study.

MR. GIDLEY: Two new studies, Your Honor.

MR. CARY: Let me make this very clear. What he has done is he set out to duplicate the analysis that Professor Hausman has done. And he is prepared to testify as to what happens when you duplicate that analysis. The problem is that the parties provide additional data and they use the additional data that they didn't give us previously as a way to argue that his analysis is wrong. What he has done is taken the additional data that he received about a week ago from these parties and he has run the same analysis on that new data. And he is prepared to testify that the conclusion doesn't change.

THE COURT: Do you have any other witnesses here today?

MR. CARY: Yes, Your Honor, we do.

THE COURT: Well, it seems to me Defendants should have a chance to look at this study that was just done yesterday, apparently, or supplied yesterday, before he testifies about it. I do not want to delay the case and I do not want to start these depositions any more than we have already allowed in mid-trial. It is getting far too late.

On the other hand, if this material was just supplied, I think the experts are right to look at it and use it. If the Defendants want a couple of hours to look at the study and review it with their expert before Dr. Ashenfelter testifies, I will give them a chance to do that. And we can take up another witness in the meantime and have him come back and testify. I won't stop his testimony and have a deposition taken at this point.

MR. CARY: Thank you, Your Honor.

MR. GIDLEY: All right, Your Honor.

THE COURT: If you want to regroup and call someone else for an hour or two for the Defendants to look through this new study and talk to their expert about it, we can do that. I will put another witness on instead until later today and then we can call Dr. Ashenfelter back.

MR. CARY: We will be happy to make Professor Ashenfelter our last witness.

THE COURT: All right.

MR. DOYLE: Your Honor, the Commission calls Robert Gellman of the Tandy Corporation. Mr. Gellman is represented by Ray Hill of Tandy Corporation, Your Honor.

THE COURT: Also, I received over the evening recess several Third Party or witness -- potential witnesses, filings to keep certain matters confidential under seal. And I assume that counsel have gotten all of those as well. I think the rules should be these people who filed these materials should contact counsel on both sides to find out if these materials are going to be used or not. And if they are, then alert the Court so we can take up that issue before the testimony comes in or the documents are referred to. Because I don't have any idea that these people -- that these documents will be used in the trial or not. So counsel have to be advising the people who are concerned. And if there is a concern, I will take that up before the document or the witness testifies about it. All right.

You can be sworn.

THE DEPUTY CLERK: Raise your right hand, please.

ROBERT GELLMAN, GOVERNMENT'S WITNESS, SWORN

DIRECT EXAMINATION

BY MR. DOYLE:

Q. Would you state your name for the record, please.

A. Robert Gellman.

09:45 Q. By whom are you employed, sir?

A. Tandy Corporation.

Q. How long have you been employed by Tandy Corporation?

A. 24 years.

Q. Could you tell us what relationship Computer City has to
09:45 Tandy Corporation?

A. Computer City is a division of Tandy Corporation.

Q. Do you hold a position in Computer City?

A. Yes, sir.

Q. And your position is what, again, sir?

09:45 A. Vice-president, operations.

Q. Now, can you tell the Court a little bit about Computer City. What are the product lines carried by Computer City?

A. Computer City is a computer supercenter chain. We carry a full selection of computer end equipment, and also
09:45 software, accessories, supplies, peripherals, and a full assortment of services to support our customers.

Q. How many stores, sir, does Computer City have?

A. 93.

Q. And are they located nationwide?

09:45 A. We are in the US, Canada, and Europe.

Q. When was Computer City founded?
A. June of 1991 was when we publicly announced the format.
Q. Sir, what are the primary product lines of Computer City? Can you elaborate on that, please.
09:46 A. Certainly. In end equipment we carry desktop computers; notebooks; printers; other imaging products, such as scanners; a large selection of software products, from productivity to entertainment, education; a large selection of options, peripherals and supplies and accessories.
09:46 Q. Have you been with Computer City since its founding in 1991?
A. Yes, sir.
Q. Can you describe the various positions you have held since 1991?
09:46 A. Initially, I was the western division manager, responsible for half of the U.S. for the store operations. I was promoted to vice-president of operations in January of 1993. In August of 1995 was made vice-president of North American sales. And in January of 1997 I became
09:47 vice-president of operations with expanded responsibilities for real estate and store planning.
Q. Now, when you say that you have responsibility for store planning, can you elaborate on that, please?
A. My department is responsible for all of the things
09:47 necessary to build a Computer City store, from fixture layout

to planigrams to retrofits, remodels and the like.
Q. If a store was going to be expanded, would you be involved in that?
A. Yes.
09:47 Q. If a product line was going to be extended within a store, a major product line extension, would you be involved in that, sir?
A. Yes, sir.
Q. Would you be involved in a major modification of a
09:47 retail store?
A. Yes, sir.
Q. Are you familiar, sir, with the term "office supplies"?
A. Yes, I am.
Q. What does that term mean to you, sir?
09:48 A. It is a broad definition of the large assortment of products that could include end equipment such as computers and office equipment, and supplies, consumable supplies.
Q. Now, when you say "consumables," what do you mean by consumable office supplies?
09:48 A. I guess the way I look at it is there is basically two categories. Computer related; those would be consumables that would be utilized by computer products, such as printers. And then non-computer-related, which would be things like pens, pencils, notebooks, Post-it notes, et cetera.

Q. And pens, pencils and Post-its and notebooks, you would consider to be non-computer-related consumables?
A. Yes.
Q. Let me ask you this, sir. With respect to the end products that you talked about, which are within your definition of office supplies, could you elaborate on those products as well?
A. It certainly includes computers, printers. It would include options and peripherals, fax machines, telecommunications equipment. And certainly durable products also, whether they be cassette cases or other products that are utilized to hold consumable products.
Q. So you look at office supplies as durables and consumables, if I could use your terminology; is that right?
A. They are both within that category, yes, sir.
Q. Let me ask you a couple of questions, sir, about the consumable category. With respect to the consumable category, I think you said there is a computer-related and a non-consumer-related consumable category. How many product Stock Keeping Units does Computer City have within the computer-related-consumable office supply segment?
A. We carry a little over 200 SKUs that could be considered computer-related supplies, the majority of which are consumable; not all of which are consumable.
Q. On the other side, sir, the non-consumer -- the

non-computer-related consumables, how many Stock Keeping Units does Computer City carry in that category?
A. Insignificant. I can't think of one, offhand.
Q. Those are pens, paper, Post-its; can you elaborate on that?
A. Paperclips, staplers, the kind of products that you would find in an office that are not necessarily tied into a computer.
Q. Now, sir, does Computer City have a marketing goal that it likes to project to the public?
A. Well, our mission statement and our strategy is to do a great job of providing computer products and solutions to the experienced computer user. And we are targeting primarily the "SOHO" customer, the small office, home office customer.
Q. Sir, did there come a time in the 1991-92 time frame when Computer City expanded into the non-computer-related consumable office supplies?
A. In late 1991 we opened our first eight stores. We were certainly testing a lot of different products to see what our customers would purchase. Included in that assortment were less than 20 consumable non-computer-related products, like Post-it notes, Bic pens. We also carried at one time or another chocolate diskettes. We had a gift shop where we sold computer-related clothes. All of these were tests to find out whether our customers would pick those products up

while they were in our store buying other things.
Q. Can I ask you to focus on the non-computer-related consumables that the company expanded into the '91-92 time frame. Were you involved in that decision?
09:52 A. Yes.
Q. Can you tell us what motivated the company to move into that category?
A. It was purely a test to determine whether customers, while they are in the store buying computers, would also pick
09:52 up, impulsively, unrelated consumable office supplies.
Q. Was that expansion a successful expansion for Computer City, sir?
A. We discontinued carrying those items sometime in 1992, because we weren't able to price it competitively. We were
09:53 only eight stores, and we are not able to get the purchasing economies that would allow us to price it competitively and felt if we were extremely overpriced compared to the market, it sent out a bad message to our customers.
Q. What would be the bad message that was sent out to your
09:53 customer if you were unable to price those products competitively?
A. Well, clearly part of our strategy is to provide competitive prices to our customers. If they come into a store and see benchmark products that are priced considerably
09:53 higher than what they feel they are worth, where they can buy

it at another retailer, that would send out a bad message that maybe our computers are overpriced or the other products are overpriced in our store.

Q. So the bad message would impact adversely on your core
09:54 business. Is that what you are saying?

A. Well, yeah. I mean, the bottom line is we are in business to make a profit. We have a choice of either selling the product at little or no gross margin, or selling it at a price considerably higher than market, because we did
09:54 not have the purchasing capability that our competitors did. And we elected not to carry it.

Q. Now, sir, in or around 19 -- I guess it was April or May of 1997, did you expand your existing office supply product line again?

09:54 A. Yes, we did.

Q. Can you tell the Court about that expansion.

A. We have expanded to carry additional computer-related consumer consumable products like labels that print in laser or ink jet printer, ink jet cartridges, and a variety of
09:54 other specialty items that would run in a printer. We have expanded using some additional products from Avery. I think it is 17 or 18 additional SKUs.

Q. I think you said consumer -- I'm sorry?

A. Consumer products.

09:55 Q. Computer-related consumables; is that right?

A. Yes, sir.

Q. Now, when you say "computer-related," how does that fit into your core business?

A. Well, again, our target customer is the experienced
09:55 computer user, the ""SOHO"" customer. They not only buy equipment, but they also need the supplies to be able to get functionality out of their purchases. And when they are in our stores, we are hopeful these are things they are already buying that they might purchase from us. If we have a
09:55 reasonable assortment at a competitive price, we think we can get a part of that market.

Q. Now, sir, with respect to these computer-related consumable products that were added in 1997, how many Stock Keeping Units were added?

09:56 A. Approximately 17.

Q. Now, sir, are there plans to extend further the number of Stock Keeping Units in the computer-related-consumable category?

A. We are in a very dynamic business. We are constantly
09:56 looking for additional products that our customers would like to purchase. So the answer is, we will continue to add additional products and see whether they are accepted by our customer.

Q. Given your position as vice-president of operations, if
09:56 there was to be an expansion in the computer-related

consumable area that required some store configuration, you would know that, wouldn't you, sir?

A. If it was a major addition, yes, sir.

Q. Are there plans for that type of store modification
09:56 related to computer-related consumables?

A. No, sir.

Q. Now, sir, with respect to the non-computer-related consumables that you tried back in '91-92, are there any plans at the company to revisit that expansion?

09:57 A. We will always revisit it. We have no plans at this time, but we are always revisiting opportunities to increase sales and gross margin.

Q. Are you aware, sir, of any of the intentions of the company to expand again into that product line?

09:57 A. I am not aware of any at this time.

Q. You would know that, wouldn't you, if it required a store modification?

A. Yes, sir, that is correct.

Q. Now, sir, based upon your understanding of the company,
09:57 does Computer City plan to become an office supply superstore?

A. No, we do not.

Q. Does it have a business plan for the expansion of the non-computer-related consumables that you tried back in
09:57 1991-92?

A. No, we do not.
Q. Is there a strategy to move into that area?
A. There is no strategy to move into that area. But again, we will continuously review products that we could add to our mix, based on our customers' need.
09:58
Q. Are you aware of any plans to expand an existing retail store to accommodate the movement into the non-computer-related consumable category?
A. No, I am not.
09:58
MR. DOYLE: Your Honor, I have no other questions.
THE COURT: Thank you.
MR. ASSAF: Gene Assaf.
Good morning, Mr. Gellman.
THE WITNESS: Good morning.

CROSS-EXAMINATION

BY MR. ASSAF:
Q. Let's talk a little bit about Computer City's competition. First of all, you heard the term "category killer"?
09:58
A. Yes, sir.
Q. Is Computer City a category killer?
A. Certainly my definition of a category killer is someone that offers a tremendous selection of name-brand products with competitive prices and all of the services that a
09:59
customer might demand, so they can go into one location and

meet all of the needs of that particular niche. And based upon that definition, yes, sir, we are.

Q. Is it fair to say that Computer City is a computer superstore?

09:59 A. That is correct.

Q. What are the other computer superstores?

A. Certainly the primary competitor is CompUSA and Micro Center.

Q. Can you think of any computer superstores?

09:59 A. I cannot think of any other national computer centers or computer superstores. There are some local players, and by that I am talking about people where that is their sole business of selling computer products.

Q. So Computer City, CompUSA and Micro Center are the major

09:59 computer superstores nationwide?

A. That is correct.

Q. Are they -- are Micro Center and CompUSA Computer City's only competitors in the sale of computer products?

A. Absolutely not.

10:00 Q. Why do you say that?

A. First of all, we compete with anybody that might -- we compete for anybody that has a dollar to spend. But certainly as far as our particular products are concerned, there are consumer electronic chains like Incredible

10:00 Universe, which was part of Tandy. Circuit City, Best Buy, Campo on and on, that carry a significant portion of computer products, supplies, software and accessories. The office supply supercenters carry a significant amount of computer end equipment. Wholesale clubs, Wal-Marts, even small 10:00 specialty stores like Radio Shack are competitors to Computer City.

Q. What about regional or local computer stores?

A. Certainly you have those. And you have local bars, resellers, ma-pa shops. Anyone that is selling a computer or 10:01 software or accessories or supplies, we consider to be a competitor.

Q. Let's talk a little bit about Computer City's pricing. Does Computer City have national uniform prices for every product?

10:01 A. We have national uniform pricing for what I will call benchmark products for the end equipment and for the majority of the products that we sell.

Q. Well, does Computer City have any price zones where prices are different in one zone as opposed to another?

10:01 A. We do have the systems to be able to have price zones, but there are many products that are uniform across all five of the price zones.

Q. How many price zones does Computer City have?

A. Five.

10:02 Q. On the products that -- withdrawn.

Leaving aside the products that are uniform in price across the country, let's talk about the products that differ within the zones. How does Computer City determine how price zones differ on certain products?

10:02 A. Let me see if I can answer the question this way. The intent was for us to be able to adjust prices downward in extremely competitive markets. We used to be in Los Angeles, which was an extremely competitive market. And we found that it was necessary to lower our prices below our chain price in
10:02 that particular competitive situation.

The reality is that, number one, we have strong competition in every market that we participate in. And number two, that our advertising is national in scope, so when we promote an item we have to have the same price in
10:03 every store. So therefore, even though we have the systems, the reality is that most of our prices are national.

Q. With respect to pricing, does Computer City have a rule regarding the products that are advertised across price zones having to have the same price?

10:03 A. Yes, we do.

Q. So you will never get into a situation where you run a circular in one city that has a lower price next to a city that is a different price zone?

A. That is correct.

10:03 Q. FTC ever complain to you about having different price

zones?
A. Not that I am aware of, no, sir.
Q. So, Computer City's prices are low all the way across the United States. They are just lower in some markets.
10:04 A. That is correct.
Q. Let's talk about -- I think Mr. Doyle said non-computer-related consumable office supplies?
A. Okay.
MR. DOYLE: Your Honor, I object to that. That was
10:04 not my characterization. It was the witness' characterization.
BY MR. ASSAF:
Q. Let's talk about non-computer-related consumable office supplies. Computer City doesn't sell a lot of those
10:04 non-computer-related consumable office supplies, does it?
A. No, they don't.
Q. But Computer City sells office supplies, doesn't it?
A. We do carry some office supplies.
Q. And Computer City sells what you understand to be
10:04 consumable office supplies, doesn't it?
A. Consumable and durable.
Q. Are some of the things that you sell toner and cartridges?
A. Absolutely, yes.
10:04 Q. Diskettes?

A. Yes, sir.

Q. They are all consumable office supplies?

A. Yes, sir.

Q. Now, you even recently have added some office supplies
10:05 to Computer City's line, haven't you?

A. We have -- yes, sir, we have.

Q. Would you tell the Court what you have added just recently?

A. In the last 30 days we have expanded the line of labels
10:05 and other consumables that function in printers by adding 17 SKUs from Avery. And we have added a telecommunications department that carries single and multi-line phones, answering machines, fax machines, cordless phones, and corded phones.

10:05 Q. And as we sit here today, isn't it the case that Computer City is right now currently reviewing the potential of adding even more office supplies to serve the needs of its customers?

A. To serve the needs of the ""SOHO"" customer, that is correct.

Q. What do you mean by "SOHO" customer?

A. It is an industry jargon for the small office, home office segment of the business.

Q. And is Computer City committed to the "SOHO" customer
10:06 for their office needs?

A. We are committed to provide them with computer solutions. And if while they are in our store to buy those computer products, we are able to sell them some related products at a profitable price, we would like to do that.

10:06 Q. You have come a long way from Texas, and I would like to give you an opportunity to tell us a little more about the story of Computer City. Would you explain to the Court what Computer City has done in terms of its growth from 1991 until today.

10:07 A. Computer City was a very aggressive retail chain. We announced the concept in June of 1991 and within 90 days opened our first eight stores. And within three years we had exceeded one billion dollars in revenue, which we are told is the second fastest growing retail chain. We continue to add
10:07 30 stores, roughly, per year under a very aggressive program, achieving just short of 2 billion dollars in revenue. We are now at a point where we are spending less time on store expansion and more time on maturing our retail chain, growing corporate sales, and doing a better job of servicing the
10:07 needs of the "SOHO" customer.

Q. So, Computer City has gone from one store to 93 stores in what, five years?

A. Yes, sir.

Q. And in that time has generated revenues, annual revenues
10:08 of over 3 billion dollars a year?

A. No, sir. Just short of 2 billion.
Q. That is your goal?
A. One of our goals.
Q. In this national growth of Computer Cities across the
10:08 country, what types of customers have you reached out to, to try to serve their needs?
A. Well, there is all kinds of customers out there, and we don't want it to exclude any of them. We certainly are retailers, so we have a retail presence, and that does give
10:08 us the opportunity to sell to the new consumer to "SOHO," because many of those customers do buy retail as versus an in-bound or outbound sales force. We also do a significant portion of our business with a corporate sales group, business to business, if you will, selling to medium and
10:09 large corporations. But our primary focus is on the experienced computer user as versus the neophyte.
Q. Again on this growth point, Mr. Gellman, would you explain to the Court whether Computer City had seen any efficiencies in their volume discounts as you have grown from
10:09 one store to 93?
A. Well, certainly we have been able to negotiate more favorable terms with our vendors as we became a more significant customer to them. In the early days we had the strength of Tandy Corporation, so there was a lot of
10:10 credibility. And they believed in our vision and our

commitment, and that helped us establish good pricing. But as we become more significant to our vendors' distribution, I think that we have also been able to get bigger shares of soft dollars, market development funds, co-op dollars, other types of support that have made us a more profitable company.

Q. What are soft dollars?

A. Soft dollars are additional funds that a vendor makes available to their customers, either to help fund advertising or to help with promotional activities, to help better train the associates in the store as to the product knowledge, those kinds of things.

Q. So as Computer City has grown to be a national category killer, you found it easier to get more soft dollars and co-op programs from your vendors?

A. Certainly as we became more important to those vendors, they were more committed to us being successful.

Q. Lawyers have to ask this question. When you get more co-op dollars and more soft money and you are able to train your associates better, do you think that makes you a better company?

A. Absolutely.

Q. When you responded to Mr. Doyle's question about Computer City's business, you used the phrase "dynamic business world." What do you mean by a dynamic business world?

A. It is ever-changing. Five and a half years ago I think we had a vision that we were going to sell only to an experienced computer user, and we found out that as prices
10:11 came down and equipment -- and as software became more intuitive, there was a whole new world of folks that had never touched a computer before that were coming to our stores. Technology is changing, cycles on product are changing every 90 days. CPUs become obsolete, it seems. So
10:12 you have got to be -- it's a dynamic business we are in. It is an ever-changing business, and you've got to constantly adjust to what the customer demands and is expecting when they visit your store.

Q. And Computer City and Tandy is committed to meet the
10:12 needs of its customers as this dynamic marketplace continues to evolve?

A. Absolutely.

MR. ASSAF: No more questions, Mr. Gellman.

THE COURT: Mr. Doyle, some redirect here?

MR. DOYLE: A couple.

REDIRECT EXAMINATION

BY MR. DOYLE:

Q. Mr. Gellman, I believe you said that the prices are uniform for most of your products across the nation?

10:12 A. Yes, sir.

Q. So you don't see lots of variation from city to city?
A. That is correct.
Q. And you would not see prices differing dramatically from place to place, would you?
A. That is correct.
Q. And that would include your consumable office supply products as well; is that right?
A. Yes, sir.
Q. Now, with respect to the more favorable terms that you have gotten from your vendors through your increase in size, that came from internal expansions, didn't it, sir?
A. Would you repeat the question, please?
Q. In terms of the more favorable terms that you have been able to get from your vendors, that has come from your growth -- from internal expansion?
A. Well, I think it is internal expansion, increasing market share. There are a lot of factors, but they look at their customer base and they know who their best customers are and they will tend to give their best pricing to their best customers.
Q. And you have grown internally from the one store to the 80 or 90 stores?
A. Well, we certainly added more units, and I would like to think we are also doing a better job in average volume per location.

MR. ASSAF: Your Honor, no further questions. Thank you, Mr. Gellman.

THE COURT: Thank you, sir.

MR. CARY: Your Honor, the Government calls Professor Warren-Boulton.

10:14

THE COURT: All right.

FREDERICK WARREN-BOULTON, GOVERNMENT'S WITNESS, SWORN

MR. CARY: Good morning, Dr. Warren-Boulton.

THE WITNESS: Good morning.

DIRECT EXAMINATION

BY MR. CARY:

Q. Would you please state your name for the record.

A. Frederick R. Warren-Boulton.

Q. And what is your occupation, sir?

A. I am an economist, specializing in industrial organization, which is the study of the behavior of firms and markets. I am currently a principal at Micra, Micra Economic Consulting and Research Associates, a consulting and research firm in Washington, D.C.

Q. Dr. Warren-Boulton, did you provide a declaration in this matter?

A. Yes, I did.

Q. Is your curriculum vitae or your resume attached to that declaration?

A. I believe so.

MR. CARY: Your Honor, for the Court's reference, Dr. Warren-Boulton's declaration is at PX, and it includes his full curriculum vitae.

THE COURT: Okay.

BY MR. CARY:

Q. Dr. Warren-Boulton, would you please describe briefly your educational background.

A. Yes. I have a bachelor's degree in economics from Yale University, a master of public affairs from the Woodrow Wilson School at Princeton University, and my Ph.D is in economics from Princeton University.

Q. After you graduated with your Ph.D degree, what did you do?

A. I became a professor of economics, as an assistant and associate professor of economics at Washington University in St. Louis from roughly 1972 until 1983.

Q. And in 1983, what did you do?

A. I came to Washington.

Q. What did you do in Washington?

A. From 1983 until 1989 I was the chief economist for the antitrust division in the Department of Justice, first as the director of the economic policy office and then as, I guess, the first deputy assistant attorney general, which is a long title which does not mean that you are an attorney.

Q. What were your responsibilities as a deputy assistant attorney general?

A. I supervised and was involved with all of the analysis -- antitrust analysis of mergers at the division, monopolization cases; price-fixing. In addition, the filings by the division in front of regulatory agencies and general public policy issues, such as revisions of the merger guidelines.

Q. Were you also responsible for formulating the division's economic position with respect to mergers during the Reagan administration?

A. Yes. That would be included both in terms of the way we went on analyzing mergers and the general policy issues such as the merger guidelines.

Q. After leaving the Department of Justice, what positions have you held?

A. I have been a resident scholar at the American Enterprise Institute. I was a visiting lecturer at the Woodrow Wilson School at Princeton University and a research associate professor of psychology at the American University, locally.

Q. Dr. Warren-Boulton, can you explain how someone with a Ph.D in economics became a professor of psychology?

A. By accident. Psychology and economics isn't all that different. We both try to predict behavior. Economists do it in boring ways. Questions like how do consumers respond

to a price change. Psychologists look at it in more interesting ways, which is, you know, how do people respond to different reinforcements. But prices can be really looked at as reinforcements, and the quantity that you buy is like behavior. So essentially it is a very similar set of questions, just very different techniques.
Q. Now, as a principal of Micra, what are your responsibilities?
A. Micra largely does research, writes reports, provides consulting and expert witnesses.
Q. And as a principal of Micra, have you reviewed mergers and acquisitions?
A. Yes. At Micra, in contrast to the division, where one's responsibilities, shall we say, are sort of fairly broad, and one would look at a very, very large number of mergers, at Micra and before, I have been involved in merger analysis at the detailed level.
Q. Have you testified in Federal Court on mergers?
A. In the general area of antitrust, yes. Most recently for the Department of Justice in U.S. v. Englehart. And actually, my maiden effort was also for the Justice Department in U.S. v. AT&T, for which my mother has never forgiven me.
Q. Have you been involved in reviewing any mergers on behalf of private parties?

A. Yes. Although --

Q. Have you done any retail merger cases?

A. Yes. I was the expert for Bon-Ton in Bon-Ton v. May Department Stores, which was an acquisition of retail -- of department stores in Rochester.

Q. Have you done any publication in the world of industrial organization?

A. Yes. Unless you do, you can't get tenure. And I published in the area of industrial organization, mergers, efficiencies from mergers; broadly speaking, those areas. And regulation.

Q. When were you first retained by the Federal Trade Commission in connection with the Staples matter?

A. I believe in December of last year, the first meeting. Or I can recall a meeting on New Year's Eve, which is why the date is more or less fixed in my mind.

Q. What were you asked to do by the FTC?

A. I was asked to look at the merger and evaluate the potential effect of the merger on competition in the sale of office supplies.

Q. Did you reach a conclusion?

A. Eventually, yes.

Q. What conclusion did you reach?

A. Well, I think the overriding conclusion that I have reached is that even after taking into account potential for efficiencies -- any reasonable potential for efficiencies from this merger, that this merger can be expected to lead to a large and significant increase in the price of consumable office supplies.

Q. Now, you testified that your overriding conclusion was that the merger would result in a large increase in the price of office supplies. Do you come to any preliminary conclusions on the way to reaching that final conclusion?

A. Yes. There are a number of steps in that process. The first is to define the product market, and I believe that the relevant product market is indeed the sale of consumable office products through office superstores.

Second is that the participants in that market currently are the three current office superstores: Office Depot, Staples and OfficeMax.

Third, that before considering efficiencies or at least absent efficiencies, this merger could be expected to result in a very large increase in the price of consumable office supplies.

And then finally going back, I guess, to the original conclusion, which is that even after taking into account reasonable efficiencies, this merger appears to be likely to result in a significant increase in the price of consumables.

Q. What type of evidence did you look at in forming these

conclusions?
A. Well -- whoops. We have a slide that is more informative. This case is very unusual in that we have access to very diverse sources, types of evidence. The three broad types I have looked at are from the documents, various documents of the parties and others.

In addition to that, however, we have also had the results of econometric evidence from an econometric model, a very detailed large-scale one.

And then third, we also have looked at the information that can be provided about the likely effects of this market from looking at that financial markets.
Q. Financial markets, you mean the stock market?
A. In the stock market, yes.
Q. And is this a methodology that you would typically follow in reviewing a merger?
A. It's a methodology I typically follow, yes.
Q. Can you describe the type of business records you looked at in considering the effects of this merger?
A. We looked at the -- first is the kinds of documents that you went over rather extensively yesterday. Internal documents that looked at differences across pricing zones for Staples, depending on whether it was three-player, two-player, or non-competitive zones. I've also looked at the internal planning documents and internal pricing strategy

documents. I have looked at the reports of financial analysts, and I have read numerous depositions and declarations of industry participants.

Q. Why is the review of internal company documents important in assessing the competitive effects of the merger?

A. Internal documents, particularly ones written -- for obvious reasons that we probably don't need to belabor -- before the merger was announced, give you access to two things. It gives you access to the expertise and the knowledge of industry participants, which are unique. And second, it also can provide you with some guide as to what the incentives, effects, expectations from this merger are.

Q. Now, the second type of evidence that you described was econometric evidence. Would you explain what the term "econometric evidence" means.

A. "Econometric" refers to the applications of statistical analysis to economics. Similarly, cliometrics is -- for those of you who like Greek, is the application of statistical evidence to history. Econometrics is the application of statistical analysis to economic issues.

Q. Sorry to have interrupted you there a little bit.

A. That is all right.

Q. What --

A. Econometics.

Q. What econometric analysis was performed in this case?

A. In this case a large-scale econometric model was constructed by Professor Orley Ashenfelter of Princeton, under, I guess, my direction, to look at the effects that are -- to enable us to better predict the effects of merger.

Q. And do you know where the data came from for that econometric study?

A. Yes. It came from the parties.

Q. What does the econometric analysis allow you to do?

A. The econometric analysis, first of all, allows us to look at the relationship between the prices; in this case, the prices of Staples, because that is the data we had. The prices, and the presence, absence, amount of other retailers that are alleged to or arguably might have an affect on that pricing.

So the first thing it lets you do is it lets you disentangle out the effects of different alternative causes for prices. And in addition, it allows you to hold constant for other things that might be affecting prices, like local costs and things like that.

The idea is to take a mass of confusing data and to be able to basically unscramble an omelet. Try to figure out -- out of all of this, let's figure out what the independent effect is, of all of these different things that could be affecting what it is that we are interested in explaining.

In this case what we are interested in explaining is the prices charged by Staples and particularly how that varies depending on competition. We want to make sure we don't have it confused with a bunch of other things.

Q. In other words, going back to my presentation yesterday, it is a way to explain why the red bars are higher than the yellow bars and the green bars?

MR. KEMPF: Your Honor, I object. That is a leading question.

THE COURT: I will sustain it.

That is all right, I sustained it. He can just ask another question.

BY MR. CARY:

Q. Withdrawn. Does the econometrics allow you to figure out what is causing observed differences in prices?

A. Strictly speaking, by itself, if you had econometics with no theory, it would show correlation. However, in this case the issue really is, is it reasonable on the basis of economic theory to believe, for example, that the presence of competitors affects prices? Or is it more reasonable that prices affect the presence of competitors?

In this case, the market has to be structured with an underlying understanding of the economics and economics theory. That the variables, the explanatory variables that are on the right-hand side of this equation -- it's a big equation and it basically says-- it's like a recipe. Here's a price of staples, and that price of staples is equal to -- and then you have all these things that might affect the cost of staples.

And economic theory enables you to go from the idea that what's on the right-hand side of this equation, the explanatory variables are in fact causal; that they are the ones that determine the left-hand side, rather than the other way around.

Q. So it allows you to test that hypothesis?

A. Yes.

Q. You also testified that you looked at evidence from the financial markets. Can you briefly describe what evidence you looked at?

A. We looked in particular at the effect of the merger -- or more exactly, changes in the probability that this merger would go through, on the stock market values of the parties; the parties combined; and a number of other firms including, obviously, OfficeMax, which are arguably or are believed to be competitors or might be competitors, or any firm that might be thought of as potentially in the relevant market.

Q. What is the significance of this type of financial market evidence?

A. Well, the idea behind this is extraordinarily simple, and you don't need to be an economist or even a rocket scientist to understand it. And if you just read the Wall

Street Journal virtually daily now, the idea basically is that if you -- there are two scenarios. One is the anti-competitive scenario, one is the pro-competitive scenario. In the anti-competitive scenario, what happens is two firms merge. They gain market power, they raise their prices, they reduce their output. And that's, by the way, holding all else constant. It means what the rise in their prices would have been but for the merger. In other words, they either raise their prices or they-- or they don't lower them by as much as they would have. So we have an anti-competitive scenario in which we have market power leading to higher prices.

And then the question is what happens to rivals. And if in fact prices have gone up in the market as a result of the merger, then rivals will gain. They have the opportunity to raise their prices and they have the opportunity to expand on output. This event will be profitable for that rival.

And if the market believes that this merger is going to result in higher prices, then what you should see is a result is, because they expect that the profitability of these rivals would go up, we should see a significant increase in the market value of the share price of those values.

The other scenario is the pro-competitive scenario. It's the efficiency story. It says that we will merge these two firms and there are going to be big efficiencies and little or no increase in market power. So the efficiency effects will offset the market power effects. The result is that the merging firms will increase their output more than they would have and they will reduce their prices by more than they would have. And the rivals will look at this, and that is bad news for the rivals. It has lower prices and it will either reduce its output -- it's going to have to cut its prices. In any event, its profits are going to, will fall. When its profits fall, when you expect a firm's profits to fall, if that is understood in the financial market, then the share prices of that firm will fall.

So we basically have a fairly simple test in whether the financial markets believe prices are going to go up or down after this merger. If the financial markets believe the prices are going to go up after this merger, then what we should see is a significant price increase in the share prices of rivals. The obvious candidate, of course, is OfficeMax.

On the other hand, if the financial markets think that this merger is going to lead to large efficiencies and further drops in prices, this will be bad for OfficeMax and we should see that a change in the probability of this merger, an increase in the probability of the merger, should result in a fall in the value of OfficeMax.

Q. Did you review that data?

A. Yes.

Q. What conclusion did you come to, briefly?

A. The key word being "briefly". An increase in the probability of this merger has a very large and significant effect on the share price of OfficeMax. And of all the other firms we tested, the only other firm that this merger or a change in the probability of this merger has an affect on appears to be CompUSA, and it is a much smaller effect.

Q. Going back to OfficeMax, in which direction is this effect?

A. Oh. When the probability of the merger goes up, the share price of OfficeMax goes up. When the probability goes down, the share price of OfficeMax goes down. That connection is a very, very strong and very clear one. You can simply see it right in front of you on the graphs. And of course, being economists, we also tested it on the model and regressed it, and got significant numbers and things like that.

Q. In other words, it is consistent with the anti-competitive scenario of higher prices that you testified to?

A. Yes.

MR. KEMPF: Your Honor, I object at this point.

THE COURT: It is a non-jury trial. It is all right. Go ahead.

BY MR. CARY:

Q. Why did you use these three types of evidence in formulating these opinions, and how do these three types of evidence interact in forming your opinion?

A. Well, other than more evidence is better than less, they are -- come from different sources. And to a large extent often they address different aspects of the case.

Q. Were the results from these three types of evidence consistent, in your view?

A. Yes. They were highly consistent, all coming to the same conclusion.

Q. What was that conclusion?

A. As I said before, that this merger can be expected to lead to significant price increase for consumable office supplies.

Q. Will you please characterize the quality of the evidence that you have seen in this case, relative to the other cases that you have reviewed when you were in the Government?

A. I would describe it as extraordinarily strong, I'd say both in terms of the range of the evidence that is available in this case and the strength of the individual components.

Q. Mr. Kempf has argued in this proceeding that this case rests upon a very novel, revolutionary antitrust theory. Is this a case that you would have recommended when you were in the Reagan administration in the '80s?

A. On basis of this evidence, yes.

Q. Now, when you go about analyzing a merger, what question is it that your analysis is designed to answer?

A. The fundamental question is whether or not the merger can be expected to allow the merging parties to gain or better exercise or facilitate the exercise of market power.

Q. What is market power?

A. Market power is usually defined as the ability to raise prices above competitive levels for -- and sustain that for some period.

Q. Why is it important to prevent the exercise of market power?

A. Because the exercise of market power leads to higher prices. That leads to inefficiencies of misallocation of resources and a transfer of income from consumers to shareholders.

Q. Is there a particular methodology that you follow while reviewing the evidence?

A. Yes. I think the best guide how to evaluate a merger is the Department of Justice/FTC merger guidelines.

Q. Can you describe what the steps of that analysis are?

A. Broadly, four steps. The first step in the merger guidelines is to define a relevant market and identify the participants in that market.

The second step is to ask by how much has the structure changed in that market. By how much has concentration changed in that market. How far have you moved towards a monopoly.

The third step is, if on the basis of your first two the merger looks problematic, you then check to see if entry that would be sufficient to either prevent a price increase or to reverse it within a relatively short time period, if there is a sufficient probability that that entry will occur so as -- so that that price increase would not happen.

And then finally, if the merger still looks problematic, you would proceed to investigate efficiencies and ask whether or not the efficiencies that might be expected from the merger would be large enough to negate any price increase.

Q. Why don't we take these four steps one at a time, starting with product market definition. What is the purpose of defining a relevant product market in a merger analysis?

A. The purpose of defining a relevant product is -- is to ensure that -- it is like a reality check, if you like. We define a relative -- I am sorry. We define a product market under the guidelines as that group of products which is large enough so that a hypothetical monopolist of that group of products would find it profitable to impose a small but significant price increase, usually taken to be about 5 to 10 percent.

So the first step is to define the set of products such that, if they were a monopoly -- if somebody achieved a monopoly over that set of products, there would be a substantial harm to competition.

Q. Can you describe the process that one goes through in defining the product market?

A. Yes. Under the merger guidelines, you begin small and grow. And you begin with the product sales of the merging parties, and you would first ask the question, If we took only the products of the merging parties and you went to monopoly or you merged, would that result in a small but significant price increase. If the answer is no, you continue to add products to the market and reask the question.

Now suppose that the hypothetical monopolist had a monopoly over this wider range of products. Would he be able to -- would he find it profitable to impose a small but significant price increase? You continue that process until you've expanded your market large enough so that you have got -- my favorite term is, you have got something worth monopolizing. It is something under which, if you gained a monopoly over that range of products, that set of products, that you would find it profitable to raise prices by something on the order of 5 percent.

Q. Are you aware of the term "smallest market principle"?

A. Yes. The smallest market principle says that you stop there. You don't keep adding every possible product to the market. And when you're adding participants to the market, you don't just keep adding participants. You stop. The whole idea is to stop when you to get to the point where a hypothetical monopolist of that product would have the incentive to raise prices by a small but significant amount. Otherwise, you risk simply hiding the effects of the merger if you expand the market definition too large, into what you might call the kitchen sink. What you are basically doing is that you won't see something that is there.

Q. You testified at the beginning that you have come to the conclusion that consumable office supplies sold through superstores is a relative product market for antitrust purposes. What are the distinguishing characteristics of this product market that lead you to that conclusion?

A. Well, I would look at an office superstore as something that offers consumers who are interested in one-stop shopping, and low prices, or for office supplies, or who need a very wide variety to choose from. That can be measured in various ways. In particular, you can ask how many SKUs of office supplies does an office superstore carry versus a Kmart or a Wal-Mart. And you can sort of get into long debates about whether it's 300 or 400 or 500 versus 6,000.

My feeling about this is that perhaps the easiest and simplest way to resolve this is to simply go look at it. I think that if you drive to Staples and Office Depot up in Rockville, you will see what an office superstore looks like. It looks completely different. It is really a totally different format. And I think that if you go up a little further and go to BJ's or CompUSA; and ultimately, I suppose if you want to drive all the way up to Germantown and visit a Wal-Mart, what will happen is -- I think essentially one visit is worth a thousand affidavits, which I think is the line that you stole from me the other day.

Q. Yes, I did. I apologize for that.

Are there other retailing formats that in your experience have similar characteristics that would lead one to conclude they form a separate product market distinct from other types of retailers?

A. The obvious one is the one that Mr. Stemberg himself cites as the genesis for this, which is the supermarket. In fact, I think that Mr. Stemberg got this idea from his experience in supermarkets, and has characterized office superstores as basically a supermarket for office supplies. And I find that to be a really pretty accurate description.

Q. Are there other retailers that sell many of the same products as supermarkets?

A. In my experience, since I shop at Safeway; I also buy groceries from PriceCo, and the 7-Eleven on the corner, and a very small grocery on Connecticut Avenue, depending on how much I need to buy and when.

Q. Now, in your view, would the availability of groceries from each of those sources lead to you a conclusion that a merger between Safeway and Giant would never create an antitrust problem?

A. No. I am really going to PriceCo and 7-Eleven and Safeway for different assortments. What I am trying to get at Safeway, if I can't go to Safeway I would have to go to Giant. There is a big difference between Safeway and PriceCo on food, and a much bigger difference than there is between Safeway and Giant.

Q. Now, the parties here have argued that the market share of Staples and Office Depot ought to be considered against the universe of all office supplies sold anywhere in the country through whatever outlet. Do you agree with that characterization?

A. No. I think that the whole exercise of what we are trying to do here is to try to define a market in such a way that it will facilitate the answer to the question, will this market be -- will this merger be expected to lead to a price increase? You don't want to simply define a market as arbitrarily large, because, as I say, you will simply miss the effect. In the smallest market principle, the whole idea is that you stop expanding the market until you get to the point where you find a significant price increase.

Q. Going back one step to the whole genesis of the superstore and your description a little bit of the background of that, have office superstores been a successful retailing format concept?

A. Yes, they have been very successful. Office superstores have first, and from my point of view most important, clearly have resulted in large priced falls to consumers. As a matter of fact, the chart which I think the Plaintiffs put up yesterday was a really nice demonstration of this. They showed that the entry of an office superstore in a market resulted in price falls in an index, as I recall, from 135 to 110, about a 22 or something like that price decrease.

So, the entry of office superstores in the market, the first office superstores, have clearly been highly beneficial for consumers. It has been even more beneficial when there has been two or three office superstores.

Other indicators, of course, are the number of stores using the office superstore format of the three chains have expanded very rapidly. It has been a -- particularly for Staples, a highly profitable business, which economists like. And something else which economists like that probably most people don't is evidence of how efficient they have been, is that they have driven out a very large number of independent stationers. I think the number has dropped from something like 15,000 down to 6,000. In that sense I think it parallels the history of the supermarkets and the mom-and-pop grocery stores.

THE COURT: You mentioned the word "Plaintiffs." You meant the Defendants put up on the chart?

THE WITNESS: Yes. My apologies.

THE COURT: The people being sued; right?

THE WITNESS: Yes, the Defendants.

MR. KEMPF: The good guys.

BY MR. CARY:

Q. Given this history that you have described with the growth of the superstore, and given the differences in the characteristics that you testified are apparent just from observation between a superstore and a mass merchandiser or a computer store, does that lead you to any preliminary conclusions as to what the appropriate product market is?

A. I think on the face of it, somebody looking at this being announced, would say this certainly looks like it has all of the characteristics of separate market. And it is a reasonable way to begin, if you like, at a provisional market by simply looking at the characteristics. It does something different in different ways and really seems to have a significant effect.

Q. Once having established the superstores as a provisional market in this way, what do you then do to test this provisional market?

A. Well, you would want to start looking at other kinds of information. Internal information as to how the parties characterized themselves and their market. And empirical information that might let you test more precisely just what the expected effect would be from a merger to a monopoly, would be in this case.

Q. Referring you back to the charts that you put on the board here, you have some documents that are listed here. Were these documents part of the review that you did to test this provisionally accepted market?

A. Yes. And many of them are documents that you referred to earlier yesterday.

Q. Okay. Going down the document list, the parties do identify other office superstores as their primary competitors and Staples tracks other superstores. You note that Office Depot under certain circumstances identifies Best Buy, but Staples identifies only other office superstores. And the similar is not true of Staples designating cities without office superstores as noncompetitive in all the documents, they clearly regard their primary competitors as being office superstores, as I say, with a possible exception of Best Buy by Office Depot. So that is their own internal perception.

If you look at the second point there, if you look at the Staples strategic pricing documents of -- you know, which basically lays out their rules for how they price. They basically say that is what they do. Their primary competition is other superstores and they price against other office superstores. And assuming they do what they say they do, you can almost stop there.

In addition, in the documents as you went through yesterday, the documents contain a wealth of what you might call simple cross-sectional comparisons across zones for Staples, in which you can look at each zone, identify whether it is a one-player or two-player or three-player zone. And you can calculate average prices of those zones simply by the internal documents, and compare those across zones. And that, of course, is one thing you can do just out of the documents, without going any further.

Q. That is your second point, there, Staples and Office Depot base pricing primarily on office superstore competition?

A. Yes.

Q. Now, you testified that to some extent Office Depot recognizes Best Buy. Do both of these firms completely

ignore non-office superstores in their documents?
A. No. And nor would it be reasonable to do that, for several reasons. You know, if we were doing a merger of, as I say, Safeway and Giant, I would expect to see references to 7-Eleven or PriceCo, even though they would regard each other as their primary competitors. So, people will recognize anybody that they will lose sales to is in some sense a competitor. The issue is, who are the primary competitors that you face.
Q. Now, if you're making a distinction between a primary competitor and another competitor, under what circumstances in the documents have you seen references to other competitors?
A. Well, in particular I would expect in this, given the data here, that when an office superstore faces competition from other office superstores, in those markets its primary concern will be with respect to the pricing and the behavior of the other office superstores. By necessity, if you are the only office superstore in town, you are not looking at another office superstore in terms of your competition. What you are looking at is whatever is there in that town or what is available in that town.

The real issue is -- with identifying competitors is at what price level. When prices are -- when you have multiple office super supplies in the market -- stores in the market, and prices are low, then the office superstores are low because they are competing with each other. And if you had a merger or if you looked instead to a market in which you only have one office superstore, what we'd expect is that prices will be higher.

And prices will continue to rise until competition appears from somewhere. There is always some kind of competition. The issue in merger analysis is how far do prices have to go before that price rise is checked by these other competitors. Just as in a supermarket you ask the question, how high would supermarket prices have to go before so many people would decide to go to 7-Eleven or PriceCo or something like this as to make a further price increase unprofitable.

Q. All right. And now, once you analyze that question, does that require that you include these other firms that are competing, as you have described it in markets where there is only one superstore, and prices are high in the relevant market?

A. No. You would again stop at the point where you have added enough competitors, to the point where a merger amongst that group would result in a significant price increase. I mean, if you add more people -- if you added Best Buy and you kept adding people, you get a larger market. But presumably you get a larger price increase in that market as well. So, it's a balancing act. Simply the exercise of adding more firms to the market doesn't result in a prediction that somehow the price effect of the merger is going to be less severe.

Q. Dr. Warren-Boulton, in reviewing the company's documents and the like, did you find any evidence as to what a potential price increase might be if Staples and Office Depot were permitted to merge?

A. Yes. From two sources, as I said. Both the internal documents and from the econometics study. And I think we're about to get a table here.

This is the exercise basically you go through in market definition. You ask the question, having identified a provisional market, can we now ask what would happen to prices in that market if a hypothetical monopolist -- if you had a hypothetical monopoly over that market. In our case, having identified a provisional market as the -- consisting of consumable office supplies sold through an office superstore format, and identifying the three participants, the issue will be what would happen if you had a merger amongst the three in that market.

What the merger guidelines say is that you should stop when you have enough people or enough products in that products market so you can expect to see at least a 5 percent price increase. As you can see, for all office supplies we

are way over that simply with our three participants.
Q. Let's back up a little bit and take each one of these cells here one at a time. The top cell is the zone Staples prices. Staples, Office Depot, OfficeMax versus Staples. What does that mean?
A. That is the simple comparison. That is, I guess, the bottom line number from all of the charts that you were putting up yesterday. It looks at the average price in Staples' pricing zones, comparing three-player markets with one-player markets. And what it shows is the average price in Staples-only markets is 10.4 percent. This is basis points, because that is what everybody uses. So, it's 1,040 basis points, which is 10.4 percent higher for all office supplies, with a -- not surprisingly, a larger percentage difference for price-sensitive items, 12.52 percent, than for non-price sensitive items, five-point -- 8.99 percent. But this number is basically the bottom line number that comes out from the charts you were putting up the other day.
Q. Now, the next line, this is my attempt at high-tech, Your Honor. Right here, it says zone OD prices. Office Depot, Staples, OfficeMax, versus Office Depot. What is that?
A. It is essentially the similar procedure, but what it is based on is in the Office Depot documents looking at Office Depot prices. And what you see there is that there is less

of a difference in Office Depot prices between one-player and three-player markets than there is at Staples. It's still pretty high.

Q. This is basically comparing what the prices are where there are three competitors with what the prices are where Office Depot is in the market by itself.

A. Yes. The second one, yes.

Q. And that would be 7.66 percent.

A. Correct.

Q. In other words, Office Depot would have the ability to raise prices 7.66 percent if it faced no competition?

A. That is the inference between the cross-section comparison, yes.

Q. Now, down the bottom it says econometric model fixed effects. I'm not going to ask you to explain what fixed effects is at this point, but why don't you explain for us what you mean "econometric model" there?

A. Let me tell you why you would want to go to an econometric model. Because these are averages across zones, you may be concerned that there may be other influences that are going on out here; that other omitted variables, in economics terms, or other causes of what could be doing this. This is essentially a correlation.

And so the question that you would ask is, is that 10.4 percent -- does that really reflect the effect of competition or could there be other things going on that is producing that effect that correlate or confused this competition.

Q. What type of things might those be?

A. Well, the obvious first candidate is cost. For example, suppose that you thought that costs were much higher in markets which happen to be single-player markets, and much lower in markets where you happen to have three players. And if you simply compare one-player and three-players, what you might find is much higher prices in the one-player market. But in the scenario that we've just created, the reason for that isn't necessarily because there is just one player. It could well be partially or totally because costs are so much higher in a one-player market.

If you look at that across markets, what you do see, for example, is these two one-player markets which have very high costs; Manhattan for Staples, and Hawaii for Office Depot. On the other hand, if you look at the other cities, you expect to see the causation or the going in the opposite direction. In general, small towns or small rural areas that will tend to just have one supply chain there, it also will tend to have relatively low costs.

Larger urban markets which might be -- you might expect to find two or three office supply chains, might be expected to have higher costs. So when you look at the documents and you say to yourself, Is there anything that springs out at you from the documents? Is there an 800-pound gorilla here that you look at it and say, Ah-ha, there is clearly something else going out there.

I don't see anything in the documents that leads me to perceive there is a significant bias in that number.

Q. Okay. And then you run all of the data through the econometric data to test that and see if there is anything else out there; is that correct?

A. That's correct. And your colleague's term, we have a black box. And out of this black box comes 8.66. That number actually has just gone down by a percentage point, because I understand Professor Ashenfelter has just had access to some more information from the parties and has lowered his black-box estimate to somewhere in the range of 8. But it's still in that ballpark, yes.

Q. And again, this is basically to hold constant for cost. What else does it hold constant for and adjust for?

A. That result simulates the effect of the merger. And what it holds constant for is the presence of a non-office-superstore competition. And it also holds constant for variations across time and across regions in terms of costs and other factors that might be piercing this result. Essentially what it tries to do is separate out purely the effects of office superstore competition from all of the other possible factors.

And as you can see when you do that, it does turn out that you get somewhat smaller numbers.

Q. Now, in the econometric model, does that take into account the presence of Wal-Mart stores?

A. Yes.

Q. And Best Buy stores?

A. Yes.

Q. And the warehouse club stores?

A. Several, yes.

Q. And Kmart?

A. Yes.

Q. Computer stores?

A. Yes.

Q. And after having taken an account of all of those different types of retailers, the econometric models yielded the result of roughly 8 percent?

A. That's right.

Q. Given the distribution of all of those markets and all of those stores, the question that the model was intended to ask here was, if you had a merger to monopoly of all three office superstores, what is the price increase that you could expect to observe, even after taking into account the role of other suppliers of office supplies and of different costs and things like that?

Given that conclusion, what is the implication of that for the product market definition at issue in this case?

A. The implication is that the relevant product is indeed the supply of consumable office supplies through an office super supply format.

Q. Have you reviewed some materials presented by the parties, some graphs they put up on the board yesterday which showed that when a Price Club or another retailer opens in the nearby location to a Staples or an Office Depot, that that has an effect on their total sales?

A. Yes.

Q. Does the fact that another retailer opening has an effect on Staples or Office Depot's sales affect your analysis that those dealers ought to be excluded from the relevant market?

A. Let me answer that question this way. First, when another retail store opens near your retail store, your sales may go up or down, because that other retail store may attract customers to your store as well. There is a balancing act. And you may win some and you may lose some.

In fact, I believe Mr. Stemberg once described his favorite place to locate as a shopping center that had a Home Depot and a PriceCostco. And so in fact his sales would go up if a PriceCostco was located right next to him.

But the more fundamental problem is, even if the entry of another store locating somewhere near you meant that you would lose sales, that's the wrong question that we are trying to ask. We are trying to ask the question, What did it do to your prices? Not what did it do to your sales? And even if you have what I think the parties are calling a large hit; even if, for example, the entry of a Best Buy nearby would result in a significant reduction in sales, there are two real qualifications that you want to make in interpreting that evidence. The first is even if it results in a significant effect in your prices, you go back to this issue that you don't want to add every single potential or supplier to the market, even if it has some effect on your prices. Remember, what we are trying to do is we are trying to construct a market that will inform us as to the central issue in this question, which is, will prices go up? So even if there is an effect on your prices, you may not need to include them in the market.

And second is a point which is not exactly obvious, and that is that even if the entry of a rival retailer near you results in a loss of sales, it doesn't necessarily mean that you will reduce your prices. And you might even raise them. And the classic example of this turns out to be generic drugs. If you look at what happens to the prices of prescription drugs when a patent expires and generic manufacturers appear. All of us intuitively would expect that the manufacturers of prescription drugs would react by saying, Whoops, competition has arrived and what I am going to do is I am going to drop my prices. It turns out that in drugs, what happens is that the generic drugs appeal to a particularly price-conscious group of customers. So the entry of a generic drug means that while the prescription drug manufacturer may lose sales, what he has lost is his sales to his most price-sensitive customers.

His best response in that circumstance turns out sometimes to be to say, Okay, I don't like it, it is a hit. But my response is instead of lowering my prices in response to this entry, what I do is I raise my prices.

So, fundamentally, the hits analysis asks the wrong question. The question we want to know is, what will be the effect or what is the effect of these other suppliers on the prices charged by Staples. Not what is their affect on sales.

THE COURT: Can we take a break?

MR. CARY: Sure, Your Honor.

THE COURT: We have been here since 9:30. It is time for morning recess for 15 minutes. We will be back at 20 past 11:00 on the clock on the wall here. So be back at 20 past 11:00. Thank you.

(Brief recess.)

BY MR. CARY:

Q. We were talking about the parties' hits analysis, and you were explaining that the relevant question is not how much their sales might be affected, but rather how their pricing is affected in terms of whether the hit -- whether the alternative vendor ought to be included within the market. Can you explain why a reduction in the sales is not dispositive on the question of whether the firm moving into the area ought to be included in the market?

A. Well, essentially, as I think I said before, for two reasons. The first is that the reduction in sales, while the entry of a new firm that reduces your sales may reduce your sales, they may not induce you to keep your prices low.

And the second, of course, is that once again, you know, in trying to figure out what the expected effect of the merger is likely to be, if you don't follow the smallest market principle and stop when you get to a relevant market, and just keep going, you will miss the effects that you are looking for.

Q. Going back to the econometric work that you described, what does that work show about which firms have a significant effect upon Staples' prices?

A. Well, two things are done in the econometric model that are relevant to this question. The first is in defining the model, which is the 8.86 percent there. And the second was asking as to just can we determine what the role and importance of all of these other chains that have been proposed as having a significant limiting affect on Staples.

And so the experiment was performed, if you like, with the data, asking the question as, Suppose that we ran the experiment in the data of simply closing down all of each type of store. So the floor experiment is, for example, all of the Wal-Marts disappear. Or alternatively, then we run the same experiment and ask, What happens if all Sam's Clubs disappear from the data set? We can ask that question in those markets in which Wal-Mart competes with Staples, what will be the effect of having Wal-Mart just disappear, on the prices charged by Staples? We go through that exercise similarly for each one of these other chains that have been proposed as having a significant effect on prices. And we ask the right question, which is what is the effect on Staples' prices, not what is the effect on their volume or the quantity of their sales.

Q. Okay. Now, if you examine the econometric results with that question in mind, what result do you find?

A. What you find is that this entire set -- and I don't know if I need to read them all off, but I guess it is Wal-Mart, Sam's, Computer City, Best Buy, Price Club, BJ's, CompUSA, Kmart and Target. Of this entire set, we only find a statistically significant affect on Staples' pricing from closing all of the Best Buys, and we also find a statistically significant effect from closing all of the CompUSAs.

Now, the Best Buy effect is not only significant, statistically, but also quantitatively very sizable. The best estimate here is that if all of the Best Buys simply closed, then in areas where they do compete with Staples, Staples would raise their prices by 3.7 percent. In the case of CompUSA, while the effect is statistically significant, the effect is really quite small. It is less than 1 percent.

What this process would do, it looks at each one of these firms. And recalling that we are looking at a data set over the last 20 months. So the relevant question is, taking that period over the last 20 months, what would have happened to Staples' pricing? Who was constraining Staples' pricing? The answer is, outside of the other office superstores, the only one outside of that group that looks like it has any significant effect on the pricing of Staples would be Best Buy. The others have a statistically negligible impact.

Q. And, again, the Best Buy effect is in about 3 and a half percent range, where the Office Depot effect is around 8 percent range?

A. 8 percent, yes.

Q. Does the fact that Best Buy has this effect, require its inclusion in the relevant product market?

A. No. Again, for two reasons. One is that you already have a relevant market without including Best Buy. But the other reason I think is a good illustration of why you want to look at different kinds of evidence. In looking at that question, as I say, you can look at the documents. You can look at the econometric evidence and you can look at the events study, the effect of the stock market. Apply that to this question, which is, should Best Buy be in the market?

If you look at the econometric evidence that we have just gone through, Best Buy looks like a good candidate. If you were to add a fourth participant to the market, you would add Best Buy. In addition, if you look at Office Depot's documents, what you find is that Best Buy is the only non-office superstore that anybody identifies as a real competitor. For both of those reasons you might say maybe we should add Best Buy.

But then you also look at the documents, and what you find is that Best Buy has been very active in the office supply industry over the past 20 months. They have been making a real effort to be a real presence in the office supply. And they have essentially run this as an experiment, is my understanding from reading those documents is that they have decided that this was not as profitable as they hoped it would be and they have pulled back at least significantly. They have made an attempt to -- and had a significant effect over this period on Staples prices. But given that they have changed their strategy, and now if you are forward looking -- as you must be in the merger analysis -- that would say while Best Buy might have been in the market in the last 20 months, it is unlikely to be in the properly defined market looking forward.

Finally, you also want to look at the events study. And you want to ask the question, again looking forward, because that is what the stock market does, does the stock market think this is going to be a great thing for Best Buy in the same ways it thinks it will be a great thing for OfficeMax. And the answer is no. There is no significant impact. The significant impact is on Best Buy which once again says, looking forward that you wouldn't want to include it.

Q. If one were to include Best Buy in a relevant market, would that change your conclusion as to whether this transaction is likely to be anticompetitive?

A. No. Even if you include Best Buy, if you were talking in terms of numbers, you would still be talking from two to one in some markets, three to two in some markets, and four to three in some markets. In addition to which, the increases in concentration, if you do something more complex than count heads -- which is what the HHI does. It counts the market shares, those increases in concentration, if you define the market to include Best Buy, it would still be very large and a large number of markets.

Q. Have you reviewed the market share charts that have been submitted into evidence in this proceeding?

A. I have seen them, yes.

Q. Have you seen that they in essence add one firm at a time and recalculate the Herfindahl indexes?

A. That is an exercise you can go through. If you don't know where to stop, you can keep adding firms until you say what happens to concentration, assuming that all those firms are the same and belong in the relevant market. The main point is that you are supposed to stop when you get to a market in which there would be a substantial price increase if there was a merger amongst all of the participants in that market, and not keep going. And that point you arrive at, in my opinion, before you would include Best Buy or anybody else in the market.

Q. It would include only the three office superstores?

A. Yes.

Q. Have you assessed the relevant geographic markets in this case?

A. Yes. I think the geographic market is relatively uncontroversial. And that is that I think everybody would agree it is local.

Q. And why would you conclude that it is local?

A. Well, you want to think about geographical markets both in terms of the abilities of consumers to substitute from outside of that market, and also think about it in terms of whether or not the presence of firms outside of that geographic market might influence the pricing of firms within that market.

In terms of the first point, if you are a consumer of consumer office supplies in Washington, D.C., it really doesn't matter to you very much if another office supply company is in, you know, Philadelphia. There is a limited distance that you are going to travel. So in terms of consumer substitution, the market is clearly highly local.

The other possibility that you might want to consider is that firms in the local area might constrain their pricing because of potential competition from firms that are outside. So, for example, Staples or Office Depot in Washington might lower their prices or keep their prices lower, because of the presence of, say, OfficeMax out there, somewhere else. And under certain circumstances that kind of potential competition at the wing can in fact influence prices. It doesn't appear to in this case, and the reason for it is pretty simple. And that is that potential competitors outside of the local market would influence your prices if you thought that they could enter very rapidly, like hit and run, with very small sunk costs. And if they did enter it would take a while before you could adjust your prices. So you had to be prepared. You had to cut your prices in anticipation to block entry.

In this case, the costs of entry are largely sunk. And there doesn't seem to be any reason why incumbents would delay their pricing. So that, since you know that if the entrant does enter you can always drop your price then, there is no gain to dropping your price early. And dropping your price early is not going to deter somebody from entering, because he is going to want to know what is the price after he enters. He doesn't care what the price is before he enters.

The operative word in this is that potential competition from outside of the geographic markets is not a binding constraint. And the best strategy from the point of view of office supply firms in individual markets is look at the competition from other office supplies in that market. And basically, even if you think somebody is going to come in later, you know, the best decision is to make hay while the sun shines.

Q. Make hay while the sun shines. Where did that expression come from?

A. That actually comes from an Office Depot document, the District 8, where the writer was talking about the fact that there was not competition in the market, but perhaps

OfficeMax might enter. So given the competition was on the horizon, we better make hay while the sun shines.

Again, I stole that line, but then you stole my earlier line.

Q. Now, going back to your description of the circumstances where it would not make sense to lower your pricing in anticipation of entry, you used the word "sunk" costs. What is a sunk cost?

A. A sunk cost in this context would be an expenditure that you would have to make to enter a market that you would not be able to recover if you leave the market. It would be all of the expenditures of entering in the market and setting up and getting leases, things like that. If you exited the market you might be able to sell off something, but in that process of entering and exiting you would have left a lot behind. And what you left behind is basically sunk, you have to write it off.

Q. Again, remind us how that is relevant to the conclusion with respect to a geographic market.

A. Well, given that there are sunk costs to entering, an entrant can't just come in on hit-and-run entry; basically enter and drop the price, make money, and until you have had a chance to drop your price, the incumbent has a chance to drop his price. What happens is, by the time he has entered, the incumbent can adjust prices, lower his prices. And it will turn out to be a very expensive proposition for you to try to do that, because if it is not profitable for you to stay at the lower prices, and you have to leave, you will have lost your sunk costs.

Q. If there is sunk cost, it is less likely you would stay?

A. Yes.

Q. I think we have now covered basically the first two of the merger guidelines checklist that you laid out for us at the beginning. Product market, geographic market.

The third element that you mentioned was entry conditions. Can you describe what the relevance of entry conditions is to the analysis of the anti-competitive effects?

A. Well, after you have looked at a structural analysis, after you identified the market and looked at the change of concentration in that market, if -- as I said, if the merger still looks problematic, then you have to ask the question, Is it possible or likely that there is sufficient entry out there of firms who, in response -- if the merging parties tried to raise prices, that there are potential entrants out there that could come in, and that the entry of those firms would be enough to either dissuade the merging parties from ever raising prices at the prospect of that entry; or if they did try to raise prices, that that entry would happen sufficiently quickly so that it would drive those prices back

down to premerger levels within a very short time period.
Q. Okay. Now, this assumes an anti-competitive pricing effect in the merger in the first instance?
A. Yes.
Q. Did you examine the prospects for an anti-competitive price increase here?
A. Yes. And we did that in a couple of ways.
Q. In making the analysis whether a merger is likely to have an affect on prices, absent later deficiencies, what kinds of evidence do you look to?
A. Well, in terms of looking at that process, you would go through both a structural analysis, and you would also look at the quantitative evidence.
Q. Let's start with the structural analysis. Can you describe what the structural analysis is and what kind of evidence you looked at?
A. The structural analysis basically asks, having defined the market and having determined the participants and defining the geographical market, you can now ask how much of a change in structure is going to occur because of that merger. One way to do it is to compute HHIs in every market. I think broadly speaking this is a market in which these firms are growing rapidly. And the fundamental nature of the structural change can probably best be addressed by saying that there are -- particularly if you look at the

immediate effects, there are 41 markets out there. And in 16 of those markets that the FTC has identified we will go from two to one office superstores, and in the other 25 markets we are going to go from three to two. So the immediate effects are in a group of markets we will go from two to one, and another group will go three to two. That is a large structural change and one which would generally be expected to result in a significant price increase if you define the market correctly.

Q. You said these firms are expanding rapidly, and that is also relevant to your analysis of the likely competitive affects. How is the expansion of the firms relevant to that analysis?

A. Well, the expansion, it is relevant because that, amongst other reasons, might lead you to believe that the immediate structural effects that you observed might underestimate the effect of the merger. And at some point I have a slide from -- looks like -- that's right, yes.

This is taken from Staples' 1996 strategy update. And essentially it looks at their expectation of the overlap between Staples and other office super supply stores, between 1995 and approximately the year 2000.

As you can see, at the time the update was written, approximately 17 percent of Staples stores were in the markets where there was no superstore competition. 29

percent, they faced only Office Depot. 37 percent, only OfficeMax. And 17 percent were in three-player markets.

And this is their expectation, their forecast of what, but for the merger, would be happening by the year 2000. And what you can see is that these firms are on a very rapid collision course with each other. They are, or would be absent the merger, expanding into each other's markets rapidly. By the year 2000, instead of 17, we would see only 12 percent of Staples stores would be in Staples-only markets.

The biggest increase, of course, is in the number of three-player markets. It would go from 17 to 69 percent. And from our point of view in terms of looking at the overlap with Office Depot from the merger, what you probably want to do is add the 29 and 17. And the overlap between Staples and Office Depot will then go from 46 percent of Staples' stores all of the way up to 76 percent. So, these firms are facing a significant increase in the extent to which they will face each other in head-to-head competition.

Q. Let me throw on the screen a document that you have selected from the parties' records. Is this one of the documents that you reviewed?

A. Yes. That's from the Staples' '96 update and it is discussing exactly this phenomenon, which is looking into the future; what is likely to happen, but for this merger, of course. The competitive pressures, three-player markets increase to 76 percent, are going to increase. So competitive pressures increase as the overlap moves to 76 percent between -- I presume that means between -- actually, its ODP overlap markets increase to 76 percent. It is hard sometimes to tell what they are meaning, but I interpret that to saying the increased overlap with Office Depot to 76 percent will lead to increase in competitive pressure.

Q. This is PX 14, Your Honor.

THE COURT: All right.

BY MR. CARY:

Q. What do you expect the impact on prices to be of -- as you called it, the increasing head-to-head competition between these firms?

A. Well, I think that if you look at the level of competition between them currently, while highly desirable, I think both as an economist and reading the documents and the opinions of others, I think there's a general expectation that that competition, at least absent this merger, can be expected to intensify, both as the overlap increases, and also as these individual local markets approach what the parties' call saturation, which is basically the largest number of stores that can -- of office superstore format that can fit in the market.

And I think if you think of the process of the growth of the office superstore sales with any one market, when they first enter, they are essentially competing with independent stationers and other relatively high cost suppliers. And as we've noted, the first office superstore to enter, and then the second, offers a significant price discount off what they are charging. But you know, when you are still small in the market relative to the saturation level, you know, as you grow, you can continue to take sales away from independent stationers by continuing to offer that 25 to 30 percent discount off. During that process, there really isn't any real need to sort of, you know, beat each other's brains out in terms of the office superstores. You can get enough market share, you can grow rapidly enough simply by taking share away from the independents.

Finally, though, as you reach saturation, you are in a situation in which you have already backed out the independent retailers. And the only way now to gain market share is if you like to turn on each other. And that is essentially the pattern that, as an economist, I would expect to see in these kinds of markets. And that also is consistent with what both parties have described of this story, and it is very consistent with what financial analysts have expressed; although when the financial analysts have talked about it, of course, from their point of view it is a real concern. From their point of view, as markets approach saturation, the concern is that this would lead to irrational pricing, which is what in the antitrust field we call competitive pricing.

Q. Let me show you a document that you have selected from the materials that you have reviewed, PX 9. Can you describe this document and explain its relevance to your analysis.

A. Yes. This is a quote in Staples for Success with Tom Krasnow and it discusses --

Q. Who is Tom Krasnow?

A. At Staples. And it is a description of their pricing in the relatively early days. And it talks in the rest of the -- this is blown up for this section. It is all well worth reading, as is indeed all of Staples for Success. Excellent book, from my point of view. And it discusses basically the early days in which the office superstores and the Price Clubs opened up the price war with each other. And Krasnow's reaction to that, or description of it, basically says we in the industry didn't get more rational in 1992. It is not in any company's self-interest to have a price war because you get lots of market share without having a price war. And having a price war among low-price competitors doesn't get you more market share. It didn't serve any purpose.

Now, what that's basically saying is that if you have a group of low cost competitors such as office superstores, and you are dealing with high cost competitors or different stores, there is no point in vigorous competition amongst the low cost suppliers until you back out all of the high cost suppliers, so you don't gain much of any market share as a group. That is what we expect to see, is that as these markets approach saturation the competition is going to have a bigger impact then than it has today.

Q. Dr. Warren-Boulton, are you familiar with the term "next best substitute" in the merger guidelines?

A. Yes.

MR. KEMPF: Your Honor, does that yes mean no?

BY MR. CARY:

Q. Let me ask the question slightly differently. What is the relevance of the closeness of competition between two firms for the analysis of the merger?

A. The -- when you look at a structure analysis and just think of it as three to two, you are implicitly assuming that all three are the same. If you actually look at the particular situation, they may not be three homogeneous firms. Looking at this case, looking at it as simply three to two, as three equivalent firms going to two firms is misleading. This is really a merger amongst not only the two largest but the two most efficient and perhaps the two most aggressive pricers in this market. A merger between Office Depot and Staples is really very different from the merger between, say, OfficeMax and Staples. While that merger may result in a price increase, that a merger amongst the two largest and lowest price competitors means that a merger that takes you from three to two has a bigger impact in that circumstance than if they were all of equivalent size.

Q. In other words, OfficeMax is the highest priced of the three competitors?

A. More that, in terms of both the documents and particularly in terms of the econometric analysis we do, OfficeMax has a much weaker constraining influence on Staples than does Office Depot. Throughout the econometric and also the simple comparison analysis, what you find is that the presence of Office Depot has a much bigger impact on Staples' pricing than the presence of OfficeMax. That is a very clear result that just -- it shines through all of the data.

Q. You have described the structural analysis of the merger. Are there other things that you can do to test the structural analysis or to explore other potential anti-competitive effects of the --

A. The structural analysis may not give you a precise prediction of the size of the increase, of the amount of increase that you might expect. So to do that we can look at two other pieces of evidence. Once again, if we switch to our earlier table -- or you can ask the question, what happens in a simple cross-section results, the tables that you were putting out yesterday? If we then ask the question, what is the average effect across all Staples stores? Some of those, some of those markets are going to -- the zones are going to go from three-firm to two-player zones. Some will go from two-player to one-player zones. If we look at the average effect across all of the zones, what kind of price differential do we observe? And in a case of Staples --

Q. Let me interrupt you a minute, just to make sure we are all understanding this. To contrast this portion of the table from the one we saw earlier, the earlier portion was designed to answer what question?

A. It was designed to ask what is the market definition issue. The market definition issue asks, what happens when you have a monopoly, three-to-one in this particular example.

Q. And this slide, what is this one designed to answer?

A. This one is designed to answer what is the actual effect of not a merger to a monopoly, but what is the actual effect of this merger. Some partial distance in that direction.

Q. And what does this tell is?

A. The second one is what we are just discussing now, which is if we look at the cross-sectional comparisons, across zones for Staples. What we find is if you take the average, if you weight the average of three-to-two, two-to-one, the same as in the figure we had before with the three circles, what you would get is an average differential of between -- when Office Depot is there and not there after the merger, of about 9.09 percent. So assuming that there aren't other effects which are causing this, the implication is that the merger would result in approximately 9 percent price increase across all Staples stores.

Q. And again, this is using all of the data that the parties made available?

A. Yes.

Q. Let's go to the third line from the top, the one where it says econometric model, fixed effects?

A. That is the econometric model which Dr. Ashenfelter has contributed. Once again, I think he has some new data from the parties, and that he should probably take maybe another 1 percent off that number. So that econometric estimate, which holds constant for all of the other factors that might be relevant, comes up with an estimate of something in the order that the merger can be expected to result in approximately 7 percent price increase across the board for Staples.

Q. And again, that is holding constant for differences in costs, differences in the number of competitors, differences in the identity of competitors, and the differences in the number of non-superstore vendors in the markets?

A. It is holding constant for everything that I could think of or that the parties have suggested, or that we can get data on. It is a pretty thorough large model.

Q. Now, there is also the top line. There it says Staples

'96 strategy, and it says all office supplies, 500 to a thousand, or 5 to 10 percent. Can you explain where that number comes from?

A. That is the Staples 96 strategy update. It is a fairly complex document, and it does a couple of things. It enables you to get a feeling for what the parties think the price decreases would likely be, absent the merger, because of increase in competitive pressure. And depending on what question you are trying to answer, which is like what happens on a three-to-two market or two-to-one market.

You can try to back out, if you like, the numbers in that document to try to figure out what are they assuming. What do the parties believe is the difference in pricing between markets where Office Depot is present and what isn't? So it is the internal belief as to how much of a difference it makes, depending on when Office Depot was there. And depending on the question and how you do it, you can get numbers anywhere from 5 to 10 percent.

Q. Can you give us a general idea -- I know it is spelled out in more detail in your declaration. A general idea how you went about calculating that number.

A. You can do it a lot of ways. The simplest example is that in it makes a reference to what happened in New York, Long Island and Connecticut when Office Depot entered. Now that is in our terms of going from a three-player to a two-player. So we expect something, you know, from the other evidence, such as for example the Prudential study, something on the order of 5 or 6 percent. They report that the effect on Staples' margins when Office Depot turned it from a two-player into a three-player, was 169 basis points. I think that is probably on the earlier slide.

To get from there to prices is not all that complicated. It is really basically just two steps. If you have 160-basis-point increase in the margin overall, that is for all of the sales of the office superstore. Now, the effect on prices, from what we can see, will be concentrated primarily or exclusively on office supplies. Okay. We are not alleging a market in computers or printers or anything like that.

Office supplies, consumable office supplies of the type that we are talking about here where we think there would be a significant price effect from the merger, account for about 40 percent of all of those sales. So if you get a 160-basis-point change over 40 percent, then that means that you divide the 160 by, you know, .4, and you get 3.25 basis points.

I am sorry. Then what you have to do is, you have to remember that a basis point is not saying it is a price point. One basis point in the margin results in approximately 1.4-basis-point difference in the price. So, you would take the change in the margin, divide it by .4, and multiply it by times 1.5, and you get a number of 4 or 5 percent.

Q. That would be in a three-to-two type situation?

A. Yes.

Q. These are all basically ways to check and recheck the conclusion that there will be a price effect as a result of this transaction?

A. Yes. You are looking at just a very wide range. You are looking at a number of different possible estimates, directions, as you can collect. And they are all highly consistent.

Q. Has Staples considered similar acquisitions to this one in the past?

A. Yes. Staples has considered merging in the past with Office Depot, and also with OfficeMax.

Q. And did Staples consider in the course of those mergers what their ability to raise prices might be as a result?

A. Yes. In looking at those documents, there was a leak in both of those cases that they would lead to higher prices for those mergers as well.

Q. Dr. Warren-Boulton, going back to the slide that you put on the board, can you summarize your conclusions with respect to the likelihood of anti-competitive effects of this transaction?

A. I would say that the evidence from the large number of sources, structural evidence, of the evidence in the cross-sectional comparisons, the evidence from internal documents showing intentions and expectations, the evidence from the econometric model, all point to the same conclusion; which is that at least before taking into consideration nationwide efficiencies, not efficiencies that would change of the national level, that this merger can be expected to result in a large and significant increase in prices for consumer office supplies. Somewhere along the order of 7 percent is probably about as good a number as any.

Q. Between 5 and 10 percent?

A. Yes. That would make it quite safe.

MR. CARY: Your Honor, if this is a convenient time for the Court, this is a good breaking point in terms of our examination, if this would be a good time for lunch.

THE COURT: You are going to go into the efficiency part now?

MR. CARY: Yes, Your Honor.

THE COURT: Let me see the timing.

MR. KEMPF: How much time do you have? I know you have more. About how much longer?

THE COURT: 15 minutes?

MR. CARY: 45 minutes.

MR. KEMPF: It is up to the Court.

THE COURT: We can take lunch and come back a little early so we don't lose any time.

MR. CARY: Thank you, Your Honor.

THE COURT: All right. We will take our luncheon recess at this time. We will take it for one hour and be back at 1:00 this afternoon, be ready to go at 1:00.

(Court Recessed For Lunch)

CERTIFICATE

I, PATRICIA J. YERKES, RMR-CRR, do hereby certify that the foregoing transcript constitutes a full, true, and correct report of the proceedings which then and there took place.

PATRICIA YERKES, RMR-CRR

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