FTC/Staples Transcript

As filed 5/20 pm

No missing pages....

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MR. KEMPF: Your Honor, I had a preliminary matter to take up with the Court.

THE COURT: Yes, sir.

MR. KEMPF: I am content to -- however the Court wishes to resolve it. It is a practical problem we have.

Pursuant to the time estimates we received from the plaintiff and the Court's admonition that we ought to have our people here and ready to go when we are moving along here, we had had our first witness -- who is a gentleman by the name of Morry Seigal -- here based on the expectation that he'd go on this afternoon.

He is here. He is from up in Boston. He is a retired former CEO of Zaire's up in that area, he's a retailer, does some teaching at MIT on that subject now. So he flew down to be here.

The practical problem is that based on the government's current estimates of their time, where we stand, we are unapt to hit him. He is -- while he's retired he sits on a number of boards, and he specifically sits on the board of American Airlines. This evening, they have an executive committee meeting on which he also sits, and tomorrow morning they have a full board meeting. We can -- we have talked to him. We can have him leave here, go down there and come back Thursday which -- we would reshuffle our witness order and put him on later in the case.

Or, alternatively, and what we raised with the government, was to take him out of turn while he is here this afternoon and continue on. I thought that might tie in to the problem we had with Dr. Ashenfelter completing his deposition before he testifies. They have said they don't agree with that.

I don't fault them for that. Nobody likes to have their case interrupted. But I did tell them I would like to take it up with the Court. We could, when Mr. Cary finishes his direct of Dr. Warren-Boulton, we could put Mr. Seigal on. Our direct will run about a half hour I'd say. Then I'm prepared to and would finish my cross of Mr. Warren-Boulton this afternoon. I'm not looking to buy any time on that, Your Honor.

THE COURT: Mr. Cary, you were concerned with bringing Seigal on at this time?

MR. CARY: Yes, we are, Your Honor. We certainly don't want to interrupt Dr. Warren-Boulton's testimony. We also have a witness that has come down from Princeton, New Jersey and he'd be seriously inconvenienced if he could not finish his testimony this afternoon.

THE COURT: I regret the inconvenience to either side. It happens in the trials and the best plans people attempt to make. I will ask Mr. Seigal to come back later in the week at the appropriate time then. I won't interrupt this testimony.

MR. KEMPF: That is fine. We will work that out.

MR. ORLANS: I have one more housekeeping matter. Melvin Orlans, representing the Federal Trade Commission.

I learned today the defendants intend to read omorrow into the record portions of the declarations as part of the time that they are entitled to spend. From the standpoint of the rule of completeness, obviously, we would like to be sure that fair portions of those are read and placed in context. I assume that we will have to probably do that on our time, but we have had no notice as to what segments of those declarations they are going to read.

It strikes me if they are going to do that, that at the very least we need a full and complete listing as soon as possible of the portion of the declarations they intend to use.

MR. KEMPF: Let me respond, Your Honor.

THE COURT: All right, please.

MR. KEMPF: As far as our use of declarations, very early on in the pretrial proceedings I said we would do that and confirmed it later in the pretrial proceedings.

There are actually two things we will do in connection with this. The first piece is the testimony from various competitors. One is a deposition. We have worked out line-by-line, back-and-forth designations and counter-designations.

But on the declarations, my view on tose is we should get to read what we want. If they want to read something else from it during their case -- whether from that declaration or from some other one, in rebuttal or otherwise -- but I don't see why we have to take a declaration and read from that during our portion of the case.

THE COURT: I don't think he meant that.

MR. ORLANS: Actually, I did, Your Honor, in the sense that it strikes me as it would be the equivalent of cross-examination. The rule of completeness would require the thing to be considered in context. It seems to me we shouldn't have to wait for our rebuttal case to read portions we think should be read in context with anything they read. I'm happy to have that be on our time, but it seems if they are using this in lieu of live testimony, we should be able to use in it lieu of cross.

THE COURT: I was speaking of your time. You didn't mean you weren't going to charge it to your time.

MR. ORLANS: Of course.

THE COURT: You want the have those read in rebuttal or some other time?

MR. KEMPF: Yes, Your Honor. Let me say this. I draw a distinction in what I would call a fairness designation. That's something if you ask someone a question and he says yes, but I really don't think it's a -- is there a correlation, and he says yes; but I think it is a very weak one. I think that's a fairness designation. Something that says yes, and then elsewhere they have something they like, that seems to me that that is not a fairness designation. That is something they ought to put in as part of their case. Whether it is now or in rebuttal, I don't care. It doesn't seem to me our case ought to be interrupted to read declaratory stuff that they like.

THE COURT: Let me do this. Perhaps this evening you can give me an example of what you will be reading in in a declaration, and I can look at the declaration and maybe in one of these declarations you can tell the government what you will be reading so they have some idea what you are talking about. I don't know if you are talking about lengthy descriptions or you are talking one line.

MR. ORLANS: To further complicate matters, Your Honor, a number of witnesses in this case who are appearing only on paper have have submitted multiple declarations.

THE COURT: Let me just get one example of what you are talking about this evening. I will look at it.

Why don't we go off the record.

(Discussion off the record)

(Dr. Warren-Boulton resumed the stand)

CROSS EXAMINATION - resumed

BY MR. CARY:

Q. Good afternoon.

A. Good afternoon, sir.

Q. Previously, you testified -- in your testimony, you touched upon the subject of entry and its relevance to the consideration of the anti-competitive effects of the merger. Do you recall that testimony?

A. Yes.

Q. Would you now elaborate having shown your conclusion with respect to the likely price effect, putting aside efficiencies for the moment, on what you perceived to be the likelihood that those anti-competitive effects will be somehow eliminated as a result of the new entry coming into this market?

A. My conclusion is that they will not be, because there are significant entry barriers in this market.

Q. Would you describe what those entry barriers are?

A. Well, I think that the entry barriers that are involved here can really be explained in -- from three pieces of evidence, if you like. One is simply the history of this industry.

Given the presence of economies of scale, the office super-supply market is basically like a horse race. We started this race with some 23 entrants. We are now down to three. And I guess I would regard that as we are heading into the finish line. None of these three look like they are failing; and so, absent a merger, it looks like the final equilibrium is going to be that we are going to have three firms in this industry. But the history of this says that you grow, or, if you don't grow, you are acquired by one of the three.

The second underlying reason for that is that there clearly are economies of scale in this industry at both the local level and at the national level. This is not usual. In a large number of industries and firms you tend to get significant economies of scale, particularly at low levels of output. Eventually firms reach a critical mass, and those scale economies level out. And those firms are the survivors, if you like, in that market. That is essentially the pattern that looks like is happening here.

So those are our two reasons why it looks like there are significant scale economies here.

Q. Are there also barriers to entry at the local level?

A. Yes. As we talked about earlier, you need a certain minimum number of stores in many local markets in order to be able to cover the cost of advertising, particularly in large markets like Los Angeles or New York or Boston. Entry with just simply one store is not economically feasible; and so there is a critical mass that you should enter with. And over time, what happens is when you approach saturation in these markets -- that is to say as the total number of stores in these markets, individual markets, approach the saturation level -- it becomes less and less easy for somebody to just enter de novo, because there isn't essentially that kind of room.

What you have to do is instead of displacing an independent stationer that is a very high-cost firm, you now find yourself, upon entering, you run right up against an office superstore. That is a much more difficult proposition than one which is less likely to succeed than if you have a nice target, which is essentially what the initial entrants all had.

Q. Have you seen or reviewed documents of the companies that addressed this issue of saturation in local markets?

A. Yes. I've looked at two kinds of things on saturation, as we mentioned before. One is the effects in the econometric model of what happens as you approach saturation; and also I have looked at documents that go down city-by-city and asked how much room is there left, how close are we to saturation in those markets?

Q. And what have you discovered with respect to how close we are with respect to saturation in some of the important metropolitan markets?

A. In a large number of them, the existing situation with however many office supersupply firms are in there is getting very close to saturation in the sense there simply isn't room for a minimum efficient scale entrant to come in in those markets. And at the rate at which these firms are expanding, my guess is that that vacuum is going to be filled very rapidly in terms of the numbers of stores.

Q. Have you also evaluated the likelihood that other firms outside the market might constrain any attempt to raise prices by Staples and Office Depot?

A. Well, now we are essentially asking the question are there -- is there a non-traditional type of entry, some kind of -- not necessarily entry but -- that would have increased competition for the office supersupply format. The answer to that is, of course, yes, because we do have the experience of Best Buy. Best Buy, in fact, as we have talked about earlier, did try to significantly expand its offering of office supplies. They did it within their existing framework and essentially found that it was not as profitable as they had hoped and retreated from that; so that was an attempt at becoming a more aggressive presence within the office supply -- sale of office supplies without actually becoming an office superstore.

Q. And what does that experience tell you about the likelihood of that kind of entry constraining an anti-competitive price increase?

A. I think what it tells you is that if it is going to be successful, somebody is going to have to have something that Best Buy didn't have. They tried that route. Apparently, it has not succeeded; and so I think in looking forward, if you are looking for a potential candidate to play the role, for example, that Best Buy apparently played over the last 20 months, you are going to have to find somebody who is different, has some strategy or something that is different than from what Best Buy did.

Q. You previously testified that even with this strategy over the last 20 months, Best Buy did not constrain Staples to the same degree that Depot does?

A. That's certainly true, and would not have been in the market. So, yes.

Q. Now the parties in their opening argument referred to Wal-Mart as the threat here, as the firm that will constrain these parties if they merge and attempt to raise prices. Have you evaluated whether Wal-Mart is likely to be able to play such a role?

A. Yes. I have some views on that.

Q. What are your views on that, sir?

A. It seems to me to be unlikely; and the reasons I think are fairly straightforward. The first is that when we again look at the question of how much historically has Wal-Mart actually in the past -- which is all the experience we have -- constrained the prices of Staples, the answer is as I talked earlier, not by any significant effect that we can pick up. That's not to say they had no effect; but just that the level of effect was apparently too small for us to pick up in a large-scale econometric model and certainly much smaller than people like Best Buy or Office Depot.

So if we look just to the past, we find no evidence whatsoever that Wal-Mart in the way it was or the way I guess it is today shows much promise of doing that. So the question is going to have to be what could it do to change; and is there something that it's going to become? Is it going to become something completely different, so that it's role will be fundamentally different than it has been in the past?

And there the obvious limitations are, first of all, as I understand Wal-Mart's plans in this direction, it is simply to expand by some percentage, 10 percent or something like this, of the number of skews.

That may make it more of an office supply supplier, but it doesn't turn it into an office superstore; indeed, as I recall, the president of Wal-Mart stated we do not plan on becoming an office superstore.

The second problem is, of course, that even if they fundamentally change the nature in which they sell office supplies within their existing framework -- some sort of store-within-a-store-type concept -- it is not by understanding that Wal-Mart is literally planning to build new stores in response to a 5 or 10 percent price increase. Given that office supplies are such a small proportion of the total sales of a -- of a Wal-Mart store, that really would be the tail wagging the dog here.

It doesn't make sense that somehow this particular mergers -- the price increase resulting from this merger would result in Wal-Mart building new stores in downtown areas where you would attract the kind of customers that traditionally have gone to office superstores.

So essentially for all those reasons, it is difficult to see how Wal-Mart is likely to perform -- is likely to be in any way able to frustrate the kind of price increase that can be expected from this merger.

Q. So, Professor Warren-Boulton, you wouldn't expect that if Staples and Depot merged their, for example, Connecticut Nell's store with a Staples store in Georgetown, that Wal-Mart would plunk a new store down in the middle of Washington, D.C. if they raised prices?

A. It seems to me to be extraordinarily unlikely. I think you still face the same problem in your example.

If Staples and Office Depot raise prices in downtown D.C., and you wanted to somehow escape from that price increase, you have to drive to Germantown, which is a fair distance.

And it seems to me that no matter what Wal-Mart does up in Germantown, it is unlikely that, for example, my office manager is going to be willing to drive up to Germantown for -- to visit to buy a few office supplies.

Q. You testified earlier about the guidelines -- the Justice Department/FTC Merger Guidelines providing a framework for your antitrust analysis. What is the framework in which you consider the possibility of entry in analyzing a merger?

A. The critical issue once again is not whether entry would occur. It is not whether other firms wouldn't increase their sales. The critical issue is whether in response to that five or 10 percent price increase, entry would occur that is sufficiently of size, timely such as to frustrate that price increase.

So the experiment that we have in mind here is that Staples and Office Depot would say no, I can't raise my prices by 5 or 10 percent because if I did and because of that price increase, Wal-Mart would enter this market in such degree that it wouldn't make that 5 or 10 percent price increase profitable.

Q. And what does your review of the evidence suggest as to the likelihood that anyone would enter this market in such a way as to satisfy that requirement and constrain such a price increase?

A. On the basis of everything I've seen, I would regard anything like that as being highly speculative.

Q. Now taking all of the points that you have discussed so far -- product market, geographic market, likely competitive effects and entry into account -- what is your assessment about the likely competitive effects of this transaction?

A. Looking at all the different sources of evidence that I've seen, I think that there is a -- you come to a very strong conclusion at this point that says that before looking at efficiencies and cost reductions under this merger, that at least absent that, the price increase that can be expected from this merger would be very substantial.

Q. Okay. Let's turn now then to the efficiencies that the parties have alleged will come out of this transaction? First I would like to ask you what is the framework that you use in analyzing the significance or the importance of efficiencies in analyzing a merger? What do you look for? What kind of efficiencies must they be -- what kinds of things do you look for in assessing whether the efficiencies will counteract any anti-competitive effects?

A. The criteria that you are looking for is that, first of all, the merger -- the efficiencies must be merger-specific. In other words, you are looking at what the price effect of the merger is; and you should look at what the efficiencies are for the merger. If there are cost reductions that are going to occur anyway, with or without the merger, then those cost reductions are not the result of the merger in the way that the price increase is the result of the merger. And, therefore, when you look at efficiencies, particularly efficiency assertions, you have to be very careful to make sure that those efficiencies aren't going to be achieved anyway, say, just for example, by normal growth or couldn't be achieved in other ways without the merger. So they have to be merger-specific.

And the -- so that would be my first criteria.

Q. Okay. Are there other criteria that you would apply in assessing the efficiencies?

A. In addition to being specific to the merger, they should be non-speculative. In other words, you should have some clear evidence that they are going to occur.

Q. Finally, what else would you look to with respect to efficiencies to determine whether the expected price increase as a result of the transaction will not materialize because of the efficiencies?

A. You would have to look at the potential extent of any efficiencies and compare those with the price increase that would occur absent those efficiencies. So you would have to look at the size.

Q. We have put another slide up on the board here. And I would like to refer your attention to the second column, the econometric model column. Could you describe what that column shows?

A. The purpose of this column is really to get into the question of which is the other criteria for mergers, for efficiencies, which is whether or not they are going to be passed on to consumers. In addition to being merger-specific, the other question -- which if you are concerned about what is the price effect of this merger -- you have to ask yourself even if there are efficiencies which are specific to the merger, how much if any of these mergers -- of these efficiencies are going to be passed on in the form of lower prices?

And in this particular case, you cannot look at the -- simply the historical experience with the average rate of pass-through, what is called pass-through efficiencies into lower prices to predict the effects of this particular merger.

Q. Let's slow down just a little bit. When you say pass-through, what are you referring to?

A. A pass-through is generally termed the percentage of any cost reduction that is "passed through" to consumers. So, for example, if you had a 10 percent reduction in costs -- a reduction in costs that was equal to 10 percent of revenue --

Q. Why don't we just take the example of a dollar. Let's say you save a dollar in costs?

A. The pass-through is usually a percentage. So if you saved 1 percent in costs, then the question is how much a price decrease would you get? A pass-through rate of 25 percent, would save .25. A pass-through rate of 50 percent, would mean a half of 1 percent.

Q. I'm not sure I followed the numerical example there.

If you have a dollar in cost savings and the pass-through rate is 50 cents, presumably you would keep 50 cents and pass on 50 cents to consumers; right?

A. That would be the pass-through, yes.

Q. Okay. So what kind of a price effect would -- I guess I'm doing it backwards. What kind of a price effect would you have to have so that as a result of the cost savings prices end up exactly the same on the anti-competitive side?

A. Well, for example, let's suppose that absent the sheer market power effect was that prices were going to rise by, say, 6 percent; let's suppose that somebody alleged that there was 4 percent efficiencies, efficiencies were 4 percent of total costs and that half of them were going to be passed through.

Then you would have a 6 percent price increase absent efficiencies, but then you would have efficiencies of 4 percent of revenue; half of those are being passed through, so you get a 2 percent offset so you say that your net effect on prices is 4 percent. So it's a fairly simply equation.
Q. In order to do this equation, you needed to figure out what the pass-through rate is?
A. Yes. Exactly.
Q. Did you do anything to figure out what the pass-through rate is here?
A. Yes.
Q. What did you do?
A. We started with the expectation, a theory that an historical pass-through rate would not be a very good predictor of what actually would happen with a merger.
Q. Why is that?
A. Because the pass-through rate depends on a number of conditions. In particular -- and this is fairly intuitive, that you would expect that the more competitive the industry, the higher the pass-through rate. If a firm is in a highly competitive industry, and its costs lower, it is more likely to pass those on because lower prices -- lowering its prices is more profitable.

Second, and most important, is whether or not the efficiencies are specific to the firm or are general. If you have a cost reduction which applies to all the firms in an industry or in a market, then you get a much higher pass-through rate, because what is happening is not only are your costs falling, other people's costs are falling. That's leading them to lower their prices, and that's forcing you to lower your prices. So if your efficiencies are firm-specific and apply just to you, you have a much lower pass-through rate.
Q. Okay. So a firm-specific cost reduction is passed through to consumers at a much lower rate than one that applies generally?
A. Yes. You would certainly expect that, and -- from economic theory. And, in fact, in this case, Dr. Ashenfelder has, in fact, done a study to try to answer the question what is the pass-through rate for cost reductions in this industry, depending on whether or not they are across-the-board, in other words, whether they are industry-wide cost reductions or compare that with what the pass-through rate has been when the cost reductions have been firm-specific.

And what he finds is that, indeed, if you look at the industry-wide cost reductions, you find a pass-through rate which is just about the average from historic experience. But when you --
Q. What's that percentage rate?
A. Probably about 60 percent, 70 percent. It is a high proportion that gets passed through. The high portion that is getting passed through in the past both because they are industry-wide cost reductions and, of course, because it's been a highly competitive industry.
Q. Right.
A. Now we are moving to a different world if this merger goes through. We are talking about efficiencies here which are presumably specific to the firm; and we are talking to some extent about, of course, a less competitive industry.

If you ask the question how much historically, even in past conditions, have these firms passed through when it has been a cost reduction which is specific to that firm, the answer is somewhere around 17 percent. I think Professor Ashenfelder's earlier estimate was 14.9; I think it is now around 17 percent.

But it is far lower than the historical rate.
Q. Now assuming a pass-through rate at about that, let's say 17 percent, cost reduction of a dollar that is merger-specific or firm-specific -- the firm passes on 17 cents, the firm keeps 83 cents -- assuming that kind of a ratio, what kind of an efficiency as a percentage of sales would be necessary to counteract the pricing impact that you see as a result of this acquisition?
A. It would have to be extraordinarily large. I mean, if you just think of a simple example, if you have a 6 percent price increase absent efficiencies and you have only 20 percent of efficiencies which are passed on, you know, you would need a 30 percent -- efficiencies equal to 30 percent

of your costs in order to balance that out. Once you have a very low pass-through rate, if your concern is the effect of the merger on prices paid by consumers, then efficiencies have to be extraordinarily large in order to be able to counteract the market power effects on prices.

Q. Now Professor Warren-Boulton, I'm not going to ask you to opine at this time on the likelihood, the credibility of the efficiencies, since we haven't heard the testimony from the defendants; but we will probably be asking you back after that testimony to speak to some more efficiency issues.

Let's go now to the third column that you have got here, the Event Study; and first I would like to ask you what the relevance of the Event Study is to this efficiency issue that you've just discussed?

A. Well, the relevance of the Event Study, particularly to this issue, is that the predictions that the Event Study would make as to the implied price effect of the merger is, of course, after efficiencies. As we went through in our pro-competitive/anti-competitive scenario before, the prices of rivals are expected to rise, if prices rise in the market after the merger.

Now, the prices that we would observe in the market after the merger are what people expect after you've taken into account both any efficiency assertions and market power assertions. So essentially, if the prices of rivals rise after the merger --

Q. The stock price?

A. The stock market prices of rivals rise after the merger, what the market is saying is that they think even after taking into account any efficiencies, that prices for the products are likely to rise in this market significantly after the merger.

Q. And thereby enhance the profits of those competitors?

A. That's correct, yes.

Q. And did you do anything to test whether in this case the stock market price of rivals tells us anything about the likely anti-competitive effects of this merger?

A. Yes. I estimated the relationship between the probability of the merger and what are called the abnormal returns to both the parties and Office Max and a number of other firms, the goal of which is to determine what the difference in the value of each of these firms would be if the merger goes through, to come up with a percentage number and an absolute number, what is this merger worth to each of these firms?

Q. What did you discover -- first of all, let me back you up one minute and ask you to describe how you did this, where did you get the data, what did you do with the data when you got it?

A. First of all, you look at the -- you try to calculate an index for each day as to what the market thinks the probability of the merger occurring. Intuitively, what happens is that there's an exchange rate in the merger. In this case 1.14. We get 1. -- under the terms of the agreement, there's 1.14 Staples' shares for each Office Depot's share.

Q. In other words an exchange ratio of the stock between the two companies?

A. Between the two.

Q. Okay.

A. If everybody thought the merger was absolutely certain to go through, okay. Then if you look at the prices of the two shares, they should be lockstep in that ratio.

Q. They should move together when they go up and down with the general market?

A. That's right, and they should move absolutely together if it stays at a hundred percent.

Q. Right.

A. If, on the other hand, what is happening is that the people don't think the merger is certain of going through, then that 1.14 link will get broken. The more the divergence from the agreed-upon ratio that you observe, the lower the probability of the merger. So -- it is a little more complicated than that, but that's basically what is going on here. And that enables you to calculate statistically for

each day exactly what the market thinks is the probability that this merger would go through.
Q. So you start with the pre-merger announcement prices of the two companies; you then see what happens when the exchange ratio is set, and then you see -- you use that as the benchmark to determine what the market thinks is the likelihood of the merger going through based on how far they diverge from that exchange ratio?
A. That's right. You use the data from the share prices of the two parties, from Staples and Office Depot. You use that information, plus the exchange ratio, plus your projection of what the price of these would have been; and that collection of data is enough for you to solve arithmetically for what the probability of the merger is.
So now you can calculate a continuous time series for every day since the merger announcement as to what the probability of the merger is. In this particular case, given the number of interesting events that have occurred, that probability has had a lot of variation in it.
Q. A lot of ups and downs?
A. A lot of ups and downs here from the stock market, yes.
Q. Now once you get this -- this data in terms of the daily stock quotation and the exchange ratio and you've calculated what the effect of the probability of the merger is, what did you then do?

A. You then look at each firm that you are interested in or in addition a combination -- in this case Staples and Office Depot combined -- and you ask the question: How closely do the values of those firms move with that probability, and what is the resulting implied effect of the merger in terms of the value of those firms?
Q. All right. Now let me put another chart up here.
A. Ah.
Q. One of the firms that you tracked in this comparison was Office Max; is that correct?
A. That's correct. That was my central concern, because as we mentioned earlier, the purpose of this is to see what the effect of the merger is on the share price of rivals. And Office Max is clearly our number one rival here. So our question is does the price of Office Max move with the probability of merger or does it move against the probability of the merger.
Q. Okay. Let's start at the far left here where it says 0.0. And then follow that line and explain what the -- first explain what the red line is and what the blue line is?
A. Okay. The red line is the cumulative abnormal return. By abnormal, I simply mean after adjusting for changes in the market as a whole. Stocks go up or down like like the tide, with the S&P 500. So we take that out and just simply look at what is happening to the value of the firm after allowing for changes in the market, market movements in general, to try to get that out.
Q. Okay. So you have a statistical technique to neutralize all the other ups and downs in the stock market?
A. At least neutralize the general effect of the stock market, yes.
Q. What is the blue line there?
A. We have -- we haven't done the red.
Q. I'm sorry. Go ahead.
A. So the red line is what happens to the value, in this particular case of Office Max, the abnormal return to Office Max over this time period in which two critical events occurred that, as you can see, changed the probability of the merger. The probability of the merger is the blue line.
Q. Hold on a second. The blue line. That's what I wanted to get to. The blue line is the probability of the merger and the red line is Office Max's stock price?
A. Essentially, yes. It is after allowing for other things, it's what happened to Office Max's stock price.
Q. All right. We see obviously a very dramatic fall in Office Max's price on March 10, 1997. Do you know what happened between March 9, 1997 and March 10, 1997?
A. Yes. The Commission, to apparently everybody's surprise, authorized the staff to go ahead with a preliminary investigation; and as you can see, the result was a

significant drop in the probability of the merger going through; and associated with that, of course, was a very large drop in the value of Office Max.

Q. You said preliminary investigation. Did you mean preliminary injunction?

A. I'm sorry. Preliminary injunction, yes.

Q. All right. So that was the date on which the Commission decided to go into court and block the deal?

A. Right.

Q. So the probability of the merger apparently went down based on a divergence in the exchange ratio between Depot and Staples' share?

A. On the left what you can see is the probability of the merger falls by 40 percent, a 40 percent probability fall in the market's estimate of the probability that this merger is going to occur, and it is associated with a 16 percent fall in the value of Office Max.

Q. The value of Office Max stock dropped 16 percent?

A. Sixteen percent, when the probability of the merger fell by 40 percent. Now, if you then ask the question how large a drop would you expect if the probability of the merger changed by a hundred percent, if 16 percent results from a 40 percent increase, then we are going to get a very large price increase or -- effect on Office Max.

Q. All right. Now why would Office Max's shares, why would the price of Office Max react so dramatically to a change in the probability of a merger between Staples and Office Depot?

A. Well, the obvious answer is that the financial markets believe and, in fact they have stated, that what this merger does is it is going to prevent an outbreak of particularly severe competition in three-firm markets. It is going to lead to price increases, and those price increases are -- relative to what would have happened absent the merger -- it is going to increase the profitability of Office Max. Office Max is more profitable as one of two firms in the market as opposed to one of three firms in the market.

Q. Okay. So what this is telling us is that when the stock market determined that the merger may not go through, the likelihood of those price increases went away and Office Max's profits went down, or predictions of profit went down; and, therefore, their stock price went down?

A. Yes.

Q. The next day apparently it had a miraculous rebound. What happened the next day?

A. The next day the parties announced that they had proposed a settlement to the Commission, which apparently the market believed would pretty well take care of the problem and the probability that the merger would go through, the probability that the merger would go through, the market goes way up.

Q. When you say "take care of the problem" you mean from the market's point of view take care of the problem of more competition? Is that the probability the market is seeing as taking care of here?
A. Yes. But that the merger would go through would take care of their legal problems, yes.
Q. Now, the price goes up and down a little bit, up and down a little bit. Are there any particular events of note during the period?
A. Well, we have a dramatic fall, we have a dramatic rise. The two start moving along together. Then there's another shock which is, of course, that the Commission votes to reject the settlement; and when the Commission votes to reject the settlement, what happens is that the probability of this merger just drops precipitously; and right along with it, as you will see, is a similar large drop in the value of Office Max.
Q. So again when the transaction is put on hold and the threat of price competition reemerges, Office Max's shares go into decline?
A. That's correct.
Q. It's a fact, isn't it, that Office Max in general is the highest priced of these three companies?
A. I believe that's true, yes.
Q. Now does this stock market analysis of the effect on Office Max's price of the probability of the merger going up and down tell us anything about the likely efficiencies from this transaction?
A. Well, what it tells you is that if there are efficiencies from this transaction, there's certainly -- they are certainly not large enough to counter the price effects. Because the linkage here is the price effects, after taking into account any effects of efficiencies.
Q. How does the stock market take into account any effects of efficiencies from the transaction?
A. In the sense that what is being reflected in the stock market price of Office Max is what is happening to prices in the market; all right? And that, presumably, is the combined effect of market power and any efficiencies that are out there.
Q. So the stock market is telling us that prices are going to go up after this transaction whether or not there are efficiencies; correct?
A. That's correct.
Q. All right. Now we have put back up the slide that shows the numerical values. Could you walk us through this slide and explain what each of the bars means?
A. Okay. The one on the far left goes for a similar exercise for Staples. The next one is --
Q. Let's stop on that one. Staples' stock price depending upon the probability of the merger seems to be going down?
A. Yes.
Q. Could you explain what would cause that?
A. Well, I think what the market is saying is that if this merger goes through, it in fact will harm Staples' shareholders; and the reason for that presumably is because of the exchange ratio. As you will notice, there is a very large positive effect of the merger on the value of Office Depot; and if you go to the third one, a large and significant effect on the value of Office Depot and Staples combined.

But it is the exchange ratio for the stock that determines how that gain is divided up between Staples' shareholders and Office Depot's shareholders. In this case, the results we are getting say that, in fact, Office Depot's shareholders not only come out very well out of this, but they actually get more than all the gains, the private gains from the merger. The shareholders of Staples actually would be better off if this merger did not go through.
Q. And does this tell you anything about whether the market believes Staples is paying too high a price for Depot?
A. I think that's a reasonable inference, yes. At this point.
Q. And does that tell you anything about the likelihood of -- of huge efficiencies?

MR. KEMPF: Just so the record is clear, we may be looking at different slides. The one that is on here is not the one that is on there. He's testifying about a different one.

MR. CARY: Your Honor, one is on percentages. The other is on dollar amounts. We need to be on the percentages.

THE COURT: The percentages is on the board.

Thank you.

BY MR. CARY:

Q. My question, Doctor, was whether the bar going down for Staples and the fact that Staples according to the market is paying too much for Depot tells you anything about the likely efficiencies from the transaction?

A. Well, what it basically says is that if you go back to the initial determination of the exchange rate ratio, whatever the efficiencies were that were anticipated at the time, presumably in the financial reports at the time, in determining that exchange rate, it is my understanding that Staples was expecting a certain level of efficiencies that would mean that despite the exchange rate that it had determined between Office Max, that the efficiencies were large enough such that it would still be a net gainer.

I guess what that is looking like is saying that whatever efficiencies the market thinks are there are less than, indeed, Staples thought were there at the time that they established the exchange ratio.

Q. Let's go to the second bar that you started to describe. I interrupted you. What does the second bar show?

A. The second is the percentage effect on the value of Office Max as a result of the merger. As you can see, it is very large. The difference between this merger going through and not going through--

Q. I'm sorry, Office Max or --

A. I'm sorry. I apologize. Office Depot. A lot of Offices.

-- is about a 32 percent increase. This merger is associated with about a 32 percent increase for shareholders, gain for shareholders.

Q. What does the third bar show?

A. The third is the two combined which for our purposes is really the relevant issue. It's what happens to the combined value of the two firms as a result of this merger.

First two simply -- the first two simply determine who gets it; but from our point of view, the question is what happens to the combined value there.

The interesting thing, of course, to note here is that the estimated impact on Office Max, in fact, is larger than the estimated impact of the merger on the two firms combined. So you have a rather, I think, unusual result which is that this merger seems to be better for Office Max shareholders than even if it is for the two participants.

Q. Have you reviewed any analysts' reports or any other documents that might explain what would account for the fact that Office Max is such a big beneficiary of this merger between its two competitors?

A. Well, there were two reasons why it was a beneficiary at various times. First, and most important, is that it would share in any price increases. If the merger between Office Depot and Staples meant that the merging parties restricted output and raised prices relative to what they would have done absent the merger, this creates a real opportunity for Office Max. It can decide to raise its prices. It can decide to expand more rapidly. Either way, it is in a much more profitable situation because it is facing a less aggressive competitor. Instead of facing two aggressive competitors, it is now just facing one.

Q. And, in fact, among the three competitors, Office Max is the highest priced; Staples is the next highest priced; and Depot was the lowest priced; is that correct?

A. That's correct.

Q. The lowest price competitor has been removed from the picture?

A. Merged with the next lowest, yes.

Q. After we leave Office Max, we go to a series of boxes, one below and three above the line. Can you describe what those boxes represent?

A. Those are the estimated effects from the regression coefficients for PriceCostco according to, essentially, a similar exercise for Wal-Mart, Best Buy, and CompUSA.

Q. Let's stop for a minute. What do you mean by a regression analysis?

A. These results are actually derived from a regression or an estimation that looks at each daily change in the price, abnormal returns to each of these stocks and correlates with each day's change in the probability. So what it is looking at, it is looking at the correlation between the movement in prices of that stock and the probability of the merger. It is essentially saying how close do two bars like this move together. And if they move very closely together and if a change in the probability is closely associated with change in value, you can then estimate, as we have gone through before, what the prediction is as to the effect of the merger on the value of that stock.

Q. All right. Now you measured the level of significance of each of these measurements in your regression, did you not?

A. Yes.

Q. Could you comment on how significant each of these results are?

A. On the left, they are not only very large, but statistically very highly significant. The usual test for significance is that if it is significant at at least the 5 percent level or below, in other words it's less than a 5 percent chance that this is a random observation, you tend to accept the hypothesis.

So, keeping in mind a 5 percent as your sort of borderline for significance, all of the first four are significant, approximately 1/100th of 1 percent. They are beyond -- I don't know what the term in law is -- beyond a reasonable doubt or something like that. Once you get past Staples/Office Depot, the combined firm, and Office Max, not only does the size but also the significance of these coefficients -- in other words, you always observe some relationship. The question is could it be a random or accidental relationship.

And in the case of, for example, PriceCostco, the point estimate is minus .57; but it is virtually completely insignificant. In other words, we can't say it is different from zero. The same thing is true with Wal-Mart. That estimate is not significantly different from zero. And the same thing, interestingly enough, is true with regard to Best Buy.

The only stock for which there seems to be a -- other than the participants and Office Max -- which there really seems to be any effect of this merger on a little bit is CompUSA. That is significant to the one percent level. That's fairly small. It's about 5 percent.

Q. Now I have pulled out another slide that you prepared that essentially shows the same data, except this time on the vertical axis it has dollar figures rather than percentages. Could you walk us through the significance of this exhibit?

A. Yes. What we have done is take those firms for which we could find some statistically significant relationship and asked if we have a number here which we think is actually different from zero, what's the dollar amount that's involved here.

And as you can see, just simply going across from the earlier percentage impacts, that the merger is associated with about a $300 million hit on Staples' shareholders, plus $800 million for Office Depot's shareholders. The two combined, $616 million. Most important, from our point of view, is associated with about a $221 million windfall gain for the shareholders of Office Max. In addition, there's a small gain for the shareholders of CompUSA.

Q. At whose expense does this windfall gain to Staples, Office Depot, and Office Max come?

A. The windfall gain from Office Max is clearly coming from consumers. When you look back and you ask how much of that price increase, that increase in the value on the combined values of the merging parties is due to price effects rather than any efficiencies, the fact that we are getting such similar results in terms of percentages between Office -- the combined parties and Office Max -- implies that what they are sharing here is the price effects of this merger.

In that case, essentially what is happening is there's a transfer from -- if this merger were to go through, a fairly large transfer from consumers to the shareholders of Office Max and particularly, of course, Office Depot somewhere on the order of a little over $800 million.

Q. Let's take you back, Dr. Warren-Boulton, to the grid that we had previously put up; and now continuing with our theme of being out of sequence here, let's go to the middle box. Can you explain what this middle box shows?

A. It tries to go from the percentage increase in the value that we observed for Office Max and to translate that into once the implication of that increase in terms of prices in the market. And as you note from the previous slide, the derivation of this is really pretty straightforward. We can do it in our head. You are talking about something over a $200 million increase in the share value of Office Max.

That is the capitalized value of some increase in profits that the market expects is going to go to Office Max as a result of the merger. To get there, we have to take the $200 million and we have to say what kind of flow of profits would justify a $200 million increase in share value.

Essentially, the first question you have to ask is what kind of discount rate are you using? You can find stories that would say 10 percent, stories that would say 20 percent. If we pick right about in between and you say let's discount this at 15 percent, the implication is that this $200 million is supporting or is being justified by an increase in profits of about $30 million, ballpark estimate.

Now, that's after-tax profits. So now you have to go to pre-tax profits. So if we assume a 40 percent tax rate, we would have to take our $30 million, divided by .6; and now we are up to $50 million a year in pre-tax profits.

If you take $50 million as a proportion of the sales of office supplies, which is about a billion dollars, what you have is a lot of -- about 5 percent. The implication is if we see about a 13 percent increase in the value of Office Max and if that increase is because of higher prices and increased profits in the sale of office supplies, the implication is that what the market is expecting is that the merger will result in about a 5 percent increase in the price of office supplies in markets where Office Max competes with Office Depot and Staples.

Q. Professor Warren-Boulton, taking all of the three sources of evidence that you have looked at, all of the pieces of evidence within the three categories, the documents, the econometric model, and the Event Study, are you able to form an opinion as to what the likely effects of the merger of Staples and Office Depot on consumers in the United States will be?

A. All three sources of evidence lead me to a remarkable extent approximately to the same predicted percentage price increase because of --

MR. KEMPF: I'm going to object at this point. I thought you said you were not going to factor in efficiencies with this witness because there is no evidence of it. Now you have a slide up there that says allowing for the efficiencies you said you were not going to factor in.

MR. CARY: Mr. Kempf, what I said was this witness was not going to comment on the credibility of your efficiencies. The witness is assuming your efficiencies --

MR. KEMPF: Got you.

MR. CARY: -- in answering the question as to whether other evidence disproves those efficiencies.

THE COURT: All right.

MR. KEMPF: Got you.

THE WITNESS: Basically we are getting to a bottom line number through three completely different ways. We are getting there through the econometric estimates, and then making some allowance for efficiencies; we are getting there through the internal documents; and we are getting there through the Event Study.

In all three, they get you to a conclusion that the expected effect on prices of consumer office supplies because of this merger is somewhere on the order of 5 or 6 percent. As we have just gone through on the Event Study, a 13 percent increase in the price of Office Max associated with the merger gets us about a 5.5 percent, 5 to 6 percent increase in the price of office supplies.

Similarly, if we took the econometric estimate of the effect of the merger absent efficiencies of somewhere around 7 percent, even if we were then to assume that efficiencies were as large as 6 percent of total revenue of the merging parties, if you have a pass-through rate on the order of 17 or 20 percent, then that analysis leads you into an expected price increase after allowing for efficiencies of about 5 to 6 percent.

And similarly, the internal documents when you look at the strategy update and things like that and ask what are the implications of the parties' own expectations in terms of the kinds of price decreases that they could avoid by this merger, the answer once again is in the range of about 5 to 6 percent. So you have three different sources of evidence that are all coming up with just about the same number.

Q. Thank you, Dr. Warren-Boulton.

THE COURT: Give me a couple of minutes here. I want to get back into my computer. Then we will have cross.

THE COURT: Ladies and gentlemen, we are going to take a short break. They are going to substitute reporters in here. I will take about a two-minute break and we will be right back.

(Recess)

THE COURT: Thank you, counsel. I appreciate your patience. My court reporter became indisposed over lunch so we had to get some new reporters in, but I think we have worked that situation out for tomorrow. Are you ready to go with the cross-examination?

MR. KEMPF: Yes, Your Honor.

THE COURT: Thank you. Go ahead with cross now.

MR. KEMPF: The first thing I'd like to do is to ask for the witness' notes, including a lot of notes he has written on over the break. And I would like to get those and let my partner, Mr. Smith, look at those while I start my examination, if I could.

MR. CARY: Your Honor, we produced everything in copy form that the witness had prior to resuming his testimony. There may be some scribbles he made while testifying, but everything he had before, we produced.

MR. KEMPF: I'm not so much interested in the slides; I'm interesting in the scribbling.

THE COURT: Would you let him look at that scribbling.

MR. KEMPF: I'm talking about the stuff that you wrote on all the documents. The documents with handwritten notes on them are what I want to look at.

THE COURT: He has copies of that.

MR. SMITH: We can't read those, Your Honor.



THE COURT: We can give them back. You can look at those, but he represented that copies of those were given with the notes on them.

MR. KEMPF: Here is what I will do. I will take a quick look through and see what doesn't have anything on it and give it right back right now.

MR. CARY: Why don't you return the xerox copies that we provided you for the witness as well.

THE COURT: That is a problem either way.

MR. KEMPF: To whom did you provide those?

MR. ORLANS: We gave you a set of xerox copies.

MR. SMITH: All but two pages, Your Honor, and I will return them right to him.

MR. CARY: We gave them to Mr. Smith.

THE COURT: Let's go. We don't need to debate this here. Let's just get going.

MR. KEMPF: All right, Judge.

CROSS-EXAMINATION

BY MR. KEMPF:

Q. Let me correct one thing I think you misspoke on. Let's make sure we get the record straight on this. You said that a one basis point increase equals a 1.4 percent increase in price; do you recall that?

A. Yes, one basis point increase in the margin is associated with about 1.4 increase in price or change in

price.
Q. That is not right though, is it?
A. It is approximately correct. It is taken from one of the Staples documents. There I believe Govan Sachs was predicting the price increases from the merger line by line. And on one of those it was a one percentage point increase in margin and 1.46 percentage increase in the pricing.
Q. What is a basis point?
A. A basis point is 1 percent of 1 percent. So 100 basis points is 1 percent.
Q. Isn't it 100 basis points?
A. Yes, I'm sorry. 100 basis points is 1 percent.
Q. It is not 1 basis point, it is 100 basis points?
A. Yes.
Q. You had said one.
A. If I did, my apologies.
Q. I want to make sure the record is clear. You meant to say 100, right?
A. Should I say what I meant to say?
Q. Yes.
A. I meant to say 100 basis points would be one percentage.
Q. All right, we are on the same page now.
You had referred to, I think early on in your testimony, that the most recent merger matter you testified in was the Englehard matter.



A. That is correct.
Q. And that is the case that was down in Georgia before Judge Sands?
A. Albany, Georgia, yes.
Q. And Judge Sands issued his public opinion in that case last month; is that correct?
A. That sounds right.
Q. And he wasn't all that keen on your relevant market analysis, was he?
A. He wasn't all that keen on our case, right.
Q. Well, I'm going to sort of narrow that in, quite apart from what he thought about the case, he wasn't all that keen on your work; isn't that right?
A. He wasn't all that keen on the product market they are finishing, yes.
Q. He wasn't all that keen on your work; isn't that right?
A. That is correct.
Q. What Judge Sands said was that in fact he had a whole section on your analysis, didn't he?
A. Yes.
Q. The name he gave that section was Dr. Warren-Boulton's relevant market analysis was not reliable; is that correct?
A. That is what it says.
Q. Now, do you remember when Mr. Cary was asking you whether, in the days when you were over at the antitrust

division you would have recommended a case like this be brought?
A. Yes.
Q. I take it the person you would have made that recommendation to would have been the head of the antitrust division; is that right?
A. That is correct.
Q. And by my count, you were over there under four people like that, Bill Baxter, ball McGrath, Doug Ginsburg and Rick Rule; is that correct?
A. That is correct.
Q. Now, had you made that recommendation when Rick Rule was the head of the antitrust division, he would have rejected it flat out, wouldn't he?
MR. CARY: Objection, calls for speculation.
THE COURT: I don't know how he can answer that. I will sustain the objection.
BY MR. KEMPF:
Q. Well, let me ask you, did you read Mr. Rule's Op Ed piece in yesterday's paper when he called this case an absurd claim.
MR. CARY: Objection, Your Honor. There is no foundation Mr. Rule knows anything about this case and the quoting from newspaper articles which seems to be what this entire defense is based on is inappropriate.



THE COURT: Well, that is not the grounds for evidentiary objection here that you think it is inappropriate what they are doing. But I will sustain the objection about what Mr. Rule said in some newspaper as concerning this witness. Go ahead.
BY MR. KEMPF:
Q. All right. Let me start over here. Can you see okay from over there?
A. Yes.
Q. Now, I have drawn on here what I would think is basic economics. Let's make it widgets for right now?
A. Yes.
Q. And you can see on this diagram I have on the left side on the left side a price axis going up. Do you see that?
A. Yes.
Q. And on the bottom side I have a quantity axis going out?
A. Yes.
Q. And then I have a price now and a quantity now, do you see those?
A. Yes.
Q. And those are intersecting where the demand curve and the supply curve are meeting?
A. Yes.
Q. Is this sort of a typical type economics 101 supply-and-demand-type chart?

A. It assumes those are industry demand and industry supply, not firm demand and firm supply. And from the fact that you have decided that the price and quantity are at the intersection, I gather you are assuming a perfectly competitive industry. That would be correct.
Q. Now you could, for an individual firm, instead of calling this a supply curve, you could call it a marginal cost curve if you were doing it as an individual firm; is that correct?
A. In that case that wouldn't be consistent with that being the price, that would be the quantity.
Q. You would change this to a revenue curve, for example?
A. Yes, so it wouldn't indicate prices.
Q. Well, let's take it for a monopoly firm to simplify things. Let's take it as just the widgets for now, okay?
A. You have to tell me if it is an industry or if it is a firm, whether it is competitive or not.
Q. Fine, let's change it. Let's make it a firm. What would you change on here to make it a firm?
A. That demand curve becomes a marginal revenue curve and it becomes presumably a marginal cost curve. Then you have the demand curve, presumably up there on the right.
Q. Marginal cost, and we will call this marginal revenue.
A. Would you like to put the demand curve in or leave it off.



Q. I will leave it there for now. This is where this firm would sell; is that correct?
A. No.
Q. Where would they sell?
A. You have to put the demand curve in, sir.
Q. Let me put the demand curve in and make the demand curve like that.
A. I think you have to have it going off to the right. Its slope is much flatter.
If you intersect them at the top, if you draw that top of the marginal revenue curve up until it hits the price axis, you will have to, of course, point. Take your marginal revenue curve up to the price axis, marginal revenue curve.
Q. Up to where, here?
A. Where your "M" is on marginal revenue, just keep taking that line up straight.
Q. This way?
A. No, straight, just keep going along that same line, just extend the line. I know you can't extend it all the way. Put your finger up where it crosses the Y axis and then draw a line. Now there is a point of intersection up there. Then draw it going down to the right, another straight line. Well, okay, it is flatter than that, but that's all right.
Q. And then the supply curve will be what?
A. There is no supply curve under those conditions.

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Q. I have price now and quantity now.
A. That would not be correct. To get the price you have to go up from that point up to the demand curve. If you take that quantity point line down to the left, the intersection you were at before and just go straight up there until you hit the demand curve, now you go over to the left and that is your price line. That is your price.
Q. Let's just draw it up a little higher. And this would be P now up here, right?
A. Yes.
Q. And let me get this out. What you are saying the impact of this merger will be is to raise the price from price now to a higher price; is that correct?
A. You already have a monopoly there. I think that is the situation after the merger.
Q. That is correct. What I'm saying is the merger will take price now and raise it to price later. In other words, price will go up. Isn't that the thrust of your testimony?
A. Yes, but that graph shows where prices would be if there was a hypothetical monopoly of all three firms at market. So that is not the price now. That is where the price would be if there were a merger amongst all the firms in the market.
Q. I want to get on common ground. Give me price now, where will that be? This is what you are saying was the price afterwards.

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A. That is the way you have drawn the graph, yes. You have drawn not the current price but you have drawn the price for a monopolist.
Q. What I want to know is where would price now be? Where do you want me to put it.
A. Well, if you do the intersection between demand curve and the marginal cost curve you would have sort of the competitive price. So you would be somewhere in between there.
Q. Let's just assume that. I will make that Q now?
A. I don't think it is actually Q now. Q now is the perfectly competitive price.
Q. Let's assume it is perfectly competitive for now.
A. Okay. That's not true, but okay.
Q. What your testimony is that after the merger price will go up; isn't that correct?
MR. CARY: Object to the question. The witness has testified that he is not assuming that that is where the price is now.
MR. KEMPF: I'm taking this as an assumption that the price is now with his testimony, that is what the current price is.
THE WITNESS: My testimony is that but for the merger, prices will be higher than they would have been absent the merger.

BY MR. KEMPF:
Q. Let me put in a number at price, I will call it FTC and I will just put it, say, here.
(Illustrating.)
Are you with me?
A. I believe so. You have a completely static role here, but go ahead.
Q. When the price is raised, the amount sold will decline; isn't that correct?
A. Holding all else constant, that is your assumption.
Q. Holding all else constant, the assumption is quantity will decrease, correct?
A. Yes.
Q. As you raise price, the amount sold will go down, correct?
A. All else being equal, yes.
Q. And you understand the defendants contend that they will, in fact, lower price after the merger, correct?
A. That is perfectly consistent with that.
Q. So they are saying that the price in the future rather than higher than the current price will be below the current price, correct?
A. I think that given the nature of this industry, I think we expect prices to be falling regardless. If you would like an example, prices have been falling dramatically in the


computer industry. That isn't to say that somehow a monopoly in the computer industry is a bad idea.
Q. And if the defendants were to lower price to, say, where I have it here --
A. They would be losing money. You now have the price below the competitive price.
Q. But unless you had a change in the marginal cost curve; isn't that correct?
A. Yes. We now have two periods. So period one is the way you have drawn it and then period two, all your costs decline and then you can look at what the prices would be.
Q. Where would you draw the marginal cost curve in here if it were to change after the merger?
A. Well, it would presumably change with and without the merger, the question you have is will it fall by more or less after the merger.
Q. My question on the diagram -- shouldn't it intersect there?
A. In your diagram, if you are going to assume a perfectly competitive industry, then the margin cost curve should go through that point, but for the merger, that is correct. So you have got your cost curve shifting down and that is the marginal cost curve but for the merger. That is what you would expect to happen if the merger didn't go through.
Q. You would agree with me, I take it -- you were here for

my opening, weren't you, when I made my opening statement?
A. Yes.
Q. Do you remember when I said that consumers invariably obey one law as universal as any in social life. They buy less of a thing when its price rises and you would agree with that, wouldn't you?
A. I would say under certain assumptions and with certain exceptions we discussed in my deposition, yes.
MR. CARY: Your Honor, I want to interpose an objection. I didn't have time before. Mr. Kempf, without any testimony from the witness, has marked the top curve as MC - FTC, and marked the bottom curve as MC defendants.
MR. KEMPF: I'm sorry, I didn't mean to do that. I meant MC now.
THE WITNESS: If I understand what you are doing, I think the delta there is the FTC.
MR. KEMPF: That is correct.
THE WITNESS: The lower marginal cost, if I understand what you are saying, the lower marginal cost is but for the merger.
BY MR. KEMPF:
Q. No. I'm seeing that the defendants argue that the merger will shift their cost curve down, don't they?
A. I thought you were saying to me what would I expect the marginal cost to look like in the next period absent the



merger.
Q. I'm saying, don't the defendants contend that the results of this merger will be to take the current marginal cost curve and move it down?
A. Both sides contend that the marginal cost will fall.
Q. I'm asking you don't the defendants contend that?
A. My assumption is they say that their costs are falling, yes.
Q. Isn't that implicit in the entire efficiency presentation that the effect of it will be to lead the lower efficiencies which are derived, more efficiencies that lead to lower costs?
A. That is the basis of an efficiencies defense, yes.
Q. And so the defendant's position is that the marginal cost, compared to where it is now, if the merger goes forward, will decline; isn't that correct?
A. That is correct. I'm just pointing out that everybody is assuming the costs will decline.
Q. Is it correct?
A. Yes.
MR. CARY: Now also, Your Honor, it is sitting on the price access marked price FTC. I think we have the same problem.
MR. KEMPF: No, that I think we have with the witness. My point is he contends the price will go up and the

defendants contend the price will go down.

MR. CARY: I don't believe that has been the testimony, Your Honor.

THE WITNESS: I don't believe that is my testimony either.

BY MR. KEMPF:

Q. All right, well, I will just take it for what it is and I will move on.

Now, let me go back to where I was. Would you agree, you know who Professor Stigler is, don't you?

A. I know who he is.

Q. Nobel prize winner in economics.

A. That's right.

Q. Pretty smart guy?

A. Yes, he is dead, but -- I didn't mean to malign the professor. His work extends on after him.

Q. Have you ever been to the economic organization workshop at the University of Chicago where they have pictures on the wall?

A. No.

Q. They have all the famous economists there and the criteria for getting your picture on the wall is you have to be dead.

A. That is particularly true in industrial organizations.

Q. Now, Professor Stigler had a way with words, would that



be fair?

A. I would say yes.

Q. And one of the things he said in his basic price theory is that consumers invariably obey one law as universal as any in social life. They buy less of a thing when its price rises.

A. That is what this certainly quotes, yes. That is the basic assumption under which economists assume.

Q. And you assume that as well, right?

A. I assume that, holding all else equal, that if you get a price increase that, except under very unusual circumstances, consumers will buy less. This is Econ 101.

Q. Let me put it this way. Consumers, when prices to them go up, the volume they buy decreases. By that I mean quantity. You agree with that, don't you?

A. All else being equal, yes, holding all else constant.

Q. Now, let's flip over to the other side of what happens when there is a price decrease. Let me show you another quotation from Professor Stigler. Would you agree with Professor Stigler when he says the oldest and most basic rule of demand theory is that people will not buy less and usually buy more of a commodity when its price falls?

A. Assuming that nothing else has happened other than its price falling, that would be the context in which he would have written that statement.

Q. From the supplier standpoint, if the supplier raises prices, the quantity he sells will go down, won't it?
A. All else being equal, yes.
Q. Now, you talked during your testimony this morning about a concentration figure and you use the phrase, if you defined the market correctly. Do you recall that?
A. That sounds reasonable.
Q. Well, do you recall giving that testimony earlier today?
A. I don't recall those exact words, but I wouldn't be surprised if I used them.
Q. And you would agree with that, wouldn't you, that in order to use the numbers, you first have to define the market correctly, don't you?
A. I think, as this testimony has made clear, we are arriving at this result --
Q. I'm asking you a question. I'm not talking about your testimony. I said wouldn't you agree with me that when you are defining a market -- let me put it to you this way. If everything that sells is the same, aside from competition, you would expect, wouldn't you, that if the market is correctly defined in this industry as in other industries, that the more concentrated the market, at least after a certain level, the higher the price. You would agree with that, wouldn't you?
A. All else being equal, yes.
Q. And you would expect the price, all else being considered equal, to be lower in the place with lower concentration, wouldn't you?



A. All else being equal, yes.
Q. And those depend upon having to define the market correctly, right?
A. Well, defining the market correctly is the same thing as saying the demand curve slows downward for that set of products. That is what defining a market does. It says if I look at that group of products and I raise the price of that group of products, will the quantity fall? So, the answer goes back to your earlier statement which is defining the market correctly is equivalent to saying downward sloping demand curve.
Q. Now, when it comes to higher market shares, higher market shares can reflect greater relative efficiencies; isn't that right?
A. Yes.
Q. Now, a firm with a high market share may be a symptom of lower costs rather than a cause for competitive concern; isn't that right?
A. If a firm is more efficient --
Q. Is it right, is my question?
A. Repeat the question.
Q. A high firm market share may be a symptom of lower cost rather than a cause for competitive concern; isn't that right?

A. I don't think I would use the term symptom, but I would say it may be caused by that firm having lower costs, yes.
Q. Is my statement correct or isn't it?
A. Maybe the phrasing is unfortunate.
Q. Let me just ask you this. In your deposition were you asked the following question and did you give the following answer?
A. That is correct.
Q. Did I ask the following question and did you give the following answer?
Question: A high firm market share may be a symptom of lower cost rather than a cause for competitive concern; isn't that right?
Answer: That is correct.
Did I ask that question and did you give that answer?
A. That is correct.
Q. Let's turn to the subject of product market definition. You, I take it would agree that the product market definition exercise provides an important reality check to make sure that the allegations in an antitrust case make economic sense, doesn't it?
A. Yes.
Q. When it comes to analyzing the likely effects of a merger, isn't the first step to determine the relevant market? Isn't that the traditional first step?



A. That is the traditional first step in a structural analysis, correct.
Q. Now, the key to a product market definition is to determine, directly and indirectly, whether or not there is a sufficient ability of a sufficient number of consumers to switch their purchases such that the price increase would not be profitable, wouldn't you agree with that?
A. Yes, sir.
Q. Let me ask you this question. Suppose we are standing on a corner and there is a guy selling ice cream there and he says I've got three flavors, vanilla, strawberry and chocolate. And about ten feet away there is another guy selling ice cream and he says, three flavors? I got six flavors. Can those people compete?
A. Let me see now. I have vanilla, strawberry and chocolate on the same corner. They are just a couple of feet away.
Q. Ten feet away.
A. I'm not handicapped. And ten feet away I have vanilla, strawberry, chocolate, rum raisin.
Q. Cherries Garcia and vanilla nut rum.
A. And in fact I'm already there, so I can take either. All I'm looking for is vanilla, plain vanilla.
Q. I'm asking you whether those two people compete?
A. Clearly for certain kinds of customers, yes. You call

in your example of plain vanilla.
Q. Let me turn to different products. What do you think as a consumer of Office Club supplies, what does that mean to you?
A. I think that there is an industry view of what that means which, I think is closely correlated with what I think are the particular groupings of products where this merger is likely to create a competitive problem.
Q. Let me ask you this. When you think of consumables, you think that the characteristic that has is a repeat purchase?
A. In this context, the usual definition of what is a consumable, yes, it would get used up but that is the usual definition in the industry of a consumable. Whether or not this price increase resulting from the merger would be just the things that we could get used up is another issue.
Q. When you think of the term consumable, what that connotes to you, isn't it that that has the characteristic that it is a repeat product?
A. It has that connotation, yes.
Q. Let me ask you this. Did you testify when I deposed you that "I think the term consumable connotates -- has that characteristic, yes, that it is a repeat product."
A. Yes, I think that is a characteristic correlating with being consumable.
Q. Now, would examples be pens, legal pads, post-its,



things of that nature?
A. I think if you are asking do they get used up and disposed of --
Q. I'm asking you whether they are consumable office supplies?
A. I think they get consumed over some period of time, yes.
Q. Are they consumable office supplies?
A. I assume they are.
Q. Do you think they are or they aren't?
A. They seem to be pretty consumable. I have had pens for a long time. I consume at different rates, but yes.
Q. Let me ask you about two things I have in my Office Club. One thing I have is I have a stapler I've had for about 25 years. I have a ruler I've had for 30 years and I have some scissors I've had for 30 years and I don't know how long I will be there but I have no plans to get a new one. Are those consumable or not consumable?
A. They are relatively nonconsumable but can I point out that you are not likely, under your own assumptions, to be buying those things at Office Depot or Staples. So if they are not consumable to you, you are not part of their concerns. You are not part of their market.
Q. Are those things consumable or not consumable?
A. In your particular case, you are never going to buy another ruler. You are never going to buy another stapler.

You don't use it up. I think the answer is you are not much into the consumable Office Club products.
Q. Do you count them as consumable Office Club supplies for purposes of this case?
A. In terms of the characteristics of most rulers and things like that, yes.
Q. Do you count rulers, staplers and scissors and consumable Office Club supplies or not?
A. I think it false within the general definition of consumable Office Club supplies, yes.
Q. I also have in my Office Club a computer and it is about the fifth or sixth one I have had in the last ten years. Do you count that as a consumable or not?
A. In your case, I think you seem to be consuming computers at a fairly rapid rate. I don't count it as what is defined as a consumable Office Club supply for purposes of this analysis, no.
Q. You would not count that?
A. No.
Q. Now, do you think that Staples and CompUSA compete with each other in the sale of computers?
A. Yes.
Q. Do you think computer disks are a consumable Office Club supply?
A. Yes.



Q. How about toner cartridges?
A. Yes.
Q. Now, you did not rely on PX-3 at all in reaching the conclusions that you have reached in this case, did you?
A. PX-3 being --
Q. PX-3 being this big thick book of pricing charts.
A. Did I rely on that book, no. I relied, however, to some extent --
Q. No, I asked you whether you relied on that?
A. Literally the book.
Q. I said did you rely on PX-3 and your answer was no; is that correct?
A. By what you mean by PX-3, did I rely on the book and the charts that are in there, no. I relied on the elements underneath those books.
Q. And you didn't rely on PX-159 in reaching the conclusions you have reached in this case either did you?
A. Which one is that?
Q. That is the Herfindahl calculations?
A. That is correct.
Q. Now, you don't know of any case where a judge has explicitly said I'm enjoining this transaction on the basis of some unilateral effects theory, do you?
MR. CARY: Your Honor, this is a legal opinion that the witness is being called upon to give.

THE COURT: I will sustain the objection. You can ask the same question differently but it is not relevant.
BY MR. KEMPF:
Q. Do you know of any merger that has been enjoined explicitly on the grounds that the transaction violates some unilateral effects theory.
MR. CARY: Same objection, Your Honor. He is asking the witness for a legal conclusion.
MR. KEMPF: I don't think I am.
THE COURT: I will let him answer whether he knows any case or transaction he is familiar with to enjoin on the basis of the unilateral effects theory.
THE WITNESS: I would say that any merger that was enjoined on the basis of a monopoly or a firm theory would be the unilateral effects.
BY MR. KEMPF:
Q. Do you know of any case where a transaction is enjoined explicitly on the basis of a unilateral effects theory.
A. As I understand what a unilateral effects theory means in economics, is there a merger which would have been enjoined on the basis of a unilateral effects theory, the answer is any merger to monopoly is a unilateral effects theory.
Any merger which involves a dominant firm with a competitive fringe would be a unilateral effect. It does not require the coordinated interaction with firms outside of the



market.
Q. I'm not asking you that question. I'm asking you do you know of a single case that has ever been decided where a transaction was joined on the grounds explicitly of a unilateral effects theory as such?
MR. CARY: Your Honor, asked and answered.
THE COURT: I don't think so. I will let him answer it again.
THE WITNESS: If you are asking for a case site, I just don't think of it that way.
BY MR. KEMPF:
Q. Now, do you remember earlier today how you referred to some of the charts in PX-3 as simple cross-sectional analyses?
A. Yes.
Q. Let me ask you some questions. Calculations of simple averages do not, of course, control the other factors that may be affecting prices and that might be correlated with the amount of competition. Does that sound correct to you?
A. It sounds well stated, yes.
Q. Now, as compared to a cross-sectional estimate, time series estimates generally control better for the effects of other factors, isn't that true based on your personal experience?
A. They control better for certain kinds of factors, yes and worse for others. They are different.

Q. Now, the cross-sectional analyses that were done in this case for the FTC are all preconsideration of the efficiencies; isn't that correct?
A. Let me try to be clear. The implications of those cross-sections for the effects of the merger would be relevant to considering the effects before taking into account any efficiencies at the national level. They would, of course, take into account any efficiencies at the local level such as local economies of scale.
Those efficiencies that exist would be reflected in the cross-section. You have to distinguish between efficiencies at the national level, multimarket, multigeographic market efficiencies as opposed to local efficiencies such as having more stores in a particular area so we can take advantage of advertising, lower advertising costs and things like that.
The cross-section which you referred to as the simple cross-section would take into account the effects of differences in costs and differences across different localities, yes.
Q. Now, structural analyses and time series or cross-sectional analyses can only inform us as to the expected price increase before taking count of any efficiencies, isn't that true? Isn't that a fair statement?
A. The structural or time series? I think I would give you the same answer but the efficiencies that are not taken into



account or the effects of the efficiencies that are not taken into account are national efficiencies.
Q. At your deposition were you asked the following question and did you give the following answer?
Structural analyses and time series or cross-sectional analysis can only inform us as to the expected price increase before taking into account any efficiencies; isn't that true?
Answer: I think it's a fair statement with respect to structural analysis. With respect to time series and cross-sections, it would depend.
Did you ask that question and did you give that answer?
A. Yes.
Q. Let me shift over to what you call the black box econometric models. Do you recall that testimony this morning? It was either you or Mr. Cary. Did you use the term, do you recall?
A. I don't recall using that. I certainly recall it being heard but I may have once again stolen one of Mr. Cary's lines.
Q. Now, Dr. Hausman did run some econometric models,didn't he?
A. Yes.
Q. And he came up with a 0.9 percent impact taking certain factors into account in his econometric model, didn't he?
A. That's correct.

Q. And you ran Dr. Hausman's model and you got the same value that he got, didn't you?
A. With exactly the same database, yes, we replicated this from the start.
Q. And you ran it with some changes and you came up with 1.7 percent; is that correct?
A. Some changes, yes. We expanded --
Q. Am I then correct that you ran Dr. Hausman's model with some changes and you came up with 1.7 percent; is that correct?
A. Yes.
Q. Now, the number you talked about today, what is the current number that has jumped around and I gather it jumped around again even as we speak; is that right?
A. It has come down by a percentage point while this trial has been going on, yes.
Q. Actually, didn't see it go up and then come down. In other words, when I took your deposition wasn't it something like 8.05 or something like that?
A. I wouldn't be surprised. Which one are we talking about here. I have a lot of numbers in this case.
Q. I'm talking about the weighted average overall price increase that was predicted?
A. By Dr. Ashenfelder?
Q. Yes.



A. 8 percent sounds about right.
Q. Then it went up to 8.6 percent, right?
A. I don't know.
Q. I think you said today it is down from 8.6 back to 8 today?
A. Yes, and I think they are pretty close to each other. They are all big.
Q. Well, I'm going to come back to those in a minute now, it depends upon what factors you count and how you count them. Do you remember when Mr. Cary asked you if you count this company and that company. Do you remember that line of questioning?
A. Yes.
Q. Let me ask you this: Did Dr. Ashenfelder's model factor in regional differences or did he just do it for the country as a whole?
A. I think his most recent results factored in regional differences.
Q. When were those done?
A. I think they are more recent.
Q. More recent like within the last two days?
A. That is correct because my understanding is that he has now acquired some more data from your side.
Q. And he has now done it regionally as well as nationally?
?

A. I have had a brief conversation with him and I know that he has thought about regional issues and that has, presumably, influenced his final number.
Q. Now, let me show you one of the charts that you had referred to here during Mr. Cary's questions. I just want to take you to the top chart there. I gather the cross-sectional study has a 9 percent number; is that right?
A. Yes, sir.
Q. And then the fixed effects econometric model here has about a 7 and a half, a little over that, right?
A. That's right.
Q. About a percentage-and-a-half difference, right?
A. Yes.
Q. And so when you shift from cross-sectional to do an econometric model by your one hear you go down about 20 percent; is that right?
A. 760 is becoming clear in this trial. I'm not that good at arithmetic. It is down about 20 percent, right.
Q. Isn't the 760 the number that you said Dr. Ashenfelder or even since you prepared these demonstratives has actually gone down again. Didn't you say it went down about another percent specifically?
A. Yes. I think currently it is somewhere around mid 6, 6-1/2, somewhere around there.
Q. Just in the past few days, the calculation of what the



impact would be has gone down by about a third compared to the cross-sectional analysis; is that right?
A. Yes, but I wouldn't offer much hope. It seems to go both up and down.
Q. Well, let me show you that one time. Do you recognize this document?
A. Yes.
Q. Do you recognize this to be some calculations done by Dr. Ashenfelder?
A. Yes, I would recognize it better if I could see the whole document but yes, I do recognize the document.
Q. Focus? That is the best we can do on this one.
A. Perhaps you can get me a better copy.
MR. KEMPF: I will hand one up to Your Honor.
THE COURT: Thank you.
BY MR. KEMPF:
Q. Now, this is from PX-157. Do you recognize the top line there to be some results of equations of econometric models that Dr. Ashenfelder ran?
A. Yes.
Q. And the first one was sort of his effort to duplicate Professor Hausman's as I understand it, correct?
A. Yes, I think so.
Q. And he came up with 1.1 percent, right?
A. That's correct.

Q. And then he made some adjustments and lo and behold, it went down; is that right?
A. Well, it looks like the adjustment that he made was he went from weekly data --
Q. I didn't ask you the adjustment he made. I said when he ran it the second time it went down, didn't it?
A. Yes.
Q. Then he ran it a third time and this time he got 2.9 percent. Do you see that?
A. Yes. That is model number three.
Q. And he ran it the fourth time and got 3.7 percent, you got that?
A. Each time you are changing something, yes.
Q. Then he changed something else again and ran it a fifth time and got 4 percent, right?
A. Yes, although I'm not sure I would characterize it that way.
Q. Yes or no did he change it again and get a fifth column that was 4 percent?
MR. CARY: Your Honor, can the witness have time to complete his answer.
THE COURT: He needs to answer the question directly and then he can explain it if he wishes.
BY MR. KEMPF:
Q. These are yes or no questions I'm trying to pose to you,



Doctor?
A. If you are asking me if the results in column five are different from column four, yes.
Q. And then did he finally change it again in column six and get 3.7 where it went down again?
A. Which one are we going from, from five to six?
Q. That's right.
A. My answer is yes, he did that when he used the recalculated price index as opposed to the Hausman price index and the estimate went from 4.0 down to 3.7.
Q. And then finally over at column 7, we hit the mother load, is that fair?
A. There are a lot of differences from one to seven.
Q. And your results depend very much on how you take account of those differences, isn't that the fact?
A. I would say the results depend critically on whether or not you do the analysis correctly or not, yes.
Q. And Dr. Ashenfelder when he finally hit the mother load said, Eureka, I have done it right?
A. I don't think I want to answer that question.
Q. Aren't you now testifying that that is the right way to do it except over in column 7 where you made some further tweaks on it?
A. I'm stating that Dr. Ashenfelder sat there in an Office Club at Princeton, looked at a computer printout and saw 78.6

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and leapt to his feet and said I Eureka, I hit the mother load in n that case you know him a lot better than I do.
Q. Let me talk about the hits analysis that Mr. Cary talked about. Remember you said they did it wrong to focus on sales. They should have focused on pricing?
A. I said that was relevant question, yes.
Q. You know that that analysis was done long before this merger agreement was entered into, don't you?
A. I don't have any information on that.
Q. Didn't you see on the charts it is dated from May of 1996?
A. I'm sorry, you are talking about the charts data as opposed to Professor Hausman's?
Q. I'm talking about the company's internal hits analysis, isn't that what you were asking? Isn't that what you were responding about when Mr. Cary was asking about it?
A. That's correct. I have seen it in two forms, yes.
Q. That was done, when was the merger agreement entered into in this case, September, does that strike you about right?
A. That is about correct.
Q. Don't your numbers you had for your so-called event analysis, don't they beg off of a September date?
A. That's right, September 4th, I believe.
Q. Don't you know that those hits analyses, whatever they

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did, whatever they focused on, right or wrong, they did it before the merger agreement was entered into?
A. That set of documents was before the merger, correct.
Q. That was just a bunch of business guys, nobody sitting around saying how do they come up with this number or that, they ran it and they came up with what they came up with, is that fair?
A. That is not only fair but I find the results perfectly reasonable.
Q. Now, let me go to the events analysis. Now that has changed too, hasn't it?
A. Yes.
Q. When I took your deposition, I was looking at a number when we came into the room of about a billion two, wasn't it?
A. A billion two for what, for whom?
Q. Weren't you, at that time, finding the movements in the company's stock implied that the movement would increase the value of the combined firm by about a billion two?
A. Of Staples and Office Depot?
Q. Yes.
A. It is not totally implausible. I would have guessed it was lower than that.
Q. I'm talking about when we first started that morning, wasn't the number I was looking at a billion two?
A. I don't know.

Q. I'm asking about what your number was. That is the number I was looking at.
A. Well, the number that I'm looking at is for the combined firm is about $616 million for the combined firm.
Q. Yes, that's right.
A. For the combined firm and Office Max, somewhere around 800-plus million.
Q. I'm talking about the combined firm, 600 million. I'm saying when you started off the exercise and you did it the first time it was about double that when you did it the first time?
A. I can't answer that.
Q. You don't remember?
A. No.
Q. Do you know who Dr. Gould is?
A. Yes.
Q. Distinguished professor at the University of Chicago?
A. I take your word for it.
Q. Do you know him to be that?
A. I know he is a professor at the University of Chicago. I don't know his title.
Q. Do you know he was the dean for years?
A. Yes.
Q. Do you know he has done two declarations that were filed in this case?



A. I read one declaration, yes. I'm not sure if it was a declaration or a report.
Q. Did you read the first one or the second one?
A. I think I read the one where he thought that the Internet would solve all our problems.
Q. Well, in both of them, does it refresh your recollection if I tell you that he specifically addressed your event analysis?
A. I mostly remember the Internet story.
Q. Do you remember that he said -- Professor Gould took a look at your first event analysis of the stock market and said, boy, does this guy have this thing wrong. If you look at it and do it the right way, it proves exactly the opposite of what he says it does?
A. No, I don't recall that.
Q. Do you recall that that was the gist of his report or declaration?
A. No. I read a report or declaration from Dr. Gould which my recollection of it went into some great detail as to that the Internet was going to mean that this merger was not going to be a problem.
Q. You have no recollection of him saying anything about how good or bad a job you did at this event exercise?
A. In the event, I think fairly recently I have seen what looks like a table from Dr. Gould.

Q. Let me ask you, do you recall in his first declaration him saying you did it backwards, upside down and got it wrong basically?
A. No. No.
Q. Do you remember him saying anything at all about the quality of your analysis at all?
A. No.
Q. Now, would it refresh your recollection if I told you he had a footnote in there that said basically this guy is always changing his numbers, so I reserve the right to put in a supplemental declaration too?
A. Obviously you are reading from something. I'm not going to try to answer the question.
Q. Well, do you recall that he did a second declaration that said well, now that I've taken a look at Dr. Warren-Boulton's second set of numbers, they are about half what his first set is. He still got it wrong?
A. My recollection --
Q. Do you recall him submitting a declaration to that effect?
A. Can I tell you what I do recall?
Q. No. You can tell me that later or you can tell Mr. Cary if he asks you. I'm asking you if you recall what I'm asking?
A. Not particularly in those words.
Q. In effect, I said?



A. I'm sorry, in effect saying what?
Q. That he took a look at your revised work and you still had it wrong and if you did it right it would prove the opposite of what you said it proved?
A. That I don't recall but I wouldn't be surprised if he would say that.
Q. Now, let's break it down a little bit here. Let me ask you this: You know how all your charts said that Staples is the big loser here. Do you remember that, they are below the line all the time?
A. I think it said that Staples shareholders at this point could expect to see the price of the shares go up if the FTC were successful.
Q. Yes, in other words, they should be in here trying to lose this case is what your model shows, right?
A. If I were a staple shareholder, I think I would be praying for the FTC, yes.
Q. You know you would be saying you know, our management is a little bit whacko?
A. I would say it is fortunate that the person in charge of the negotiations at this merger comes from Office Depot.
Q. Because the Staples people are a little bit screwed up when it comes to analyzing these things, is that the thrust of your testimony?
A. No, I'm saying that the financial markets are saying

that this is, at this moment, a bad deal for Staples under the current exchange ratio. And in fact, as I recall, there are stories in the financial press that they may renegotiate the ratio.
Q. Have you overheard any executive from any defendant say anything like that?
A. No.
Q. Do you have any information of any kind that supports that contention?
A. Which contention is that.
Q. The contention that the ratio be renegotiated?
A. It was in yesterday's, I think, Wall Street Journal.
Q. Do you have any information of any kind that is directly from any document from any witness in this case that supports that?
A. No. It is just pure --
Q. Is the answer no?
A. I'm trying to say the following instructions, I give you an answer yes or no and then I explain it.
Q. Well, I think what I prefer, unless it is something that can't be answered no, is that Mr. Cary clean up anything he wants to clean up and try to rehabilitate you anyway he wants.
Now, is the stock market, the way you read it, saying you know these shareholders ought to throw out Mr. Stemberg and his colleagues and the management because they are


pursuing something that is really a bad deal for us?
A. I can't tell you what the shareholders should be doing. My only contribution, shall we say, is to note that at this point the financial markets clearly indicate that if this merger goes through, the share price of Staples will fall. It is a fairly straightforward statement.
Q. Let me ask you this: The stock market analysis type of approach that you testify about here today, there is not a single word about that in the merger guidelines, is there?
A. That is correct, and there also isn't anything in the merger guidelines about using the econometric studies. The merger guidelines is a structural approach.
Q. The answer to my question is yes?
A. Yes, and you get an explanation.
Q. Now, let me ask you about one of your charts here. Do you have the overhead with the two tops with the red and blue chart, the stock market price with the two dips in it? I tell you what put it back the other way.
A. It works just as well upside down as it does upside up.
Q. I think you are right on that.
A. They go together upside down and they go together downside up.
Q. Equally as well, right?
Now, just so we are back on the same page, which is the red and which is the blue?

A. By the way, somebody has gone off with my copy of that but the blue is the cumulative change in the probability starting -- it would be easier if I could read off mine.
(Document proffered.)
BY MR. KEMPF:
Q. Now, is the red line what happens to the value in this particular case of Office Max and is the blue line the probability of the merger?
A. No. The blue line is the estimated change in the probability of the merger starting on 3/5/97.
Q. Let me interrupt you, can you call up your testimony at 145.
THE COURT: I think we have a different reporter here. It may be on someone's computer.
MR. KEMPF: I will move on here.
BY MR. KEMPF:
Q. The blue line is the probability of merger; is that right or is that wrong?
A. No, at least not on the left axis. The idea was to look --
Q. I'm just asking you what is the blue line?
A. The blue line is, as I think I said before, that measures the change in the probability of the merger starting from 3/5/97.
Q. And the red line is what?


A. The red line is the estimate of the abnormal return to Office Max.
Q. Now, you said you would adjust it for the S and P 500? What deflater did you use?
A. Yes, the S and P 500.
Q. Did you go back and look at the betas of these two companies?
A. Yes.
Q. And what did you find?
A. The beta for Staples and Office Depot is about 1.8. The beta for Office Max that I'm using is about point 8.
Q. Now the beta 1.9 means it is about twice as volatile as the S and P 500; is that right?
A. 1.9, a beta two would say that.
Q. Didn't you say it was 1.9?
A. I think they were about 1.8.
Q. Two would be twice as volatile?
A. The correlation with the market is twice as volatile.
Q. Did you adjust for a beta calculation?
A. Yes.
Q. Is that reflected here?
A. Yes.
Q. As well as the S and P?
A. Yes.
Q. Now, Mr. Cary asked you, well gee whiz, what accounts

for the big drop in Office Max value, remember that?
A. That's correct.
Q. You know, you said you know I think what it is is the market says they are not going to get those increased profits that they are going to get from increased prices and, therefore, down it comes, is that a fair summary of your testimony?
A. That is the results from their regression analysis, yes. In this particular event, you have, of course, I don't know if you want to get into this but two events, in a sense, going on at the same time.
Q. I'm just going to go to the big drop there on 4/4, you see it there, where it goes way down.
A. Right.
Q. Now, can you think of anything else that maybe might have accounted for the big drop in Office Max's price?
A. Yes. As part of the proposed settlement, the Staples and Office Depot were going to sell some 63 stores to Office Max.
MR. KEMPF: Your Honor, could I have that answer read back.
(Whereupon, the record was read by the reporter.)
BY MR. KEMPF:
Q. Did you ever say to yourself well, gosh, maybe when the FTC decided to sue, what the market was saying is this is bad



news for Office Max because they were going to get 63 stores for a song and they are not going to get them any more?
A. Of course I did.
Q. Did you ever say to yourself, you know I read in the paper that Mr. Foyer said this was Christmas coming early and that the FTC, like the Grinch, just cancelled Christmas.
A. Well, I can't say I use those exact words but I can say that I read reports that factored into the analysis, a transfer of somewhere between 140 and $200 million because of the sale.
Q. Did you ever look at analyst reports that Mr. Cary was asking you about and say, you know what all the analysts say here is the reason Office Max stock dropped is that they were going to get a being spectacularly attractive deal where they were buying several hundred million dollars worth of assets for about a hundred million dollars and they aren't going to get it any more and that is why their stock dropped?
A. That is correct and that is why I took that into account in the analysis.
Q. You didn't read any analyst report that said the reason the stock dropped is because they aren't going to get monopoly profits, did you?
A. I think there are a lot of analyst reports that talked about the effect of the transaction on share prices. But if your question is did I take into account the transfer, to the

extent that the implied transfer was somewhere between 140 or $200 million, yes. That is already factored into my estimates.

MR. KEMPF: Now, Dr. Gould's declaration, just for the record, Your Honor at DX-1873 and DX-5029.

BY MR. KEMPF:

Q. Now, let me ask you a preliminary thing. I was looking at one of your charts and I sort of highlighted myself what I had here and you see in the corner where it says estimated by regression over 9/4 to 5/14/97?

A. Yes.

Q. And then do you see the one that you have up on the board there, that is from the time period of 3/5 to 4/10, correct?

A. Yes.

Q. Now, I gathered the thrust of your testimony is that the stock market, when they would see the possibility of the merger going through would say, Aha, that is good for Office Max, let's bid up the price of their shares. Is that the thrust of it?

A. The thrust of my testimony is that there is a positive correlation. I'm not saying it is absolutely instantaneous but yes.

Q. What is the efficient market theorem?

A. The efficient market theorem basically says that all



known information, currently known information is capitalized in value shares.

Q. Would another way of saying it be in layman's terms, is that financial markets digest and react to information quickly and well?

A. I think certain kinds of information, very, very well.

Q. And very quickly too, isn't it?

A. For certain kinds of decisions, financial markets can discern the answer.

As an example, financial markets are not very good at figuring out what Greenspan is going to do but they are very good at reacting to what he does.

Q. Let's talk about the announcement of the merger. When this merger was announced, what happened to Office Max's stock, not over some period of months and stuff like that. The day that it was announced and Staples and Office Depot said we are going to merge, did Office Max's stock go up or down?

A. I don't think it probably changed significantly.

Q. Well, let me put something up on the machine?

A. It may have gone up. It didn't go down.

Q. Let me put something on this machine. I'm not sure you can see this as well as I'd like. It is orange and when it gets down to the black zone it goes to red and then yellow and then back again. Do you see those colors on there?

A. Yes.
Q. I will represent to you that the red part is, in fact, what happened when the merger was announced. Does that refresh your recollection at all? Your Honor, perhaps it would be helpful if I gave some hard copies of these to the court and if I could approach the witness?
THE COURT: Yes, sir.
BY MR. KEMPF:
Q. Does that refresh your recollection that what really happened in the financial markets when the merger was made is that Office Max stock fell like a brick?
A. I wouldn't describe that as looking like a fall like a brick. Just out of curiosity, is this adjusted for the S and P 500?
Q. I don't think it is adjusted for anything. It is just me after I read your stuff last night saying gee, I wonder what happened?
A. This is really the market going up and down and all that kind of stuff.
Q. Yes, that's correct. It is saying what did the stock market do with Office Max stock that day.
MR. CARY: There is no indication that this witness knows. This is Mr. Kempf's indication of what he did last night.
BY MR. KEMPF:



Q. You studied it.
A. Let me shorten this. I wouldn't be at all surprised.
Q. You are going to be back later, I gather, to testify on rebuttal, correct?
A. If I'm asked, yes.
Q. All right, let's talk about entry for a minute. You talked about saturation, do you remember that?
A. Yes.
Q. And are you familiar with the fact that people's estimates of saturation have changed a lot over the last decade?
A. Yes.
Q. And what people thought ten years ago was an impossible dream is now a reality in terms of markets that nobody thought could be entered; isn't that right?
A. What is correct is that the scope for Office Club superstores is considerably higher than what I think Mr. Stemberg first imagined?
Q. And imagined at every step along the way, wouldn't that be fair too?
A. I think his estimate of the maximum number of Office Club superstores that the country would see has grown over time significantly.
Q. Now, let's talk about Best Buy. You talked, remember in your direct testimony about how they were entering and going

in very aggressively and then they started to scale back, do you recall that generally?
A. Yes.
Q. Now, there is a reason they scaled back, isn't there?
A. I'm an economist. I assume everybody is rational.
Q. Would part of your rationale say they weren't making as much money as they thought they would make?
A. That is correct. It is not only my assumption. I think they said it was not as profitable as we had anticipated or hoped.
Q. Would that be because one witness might have said that competition in this sale of Office Club supplies is a hot bed of competition?
A. No, I think it was because they were unable to attract customers whose destination was an Office Club supply store, primary destination.
Q. Well, would it be that the way they would have had to do that, one way they might have tried to do that is by lowering their prices still more?
A. That was apparently unprofitable. What they tried to do was to become close to an office superstore and apparently failed.
Q. Was the reason it was unprofitable because prices are so darn low?
A. No, the reason it was unprofitable is because customers



who wanted to just buy at their primary destination Office Club supplies that didn't want to go to Best Buy no matter what they did. They kept going to someone else.
Q. Well, have you read the Best Buy declarations?
A. I have read, I think a couple, yes.
Q. Let me ask you a question. I asked you about this at your deposition. This is our old friend, the ten pitfalls. Remember I asked you about these?
A. Yes, I thought I was getting into the construction business for a while in the deposition, yes.
Q. I asked you about every one of these pitfalls, do you recall, at your deposition?
A. I re call being asked repeatedly isn't one of the pitfalls a merger analysis and then you would say something to me.
Q. And you disagreed with quite a few of them that I asked you about; isn't that right?
A. I think my reaction was I either disagreed or they were incomplete.

MR. KEMPF: Your Honor, let me mark as a DX-9000, the chart I used a little bit earlier?

MR. CARY: Again, I'm going to object to this exhibit as lacking any foundation.

THE COURT: He can mark it. It is not necessarily in evidence yet but he can mark it. Is DX-9000 Office Max stock price after the merger. We will label it.

(Whereupon, Staples Trial Exhibit No. 9000 was marked for identification.)

MR. KEMPF: I would like to mark at 9001 the 10,000 pitfalls to avoid in merger analysis, Your Honor.

THE COURT: That will be marked as 90001.

(Whereupon, Staples Trial Exhibit No. 9001 was marked for identification.)

BY MR. KEMPF:

Q. Now, the first one up in high Herfindahl's cause competitive problems. You would not describe that as a pitfall, would you?

A. Not the way it is stated. You can change it into a pitfall if you would like.

Q. Well, you don't think it is fair to say that the Herfindahl statistics are usually only useful in describing safe harbors. You wouldn't agree with that, would you?

A. If I understand your question, Herfindahl's statistics are only useful when they are below the safe harbor. No, I think they are useful.

Q. So you would disagree with that statement?

A. I think so but you might want to read it back to me.

Q. But you do think it is correct that anticompetitive effects may not occur even if the Herfindahl is very high, wouldn't you agree with that?

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A. If I understand your question, Herfindahl's statistics are only useful when they are below the safe harbor. No, I think they are useful.

Q. So you would disagree with that statement?

A. I think so but you might want to read it back to me.

Q. But you do think it is correct that anticompetitive effects may not occur even if the Herfindahl is very high, wouldn't you agree with that?

A. It is possible.
Q. And you also don't agree that one of the pitfalls to avoid in merger analysis is that market structure generates collusive outcomes?
A. That is not a grammatical statement.
Q. Well, let me just ask you the following. You asked the following question and did you give the following answer at your deposition.
Is one pitfall to avoid in merger analysis that market structure often generates collusive outcomes?
Answer: No.
Were you asked that question and did you give that answer?
A. Yes.
Q. Now let me turn to the third one. I asked you whether one of the pitfalls was to dismiss efficiencies as speculative and you said by yourself you really couldn't answer that one way or the other; is that right?
A. I think I would always regard that as narrative to dismiss anything as speculative without foundation, I certainly wouldn't want to dismiss efficiencies.
Q. Well, you can think of cases, can't you, where anticompetitive effects are every bit as speculative as efficiencies, can't you?
A. Yes. There are 3,000 mergers proposed every year and

the vast majority of those appear to raise no problem. I suppose you could say that if you looked at those 3,000 mergers, you would say the vast majority of them, any speculation as to anticompetitive effects would be speculative.
Q. Now, you also disagree with number five that one of the pitfalls to avoid is focusing on a 5 percent test. You disagree with that too, don't you?
A. My only point is --
Q. My question is do you agree or disagree with it?
A. Focus on a 5 percent test as a statement, there is some context to this. I can't tell that from these things. I can tell you how I might rephrase it so it would make sense to me.
Q. Let me mark 9001 -- let me also mark and hand to you a document which I will mark as 9002.
(Whereupon, Staples Trial Exhibit No. 9002 was marked for identification.)
MR. KEMPF: May I approach the witness, Your Honor?
THE COURT: Yes, sir.
(Document proffered.)
BY MR. KEMPF:
Q. Do you recognize this document as containing some of the other things I asked you about at your deposition?
A. Yes.
Q. Now, after the deposition was over, did you say to

yourself, I wonder where we got all these ten pitfalls?
A. No, actually.
Q. Did you discuss with Mr. Cary all these pitfalls to avoid in merger analysis? I wonder who wrote those?
A. I assumed that you hadn't written them. Somebody must have written them.
Q. Did anybody tell you that somebody at the FTC had written them?
A. No.
Q. Do you know who Malcom B. Coat is?
A. No.
Q. Are you familiar with his book, The Economic Analysis of Mergers?
A. No.
Q. It was just published a couple of months ago, March 1997.
A. Yes.
Q. You are not familiar with that book?
A. No.
Q. As to who Mr. Coat is, would it refresh your recollection if I told you he is the deputy assistant director in the Federal Trade Commission's bureau of economics? Does that help you?
A. No, I never met the gentlemen.
Q. Isn't it true that increasing market concentration can

be associated with lower prices as well as higher prices?
A. If, by association you mean correlated, yes.
Q. And now suppose there are ten firms in a market and five acquire five others and they realize enormous efficiencies, is it possible in that situation that the increase in concentration would be associated with lower prices following the increase in concentration?
A. Ten firms in industry acquire ten other firms?
Q. No. Ten firms you start out with, five acquire five. They realize enormous efficiency. It is possible in that situation that the increase in concentration would be associated with lower prices following the increase in concentration; isn't that correct?
A. Yes, that is correct, that is possible.
Q. There is no hard and fast rule you can draw here. Every case has to be decided in light of its own particular facts and situation; isn't that correct?
A. I think that is a reasonable rule if you invest the time and effort, yes.
Q. Do you remember Mr. Cary was asking about past nonmergers that the company had engaged in and saying what they thought about what prices might do afterwards if those mergers that weren't completed had occurred? Do you recall that questioning?
A. No.

Q. You don't recall Mr. Cary asking you about certain possible acquisitions between Staples and Office Max or Office Depot and what might or might not have happened with respect to those transactions to prices after those transactions were completed, had they been completed?

A. Oh, yes. Yes.

Q. Did you take a look at what happened? Instead of nonmergers, real mergers, ones that did occur?

A. I haven't done any kind of extensive analysis of what happens as a result of past mergers.

Q. Let me ask you this. Would you take a look at what happened out in Los Angeles back in 1990, not when there was a nonmerger but when there was a merger?

MR. CARY: Your Honor, again, objection, there is absolutely no foundation whatsoever for this document.

MR. KEMPF: We can argue that, Your Honor. This is in evidence.

MR. CARY: Again, it is not in evidence in the sense that it is qualified under the rules of evidence. It is in evidence because it is in one of the 65 binders Mr. Kempf put in.

THE COURT: I will let him cross-examine with it and then you can argue about its weight afterwards.

BY MR. KEMPF:

Q. Did anybody discuss this with you?

A. That chart, no.
Q. Did you take a look at what the impact was of the actual merger out in Los Angeles in 1990 when Staples acquired HQ Office Club Supplies. Did you study that at all on your own?
A. No.
Q. Did you study at all what happened to actual prices down in Dallas, Texas when Office Depot acquired Office Club?
A. I certainly read on the first page of your statement and what you will notice is that while prices seem to have fallen in Dallas, Texas when you went from three to two, they went down even more in Houston. I suppose that is a relevant comparison.
Once again, if you make a comparison, do prices go down more when there is an increase in concentration more than if there hasn't been. In the market where there was a merger the prices went down less in your comparison than when there wasn't.
Q. Does this show that or does it show that prices went down in Texas?
A. It shows that prices went down in Texas.
Q. This doesn't show that prices went down more many Texas?
A. This chart doesn't show that.
Q. Let's go back to Los Angeles. Nothing in this chart in Los Angeles says anything about prices elsewhere in the country, does it. It shows that prices went down in Los

Angeles after the merger doesn't it?
A. Over a year after the merger, yes.
Q. Now, would it be fair to say that a consumer is interested in value and that value is comprised of a bundle of items including price quality and service?
A. Unobjectionable, yes.
Q. You know that there is such a thing as a time value of money, correct?
A. Correct.
Q. Some people value the time required to, say, visit an Office Club superstore differently from another consumer; isn't that right?
A. If they have a different value on their time, yes.
Q. And that might lead one consumer to invest in that time and another to forego that time and, for example, over the phone instead of visiting the store; isn't that correct?
A. That is true.
Q. And different people have a different value of their time; isn't that correct?
A. Correct.
Q. And that leads them to different patterns of purchasing, isn't that fair?
A. That is correct.
Q. Now, how many items does the average purchaser buy on a trip to an Office Club supply superstore?

A. I have seen numbers ranging from two to six or three to six in terms of Office Club supplies.
Q. How about the average receipt for the total of two to six items. Do you have a recollection of that?
A. Depending on the estimator, anywhere from 30 to 50.
Q. You don't personally know of anybody who has ever gone to a staple store and said, today, I think I will pick up a couple of hundred SKUs.
A. I can promise you I know of no one who has ever said that.
Q. Or anything to that effect.
A. My sample is extraordinarily small. Do I know of anybody who has bought 200 SKUs at a staple store, no.
Q. And 200 SKU's would be kind of hard to tote around, wouldn't they?
A. I don't know what the lightest weight SKU available is.
Q. Well, 200 purchasing of SKU's would be unusual, wouldn't that be fair?
A. I certainly think so. I think Staples would be delighted if people would pull up and buy 200 SKUs.
Q. Let me shift to the 80/20 rule. You can't say that is not approximately right for the Office Club supply industry, can you?
A. No. I would have no reason to believe that that would be far off as I understand the way in which you were using it

in your opening statement.
Q. Now, you would expect that if the combined firm raised prices by 5 to 10 percent and Office Max did not, that Office Max's quantity of sales and revenues would go up, wouldn't you?
A. Yes.
Q. As far as competitive image goes, you don't have any particular view as to the significance of office depot, Staples and Office Max maintaining an image in the marketplace that they are deep discounters offering deep low discounts for office supplies do you?
A. I think any firm that wants to attract customers where the customer isn't absolutely certain what the prices actually are would benefit from a perception that the prices were low if that is what you mean by an image.
Q. Is that something that you think they would be very worried about that they would not lose that image?
A. I think that firms advertise low prices precisely to foster that image. I don't see a lot of advertisements that say come to Staples for their high prices.
Q. Have you ever heard of comparison advertising?
A. I have heard of it. I'm an economist not a marketing person.
Q. Well, if someone were to raise prices, isn't it possible that someone else could go out and say, you know those folks

just raised their prices 5 to 10 percent. You ought to be coming over to our place to buy your stuff. Isn't that just common sense?
A. I can think of examples in which that would be expectable if those people were out there.
Q. Now, let me carry you to a town where there is no Office Club supply superstore. Are you with me?
A. Yes.
Q. And let's say it is a town. It has like 150,000 people in it?
A. Okay.
Q. Of their relevant product market, as you define it, who has what share in that town?
A. The product that I would define at that point simply isn't being supplied in that town.
Q. It is not there?
A. It is not there.
Q. Nobody has any market share, is that your testimony?
A. There is nobody supplying what I would call consumable Office Club supplies through an office superstore type format, no. There are local stationers, mail order, a bunch of people buying the product but not the product in the same way as it is supplied by and with the same characteristics as it is supplied by an office superstore.
Q. So the way you see it there is no relevant product

market in that town, is that what you are saying?
A. I'm saying that --
Q. Is that what you are saying?
A. It is not that there is no relevant product. It is that there is nothing being supplied in that market at that time.
Q. The relevant product we are talking about in this trial when it comes to towns like that all across this country, just plain doesn't exist under your view of the market; isn't that right?
A. That is why we speak about --
Q. My question is is that right?
A. That is why I speak about entry into that market.
Q. Is my statement right or not?
A. Yes, the first entrant into that market supplies that product.
Q. Now, when that first entrant comes in under your view of the market, they are a monopolist from day one; isn't that right?
A. Yes.
Q. Now, when they come to town --
A. They have a monopoly, yes. They are the only supplier of that particular product.
Q. And when they come to town with a monopoly according to you, the first thing they do is they lower prices, right?
A. That is correct.

Q. Now that is a good thing, not a bad thing, right?
A. Entry is a very good thing, yes. I could think of more examples of this if you would like.
Q. Now, you work over at Micor, right?
A. Yes.
Q. And you remember Mr. Cary was talking about some questions with you and you said your Office Club manager, if she didn't like the prices at one place she could go to Wal-Mart. But she may not want to drive all the way over to Germantown. Do you remember that testimony?
A. I haven't actually asked her but I don't think she would do it.
Q. That is because you don't get your Office Club supplies there, do you?
A. Well, actually we have just switched.
Q. But when I took your deposition, first of all you have less than 20 employees in your business; is that right?
A. That's correct.
Q. And where you get your office supplies is from BT; is that correct?
A. That was correct at the time of the deposition, yes.
Q. When I took your deposition a week or so ago and I asked you where you got your office supplies, you didn't tell me your Office Club manager may have to drive to Germantown. You told me she got them at BT; isn't that right?

A. That is correct.
Q. Where did you switch to?
A. I hate to say this, Staples. If worse comes to worse, you will have another customer. It truly has been a learning experience. I knew nothing about office supplies before I began this case.
Q. Well, I think that is pretty clear.
THE COURT: You walked into that one.
THE WITNESS: I'm not sure that you knew too much about them either.
BY MR. KEMPF:
Q. Now, you can't necessarily infer causation from correlation, can you?
A. That is correct.
Q. But when it comes to consumer opinion, you think that any merger under investigation, the position of informed consumers and the views of informed consumers are something one should look at, don't you?
A. I would say yes if you have an informed consumer, their opinion is very important.
Q. Let's talk about efficiencies for a minute. The case for allowing efficiencies to be considered with respect to individual mergers is a powerful one, isn't it?
A. Yes.
Q. Mergers can result in efficiencies and all else being

equal, those efficiencies may, under certain circumstances, rebound to the benefit of consumers; isn't that correct?
A. That's correct.
Q. It is true, isn't it, that efficiencies likely to be obtained through a merger may increase the competitiveness of the merged firm and improve or at least not impair the competitive performance of the markets in which the merged firms operate, ultimately resulting in lower prices, increased outputs and/or higher quality of goods or services for consumers and other buyers?
A. That is correct and the operative words of course are likely and may.
Q. It is important, always, to assess possible efficiencies in a merger analysis. It is correct in this case. It is correct in general, isn't that true?
A. I have always held that position, yes.
Q. In taking into account in predicting the price effect of a merger, you should always consider credible efficiencies; isn't that right?
A. That's correct.
Q. And all efficiencies claims should be carefully examined. And isn't the purpose of the inquiry to determine, on a net basis, the effect of an acquisition?
A. The first part of the sentence I would agree with. I think there is probably something else. The net effect of the

acquisition on what?

Q. Wouldn't you agree with this entire statement, all efficiency claims should be carefully examined and the purpose of the inquiry should be determined on net price effect of an acquisition?

A. I'm sorry, the second part of that is going past me. The first part is fine. What do you mean by the purpose of the inquiry?

Q. Let me ask it to you this way. At your deposition were you asked the following question and did you give the following answer?

Question: And wouldn't you agree that all potential efficiencies should be measured and balanced against potential adverse effects to protect the likely net effects of the transaction?

Answer: I think all efficiency claims should be carefully examined, and I think that the purpose of the inquiry should be determined on net price effect of an acquisition.

Were you asked that question and did you give that answer, however poorly the answer was phrased?

A. Well, I certainly agree with the last part of your statement about being poorly phrased.

Q. Well, my question is did I ask you that question and was that your answer?

A. I'm assuming that the reporter took it down correctly.

MR. KEMPF: Your Honor, I have no further questions.

THE COURT: We will have the redirect now.

REDIRECT EXAMINATION

BY MR. CARY:

Q. Professor Warren-Boulton, all of us involved in litigation won a few and lost a few. I thought I would give you an opportunity to talk about one that you won.

A. One that I won, oh, good.

Q. One in which you were a testifying expert witness providing declaration and testimony to the court. Isn't it true that you were expert witness in Wonton versus May Company Department Store?

A. Yes, that is correct.

Q. Isn't it true that the court did, in fact, enjoin that merger?

A. That's correct.

Q. Now, Mr. Kemp asked you a series of questions based on his diagram of a demand and a supply curve and various effects on prices.

A. Yes.

Q. Did he ask you whether it wasn't true that if you lowered price you increased the quantities sold. Do you recall that testimony?

A. Yes.

Q. Professor Warren-Boulton, isn't it the case that it is not always the profit maximizing strategy to lower price?
A. Almost by definition, if you look at the prices people have chosen, those prices have been chosen presumably because that is the profit maximizing price. If they, then, drop the price below that for some reason, the profits will fall, similarly if they raise their price.
Q. It could be the price that the profit maximizing strategy would be to raise price in some cases, correct?
A. That is certainly true.
Q. And that would be because you would lose very few customers in raising the price; is that right?
A. If, when you raise price you will lose some customers, all else being equal, what will happen is that you will make more money on the customers that you keep and you will lose the profits that you had made and the customers that you are going to lose.
If, on balance, the increase in profits on your old customers is greater than the loss of profits on the customers you have lost, your total profits will go up if you raise the price.
Q. And if you eliminate from the marketplace your most aggressive competitor, you are likely to keep more of your customers even if you raise the price?
A. That is correct, in a situation in which the price

increase would not have been profitable would become profitable.

Q. Mr. Kempf asked you whether you relied on PX-3 and I believe you said no and you started to answer about underlying documents and I believe at that point you were cut off. You have, in fact, looked at some of or all PX's in this case, have you not?

A. Yes, that is correct.

MR. KEMPF: Your Honor, I know that this is redirect but it is awful leading.

THE COURT: I will sustain the objection. Why don't you go to the areas you want to go to and let him answer the questions.

MR. CARY: All right.

BY MR. CARY:

Q. Your analysis relied on certain pricing documents that you reviewed?

A. Yes.

Q. And they relied on pricing documents which showed the difference in prices between one firm and two firm and three firm markets?

A. That is correct. That is the same pricing document on which PX-3 is based.

Q. And you relied on various Goldman Sachs reports that were in this --

MR. KEMPF: Your Honor, this is just --

THE COURT: Let him answer what he relies on the documents backing PX-3 as opposed to telling him.

BY MR. CARY:

Q. Not only the documents in PX-3 but all of the documents, the numerous documents that you saw in --

MR. KEMPF: Objection.

THE COURT: I sustain the objection. You are telling him what to say. Ask him what documents he relied upon and he will describe them. He has done this before.

THE WITNESS: As I said at the beginning I relied on a very wide range of documents. Amongst those documents are the documents that are referred to in PX-3. I relied on all the documents that are in PX-3 and I also relied on a large number of documents other than the ones that were in PX-3.

BY MR. CARY:

Q. Mr. Kempf asked you about the econometric numbers. Do you have an understanding as to why those numbers have changed over time?

A. Yes. I can particularly speak to the example that he mentioned which is that when we first ran Professor Hausman's model we had an estimate of point nine. Given the startling or remarkable difference between that and the cross-section estimates, the question was what was generating this large difference.

The first and most obvious thing you look at is sample selection. Has the sample somehow been chosen or selected so that it shows a nontypical effect.

In our case, what we did is we had a number of stores that had been, for some reason, I don't know, excluded from Professor Hausman's sample. We added a relatively small number of such stores. We got information on those stores and added it to the sample.

The addition of a fairly small number of stores, suddenly the coefficient jumps from point 8 to 1.7.

The point that becomes very clear is that the model that we have here or the results of this model are very sensitive to the particular choice of the stores that are being used.

Q. This is Professor Hausman's model that he submitted on behalf of the parties?

A. Yes.

Q. And what did you do at that point when you realized that some of the data was excluded from Professor Hausman's analysis?

A. At that point it became clear to us that these results were highly sensitive to the particular assumptions and that a clearly more detailed and better, more thorough analysis was appropriate for any kind of time series model. And that is, of course, what Dr. Ashenfelder undertook to do.

Q. You were asked questions about time series versus

cross-section analysis?
A. Yes.
Q. Are there advantages and disadvantages to each approach?
A. Yes.
Q. Can you briefly describe the advantages and disadvantages of each?
A. My experience is that a time series analysis is somewhat better at holding constant for differences across regions or across localities or for other influences.
The cross-section analysis is somewhat better if it has an advantage in terms of if you are trying to predict the long run impacts.
One of the advantages of time series is if you look at a time series analysis often what you are looking at is the immediate short run impacts. But if you look across different regions, by definition you are getting the long term impact.
So I think you would always want to look at both. The ideal, of course, is to combine them and use a full set and that is essentially what Dr. Ashenfelder did was to have the best of both.
Q. In this particular case did the time series results correctly done and the cross-section results yield the same or different results?
A. Very close.
Q. Mr. Kempf asked you a question about Dallas, price

decreases in Dallas after a merger?
A. Yes.
Q. Did you review materials that the parties, Professor Hausman put forward comparing the rate of price decreases in various cities before and after mergers and other cities where there were no mergers?
A. The particular recollection was to the first page of the defendant's exhibit in which they talk about prices fell in Dallas after the merger and prices also fell in Houston.
Simple comparisons on that very first page, the prices fell more in Houston where there wasn't a merger than in Dallas where there was a merger. I hesitate to extrapolate from one data point. But nevertheless, as a single data point, it seems to argue that if, in fact, all else was being equal, you would infer from that that the merger had the effect of increasing prices relative to what they would have been.
Q. You were also asked a series of questions about Office Max and whether you took into account any potential benefit that they might receive by virtue of a settlement in this matter?
A. Yes.
Q. Did you, in fact, take into account in the analysis that you previously presented, any such benefit?
A. Yes. I took into account between 140 and a $200 million

potential transfer, shall we say, from the merging parties to Office Max. So I had to separate that out from the price effects of the merger.

Q. And you did separate that out in reaching the conclusions that you testified to?

A. Yes, indeed. The percentages that were put up are net of any such transfer.

MR. CARY: Thank you. No further questions.

MR. KEMPF: Just one area very briefly, Your Honor.

THE COURT: I will let you have a very brief recross. Go ahead.

RECROSS EXAMINATION

BY MR. KEMPF:

Q. Let me see if I can't get the one that I had up on the board, the Office Max one now, remember you said you compared it to what was provided in other cities?

A. No, I simply compared, if my recollection is correct, these numbers appear on your first summary PX exhibit. You have a list of points and the fall in the price between 1991 and 1992 in Dallas, Texas is, as I recall, one of those points. It is then followed by a similar point having to do with the prices falling in Houston.

Q. Well, let me see if this refreshes your recollection.

A. I could look at the PX if that would make it any easier.

Q. How about DX?

A. I'm sorry, DX.
Q. Do you recognize these two to be the same thing?
A. These are, I think the charts at the back but my recollection is that just at the front you had all the numbers.
Q. So this is DX-306. You recognize that down in the lower right hand corner?
A. If you are asking what I recognize or what I recall, it is the first page of your exhibit.
Q. You recognize the thing Mr. Smith is holding and this to be the same?
A. The same as what?
Q. Each other.
MR. SMITH: Would it help if I carried this over by him.
(Document proffered.)
MR. KEMPF: I can't find the one I had on the overhead.
THE WITNESS: I'm sorry.
MR. SMITH: Is this the same as that?
THE WITNESS: As the one that is on the screen. It looks the same, yes.
BY MR. KEMPF:
Q. I want to have a frame of reference for you. Are you with me?

A. Yes.
Q. I'm going to flip over to the next page and compare it with what happened in South Florida. You see, actually, in the first period it went down a little bit more in Dallas than it did in south Florida and in the next time period it went up a little bit more.
A. Yes.
Q. Now, let's flip to the next page and maybe this is the one you are recalling from Houston. Is that the one you recall?
A. What I'm recalling is the first page of your exhibit. These are some graphs that are underlying.
Q. This graph shows that it went down a little bit more but in the same range in Houston as Dallas, doesn't it?
A. It looks like it fell.
Q. 6.6 versus 6.7 and the second one is 12 percent versus 14.5; is that right?
A. Yes, it looks like it fell by more in Houston, 14.5 percent.
Q. You compare south Florida, it is basically the same direction, a little bit more one way and a little bit less the other way, is that basically right?
A. Wait a minute. In Dallas we went from three to two, you had the merger and prices fell by 12 percent and Houston, which has disappeared, you didn't have a merger and prices

fell by 14 percent; is that correct? That seems to be what you are telling me. So they fell by 2 percent more in the city without the merger.
Q. And in south Florida they fell by 12.5 percent, correct?
A. Actually, I can't see that but I will take your word for it.
Q. Better.
A. Yes, that is another city where, yes --
Q. And, in fact, the first time period they fell more in Dallas where there was a merger than they did in south Florida where there was no merger; is that correct?
A. That's correct. And the inference that you can draw from this is --
Q. Is it correct?
A. We would have to go back and look at the numbers but I wouldn't be surprised.

MR. KEMPF: No further questions.

FURTHER REDIRECT EXAMINATION

BY MR. CARY:
Q. Professor Warren-Boulton, I'm going to show you two documents, DX-6033 and DX-6035. These documents, according to the footnote, are described as Staples pricing, J. Hausman, chain price indices, first year dollars adjusted for inflation and the other chart says store, Staples pricing, J. Hausman DX-1902 chain price indices first year dollar adjusted for

inflation.
I'm going to but both of them on the screen here and hopefully we will be able to see them.
Can you read that document, sir?
A. (Perusing.) Yes.
Q. This document across the top says prices have come down year after year in OSS monopoly markets. Do you see that?
A. That is correct.
Q. And according to this chart prepared by defendant's expert, Dr. Hausman, how far have prices come down in the monopoly markets between 1993 and 1997?
A. 13 percent.
Q. I'm now going to show you the other exhibit, DX-6035. Can you read that exhibit, sir?
A. Not quite as well. But it looks like prices have fallen from 100 down to 80. I'm having a little trouble here.
Q. 83.9.
A. Yes.
Q. This is not the monopoly market. This is the triopoly market. In other words, markets with the three office superstores?
A. That's correct. It looks like prices have fallen by a little over 16 percent.
Q. As opposed to the 13 percent of the monopoly market?
A. That is correct.

Q. So prices fell faster where there was competition than where there was monopoly.
A. That is correct.
MR. CARY: No further questions.
THE COURT: All right. Thank you.
What is the schedule that you have for tomorrow.
MR. CARY: Your Honor, two housekeeping details. First we have Professor Ashenfelder tomorrow, I suppose, if we are about to adjourn.
Second, I would like to supplement DX-202 which is Professor Warren-Boulton's presentation, so you can have the documents all in one place.
THE COURT: It is 202?
MR. CARY: Yes, sir. We will go ahead and number them and provide those to your clerk.
THE COURT: All right.
THE COURT: Is the next witness your last witness?
MR. CARY: Yes, sir.
THE COURT: Do you expect to finish tomorrow I take it?
MR. CARY: Yes, sir.
THE COURT: You will have someone here tomorrow afternoon?
MR. KEMPF: We will, Your Honor. We. Have someone here. We will be ready to go maybe with videotape and

declaration readings but whenever they are ready to stop, we are ready to go.

MR. ORLANS: Speaking of that I wanted to develop some procedure to deal with declarations before we come to court tomorrow. I did get from the defendants a list of approximately 30, it is 28 declarations, some of which seem to be quite long with no indication of what portions they'd like to designate. So I think we need some organized manner in which we can decide how to proceed with this.

I do believe that under the federal rule of evidence 106 that an adverse party may require introduction at the time that the initial writing is introduced. At any other part of the writing, that is necessary to put it in context, I fear that we are going to be at a loss here as to quite how to proceed unless defendants are forced to designate just what portions of these declarations they are going to rely on.

It looks like, at this point, a huge quantity of material and we don't know which part of it they are going to rely on.

With the videotape we designated and they counter designated. That seems logical. Obviously, our designations would come at our time, our counter designations.

MR. KEMPF: If the criticism is from the people they had the original declarations from, we have a ton of additional declarations and the answer is we plead guilty to that. We do want to cover a fair amount of it with the court, yes.

In terms of fairness I don't have a problem with that but I don't want you to try to put in your case while we are trying to put in our case. I think we also sorted out the clock issue.

Mr. Smith just handed me an example of the kind of things that they have blown up from that. I'm happy to hand that up to the court at this juncture.

MR. ORLANS: This is an example, judge. First of all we didn't have this until now. So what they are doing is relying on one portion of one paragraph of this. I can't read the rest of it so we are going to have to go back to the document itself and try to make some assessment as to whether that is in context or not. This is exactly the sort of problem we are faced with.

THE COURT: Let e have that.

(Document proffered.)

MR. KEMPF: Your Honor, I remember when we were looking at the PX-3 when Mr. Cary was walking through it. It was a draft document and he had it blown up so it blocked out the good document.

MR. CARY: That was an opening statement, Your Honor. This is a bit different.

MR. KEMPF: We have identified all of the declarations we intend to use?

MR. ORLANS: But not particular ones.

THE COURT: But not particular portions.

MR. KEMPF: That is correct.

MR. ORLANS: And is that the complete declaration on there? There is no signature on there. There is at least one other page.

MR. KEMPF: That is probably true. We have some pretty long declarations from some people, Your Honor.

THE COURT: Well, I think that the defendants can use the declarations, obviously, as they need to to put evidence in their case. And the government has a right to counter designate, like you would at a deposition, the appropriate parts of the same declaration or contemporary declaration of the same person that would, they think, tend to refute that.

What I don't want to get into and I think what Mr. Kempf is saying that the government will designate portions which are really positive evidence or rebuttal evidence in the defendant's case. In other words, they take one sentence from one paragraph, you may want to put the whole paragraph in but I don't see the government going in saying wait a second this person has another declaration that says something different.

I don't want do have anything to do with putting in this particular sentence from one declaration. So if there is an opportunity and you want to look at the declaration and say wait a second, that is out of context because it doesn't say whatever the sentence contains in a bigger paragraph, that is one thing.

If you think you have the declarant stating something different at another time, I think that comes in rebuttal. So I'm not going to require them at this time to turn over all their designation to you and have you go ahead in their case and start putting in what you think are matters that contradict whatever the declarant says in this particular sentence.

I will allow you to put into context any particular statement taking from a declarant that they put in evidence that is in the same declaration, to put it all in context. But I think you are going to have to wait for rebuttal for most of the materials you want to submit to counter these parts of the declarations you are putting in.

MR. ORLANS: Although, Your Honor, absent some advance designation, we are going to be hard pressed to do that.

THE COURT: You will have time tomorrow. They can start putting the things on. You can come back the next day after you look at it and say I want to supplement the record with these five additional statements and this declarant has the same declaration that was taken out of context. There will be time to do that.

MR. KEMPF: Thank you, Your Honor.

THE COURT: All right. Tomorrow morning we will start with Dr. Ashenfelder and move forward at that time at 9:30 to take up that expert. And hopefully in the afternoon we will be into the defendant's case. And I think the parties are using their time rather efficiently and hopefully we can get this completed by Friday. We will see where the defendants are with their witnesses.

All right, we will be back tomorrow morning.

(Whereupon, the proceedings in the above matter were adjourned at 4:45 p.m.)

CERTIFICATE OF REPORTER

I certify that the foregoing transcript is a correct record of proceedings in the above-entitled matter.

Brenda Pearson
Court Reporter

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EXHIBITS