PUBLIC VERSION

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

FEDERAL TRADE COMMISSION Plaintiff, vs. STAPLES, INC. and OFFICE DEPOT, INC. Defendants.	Case No: 1:97CV00701 Judge: TFH

PLAINTIFF'S REPLY TO DEFENDANTS' JOINT POST-HEARING MEMORANDUM OF LAW IN OPPOSITION TO THE FEDERAL TRADE COMMISSION'S MOTION FOR A PRELIMINARY INJUNCTION

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The following abbreviations will be used throughout this reply memorandum:

FTC Post-Trial Memorandum	=	FTC Mem.
FTC Pre-Trial Memorandum	=	FTC PT Mem.
FTC Pre-Trial Reply Memorandum	=	FTCP PTR
Defendants' Findings of Fact	=	DFF
Defendants' Post-Trial Brief	=	DB
Plaintiff's Findings of Fact	=	PFF
Plaintiff's Reply Findings of Fact	=	PRF

INTRODUCTION

This merger will eliminate competition between Staples and its closest rival, Office Depot, and deny consumers the significantly lower prices that result from their intense rivalry. In support of this proposition, the record contains strong and pervasive evidence that:

- Staples and Office Depot deliberately seek to charge lower office supply prices where they face each other and higher prices where there is less office superstore competition;
- both succeed; prices are systematically lower where the superstores compete with one another and higher where they do not;
- non-office superstore competition does not prevent Staples and Office Depot from exploiting consumers in markets where there is little or no superstore competition.

These facts are outcome determinative. They establish the relevant market because defendants could not sustain substantially higher prices in areas with little or no office supply superstore ("OSS") competition if the market were as broad as alleged by defendants. They prove an anticompetitive effect because they show that Staples could sell office supplies in 42 additional markets at these higher prices if Office Depot were eliminated. They show as well that entry is unlikely, since neither entry nor the threat of entry has prevented higher prices in markets with reduced OSS competition.

The question this merger poses is clear. Once Office Depot, the most efficient, lowest priced, and most aggressive competitor, is eliminated by its main rival, can Staples exercise market power? The answer is clear as well. The documents say so, a decade of fierce pricing rivalry confirms it, and even the defendants' own economic consultant reluctantly admits its truth. And the fact that Staples canceled a planned price decrease -- intended to respond to competition from Office Depot -- as soon as the deal was announced, shows how this merger will cause consumers to pay more. That is why nine states whose consumers are most at risk from the elimination of competition in this market have joined the Commission in supporting preliminary injunctive relief. See States' Amicus Brief.

Defendants' only escape from these facts is to ask the Court to accept uncritically three propositions: (1) everyone who sells office supplies is in the market; (2) their past history as price cutters when they face each other guarantees that they will cut prices to the same degree in the future when they do not; and (3) efficiencies will dwarf any anticompetitive effects. These arguments are not supported by the facts. But they also are inconsistent with prior merger rulings of the Supreme Court and this Court:

- firms that sell similar products, but do not constrain anticompetitive behavior, are not effective competitors and should not be included in the relevant market (Brown Shoe Co. v. United States, 370 U.S. 294, 325 (1962) and United States v. Grinnell Corp., 384 U.S. 563, 574-75 (1966));

- the manner in which a product is distributed is central to defining the relevant market (United States v. Philadelphia National Bank, 374 U.S. 321 (1962) and Grinnell);

- within a broad market, narrower well-defined submarkets may exist which, in themselves, constitute product markets (Brown Shoe and Rothery Storage & Van Co. v. Atlas Van Lines, 792 F.2d 210 (D.C. Cir. 1986)(Bork, J.), cert. denied, 479 U.S. 1033 (1987));

- high market concentration creates a presumption of anticompetitive effects (Philadelphia National Bank and FTC v. PPG Industries, 798 F.2d 1500 (D.C. Cir. 1986)(Bork, J.);

- Section 7 reaches the loss of future competition as well as current competition (FTC v. Procter & Gamble Co., 386 U.S. 568 (1967));

- purported efficiencies cannot justify a merger to monopoly or near monopoly (Philadelphia National Bank and Procter and Gamble); and

- once the FTC has demonstrated a likelihood of competitive harm, the court faces a heavy burden not to impose a preliminary injunction (PPG Industries).

Defendants' Post Hearing Brief ("DB") ignores this precedent and instead seeks refuge in United States v. General Dynamics Corp., 415 U.S. 486 (1974) and its instruction to look at the "structure, history and probable future" of the market. DB at 20. But all those factors lead to the same conclusion:

- **Structure:** There are only three OSS firms and their prices are set without regard to the pricing of non-OSSs. This merger will dramatically increase concentration in 42 metropolitan markets.

- **History:** OSSs compete most aggressively where they meet head to head. Prices fall most rapidly where all three firms are present. Because of the substantial economies of scale and distribution, other sellers of office supplies do not constrain the prices of OSSs.

- **Probable future:** Absent this merger, Office Depot and Staples would have entered each other's markets, leading to more competition and lower prices. With the merger, significant present and potential competition will be lost.

Ultimately, the defendants rely on their promise that the merger will lead to lower prices. Such a promise, however, is not an adequate substitute for competition. No court has ever permitted the acquisition of market power on that basis. In enacting the antitrust laws, Congress decided to rely on competition to produce optimal performance (including low prices), not the promises of business people. As Judge Learned Hand stated in Alcoa, permitting well intentioned monopolies "was not the way that Congress chose; it did not condone 'good trusts' and condemn 'bad' ones; it forbad all." United States v. Aluminum Co. of America, 148 F.2d 416, 427 (2d Cir. 1945).

The defendants' uncharted course must be rejected. Their relevant market analysis writes market power out of the antitrust laws by redefining the concept of competition. Their competitive effects analysis ignores the real world evidence of ongoing and likely future anticompetitive effects and suggests that the merger is benign because they can be trusted to compete even after eliminating their chief rival. They assert entry is easy, but ignore the reality of substantial entry barriers and the history of permanent exit and consolidation. The defendants' self-styled silver bullet -- an efficiency claim that is neither verified, credible, nor merger specific -- must be rejected because it cannot overcome the significant risk to competition posed by this merger. Finally, the defendants' efforts to stave off a preliminary injunction by subordinating consumer interests to shareholders' desire to profit from an unlawful merger would turn the Section 13(b) standard on its head.

I. RELEVANT MARKET

We begin with first principles. The purpose of market definition in an antitrust case is to determine if a firm has the ability to exercise market power, i.e., raise prices or decrease output. Market definition is a question of constraint, not of appearances or labels. Grinnell Corp., 384 U.S. at 574-75; Rothery, 792 F.2d at 218. What defendants dismiss as "an empty semantic exercise" is in fact the critical question. A properly defined market includes only those firms that have the ability to constrain the merged firm's market power.

Here the defendants would like to define the market by including all firms selling office supplies. But there are often firms close to, but outside, the market that compete to some extent with those inside. That does not mean they constrain the exercise of market power. The defendants' expert, Dr. Hausman, concedes the point:

> Q: But you do agree that the mere fact a company or companies may sell the same product doesn't mean that they constrain price; isn't that right?
> A: Sure. Absolutely.

5/23 Tr. at 88-89.

Our evidence persuasively demonstrates that office supply superstores significantly and uniquely affect each other's prices:

- Prices are significantly higher in markets without OSS competition, regardless of the presence of other retailers. Despite such elevated prices, not enough consumers switch from office superstores to other sources of office supplies to make the high prices unprofitable.
- The defendants' internal documents show that they price *only* in relation to other OSS retailers; that they lower price *only* when another OSS enters a particular area, not when a non-superstore retailer like Wal-Mart, Kmart or Target enters, and that they look *only* at the presence of other office superstores in determining whether to enter a market. The very firms defendants identity as significant competitors testified that they do not and cannot constrain

OSS pricing.

- Econometric evidence confirms that these real world pricing differences are caused by OSS competition, and not by other firms or other factors.

Contrary to defendants' position that the characteristics of the seller and the means of distribution are irrelevant to market definition, those factors are critically important where they help answer the question of constraint, and courts routinely use them as well as product characteristics to define markets. Brown Shoe Co., 370 U.S. at 325 ("practical indicia" such as "industry or public recognition," "unique production facilities," and "specialized vendors" are factors in determining markets); Rothery, 792 F.2d at 218. For example, in Grinnell Corp., the Supreme Court expressly focused both on the characteristics of the product at issue -- "the protection of property through use of a central service station" -- and on the identity of the sellers of that service -- firms that had been accredited by insurance underwriters. Similarly, in Philadelphia National Bank, the Court defined a market of commercial banking services focusing not only on the product, but also on the means of distribution. Numerous other courts have defined markets, particularly at retail, which combined both services and products.[1]

Defendants take a similar tack with respect to other characteristics of the office superstore market: low prices, wide variety, and distinct customers. As with product-service combinations, defendants take individual cases in which products differing along one or more of these characteristics did not belong in separate markets, and conclude that such characteristics can *never*

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[1] See Henry v. Chloride, Inc., 809 F.2d 1334 (8th Cir. 1987); California v. American Stores Co., 697 F. Supp. 1125, 1129 (C.D. Cal. 1986), aff'd, 872 F.2d 837 (9th Cir. 1989), rev'd on other grounds, 495 U.S. 271 (1990); Bon-Ton Stores v. May Dep't Stores Co., 881 F. Supp. 860 (W.D. N.Y. 1994).

The cases the defendants rely upon are inapposite and show the error of ignoring a product's service component. See FTC PTR at 7 (distinguishing M.A.P. Oil Co. v. Texaco, 691 F.2d 1303 (9th Cir. 1982)).

justify separate markets. Of course, whether these factors help distinguish one market from another depends on the facts, and there are numerous cases in which these factors are dispositive. See FTC PT Mem. at 18-20. Indeed, the defendants themselves admit that "consistent price differentials may be evidence of distinct product markets if they reflect a difference in the nature and quality of particular goods."[2] As noted above, the Commission has established that OSSs sell a cluster of products and services that together constitute a separate relevant product market, and this market is supported by consistent, substantial price differentials that the defendants acknowledge. Similarly, office superstores offer "convenient one-stop shopping," a characteristic that courts have used to define a separate market.[3]

The relevant market is firmly supported by the distinct pricing evidence, contemporaneous business records, and over 30 years of Supreme Court and lower court jurisprudence. It is firmly rooted in economics and the realities of the market.

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[2] DB at 10 n. 3 (emphasis in original). We agree. See FTC PTR at 9 n.9.

[3] See Photovest Corp. v. Fotomat Corp., 606 F.2d 704, 712 (7th Cir. 1979) (market of "drive-thru retail photo processing," based on price differences and consumer perception that drive-thru offered greater convenience and service); American Stores, 872 F.2d at 840 (supermarkets comprised a relevant submarket -- exclusive of convenience stores, smaller independent grocery stores and other food retailers-- because supermarkets are the only retailers that meet consumers' needs for variety). Contrary to the defendants' position, Westman Comm'n Co. v. Hobart Intern., 796 F.2d 1216 (10th Cir. 1986), and Thurman Indus. v. Pay 'N Pak Stores, 875 F.2d 1369 (9th Cir. 1989) do not refute the principle -- embodied in Photovest and California v. American Stores -- that the convenience and other attributes of "one-stop shopping" can serve as the basis for relevant market definition. In Westman, the Court found that "competition in the restaurant-equipment supply industry [unlike the photo finishing industry at issue in Photovest], generally does not occur at the full-line-of-services level." 796 F.2d at 1222. In Thurman, unlike Photovest, and unlike this case, the Court found no price differential separating drive-thru vendors from other vendors, and consumers apparently were willing "to patronize a variety of retailers other than home centers in meeting" their home improvement purchasing needs. 875 F.2d at 1376-77.

II. ANTICOMPETITIVE EFFECTS

The Commission has adduced compelling evidence demonstrating the likely anticompetitive effects of the merger. Despite defendants' efforts to characterize the competitive effects case as based upon misleading statistics and misinterpreted documents (see DB 36-40), defendants largely fail to come to grips with the essential evidence of anticompetitive effects. Although such evidence has been discussed at length elsewhere (see FTC Mem. at 19-31; PFF 140-223), the following points are particularly significant:

- Defendants intended to create, and have in fact created, zone pricing systems in which prices within zones are dependent upon the degree of office superstore competition.
- Prices are higher where there is less office superstore competition. In an industry characterized by falling prices, prices decrease significantly more slowly where superstore competition is lacking.
- The motivation for the merger was to eliminate the aggressive competition between Staples and Office Depot and the resulting margin erosion caused by such competition. Staples' own analyses of the predicted effects of previously considered acquisitions confirm that it expects the merger will lead to higher prices.
- Once the merger was announced, Staples canceled an anticipated 3% price decrease.
- There will be a loss of potential competition where the two firms would have otherwise entered each other's or OfficeMax's territories.

Defendants' brief is silent on the majority of these issues, although a few are addressed in defendants' proposed findings. For the most part, however, defendants simply fail to engage in a factual analysis of these points. Instead, defendants resort to a familiar litany: the market is highly competitive (DB 21);[4] the FTC's statistics are misleading (id. at 36-38); and defendants' internal

[4] Defendants' oft-repeated assertion that intense competition will protect consumers from any exercise of market power is nothing more than a restatement of their market definition argument. The forces of competition they reference -- mass merchandisers and mail order -- have all attested to the fact (continued...)

documents are in fact benign (id. at 39-40). Each of these arguments is without merit.

The record amply demonstrates that defendants have systemically maintained zone pricing systems in which prices are premised upon the extent of OSS competition. Under these pricing systems, prices are higher where there is less OSS competition.[5] Because defendants cannot refute this evidence, they instead attempt to characterize it as a "nonsense correlation." According to defendants, the indisputable fact that prices are higher in markets they call noncompetition zones is not caused by defendants' efforts to set prices in accordance with the level of OSS competition, but rather by other underlying factors, such as costs or demographics.[6]

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[4](...continued)
that they do not believe they can constrain the defendants from raising their prices. While there is competition in this marketplace, in the broad sense that non-OSS firms sell some of the same products sold by OSSs, the only competitors able to constrain the prices of office supply superstores are other OSSs.

[5] Although defendants deride the strong relationship between higher prices and OSS concentration, they can not escape that their own documents recognize this critical factor. Mr. Stemberg himself agreed that this was not a "nonsense correlation," and that Staples' prices are related to those of Office Depot. 5/22 Tr. 243-44. Even defendants' own exhibits show that, although prices are falling in all markets, they fall far more rapidly -- almost 30% faster -- in three-player markets than in "non-competitive" ones. 5/20 Tr. 261-63. In addition, the States' economic expert, Professor Greer, testified that

[6] Defendants support this argument, as they have on other occasions, by contending that the Commission "itself has acknowledged that 'major reasons why price levels may differ between geographic areas are differences in cost, differences in the level of non-OSS competition . . . and demographic differences.'" DB 37 (citing Pltf's Interrog. Ans. at 19). In fact, the interrogatory correctly noted that the Commission's position was that "significant price differences between geographic areas are based primarily on the level of office superstore competition." Defs. Interrog. #20 (emphasis added). The interrogatory then asked the Commission to list "all *other* reasons why price levels differ between geographic areas," (emphasis in original), and it was to this interrogatory that the Commission provided the response in question. The Commission's consistent position throughout this litigation -- and one which is amply supported by the evidence -- is that price differences between geographic areas are primarily attributable to the level of OSS competition, although other factors such as costs and demographics may also play a lesser role.

Defendants also assert (DB 37) that, even though office supplies are more expensive in Bangor, Maine (a one-superstore market) than in Washington, D.C. (a two-superstore market), so are many other (continued...)

Defendants' pricing and other business documents undermine their new-found reliance on factors other than the level of OSS competition. This leaves them to rely solely on the econometrics of Dr. Hausman to explain why the evidence is not what it seems. But Dr. Hausman's analysis is badly flawed by his selective exclusion of data and his admitted failure to take into account potential rivals within an MSA, as is necessary to emulate the zone pricing system. See PFF 213, 215-21. In stark contrast to Professor Hausman, the Commission's expert, Professor Ashenfelter, considered all the data and took a conservative approach to his analysis, even to the point of including suggestions made by Dr. Hausman.[7] See PFF 205-11. Professor Ashenfelter's results demonstrated a significant price effect, in the range of 5-10%, that is entirely consistent with the other evidence in the record, including the average price differences observed in various geographic markets.[8]

[6](...continued)
things. Contrary to defendants' assertions, however, the evidence demonstrates that Bangor has lower costs than Washington, D.C. (see DX 6069; PX 9 at 129), higher gross margin dollars per store for office supplies (see PX 408), and is more profitable (5/22 Tr. 281-82).

[7] Professor Ashenfelter even estimated the effect for California separately from the rest of the country, thus convincingly answering Professor Hausman's main criticism of Ashenfelter's pricing study -- that the results should not be trusted because it is inappropriate to pool California data with data from the rest of the country. When Professor Ashenfelter separately estimated the California effect and then averaged with the rest of the country, the predicted price effect actually increased. Defendants' "fall-back" criticism of Professor Ashenfelter's model as yielding an "absurd" 73% price increase in California (Professor Hausman's estimate, not Professor Ashenfelter's (DFF 301)) is inaccurate in light of Professor Ashenfelter's testimony that he found a price increase in California of around 15%. See PFF 211; PX 403. This result is hardly unreasonable in view of evidence showing that Los Angeles is Staples' benchmark low price zone. The average price difference of 13% between three-player zones and non-competitive zones is measured from that Los Angeles base. See PX 3. Since California is an area where both Staples and Office Depot maintain a significant presence, the elimination of competition between them would therefore be expected to have a significant impact.

[8] Defendants offer no substantial challenge to the reliability of Professor Ashenfelter's econometric studies of pricing, which consistently show that this merger will lead Staples to raise price by an average of 5% to 10% nationwide. Their characterization of Professor Ashenfelter's results as largely showing price increases of less than 3.7% (DB at 38; DFF 66) misrepresents Professor Ashenfelter's testimony. As defendants are well aware, Professor Ashenfelter did not offer the estimates in the various columns of PX 400 at 1 as equally valid alternatives, but rather to show how Professor
(continued...)

Another anticompetitive effect that defendants strive unsuccessfully to explain away is the abandonment of a proposed price decrease. See 5/23 Tr. 109 (admission by Mr. Hausman that this would constitute an anticompetitive effect).

Even though defendants had 15 hours to present live testimony, they chose not to address this point, denying the Court the opportunity directly to assess the credibility of this inconsistent, after-the-fact explanation.

In yet another argument aimed at undermining the Commission's showing of likely anticompetitive effects, defendants maintain that the Commission's reliance on internal company

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[8](...continued)
Ashenfelter first replicated, and then corrected, Professor Hausman's model. In this exhibit, only the predicted price increase in the last column, an 8.6% estimate, is based on a model upon which Professor Ashenfelter testified it is appropriate to rely. PFF 205. Professor Ashenfelter also testified that other reasonable alternative approaches lead to similar results -- all estimating the average nationwide price effect of this merger in overlap markets as between 5% and 10%. These include the hypothetical "column 8" estimate of 6.5% to 7.5% (PFF 208), the fixed effects and cross section simulations that estimate the effect of converting Office Depot to Staples stores (7.6% and 7.1% respectively) (PFF 206 & 207), and nationwide estimates formed from averaging separate estimates for California and the rest of the U.S. (between 9% and 10%) (PFF 209).

documents is unavailing.[9] DB 39-40. Defendants essentially contend that the Commission's "documents case" is weak because business records are irrelevant, and even if relevant, have been misinterpreted. The first contention is simply a misstatement of the law. This Court and others have regularly -- and quite properly -- relied on internal documents in analyzing mergers and explaining "how the market is perceived by those who strive to profit in it." FTC v. Coca-Cola Co., 641 F. Supp. 1128, 1132 (D.D.C. 1986), vacated mem., 829 F.2d 191 (D.C. Cir. 1987). FTC PT Mem. at 20, n.20; FTC PTR at n.4.

Defendants further suggest that the Commission has misinterpreted otherwise "benign" documents that, taken in context, support the merger. Yet throughout their brief and 280-page findings, defendants attempt to distinguish only two of the hundreds of contemporaneous business records that support the Commission's case. See DB 39. And, contrary to defendants' assertions, the Commission's reliance on both of these documents is well-justified. See PRF 81-84.

Moreover, despite the ready availability of company witnesses, defendants made no effort at trial to have their witnesses address any of the internal documents relied upon by the Commission. Instead, defendants have relied principally on documents that were prepared for litigation. Lest this mass obscure the companies' business records, the Commission showcased many of the more significant documents in its opening and cross-examination of Mr. Stemberg and has provided this Court with a clear roadmap to the remainder in PX 2, 3, 3A & 3B.

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[9] For example, defendants assert that "[t]here is no document that discusses any planned price increase following the merger." DB 39. This is hardly surprising, given the quality of legal advice available to defendants. Yet defendants conveniently ignore the fact that, in Staples' prior assessments of mergers with Office Depot (in 1992) and OfficeMax (in 1996), price increases were envisioned in both instances. PX 36 at 9008; PX 37 at 8890-91;

III. BARRIERS TO ENTRY

Once the government has established its prima facie case, it is the defendant's burden to come forward with evidence that the case "inaccurately predicts the relevant transaction's effect on future competition." United States v. Baker Hughes, 908 F.2d 981, 991 (D.C. Cir. 1990). The degree of burden depends on the weight of the government's case. "The more compelling the prima facie case, the more evidence the defendant must present to rebut it successfully." Id. In this case, since the evidence of anticompetitive effects is so strong, the defendants face a heavy burden.

The defendants cite easy entry as a reason why anticompetitive effects would not materialize. Their argument, however, cannot surmount these simple, compelling facts:

- in the past decade, 20 of 23 office superstore firms have exited the market;
- there has been no new entry in the past several years;
- in numerous markets, higher prices and have been profitably maintained without being eroded by new entry;
- a recent effort at repositioning resulted in a costly failure; and
- substantial and costly barriers face anyone seeking to open a competing OSS chain.

Office superstores are not simply buildings of office supplies. FTC Mem. at 32. Rather, they require a distribution network, brand recognition, and economies of scale to justify area-wide expenditures such as advertising. Because of these and other formidable barriers, there has been no "entry" over the past several years. The only "entry" has been that of the three office superstore firms into each others' markets, a trend this merger would halt. And even those firms are unable to enter particular markets when the markets are saturated.. Although the defendants now claim that "few businesses would seem as easy to enter," when these fierce competitors were asked to identify potential entrants before this litigation began, they were unable to identify any. PFF 228.

Id. Other retailers agree. PRF 69 (

Computer City and Kmart would not reposition). Repositioning is costly and may conflict with a merchandiser's overall strategy. In order to have any significant impact, a retailer must vastly expand its office supply offerings.[10]

Perhaps most importantly, none of these non-OSS retailers has been able to constrain OSS prices in the past, and defendants have produced no evidence showing that such retailers would be able to constrain even after they repositioned. It is therefore unlikely that expansion of sales by one of these retailers would have a significant impact. Professors Warren-Boulton and Ashenfelter estimated the effect of a 10% increase in office supply sales by Wal-Mart on the projected merger-caused price increase. They determined that the effect was inconsequential: a 10% increase in Wal-Mart office supply sales would reduce the merger's price effect from a 7.5% price increase to 7.4%.

[10] Defendants also champion the emergence of Corporate Express and U.S. Office Products as examples of new entry. But these firms are contract stationers which serve a very different clientele than office superstores. PFF 129-33.

Warren-Boulton, 5/23 at 307-10.

In this case the evidence of entry cannot reverse the presumption of likely anticompetitive effects. Unlike Baker Hughes, there are neither recent successful entrants who are poised to expand easily nor opportunities for hit and run entry with few sunk costs. Where, as here, "the totality of the defendant's evidence suggests that entry will be slow and ineffective, then the district court is unlikely to find the prima facie case rebutted."[11] Baker Hughes, 908 F.2d at 988.

Defendants' efficiency story further undermines its entry claims. Defendants claim, when arguing efficiencies, that the merger will give them dramatic cost savings that are not achievable by other means. But the fact that a new entrant would face a sizable cost disadvantage versus the merged firm limits its ability to be a cost-effective entrant. To compete and achieve low prices, superstores must achieve volume. Unless a new entrant were to obtain scale equivalent to that of the merged entity, it could not achieve costs comparable to the merged firm and would therefore be unable to effectively constrain the defendants.

[11] Defendants also rely on a pair of Sherman Act Section 2 predatory pricing cases to argue that the FTC is required to "'show that new rivals are barred from entering the market.'" DB at 23 (quoting Rebel Oil Co. v. Atlantic Richfield Co., 51 F.3d 1421, 1440 (9th Cir.), cert. denied, 116 S. Ct. 15 (1995), and citing Advo, Inc. v. Philadelphia Newspapers, Inc., 51 F.3d 1191, 1200-02 (3d Cir. 1995)). This is clearly not the law under Section 7. Under Section 2, the courts recognize that "[e]rroneous jury verdicts for plaintiffs in predatory pricing cases pose a unique threat," Advo, 51 F.3d at 1197, such that it may be appropriate to resolve some doubts for defendants. Section 7, however, is a prophylactic statute that prohibits mergers that "may" lessen competition. Accordingly, the anticompetitive inferences drawn from high post-merger concentration "are not overcome unless the defendant can produce relatively convincing evidence that the feared ologopolistic coordination or monopoly pricing is not likely to occur." Areeda & Hovenkamp, Antitrust Law ¶ 917.1, at 766 (1996 Supp.).

IV. EFFICIENCIES

Recognizing that every assessment of likely price effects -- including defendants' own econometrics -- predicts that, absent efficiencies, post-merger prices of office supplies will increase, defendants rely upon their efficiencies arguments to save an otherwise anticompetitive merger.[12] Analyzed properly, however, defendants' purported efficiencies fall far short of the mark.

Although defendants' alleged efficiencies have already been extensively analyzed and found wanting (see FTC Mem. at 34-40; PFF 261-313), defendants' post-trial arguments merit some further response. In order to establish the existence of legally cognizable efficiencies, defendants must demonstrate, inter alia, that the claimed efficiencies are both properly substantiated and merger-specific.[13] In addition, defendants must also establish that their alleged cost savings will be passed on to consumers. See FTC Mem. at 35. Ultimately, defendants must show that the efficiencies are likely to overcome the merger's anticompetitive effects. Defendants have failed to carry their heavy burden in all of these respects.

There is ample reason to doubt that defendants' claimed efficiencies are properly

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[12] Defendants contend that "this merger . . . is *driven* by efficiencies." DB at 32 (emphasis in original). Yet the only "evidence" defendants cite in their findings to support the proposition that the merger "is designed to reduce prices" consists of the banner defendants unveiled at their press conference, their advertising campaign promising lower prices, and the self-serving statements of company officials. See DFF 214-18. Moreover, the essentially unsupported assertion that the merger "is designed to reduce prices" is belied by internal documents prepared in the ordinary course of business. According to these documents, this merger is, in fact, driven by a desire to reduce the margin erosion Staples would otherwise suffer from increased competitive pressures. See, e.g., PX 14 at 5501; PX 15 at 3183, 3218. Hence, the probative evidence shows that this merger is driven by a desire to reduce competition, and not by efficiencies.

[13] These requirements are essential, and must be stringently adhered to, because "much of the information relating to efficiencies is uniquely in the possession of the merging firms." Merger Guidelines, § 4. This is particularly significant in the present case, where defendants' efficiencies claims can only be preliminarily assessed in the limited context of an expedited motion for provisional relief. A complete assessment will, of course, be made in the administrative proceeding.

substantiated and merger-specific. First, contrary to defendants' litigation position, the decision to acquire Office Depot was driven by the desire to avoid competition, not by efficiencies. PFF 145-47. Second, the efficiencies have grown as the likelihood of litigation increased. The cost savings estimate presented by Staples' management in connection with the merger and contained in the January 26, 1997 proxy statement was $146 million for 1998. See PX 283, Tab 6 at FTC 960-61; PX 282, Tab 4 at FTC 771. In contrast, the cost savings estimate prepared for litigation totals $787 million for 1998 (or 5.03% of sales) (PX 317 at FTC 021-22), an almost five-fold increase in the space of a few months.[14] Merger Guidelines § 4.

In addition, the Commission presented highly credible expert testimony establishing that defendants' asserted efficiencies are largely overstated, unsubstantiated, and not merger-specific. The Commission's expert, Mr. Painter, applied approximately 30 years' worth of experience in assessing efficiencies claims to his analysis of defendants' alleged cost savings. 5/23 Tr. 177-79, 184-87. Mr. Painter explained in detail that, of defendants' total claimed cost savings of 5.03% of 1998 sales, 1.94% was demonstrably erroneous or not merger-specific and 1.66% was unsubstantiated, leaving a maximum possible amount of only 1.43%. 5/23 Tr. 245; PFF 261-87.

In a blatant mischaracterization of Mr. Painter's testimony, defendants contend that the

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[14] To make this discussion more intelligible and to facilitate consistency and comparability, we have limited our analysis to 1998 sales and cost savings. For many of the savings, defendants simply assumed that such cost savings would continue in 1999-2001 as a constant percentage of sales. See PX 282 at ¶¶ 19f & 20f. Consequently, errors in the 1998 estimates would create errors in later years as well. In other words, efficiencies allegedly realized in later years are subject to the same types of criticisms and to deductions of a similar magnitude. Moreover, defendants' unsupported assumption that these cost savings would continue unabated into the future is itself questionable. For example, economies of scale diminish beyond a point and are eventually exhausted. See 5/23 Tr. 331-32; PX 417 at 1039. Although defendants offered a year-by-year analysis for the remaining claims, their estimates were reviewed in detail by Mr. Painter and found to be unsubstantiated. See PX 282 at ¶¶ 76-98, 110-115.

Commission does not challenge $3 billion in alleged efficiencies because Mr. Painter allegedly "conceded" that, even putting aside the erroneous efficiencies, the remaining savings would still total 3.09% of sales. DB at 30 n.10. In fact, as defendants (and this Court) are well aware, Mr. Painter made no such "concession," having clearly testified that an additional 1.66% was unsubstantiated, leaving only 1.43% as even arguably valid.[15] Defendants essentially contend that all unsubstantiated cost savings claims should be fully credited to them. The law, however, is otherwise, imposing upon defendants the burden of substantiating their efficiency claims.[16] FTC Mem. at 34-35. Mr. Painter's testimony amply demonstrates that defendants have failed to carry this burden.

In a further effort to justify the magnitude of their overstated efficiencies, defendants rely on statements from their suppliers who, by virtue of their vested interests, can hardly be considered unbiased sources. Notably, many of the larger suppliers like . being less dependent on defendants' business, candidly testified that defendants' projections of future rebates or other discounts were speculative and not merger-specific. See PFF 273-77. Moreover, the vast majority of defendants' vendor statements are vague and unspecific. Excluding particularly unreliable testimony from one vendor (see PFF 277), only five of 93 vendors -- amounting to only 0.3% of the total product cost savings from best practices and scale -- were able to quantify the savings that they would achieve if they obtained all of the merged firm's business. Id. For these and other reasons, defendants' alleged cost savings from vendors must be heavily discounted. See id.;

15 Mr. Painter further testified that this 1.43% included additional errors that he could not quantify, so that even the 1.43% figure is high. See, e.g., 5/23 Tr. 209-10 & PX 317 at ¶ 41 (excluding Hewlett Packard from the selected vendors biases the calculated average); PX 282 at ¶ 19e.

16 Unsubstantiated efficiency claims must therefore be rejected, even though they have not been shown to be invalid. See University Health, 938 F.2d at 1222-24; Merger Guidelines, § 4. Any other approach would effectively write Section 7 out of the law, because all efficiency claims would have to be accepted at face value. See also n.13, supra.

PFF 281-83 (improper extrapolation ignoring unfavorable vendors); FTC Mem. at 36-37.

Another key aspect of any efficiencies defense is the pass-through rate.[17] As Dr. Warren-Boulton explained, a far larger percentage of industry-wide cost savings are passed on to consumers (due to competitive pressures) than is the case with firm-specific cost savings.[18] 5/20 Tr. 158-59; 5/23 Tr. 298. Professor Ashenfelter's analysis of Staples' historic rate of passing on firm-specific savings demonstrates that Staples can be expected to pass through to consumers only about 15-17% of the cost savings from this merger.[19] PFF 300. Applying this pass-through percentage to defendants' maximum cost savings of 1.43% yields a de minimis benefit to consumers of only 0.21-0.24%, which is dwarfed by estimates of the projected price increase.[20] See 5/23 Tr. 296-301 (Warren-Boulton).

Defendants attempt to buttress their general arguments about pass-through by contending that previous mergers have caused prices to fall (DB at 33) and that "industry participants" recognize that prices will fall (id. at 35). In terms of previous mergers, defendants make no effort to control for the fact that prices appear to have been falling during these periods. The proper analysis is therefore not

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[17] See FTC Mem. at 39-40. Defendants' bald assertion that they "have always passed cost savings on to customers in the past" (DB at 33) ignores the essential difference between firm-specific and industry-wide cost savings, and is, in any event, contrary to the overwhelming weight of the evidence.

[18] Dr. Warren-Boulton's testimony is confirmed by Mr. Stemberg himself, who recognized that competitive pressures (particularly including competition from Office Depot) play a major role in the speed and extent to which cost savings are passed on to consumers. PFF 301; FTC Mem. at 39-40.

[19] Having offered little evidence of their own on pass-through, and none that addresses the pass-through rate for firm-specific (as opposed to industry-wide) cost savings, defendants instead must content themselves with attacking Professor Ashenfelter's results. As we show elsewhere (see PRF 142-45), those attacks are unwarranted and misguided.

[20] Indeed, even were defendants' overstated cost savings of 5.03% to be fully credited, application of the pass-through rate for firm-specific savings would yield a benefit to consumers of 0.75-0.86%, a figure that is insufficient to overcome any and all estimates of the anticipated price increase (including Professor Hausman's biased and unreasonably low estimates of 1-2.4% set forth at 5/23 Tr. 40-42).

whether prices went down after these prior mergers, but rather whether prices went down faster with the merger than they would have without it (and if so, by how much). Notably, the evidence on this point demonstrates that prices fall faster in markets without mergers than in markets where mergers occur, and also fall faster in markets where there is more OSS competition than where there is less. 5/20 Tr. 260-63 (Warren-Boulton); see DX 6033; DX 6055.

Defendants' reliance on the predictions of "industry participants" is equally misplaced, since those statements are, for the most part, either self-serving (e.g., Stemberg) or uninformed. Furthermore, Dr. Warren-Boulton's stock market analysis and statements from stock market analysts demonstrate that, contrary to defendants' assertions, knowledgeable sources expect post-merger prices to be higher than they otherwise would have been. See FTC Mem. at 22; PFF 175, 177.

In sum, while defendants' efficiency claims may warrant the full scrutiny that could be provided in a trial on the merits, defendants at this point have failed to carry their burden of demonstrating the existence of substantiated, merger-specific efficiencies sufficient to overcome the likely anticompetitive effects of this transaction.

V. THE STATUTORY STANDARD OF SECTION 13(B)

A. The Commission Has Shown the Requisite Likelihood of Success

For the foregoing reasons and those set forth in our post-hearing memorandum and proposed findings, the Commission's proof satisfies any reasonable formulation of the test for preliminary injunctive relief. However, as our opening brief observed, consideration of the evidence in light of the nature and purpose of this proceeding makes the right decision an easy one. This is a suit for preliminary injunctive relief to preserve the Commission's ability to resolve the merits. Appellate courts have repeatedly recognized that in such a proceeding, the Commission carries its burden of showing a likelihood of ultimate success whenever it "raises questions going to the merits so serious, substantial, difficult and doubtful as to make them fair ground for thorough investigation, study, deliberation and determination by the FTC in the first instance and ultimately by the Court of Appeals." FTC Mem. at 40. While we obviously do not suggest that this Court must "rubberstamp" the Commission's prosecutorial decision or withhold "independent judgment" (DB 4), neither is the Court's role to "resolve conflicts in the evidence . . . or undertake an extensive analysis of the antitrust issues," once the Court's "preliminary assessment of the merger's impact on competition" persuades it that the Commission has raised questions going to the merits that warrant the final administrative resolution Congress prescribed. Warner Communications, 742 F.2d at 1162, 1164.

That a preliminary injunction may "doom" defendants' transaction also cannot justify a higher burden of proof.[21] If defendants abandon their transaction following a preliminary injunction, they will do so by choice. By contrast, denial of preliminary relief may very well, through no choice of the Commission's, fatally compromise the utility of any remedy that may ultimately be indicated following an administrative proceeding. Because Congress enacted Section 13(b) to assure the efficacy of such ultimate administrative relief, FTC v. Exxon Corp., 636 F.2d 1336, 1342 (D.C. Cir. 1980), that concern must principally inform the standard of injunctive relief that this Court applies. FTC v. Lancaster Colony Corp., 434 F.Supp. 1088 (S.D.N.Y. 1977).

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[21] The D.C. Circuit's observation in FTC v. Exxon Corp., 636 F.2d 1336, 1343 (D.C. Cir. 1980), that a preliminary injunction is "drastic," potentially deal-killing relief, which defendants (DB 3) and a few lower courts have emphasized, was made only to contrast a full-stop injunction with the stringent hold separate order entered in the Exxon case itself. The court's statement does not support imposition of a more burdensome standard for establishing likelihood of success. Id. at 1343-44 (tension between congressional intent that "injunctive relief be broadly available to the FTC" and deal-killing potential of preliminary injunction may warrant denial of full-stop injunction "if some less extreme means exists to safeguard the public interest"). Here, as we have observed, a meaningful hold separate order, if one could be fashioned, would be no more acceptable to the defendants than a full-stop injunction.

Even if this Court believes that "greater precision may ultimately be required for the FTC to prevail in its administrative proceeding," FTC v. Food Town Stores, 539 F.2d 1339, 1344 (4th Cir. 1976), the proof adduced by the Commission to date creates abundant reason to fear that the merger of Staples and Office Depot may lessen competition substantially within the numerous markets in which the two firms now compete, and those in which they would be likely to compete in the future -- consigning consumers to pay significantly higher prices for office supplies than they would pay if the merger is enjoined. Having satisfied itself of the gravity of the Commission's concern, this Court should leave to the administrative process resolution of the "serious, substantial, difficult and doubtful" questions going to the merits that the Commission, beyond peradventure, has raised.

B. The Equities Follow the Merits and Also Call for Preliminary Relief

The equities in this case clearly should follow the merits. A preliminary injunction is necessary both to prevent interim competitive harm from the merger and to preserve the possibility of ultimate relief. Defendants' suggestion (DB 41-45) that the equities in this case could possibly militate against "any award" of relief if this Court finds that the Commission has made the requisite merits showing rests upon a gross misuse of FTC v. Weyerhaeuser Co., 665 F.2d 1072 (D.C. Cir. 1981). Weyerhaeuser is not a case "upholding denial of [a] preliminary injunction notwithstanding the district court's conclusion that FTC was likely to prevail on the merits" (DB 41). In Weyerhaeuser the D.C. Circuit affirmed the district court's discretion to enter a stringent hold separate order in place of a full-stop injunction, where the district court concluded that such an order would preserve interim competition between the merging entities and preserve the efficacy of ultimate relief. Weyerhaeuser "h[e]ld only that a district court does not err when it considers private equities weighing against a total stop order," (665 F.2d at 1083); the case hardly suggests, as defendants maintain, that concern for shareholders' expectations, the alleged benefits of a merger in markets other than those in which competition may be lessened, or self-inflicted weakening of the putative acquiree during the merger review process can be grounds to deny "any" relief where the Commission has made the requisite showing of likely success.[22]

In Weyerhaeuser the district court entered a hold separate that assured operation of the North Bend corrugating medium mill (the only asset whose acquisition was alleged to create a Clayton Act violation) as an "independent competitor" of Weyerhaeuser for the pendency of the administrative proceeding, 665 F.2d at 1088. While affirming, the court of appeals recognized that "in many situations, a hold separate order would not adequately secure eventual final relief or prevent interim anticompetitive harm," 665 F.2d at 1085. It seems difficult to imagine a hold separate order in this case that could satisfy Weyerhaeuser's stringent criteria.[23] But that is largely a moot point, because

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22 Moreover, the equities that persuaded the Weyerhaeuser court to approve hold separate relief were far stronger than those that defendants here claim justify entering no relief at all. The existence of such substantial equities led the court of appeals to emphasize that "[m]ore was at stake than the private financial gain that might attend any merger." 665 F.2d at 1088. As for benefits of the merger in product lines not addressed by the Commission's complaint, the Weyerhaeuser court accommodated this interest only because it was possible to separate the product line giving rise to the antitrust challenge from the acquired firm's other business. Where, as here, no such separation is feasible, courts have not hesitated to grant full-stop injunctive relief. Food Town, 539 F.2d at 1345. Likewise, adverse effects on a merging party's stock price and "apprehensi[on] about the effect of the merger and further uncertainty about whether the merger will become effective" resulting "in loss of personnel" is commonplace in merger transactions, "yet Congress enacted § 13(b) authorizing injunctive relief, thereby indicating that it thought that little weight should be given to them." Id. at 1345-46. Office Depot's profit margins remain robust and its chairman has assured the Commission that the firm will continue as a strong competitor if the merger is enjoined (PFF 325-27); defendants' predictions of decline are simply another gun-to-our-head argument that cannot justify denial of injunctive relief.

23 The D.C. Circuit observed, for example, in terms quite relevant to this case, that "[a] hold separate order . . . may not be a feasible device where the competitiveness of firms in a particular industry turns, in large part, on aggressive or innovative management initiatives," or where, inter alia, "the acquired company was planning prior to the acquisition to embark on a new pro-competitive venture," and "it is not

(continued...)

defendants have not offered a hold separate order and any such order that might even arguably preserve Office Depot as an independent competitor in the marketplace would be no more acceptable to Staples than the full-stop injunction the Commission seeks. And even if defendants could credibly argue for some unspecified hold separate order, defendants cannot tenably show that the equities favor no relief at all.

As to the difficulty of reconstituting an independent Office Depot should divestiture be ordered, our argument rests both upon judicial and congressional recognition underlying Section 13(b) that it is "often impossible for the Government to compel a return to the status quo," Exxon Corp., 636 F.2d at 1343; as well as upon the facts of this case. As we detailed in our opening brief and findings (PFF 316-19), Office Depot is much more than a collection of stores -- it also includes a distribution system, customer loyalty and good will, a unique image, key personnel, and a number of other significant attributes. It would be virtually impossible to recreate these attributes through divestiture once they have been lost due to consummation of the merger. And even if the focus is solely on the stores, a good number of those (presumably the ones in closest competition with others of the merged entity) will be shuttered if the merger is consummated (PFF 317).

Nor does the pre-litigation settlement proposal mentioned by defendants, involving divestiture of 63 stores to OfficeMax (DB 44), support a claim that post-merger divestiture would serve the public interest. The Commission rejected that settlement precisely because it failed to address the loss of competition resulting from the disappearance of Office Depot as an independent competitor of Staples and OfficeMax, both in markets in which all three firms now compete, as well

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in the acquiring company's economic interest to preserve its new purchase as a going business." 665 F.2d at 1086-87.

as in monopoly or duopoly markets that one of the merging firms might otherwise enter if the merger does not take place. Post-merger divestiture of selected stores would do nothing to address these serious competitive concerns. Indeed, denial of preliminary injunctive relief would deprive the public even of the modest competitive benefits of the rejected settlement proposal, leaving the merged firm to exploit superstore monopolies in Washington, D.C. and numerous other local markets.

Defendants' claim that the Commission need fear no anticompetitive behavior from the merged entity during the pendency of the administrative proceeding, lest such conduct generate post-acquisition evidence that would support an administrative order (DB 44), ignores defendants' powerful countervailing economic incentive to "make hay while the sun shines." In fact, the record contains strong evidence that interim harm has already occurred, despite the risk of an administrative proceeding: Staples has canceled a planned 3% price decrease.

Furthermore, while the combined firm may expand into new markets (DB 44), the merger will eliminate the possibility of Office Depot or Staples expanding into, and increasing competition within, markets in which the other firm now enjoys a monopoly, or a duopoly with OfficeMax. Prior to the announcement of this merger, however, Staples viewed increased competitive pressure from Office Depot's entry into Staples' markets as a virtual certainty. See, e.g., PX 14 at 5501; PX 15 at 3183, 3218.

Finally, in assessing the equities, consideration should be given to the fact that the consumers of nine states have spoken, through their respective Attorneys General, in an amicus brief clearly expressing their concern that the merger will lead to higher prices.

CONCLUSION

For the foregoing reasons and those set forth in our opening brief and proposed findings, this Court should enter a preliminary injunction to prevent the merger of Staples and Office Depot pending final resolution of an administrative proceeding to determine the lawfulness of their proposed merger under Section 7 of the Clayton Act.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 6th day of June, 1997, I caused a copy of the public version of the foregoing *Plaintiff's Reply to Defendants' Joint Post-Hearing Memorandum of Law in Opposition to the Federal Trade Commission's Motion for a Preliminary Injunction* to be served by fax upon the following persons.

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