Exhibit 3–Public Version of the Supplemental Rebuttal Expert Report of Kevin M. Murphy, Ph.D.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FEDERAL TRADE COMMISSION	)	
600 Pennsylvania Avenue, N.W.	)	
Washington, D.C. 20580	)	
	)	Civ. No. 1:07-CV-01021
Plaintiff,	)	
	)	
	)	
v.	)	
	)	
WHOLE FOODS MARKET, INC.	)	
550 Bowie Street	)	
Austin, Texas 78703	)	
	)	
and	)	
	)	
WILD OATS MARKETS, INC.	)	
1821 30th Street	)	
Boulder, Colorado 80301	)	
	)	
	)	
Defendants.	)	

<u>SUPPLEMENTAL REBUTTAL EXPERT REPORT OF KEVIN M. MURPHY, Ph.D.</u>

Dated: July 16, 2007

1. In his Expert Report, Dr. Scheffman presented price calculations based on item-specific register prices at Whole Foods stores on a *single day* in June of 2007. He finds that register prices on this particular day do not vary much across stores within a given region—the vast majority of UPC's (universal product codes) have identical prices at all stores. He takes this finding as evidence that "WFM prices by regions … the prices are determined at the region level (not at the store level) and prices across stores are the same." He further concludes that prices do not vary with the existence of PNOS competition.[1] I had begun, but because of data problems that I had to resolve, not completed testing of Dr. Scheffman's conclusion at the time my rebuttal report came due. I now have finished, and am amending my rebuttal report to reflect, that testing. Dr. Scheffman's conclusions are simply wrong. The dispersion of prices on a single day does not provide a reliable basis for characterizing the general pricing behavior of Whole Foods and does not meet even minimum standards of analysis.

2. Contrary to claims made by Dr. Scheffman, the evidentiary record in this matter—both qualitative evidence from documents and rigorous analysis of quantitative data—demonstrate that Whole Foods changes the prices it charges at particular stores in response to competitive pressures felt uniquely at that store, and that prices do vary systematically across stores within a region. In my Rebuttal Report I quoted Whole Foods documents surrounding the 2005 entry by [redacted], a competing PNOS, into [redacted], [redacted], where Whole Foods operated stores. Those documents showed that Whole Foods executives planned to match [redacted]s sales prices and to make strategic price cuts that would "really punish [redacted] and make a statement about any competition [redacted]

[1] Expert Report of David Scheffman at ¶288.

that thinks about competing with us."[2] The documents recommended specific price cuts of up to [redacted] on particular items.[3]

3. This was not idle talk or bluster—the price cuts associated with this PNOS competition are reflected in data provided to the FTC by Whole Foods. In 2005 Whole Foods operated five stores in [redacted], located in [redacted] Exhibit 1 shows how Whole Foods responded to [redacted]'s entry by selectively cutting local prices. The lines in the Exhibit show the average percentage difference in weekly prices between the three Whole Foods stores located near the new [redacted] stores (in [redacted]) and the Whole Foods stores that did not face local PNOS competition from [redacted] (in [redacted]), from January of 2004 through March of 2007.[4] In other words, <u>I show the percentage amount by which Whole Foods cut prices in geographic markets where it faced PNOS competition.</u>

4. There are three lines in Exhibit 1, each representing the behavior of prices at one of the three Whole Foods stores that faced competitive entry by [redacted]—[redacted] (the blue line), [redacted] (the orange line) and [redacted] (the black line). Vertical lines are drawn at the dates when [redacted] opened new stores that competed against Whole Foods —June 15, 2005 in [redacted] and August 31, 2005 in [redacted]. Notice that there are virtually no price differences among stores in [redacted] prior to [redacted]'s entry in June. But in mid-June, precisely when [redacted] opened in [redacted], prices in Whole Foods' [redacted] store fall

---

2 WFM-123-00016697

3 WFM-123-00016472 (and attachment WFM-123-00016474).

4 These price data cover a period of over 3 years, in contrast to Dr. Scheffman's analysis that used data from a single day in June of 2007.

sharply. By the beginning of July prices in [redacted] were more than [redacted] percent below the prices in the benchmark stores. Importantly, prices in [redacted] – where [redacted] had not yet opened – did not fall at that time.

5. But prices in [redacted] did fall 11 weeks later, precisely when [redacted] opened in [redacted]. Whole Foods cut prices in the [redacted] stores by about [redacted] percent, on average, and for some months thereafter the price reductions in the three "competing" Whole Foods stores moved in near lock-step. Notice that the size of price cuts dissipated over time, perhaps reflecting the weakening of [redacted] as a competitive threat[5] – it exited the [redacted] market in January of 2007.[6] Even so, PNOS consumers in [redacted] enjoyed the benefits of substantial price reductions for roughly a year after the advent of PNOS competition in that market.

6. These episodes, including the eventual closure of [redacted] store, are illustrative of the types of PNOS local-market price wars that Whole Foods hopes to avoid by acquiring Wild Oats.[7] As John Mackey

---

[5] Indeed, contemporaneous pricing discussions reflect that Whole Foods began to raise prices in [redacted] as it became convinced that it had managed to drive the [redacted] store out of the market (WFM-123-00021188, WFM-013-00011261, WFM-109-00032941, WFM-130-00002286, WFM-128-00042539, WFM-128-00005995, WFM-051-00000248 ("We are taking them down brick by brick.")

[6] In the Investigational Hearing of John Mackey, Mr. Mackey was asked: "What about an [redacted]?" He answered: "[redacted] doesn't want to compete with Whole Foods. We are kicking their butt." (p. 195) And [redacted]'s response to the FTC's CID specifically cites "Competition with Whole Foods" as the reason why it closed its [redacted] store within 16 months of opening that store.

[7] Mr. Mackey considered applying the same strategy with [redacted] as with Wild Oats. In comments to his senior executives in May of 2006, Mr. Mackey said of [redacted] "Maybe we should approach them about acquiring them? This would permit us to close down all of their competing stores plus gain us the [redacted] store?" (WFM-109-00009099).

noted in his Investigational Hearing, closing a rival's store through acquisition "self evidently" reduces competition:

> "That to me is a relevant question here, not whether or not in the short run us acquiring Wild Oats is going to lessen competition. Because it self evidently will lessen competition in those markets that we are competing with Wild Oats in when we are going to intend to close stores. That is one of the reasons we are willing to pay $18.50 for a company that has lost $60 million in the last six years. If we can't eliminate those stores, then Wild Oats, frankly, isn't worth buying." (p. 75)

Clarification of Relevant Geographic Markets

7. I understand that the Court has asked the Federal Trade Commission to expand its explanation of the relevant geographic markets affected by this proposed acquisition. At the request of the Federal Trade Commission, I have considered the question of relevant geographic markets within which to evaluate the competitive effects of this proposed acquisition. My work and conclusions are summarized in the maps that follow.

8. The Federal Trade Commission had prepared a series of maps that show the location of each PNOS market participant (including each Wild Oats and Whole Foods store) in the metropolitan areas at issue. Based primarily on Whole Foods' planning documents (WFM-002-00002450), I then drew circles of radius six miles (approximating a 16-minute drive time) around each store to get an understanding of the draw / trade area of each store. As a matter of logic, there would be competitive interaction in those areas where there is meaningful overlap between the circles around the stores of different participants in the relevant market. The union of these circles approximates the geographic area that will be competitively impacted by this proposed acquisition, and thus represents

the relevant geographic market within which the competitive impact of this proposed acquisition can be evaluated.

9. Note that in some areas stores toward the periphery of the metropolitan area may or may not participate in the same relevant geographic market as stores located in the interior of the area. Thus, these maps only represent an approximation of the area of competitive impact of this proposed transaction. Any questions regarding which of these stores on the periphery ultimately get included do not affect my conclusions regarding the existence of anticompetitive effects in each of these markets since the merger will affect competition in these markets for any reasonable choice of the relevant market boundary. The only difference is that if the market is widened, more stores (and thus commerce) would be put at risk of anticompetitive effects.

July 16, 2007

Kevin M. Murphy

Kevin M. Murphy