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Which Standards?  
Which Substitutes?

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**Which Standards? Which Substitutes?**

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If email traffic over the American Bar Association’s Antitrust Section “conversation” list is any indication, the recent 2-1 decision by a panel of the U.S. Court of Appeals for the DC Circuit Court in *FTC v. Whole Foods* is the hottest current topic, at least in the U.S. corner of the competition policy community. In that decision, the DC Circuit reversed a district court’s denial of the U.S. Federal Trade Commission’s (“FTC’s”) request to enjoin Whole Foods’ acquisition of Wild Oats. The FTC provided evidence and expert testimony supporting a claim that these were the two largest chains of “premium, natural, and organic supermarkets” (“PNOS”). The parties contended that the firms would lack market power after the merger because consumers would respond to higher prices by going to conventional grocery stores. The decision has inspired so much comment because of the quantity of issues it raises. In this article, I briefly discuss some legal issues, then turn to aspects of market definition, and conclude with observations relating to recent discussions on the role of distributional considerations in merger assessment.

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On the legal side, the first and primary question is the burden of proof the FTC should have to meet in obtaining a preliminary injunction (“PI”). Determining the optimal burden involves, as the Court of Appeals said, a complex “balance [between] the likelihood of the FTC’s success against the equities, under a sliding scale.” The Court found that the district court erroneously simplified this by concluding that the FTC “failed to show a likelihood of success,” and thus did not have to compare the “equities.” I take the “equities” reference to be about comparing the net benefits of

- (a) enjoining the merger, having an investigation and possible trial resulting in either a permanent stay, delayed merger, or a settlement somewhere in between, and
- (b) allowing the parties to reap the benefits of the merger, after which the FTC could pursue a post-merger investigation and trial, albeit with presumably fewer or more costly remedies.

Two fundamental presumptions underlie authority to grant preliminary injunctions. The first is that effective relief is at least more costly, and even potentially not possible, to implement once a merger is consummated. If not, the argument for an injunction boils down to the argument against the case itself: that the economic harm from the merger outweighs the benefits. Whether the standard for “harm” and “benefit” should be consumer or total welfare, or some weighted average of the two, “balancing” the “equities” entails recognizing that delaying a merger may impose costs on the parties (e.g., by giving competitors added time to respond to the merger).

This brings up the second presumption: that the costs of delay are asymmetric. Specifically, the costs fall more on the enforcement agencies (and the consumers they

nominally represent) than on the parties. If the defendants were to suffer more from delay than the plaintiffs, the PI process would presumably work the other way: parties would petition courts for advance approval if they could show a “likelihood of failure” on the part of the agencies, forcing the agencies to bring a case against the merger after it has happened.

After reviewing the decision, and keeping these presumptions in mind, it seems that in either case the burden probably should be fairly low. A hallmark of this decision is the Court’s protestations in *Whole Foods* to deny that the opportunity to take issue with the merger had passed. It expressed confidence that a subsequent court would be “clothed with large discretion” to create “effective” remedies. This argument should not be made blithely, as it contradicts the aforementioned rationale for PI authority in the first place. Even if some post-merger remedy can be devised here, the Court needs to acknowledge that if the PI is not approved and the merger is allowed to go forward, then the efficient response to a district court error of not granting a PI is thus likely to be to acknowledge that the costs of further action exceed the benefits. The game will often, if not usually, be over.

If so, despite the Court’s self-assured claim of having “large discretion” in fashioning post-merger remedies, the opportunity to reverse error will typically be slim. Consequently, the burden on the agencies should generally be low, reflecting the magnitude of the costs of litigating post-merger and the asymmetry with which those costs fall. It was disingenuous, if not surprising, for the parties in *Whole Foods* to argue

before the district court that the FTC should bear a significant burden in obtaining a PI, but that the Court should invoke the costs of imposing post-merger remedies to deny the FTC's appeal. It is the very cost of the latter that increases the likelihood that the district court erred. Similarly, the Court makes the case for finding error harder, not easier, by claiming that the FTC and the courts will be clever enough to devise an effective remedy. Recognizing the magnitude and asymmetry of the costs of allowing the merger to go through before the investigation is complete, district courts should, following the "sliding scale," require the enforcement agency to show only that it has a plausible argument against the merger.

That leads to the economic side: What should such a case entail in *Whole Foods*? I am not an expert on the grocery business, and certainly have no knowledge of relevant empirical details regarding consumer behavior. However, the decision raises a number of aspects that should be approached with caution.

The first is the Court's emphasis in *Whole Foods* on market definition, to the point of requiring it. I have been a fan of market definition since serving in the Antitrust Division of the U.S. Department of Justice when William Baxter was the Assistant Attorney General and when the first edition of the modern *Horizontal Merger Guidelines* was released in 1982. I remain part of a consensus among economists that market definition is a very useful contributor to merger assessment, as reflected in the testimony economists presented on the subject to the Antitrust Modernization Commission ("AMC") in 2006.

But at the same time, the recognition of “unilateral” merger effects in the 1992 *Guidelines*, along with party-specific concepts such as “critical loss” and “diversion ratios,” suggest a theoretical recognition that one can and should look at the effects of a merger without identifying a market as such. Advances in demand-system econometric models, merger simulations, and the availability of data to feed them suggest that merger effects could be estimated directly without defining markets. Lawrence White, chief economist at the Antitrust Division when the 1982 *Guidelines* were published, observed in his AMC testimony that the market definition exercise in the *Guidelines* was based on identifying firms that could significantly raise price if acting in concert (“coordinated effects” in 1992 *Guidelines* parlance), as opposed to the unilateral effects assessment prominent today.

I raise this point for a couple of related reasons. On the legal side, the decision’s emphasis on market definition brings to light the fact that, as I understand it, the U.S. Supreme Court has not ruled on a merger case since the late 1970s, before the modern *Merger Guidelines* approach to market definition came into general use. One wonders if this decision, or something like it, will result in a legal test of whether market definition is necessary and, if it is, whether the *Merger Guidelines*’ method for doing so is correct.

Moreover, as market definition may come to play less of a role in the merger context for which it was designed, it is insinuating its way into contexts where it does not belong, specifically monopolization or abuse of dominance. To some degree, this is a by-product of the somewhat circular requirement that one has to have a monopoly in order to

get a monopoly (i.e., to monopolize). To the degree a prior monopoly or dominance is required, one appears to need to define a market over which one dominates or has monopoly power. Unfortunately, as the well-known “Cellophane fallacy” indicates, the counterfactual price increase test for defining markets in the *Merger Guidelines* is inapplicable to the notoriously thorny question of whether a single firm possesses significant market power.

Granting a continuing role for market definition, *Whole Foods* brings to light a crucial distinction often missed in at least the policy penumbra surrounding antitrust law, if not litigated cases themselves. This distinction is between what I call “gross substitutes” and “marginal substitutes.” Gross substitutes are those goods whose mere presence causes the demand curve for that good to fall. On the other hand, those goods whose effect on that demand curve depends in significant measure on their relative prices are marginal substitutes, following the textbook phrase “marginal rate of substitution” between two goods, generally equal to the ratio of their prices.

The importance of this distinction is that for antitrust analysis, only marginal substitutes matter. Bicycles and cars, for example, are gross substitutes. If there were no cars, people would almost surely be riding more bicycles. However, they are not marginal substitutes. If all of the bicycle producers merged into a single entity, their ability to raise price would not have much to do with the prices of cars. Theoretically, the distinction arises because the presence of gross substitutes affects the magnitude of demand, while the ability to raise price depends on the elasticity of demand. A demand curve can fall,

because of the presence of gross substitutes, but the remaining customers can still be sufficiently insensitive to increases in price that a merger could still have enable firms to have market power. Gross substitutes shrink the size of the market, and thus may put a proposed merger on the enforcement backburner, but they do not necessarily mitigate a merger's effect on price.

This has not been an idle distinction. In telecommunications, a common observation is that wireless voice service is cutting into conventional landline service “one funeral at a time,” reflecting the view that only older people use wired telephones, while younger people rely on their cell phones. That may be, but the presence of cell phones as a gross substitute for landline phones does not in and of itself eliminate the possibility that a hypothetical (or actual, post-deregulation) monopolist over landline services would retain meaningful market power.

The substantive issue in *Whole Foods* may turn on a similar confusion between gross and marginal substitutes. Undeniably, PNOS and conventional supermarkets are gross substitutes. But that does not tell whether the two are marginal substitutes: that the rate at which consumers of PNOS would switch to conventional supermarkets in response to a price increase. Judge Tatel, in his concurring opinion, recognized the distinction in question and the relevance of whether, as he put it “Whole Foods and Wild Oats have attracted many customers away from conventional groceries.” Although he phrased this in terms of whether PNOS were gross substitutes for conventional supermarkets, not vice versa, the mere fact that X sellers attracts customers from Y sellers is not enough to



conclude that X and Y are in the same market.

Apart from the gross versus marginal distinction is the potential imprecision in the identification of the services that Whole Foods and Wild Oats provide. The decision indicates that the market involves selling groceries, with the only question being whether conventional supermarkets should be included in the relevant market containing PNOS. However, it may be that the service offered by PNOS stores is not retailing but signaling, conveying information about the products those stores elect to carry.

Thinking about these firms as being in the signaling business may help think through some of the issues in the decision. For example, the debate between the majority and dissenting opinions regarding the description of the product might be helped by distinguishing products between those where signaling matters (perhaps organically fed beef, for example) and relatively ordinary staples where certification of origin and the manufacturing and delivery process may be less relevant. The debate about the relevance of “core versus non-core” customers similarly could be framed in terms of those consumers for whom the PNOS signal is valuable.

What Whole Foods and its PNOS competitors may be signaling may be relevant on a number of levels. Although the obvious candidate is the quality and provenance of the food, casual observation from living in a Washington, DC suburb that recently opened a Whole Foods store suggests that it may be the latest way in which “bourgeois bohemians” (as coined by David Brooks), signal to each other their tastes for not just food but how much they are willing to pay to conspicuously consume in a socially

approved way. From an efficiency perspective, one wonders how to analyze a market in which the value of consuming goes up with the price, because of the signal.

But the question may also pertain to the extent that distributional considerations should play a role, as for example they currently do in Canada and as they underpin the emphasis elsewhere on consumer over total welfare. In most cases, the presumption is that if a merger goes through, the potentially enriched parties are relatively wealthy stockholders, while the injured parties are poorer consumers, implying that distributive justice should make it harder to merge. However, in this case one has to wonder if the victims of the merger are better off than the investors and, depending on labor agreements, workers who may share in the benefits.

Thinking about distribution invites a final speculation on factors influencing prosecutorial discretion. Pondering *Whole Foods* reminds me, as I recall, of the FTC's decision in 1987 not to oppose 7-Eleven's acquisition of High's Dairy stores on the basis that supermarkets were in the same market as convenience stores. It would be instructive to understand the differences between that decision and this one. Both that past merger and this current one present a potential confusion as to whether conventional supermarkets are gross or marginal substitutes to the services offered by the merging parties. The underlying empirical data may indicate that conventional supermarkets are marginal substitutes for convenience stores, but not for PNOS. But in comparing the typical consumer in a 7-Eleven to one in Whole Foods (I confess to being in the former more often than the latter), I am left wondering a little bit about the extent to which

merger policy could be subconsciously influenced by considerations apart from the underlying economics and law.