VIEWPOINT:

IGNORING THE LESSONS OF *VON'S GROCERY*: Some Thoughts on the FTC's Opposition to the Whole Foods/Wild Oats Merger

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IGNORING THE LESSONS OF *VON'S GROCERY*: Some Thoughts on the FTC's Opposition to the Whole Foods/Wild Oats Merger

By

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One of the most maligned antitrust decisions in history involved a merger of grocery store chains. Even those voices inclined toward substantial antitrust intervention believe the Supreme Court erred in its 1966 *Von's Grocery* decision,[2] which condemned the merger of the third- and sixth-largest grocery store chains in Los Angeles. Indeed, even the president of the highly interventionist American Antitrust Institute conceded that the Supreme Court "probably went too far" and acknowledged that "if *Von's Grocery* had remained the rule, all of our industries would be highly fragmented, and consumers would have lost out on many cost-cutting efficiencies."[3] The fact is, grocery retailing involves huge scale economies and low barriers to entry – a combination that renders most consolidations beneficial to consumers.

The Federal Trade Commission (FTC) has apparently forgotten the lesson of *Von's Grocery*. On June 5, 2007, the Commission filed a complaint seeking to block the merger of Whole Foods Market, Inc. and Wild Oats Markets, Inc., two high-end natural and organic supermarkets.[4] This is bad news for consumers. If the FTC successfully blocks this merger, it will thwart consumer-friendly productive efficiencies without procuring any benefits in terms of constrained market power.

A consolidation of competitors is a classic "mixed bag" with the potential to create both negative and positive consequences for consumers. On the negative side, a consolidation can enhance the combined firm's market power, reducing the competition the firm faces and thereby permitting it to increase its prices and/or cut back on quality. On the upside, a merger may permit the larger combined firm to capture scale economies and thereby reduce its per unit costs (and thus its prices). The trick for regulators is to determine whether the anti-competitive harms of a consolidation will exceed the pro-competitive benefits. Only if anti-competitive harms are likely to significantly eclipse pro-competitive benefits should regulators intervene to prevent the operation of market forces.

So how do the anti-competitive harms and pro-competitive benefits shake out in the case of the proposed Whole Foods/Wild Oats merger? According to the FTC, which

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[2] United States v. Von's Grocery Co., 384 U.S. 270 (1966).

[3] Albert Foer (AAI President), *Playing Monopoly*, available at http://www.antitrustinstitute.org/Archives/28.ashx (reprinted from THE NEW REPUBLIC, April 12, 1999).

[4] See *FTC Seeks to Block Whole Foods Market's Acquisition of Wild Oats Markets* (June 5, 2007 press release), available at http://www.ftc.gov/opa/2007/06/wholefoods.shtm.

appears to have focused entirely on potential anti-competitive harms, the merger would represent a bad deal for consumers because a combined Whole Foods/Wild Oats would have substantial market power – that is, it would be sufficiently insulated from competition that it could profitably raise prices or decrease quality without losing too much business to competing producers. That seems wrong.

The starting point for any assessment of market power is market definition. Once regulators have determined what constitutes the relevant market, they can examine the availability of competitive alternatives within that market – i.e., the degree to which consumers could turn to another producer in response to a price increase or reduction in quality. In the case at hand, the FTC defined the market in which Whole Foods and Wild Oats participate as "premium natural and organic supermarkets." This was crucial. The market for conventional groceries is, of course, highly competitive. The market for natural and organic *foods* is also competitive, for most areas with a Whole Foods or Wild Oats also host natural foods stores, and most grocery stores – including low-priced Wal-Mart – now offer an extensive selection of natural and organic foods alongside conventionally produced foods. The FTC was able to exclude these alternative suppliers from its "market," though, by emphasizing that Whole Foods/Wild Oats customers are not purchasing just natural and organic *foods*; instead, they are buying a fancy shopping experience that is available to them only in a Whole Foods-like store. By defining the relevant market in terms of fancy shopping outlets (i.e., as "premium natural and organic *supermarkets*"), the Commission could find that Whole Foods and Wild Oats collectively comprise a huge portion of the "market."

The FTC's market definition is troubling for a couple of reasons. First, defining markets to consist of specific types of distribution channels, rather than groups of products or services, opens the door to finding narrow "markets" (and thus market power) everywhere. Is IKEA a monopolist because it sells common items in a distinctive environment? Does Nordstrom's signature high level of customer service put it in a different market than Macy's? Are Barnes & Noble and Border's Books in a different market than Waldenbooks and Brentanos because the former offer espresso bars? Surely not. The fact is, retailers routinely attempt to distinguish their products or services by offering them differently than their competitors. That is perhaps the essence of marketing. Mere marketing differences, though, should not create distinct antitrust markets, particularly when those differences are not subject to intellectual property protection and could be easily replicated by competitors.

The possibility that competitors will replicate the Whole Foods shopping experience highlights the second deficiency in the FTC's market definition: it ignores probable supply effects. A firm cannot exercise market power – e.g., it cannot profitably raise prices above competitive levels – if other firms could quickly respond by offering whatever it sells at a lower price. Obviously, existing grocery stores could easily stock the particular items Whole Foods and Wild Oats sell. Moreover, to the extent Whole Foods and Wild Oats are selling a "shopping experience," as the FTC insists, competitors could easily provide that amenity as well. It would be incredibly easy to restock and reconfigure an existing grocery store to provide the Whole Foods experience. Indeed, existing grocery chains seem to be moving in precisely that direction; the very *Wall*

Street Journal issue that announced the FTC's opposition to the Whole Foods/Wild Oats merger reported that a number of national grocery chains are transforming their stores to provide a more Whole Foods-like experience:

> After years of decline brought on by fighting Wal-Mart Stores Inc. on price, the nation's grocery chains are on the mend. The supermarkets are winning back shoppers by sharpening their differences with Wal-Mart's price-obsessed supercenters, stressing less-hectic stores with exotic or difficult-to-match products and greater convenience. … They are cutting back on drugs and health and beauty products, which are Wal-Mart strengths, to stress fresh produce, higher-quality meat and easy-to-prepare foods. Subdued lighting and high-end selections buttress the nonsupercenter experience. Instead of the rows of aisles with commonplace brands, the supermarkets are adding tables providing ingredients for planned meals, luring the kind of customer who shops for dinner instead of stocking up on groceries once a week, says Paul Weitzel, managing partner at grocery consultants Willard Bishop LLC. … Safeway Inc. has converted about half of its 1,755 stores into "Lifestyle" markets with wood floors, on-site bakeries and high-end private-label brands. The third largest food retailer after Wal-Mart and Kroger, it expects to convert all its stores by 2009.[5]

By adopting an overly narrow definition of the relevant market, the FTC likely overstated the anti-competitive harms that would result from a Whole Foods/Wild Oats merger. In actuality, the market in which Whole Foods and Wild Oats participate is probably incapable of monopolization given the low barriers to entry into just about all sectors of grocery retailing.

In addition to overstating the likely anti-competitive effects of a Whole Foods/Wild Oats merger, the FTC ignored a key pro-competitive benefit such a merger could provide: increased scale that would enable the combined company to lower its per unit costs. There are substantial economies of scale in grocery retailing. Indeed, Wal-Mart's ability to underprice its rivals is due in large part to the efficiencies its massive size creates. As the aforementioned *Wall Street Journal* article highlighted, Wal-Mart's entry into the conventional grocery market was followed by a slew of bankruptcies (26 this decade) by smaller, regional grocery store chains that could not capture such efficiencies and thus could not compete with Wal-Mart on price. By opposing the Whole Foods/Wild Oats merger, the FTC makes it more difficult for those companies to achieve the productive efficiencies that will make them vigorous competitors.

Because retail markets for groceries – including natural and organic foods – are both difficult to monopolize and subject to significant economies of scale, regulators ought to proceed with caution before they seek to block a consolidation. In this case, the productive efficiencies from the merger are likely to be large, and the possibility that the merger will create significant market power for a combined Whole Foods/Wild Oats,

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[5] Gary McWilliams, *Not Copying Wal-Mart Pays Off for Grocers*, WALL ST. J. B1 (June 6, 2007).

which participates in a market that grows more competitive by the day, is slim. Let's hope the courts have learned more from *Von's Grocery* than the FTC. Consumers will be better off if the Commission fails in its attempt to block this merger.

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