



## **The Proposed Merger of Staples and Office Depot: Lessons from History and New Competitive Concerns**

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### **I. Introduction**

The proposed combination of Staples and Office Depot presents the Federal Trade Commission (FTC) with a host of merger review challenges. The transaction follows closely on the heels of the Office Depot/OfficeMax merger in 2013 and would complete a rapid 3-1 consolidation of the office supply superstore (OSS) market. Both retail and business-to-business customers may be significantly affected by the proposed transaction. The deal puts front and center the question whether evolving alternative business models for the sale of consumable office supplies are a viable substitute for OSSs. It also raises issues that the Commission recently addressed in the successfully enjoined merger of national broadline foodservice distributors Sysco and U.S. Foods – namely that a merger of the only two rivals in a national market may have adverse unilateral effects in a targeted customer market.

The American Antitrust Institute (AAI) is concerned that the proposed transaction may substantially lessen competition in the market for the sale of consumable office supplies to large multi-regional or national customers on a contract basis (hereinafter “enterprise customer market” or “enterprise market”). In particular, we are concerned that the proposed transaction threatens substantial unilateral anticompetitive effects that alternative supply responses could not ameliorate, and that harm to customers in this market will be passed on to consumers. Some of these harms implicate unique dimensions of quality competition involving cyber security and supply chain stability. We also raise questions as to whether rapid 3-1 consolidation threatens to reverse recent positive competitive developments in the retail office supply market, as well as the competitive significance of merging the only “omnichannel” retailers principally devoted to office supplies.

The analysis in this white paper is based on our review of publicly available information and conversations with industry experts and analysts. Because we do not have access to confidential or proprietary information that the Commission collects in the course of its investigation, we draw no conclusions as to whether the merger violates Section 7 of the Clayton Act. However, our analysis

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makes clear that the proposed merger warrants very close scrutiny by the Commission. Major themes that emerge from this analysis include:

- **The Commission should determine whether there is a distinct relevant product market for the sale of consumable office supplies to large “enterprise” office supply customers on a contract basis, and if so, who participates in this market. This is consistent with the Commission’s successful approach to defining targeted customer markets in *Sysco v. Fed. Trade Comm’n*.**
- **The enterprise contract market likely is a relevant antitrust market because enterprise customers have no viable substitutes for the product and service offerings provided by OSSs. The next largest rivals are distant to Staples and Office Depot and are unable to compete on the scale and scope of the merging parties. Moreover, the merging firms may be the only participants in this market, because potential supply-side responses likely would fail to defeat a post-merger price increase in the market.**
- **The proposed transaction threatens substantial unilateral anticompetitive effects in the enterprise market, and possibly also in the broader market for all contract customers. Potential anticompetitive harm arises not only from the loss of ordinary head-to-head competition between the merging firms, which is substantial, but also from the loss of competition to provide superior cyber security to contract customers and by increased supply chain fragility resulting from elimination of any redundancy in the OSS channel. Potential anticompetitive effects are unlikely to be mitigated by repositioning or new entry.**
- **In its 2013 review of the Office Depot/OfficeMax merger, the Commission likely did not go far enough in distinguishing among competitive dynamics within and across the retail distribution channels through which OSSs provide products to end consumers. Although competition in the pure online retail channel is likely disciplined by national competition from Amazon and others, there are competitive concerns in the traditional superstore channel and in the emergence of omnichannel stores that warrant careful attention.**

## II. Background

Staples and Office Depot agreed to a \$6.3 billion merger in February 2015, just fifteen months after Office Depot absorbed the merging firms’ long-time rival OfficeMax. The nation’s two remaining OSSs currently compete to sell office supplies, office furniture and technology products to businesses pursuant to long-term contracts, and to consumers through retail stores, catalogs, and online. Staples is reportedly the fourth largest online retailer behind Amazon, Apple and Wal-Mart, while Office Depot is sixth.<sup>1</sup> The proposed transaction would move the merged firm ahead of Wal-Mart into third, with a combined \$15.53 billion in web sales.<sup>2</sup>

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<sup>1</sup> Mark Brohan, *E-Commerce Sales Grow Six Times Faster for U.S. Top 500 Merchants than Total Retail Sales*, INTERNET RETAILER (Apr. 13, 2015, 12:54 PM), <https://www.internetretailer.com/2015/04/13/e-commerces-sales-outgrow-total-retail-sales-2014>.

<sup>2</sup> *Id.*

Staples first sought to acquire Office Depot in 1997, but the Commission intervened and sued to block the deal in federal district court. In a landmark antitrust ruling, Judge Hogan enjoined the transaction based on the Commission's powerful economic evidence.<sup>3</sup> Compelled by the Commission's demonstration of likely unilateral price effects, the court defined a relevant antitrust market for the sale of consumable office supplies sold through OSSs. In particular, the court highlighted econometric evidence showing significant percentage differences in pricing depending on how many OSSs were in a given geographic market.

Fast forward 16 years. In 2013, when Office Depot sought to acquire OfficeMax, the Commission cleared the transaction in its entirety, without divestitures.<sup>4</sup> The Commission found that the market for the retail sale of consumable office supplies had broadened as a result of competition from mass merchants and warehouse clubs, coupled with the emergence of the online retail channel. The evidence and supporting econometric analysis suggested that OSSs had abandoned their price zones from the late 1990s in favor of national and/or local pricing schemes that accounted for non-OSS competition. The Commission therefore concluded the transaction was unlikely to substantially lessen competition in the retail market.

In addition to the retail market, however, the Commission's 2013 investigation revealed a relevant market for the commercial sale of consumable office supplies to businesses through long-term contracts (hereinafter "broader contract market" or "all contract customers market"). Today, these business-to-business contract sales account for approximately 35-40% of the merging firms' total sales. Staples serves this market with its Staples Advantage and Quill brands, and Office Depot with its Business Solutions Division (BSD). Staples Advantage has approximately 270,000 customers ranging from mid-size businesses (20 or more employees) to Fortune 1000 multinational corporations and federal and state government institutions. It serves about half of the organizations listed on the Fortune 1000 and more than 65% of the Fortune 100.<sup>5</sup>

Leading up to, and after, the Office Depot/OfficeMax merger, the contract channel has been growing as the retail channel has been declining. Prior to Office Depot/Office Max, industry analysts described the contract channel as "where the upside is" and where "the real money is in this business," because the contract channel "is more protected, while retail is under pressure from Amazon, discounters, and over-storing."<sup>6</sup> At the time, Staples acknowledged in a 2012 earnings call discussion that the contract market generally and the enterprise market in particular were lucrative and very competitive, yet "disciplined" in terms of pricing.<sup>7</sup> In the years since 2012, the commercial

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<sup>3</sup> See *Fed. Trade Comm'n v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).

<sup>4</sup> See Statement of the Federal Trade Commission Concerning the Proposed Merger of Office Depot, Inc. and OfficeMax, Inc., No. 131-0103 (Nov. 1, 2013) [hereinafter Closing Statement].

<sup>5</sup> STAPLES, *Customer Service Frequently Asked Questions: How Many Businesses Use Staples Advantage as Their Supplier*, <https://www.staplesadvantage.com/learn/contact-us/customer-service.html#faqs> (last visited July 20, 2015).

<sup>6</sup> Ashley Lutz, *Staples Has Some Huge Advantages Over Office Depot and Office Max*, BUSINESS INSIDER (Feb. 20, 2013, 10:06 AM), <http://www.businessinsider.com/officemax-and-office-depot-merger-2013-2> (quoting Gary Balter, Credit Suisse AG).

<sup>7</sup> See *Staples Management Discusses Q1 2012 Results – Earnings Call Transcript*, SEEKING ALPHA (May 16, 2012), <http://seekingalpha.com/article/594951-staples-management-discusses-q1-2012-results-earnings-call-transcript> ("There are instances where there is some competitive pricing in the lower-margin enterprise account area . . . . We have -- very disciplined there. . . . And again, we're going to continue to be very disciplined. And if you look at our profit growth in the quarter, it was driven by Contract because of the great discipline that we have continued to maintain in that business.") (quoting Joseph Doody, President of North American Delivery).

segment has been Staples' only segment with sales growth and has provided the company's highest income as a percentage of sales.<sup>8</sup>

This white paper examines the business of selling consumable office supplies through both negotiated contracts and retail outlets. We explore the competitive impact of the proposed transaction through an analysis of several markets. In Section III, we discuss the merger's impact in the broader contract market identified by the Commission in 2013, with particular attention to the question whether there is a distinct relevant market for enterprise contract customers. This section discusses competitive effects on price, choice and quality competition, and it raises questions regarding cyber security competition and supply chain fragility. Section IV analyzes the merger's impact in the broader retail market identified by the Commission in 2013, including the merits of considering effects on online competition, traditional brick-and-mortar office superstore competition, and omnichannel store competition. This section focuses on potential competitive effects on price, quality and choice in the merged firm's sales through traditional office superstores and through omnichannel stores in the retail market.

### **III. The Contract Market**

The Commission described the contract market it identified in its 2013 review of the Office Depot/OfficeMax merger as “the sale of consumable office supplies to businesses and other customers on a contract basis.”<sup>9</sup> It found that customers transact with office suppliers on a contract basis to “receive discounted pricing based on actual or anticipated purchase volume” and “to order office products at previously negotiated prices.”<sup>10</sup> It found that demand in this contract market comes from “[m]any businesses and public entities,” including “small and medium-sized businesses” as well as “large multi-regional or national customers.”<sup>11</sup>

In analyzing this broad market for all contract customers, the Commission concluded that Office Depot/OfficeMax was unlikely to substantially lessen competition for five reasons: (1) there were “dozens, if not hundreds,” of suppliers capable of serving small and medium-sized contract customers in this market; (2) there was evidence that the merging firms had lost contract business to non-OSSs (where non-OSSs were capable of competing); (3) there was evidence that large contract customers sometimes negotiated separately for individual office products within the office supplies category (like paper and toner); (4) the merging firms were rarely each other's closest competitors for large contract customers; and (5) the merged firm would continue to face strong competition for large contract customers from Staples, as well as non-OSS competitors (where non-OSSs were capable of competing).<sup>12</sup>

Since this first foray into the broader contract market, however, the Commission has not had an opportunity to make two additional, important determinations. The first is whether there is a distinct relevant product market for the sale of consumable office supplies to large multi-regional or national “enterprise” contract customers. The second is who is capable of competing in such a market.

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<sup>8</sup> Staples Inc., Annual Report (Form 10-K) 2015 (at B-7, B-8).

<sup>9</sup> Closing Statement, *supra* note 4.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

In 2013, the Commission foreshadowed the possibility that enterprise contract customers may form a distinct relevant market, noting that such customers may have “demanding purchasing requirements and, as a result, fewer potential suppliers capable of meeting their needs.”<sup>13</sup> However, at the time, the Commission appeared convinced that some combination of Staples and non-OSSs would sufficiently discipline the new Office Depot. The Commission expressly did *not* assess whether large enterprise contract customers form a distinct relevant product market, and if so, who participates in the market.<sup>14</sup>

### **A. Market Definition Here Should Be Informed by Sysco/U.S. Foods and Office Depot/OfficeMax**

The current proposed combination of Staples and Office Depot requires a deeper analysis of the competition to serve large enterprise contract customers. To be sure, the Commission may find that the transaction may substantially lessen competition in the broader contract market, which includes contract customers of all sizes. According to one report, the merging firms have a combined 70-75% share of the “overall corporate office supply market.”<sup>15</sup> However, if the enterprise contract market is a distinct relevant product market, the proposed transaction seems significantly more likely to substantially lessen competition. In defining relevant markets here, the Commission should follow the same longstanding principles it successfully advanced in *Fed. Trade Comm’n v. Sysco*.<sup>16</sup>

#### **1. Customers in Defined Markets Versus Markets Defined By Customers**

Judge Mehta’s opinion in *Sysco* includes an important discussion of the sometimes confused analytical treatment courts have given groups of customers that may be differently situated economically within defined relevant product markets. As the *Sysco* court recognized, there has been controversy where the Commission is said to have tried to define relevant product markets without regard to customers, but to have conceded that only one subset of customers in the market likely would switch in response to a small but significant and non-transitory increase in price (SSNIP), while another subset of customers likely would not.<sup>17</sup> However, there is no controversy where the Commission has instead defined a relevant product market *by reference* to the subset of customers that likely would switch in response to a SSNIP.<sup>18</sup>

The *Sysco* court correctly observed that a product and customer can “converge” to form a distinct relevant product market, including, for example, when the “customer’s requirements operate to

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<sup>13</sup> *Id.*

<sup>14</sup> See Closing Statement, *supra* note 4 (“[W]e assessed the proposed merger’s competitive effects in two distinct lines of commerce: the sale of office supplies to retail and contract customers.”).

<sup>15</sup> Chetan Roy Gupta, *Will the Office Supplies Market Remain Soft?*, MY PURCHASING CENTER (Aug. 26, 2013), <http://www.mypurchasingcenter.com/office-products/articles/will-office-supplies-market-still-remain-soft-buyers/>.

<sup>16</sup> 2015 U.S. Dist. LEXIS 83482 (D.D.C. June 23, 2015).

<sup>17</sup> Compare, e.g., *Fed. Trade Comm’n v. Whole Foods*, 538 F.3d 1028, 1037 (2008) (“As the FTC presented its case, success turned on whether there exist core customers, committed to [premium, natural and organic supermarkets (PNOS)], for whom one should consider PNOS a relevant market. The district court assumed the ‘marginal’ consumer, not the so-called ‘core’ or ‘committed’ consumer, must be the focus of any antitrust analysis. To the contrary, core consumers can, in appropriate circumstances, be worthy of antitrust protection.”), *with id.* at 1062 (Kavanaugh, J., dissenting) (“a focus on core customers alone cannot resolve a merger case. The question here is whether Whole Foods could increase prices by five percent or more without losing so many marginal customers as to make the price increase unprofitable.”).

<sup>18</sup> *Sysco*, 2015 U.S. Dist. LEXIS 83482 at \*72-77.

define the product offering itself.”<sup>19</sup> Quoting the Horizontal Merger Guidelines, the court stated that “[i]f a hypothetical monopolist could profitably target a subset of customers for price increases, the Agencies may identify relevant markets defined around those targeted customers, to whom a hypothetical monopolist would profitably and separately impose at least a SSNIP.”<sup>20</sup> “Ultimately,” Judge Mehta explained, “the court here need not resolve the *Whole Foods* disagreement over defining a market around a ‘core’ customer. That is because the ordinary factors that courts consider in defining a market--the *Brown Shoe* practical indicia and the Merger Guidelines’ SSNIP test--support a finding that broadline distribution to national customers is [itself] a relevant product market.”<sup>21</sup>

In 2013, the Commission defined only a broad market for sales to all contract customers and stated that it “focused on” large national and multi-regional customers within that market.<sup>22</sup> Here, consistent with *Sysco*, the Commission should instead determine whether there is a distinct relevant product market for the sale of consumable office supplies to these enterprise contract customers, notwithstanding that there may also be a broader relevant market for the sale of consumable office supplies to contract customers of all sizes.<sup>23</sup>

## **2. Enterprise Contract Customers Have Requirements that OSSs Uniquely Fill**

AAI encourages the Commission to examine very carefully whether the merged firm would have the ability and incentive to impose a SSNIP in the enterprise contract market. We are concerned that the merging firms may be meaningfully insulated from competition in this market because of their enormous purchasing power, integrated centralized purchasing and delivery systems, dedicated sales support, and technological advantages. If that is the case, then enterprise customers may have very few or no viable alternatives to Staples and Office Depot in purchasing office supplies on a contract basis.

Perhaps the most pressing concern in this market is that Staples and Office Depot have unrivaled purchasing power, which they can leverage against smaller manufacturers of office products. Because small office supply manufacturers rely heavily on OSSs to continue placing large orders for a variety of office products, OSSs are able to extract favorable terms in their negotiations. Consequently, the merging firms have been able to offer unparalleled volume discounts and rebates

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<sup>19</sup> *Id.* at \*72-73 (emphasis added).

<sup>20</sup> *Id.* at \*72 (quoting U.S. Dept’t of Justice & Fed. Trade Comm’n, Horizontal Merger Guidelines § 4.1.4 (2010) [hereinafter Horizontal Merger Guidelines]); *see also* Horizontal Merger Guidelines § 4.1.4 (“The Agencies also often consider markets for targeted customers when prices are individually negotiated and suppliers have information about customers that would allow a hypothetical monopolist to identify customers that are likely to pay a higher price for the relevant product. If prices are negotiated individually with customers, the hypothetical monopolist test may suggest relevant markets that are as narrow as individual customers . . .”).

<sup>21</sup> *Sysco*, 2015 U.S. Dist. LEXIS 83482 at \*76-77.

<sup>22</sup> Closing Statement, *supra* note 4.

<sup>23</sup> Because the analysis in this letter focuses on defining a relevant product market by reference to the demands of large, geographically dispersed customers, we do not include a detailed discussion of the relevant geographic market. *See* Horizontal Merger Guidelines § 4.2.2 (“When the hypothetical monopolist could discriminate based on customer location, the Agencies may define geographic markets based on the locations of targeted customers. Geographic markets of this type often apply when suppliers deliver their products or services to customers’ locations. Geographic markets of this type encompass the region into which sales are made.”); *id.* at note 7 (“For customers operating in multiple locations, only those customer locations within the targeted zone are included in the market.”). We do discuss geographical considerations in the context of supply responses in Section III.A.3.

to their own contract customers.<sup>24</sup> Our understanding is that rebates offered by Staples and Office Depot are substantially higher than the next largest potential competitors.

These enormous direct pricing advantages are bolstered by substantial indirect pricing advantages. Although large customers sometimes source a small number of office supply products independently, such as paper and toner, most rely very heavily or exclusively on having a centralized, multi-regional office supply purchasing system to realize additional savings.<sup>25</sup> Where large customers operate nationally or across multiple geographic regions, integrated centralized ordering and purchasing systems are necessary to reduce costs. This occurs through monitoring firm-wide spending, maximizing volume discounts, “rationalizing” SKUs (i.e., working toward reducing overall variety of SKUs and thereby increasing per-SKU ordering volume, which helps capitalize on volume discounts), and avoiding added expense and prohibitive impracticalities associated with a morass of different ordering, invoicing, payment and delivery practices across local manufacturers and suppliers in different geographic regions.<sup>26</sup>

Finally, the merging firms appear to have unique technological scale advantages, and specifically the ability to customize integrated e-commerce infrastructure to meet the varying needs of large customers and their idiosyncratic internal ordering and payment systems. Office Depot’s Business Solutions Division, which has a dedicated technology division, advertises that it can meet its largest customers’ unique computing requirements by “follow[ing] your billing specifications to support your company’s unique operation.” Office Depot employs “state-of-the-art reporting technology” to monitor spending, with a dedicated e-commerce website and Customer Integration Team.<sup>27</sup> Staples Advantage has advertised, among other things, its “E-Procurement expertise” and ability to “customize an e-procurement solution” to control costs, streamline ordering, increase program compliance and save users’ time, as well as its dedicated Account Managers.<sup>28</sup>

Publicly available information does not confirm whether the merging firms’ enormous purchasing power, centralized purchasing and delivery systems, technological advantages, and the deep volume discounts and direct and indirect cost-savings they engender, would prevent enterprise office supply purchasers from switching suppliers in response to a post-merger price increase. However, we encourage the Commission to answer this question by compiling an RFP/bidding database and

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<sup>24</sup> Office Depot actively promotes its “multi-billion dollar buying power” in marketing materials directed to Business Solutions Division (BSD) customers. See OFFICE DEPOT, *About BSD: Why Partner with Office Depot?*, <https://business.officedepot.com/specialLinks.do?ID=aboutbsd&TITLE=About+BSD&template=login> (last visited July 20, 2015). Staples emphasizes that “Our buying power is how we deliver the best possible value to you.” STAPLES, *Customer Service Frequently Asked Questions: What Are the Benefits of the Staples Advantage Program*, <https://www.staplesadvantage.com/learn/contact-us/customer-service.html#faqs> (last visited July 20, 2015).

<sup>25</sup> See, e.g., PIERRE MITCHELL & CHRISTOPHER SAWCHUK, *THE BENEFITS OF SUPPLIER CONSOLIDATION EXTEND FAR BEYOND SOURCING SAVINGS 1* (2012), available at [http://www.mypurchasingcenter.com/files/6213/8929/0096/Hackett\\_Group\\_Supplier\\_Consolidation\\_Research\\_Article\\_1.pdf](http://www.mypurchasingcenter.com/files/6213/8929/0096/Hackett_Group_Supplier_Consolidation_Research_Article_1.pdf) (“Consolidating suppliers within specific supply markets is a proven strategy to concentrate buying power and reduce purchase prices.”).

<sup>26</sup> See *id.* at 1-5, (discussing reduced purchased costs, higher procurement process efficiency, reduced purchase-to-pay costs, and reduced noncompliance costs that come with supplier consolidation).

<sup>27</sup> OFFICE DEPOT, *Welcome to the Business Solutions Division*, <https://business.officedepot.com/specialLinks.do?ID=largebiz&TITLE=Large+Business&template=login> (last visited July 20, 2015).

<sup>28</sup> Staples PowerPoint on SLIDESHARE, *Staples Advantage: The Staples Difference* slides 10-14, <http://www.slideshare.net/kbarrett88/staples-business-advantage?related=1>.

conducting aggregate diversion analysis, as it did in *Sysco*.<sup>29</sup> Detailed information on RFP/bidding results also would shed important light on the severity of unilateral effects threatened by the merger, which is another important issue discussed *infra*.<sup>30</sup>

### **3. Patchwork Approaches, National Supplier Co-operatives, and Firms in Adjacent Markets Likely Do Not Count as Enterprise Market Participants**

If the Commission does find a relevant product market for the sale of consumable office supplies to enterprise contract customers, a critical question is which suppliers participate in the market. If there are alternative suppliers in the enterprise market or suppliers that would enter the market in response to a post-merger price increase, then the risk that the proposed transaction may substantially lessen competition is diminished.<sup>31</sup>

As the Commission recognized in its 2013 Closing Statement, several supply alternatives to OSSs are capable of serving small and medium-sized customers, as well as some proportion of larger customers. We encourage the Commission to look closely into whether any of these alternatives would constrain a combined Staples/Office Depot in the enterprise market. Based on a review of publicly available information, it seems likely they would not.

In Office Depot/OfficeMax, the Commission relied heavily on the disciplining force of Staples, which was a strong #1 in the broader contracting channel at the time. In addition, however, the Commission determined that the merged firm would be further constrained because some proportion of large customers also would be able to source (or threaten to source) office supplies (1) directly from manufacturers, (2) using multiple smaller suppliers, some of which operate regionally, like W.B. Mason, or (3) using multiple distributors and wholesalers to create expanded distribution networks (hereinafter collectively, “patchwork approaches”).

While some of the patchwork-approach alternatives to OSSs may suffice in some measure for some larger customers, publicly available information suggests it is highly doubtful they can be effectively employed (or threatened) in the enterprise market. First, sourcing directly to manufacturers or using multiple smaller suppliers necessarily means foregoing substantial volume discounts from the merging firms. At the same time, enterprise contract customers would incur large cost increases associated with inefficiencies in having to work with the different ordering, invoicing, payment and delivery systems of distinct manufacturers and suppliers in a multitude of different regions. Moreover, unless and until these customers develop their own proprietary or third party alternative solutions, decentralization eliminates an enterprise customer’s practical ability to seek additional indirect cost savings through SKU rationalization, firm-wide-spend monitoring across different geographic regions, and otherwise.

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<sup>29</sup> Fed. Trade Comm’n v. Sysco, 2015 U.S. Dist. LEXIS 83482 at \*63-64 (D.D.C. June 29, 2015).

<sup>30</sup> See *infra* Section III.B.; see also Horizontal Merger Guidelines § 6.1 (“[d]iversion ratios between products sold by one merging firm and products sold by the other merging firm can be very informative for assessing unilateral price effects”).

<sup>31</sup> See Horizontal Merger Guidelines § 5.1 (“Firms that are not current producers in a relevant market, but that would very likely provide rapid supply responses with direct competitive impact in the event of a SSNIP, without incurring significant sunk costs, are also considered market participants.”); *id.* (“if the relevant market is defined around targeted customers, firms that produce relevant products but do not sell them to those customers may be rapid entrants if they can easily and rapidly begin selling to the targeted customers”).

A patchwork approach might theoretically provide the nationwide geographic coverage required by enterprise customers. But it is unlikely to come close to matching the purchasing power of integrated OSSs, which buy volume not only for their substantial contract business involving customers of all sizes, but also to meet multi-billion dollar demand for online and brick-and-mortar retail sales. In addition, it seems highly unrealistic to expect a geographically dispersed jumble of dealers and suppliers of different sizes and sophistications to match OSSs in consistency, reliability, quality, technological ability, and customer service.

The customer switching costs associated with substituting a patchwork approach for an OSS are likely enormous. According to the results of a Staples-sponsored case study of the Guild Mortgage Company, the costs of substituting a patchwork approach for Staples Advantage can run to \$30,000 *per month*, or \$360,000 annually.<sup>32</sup> Consequently, on a hypothetical \$1 million annual contract with Guild, the merged firm apparently would be able to impose a price increase equivalent to as much as \$350,000, or 35%, without losing sales to a patchwork approach. Accordingly, it seems extremely unlikely that the actual or threatened use of a patchwork approach would defeat a SSNIP by the merged firm in the enterprise market.<sup>33</sup>

In Office Depot/Office Max, the Commission also noted that OSSs might be further disciplined by supplier co-operatives capable of serving large customers, and that the merged firm might face potential competition from suppliers in adjacent markets for janitorial and industrial products.<sup>34</sup> We think both are unlikely here.

Nationwide co-operatives of small suppliers can provide an integrated alternative to a patchwork approach, may have the ability to provide the nationwide geographic coverage that enterprise customers require, and appear to be working toward comparable technological offerings.<sup>35</sup> And co-operatives have the advantage of being in the market now and actively competing for large customers. However, co-operatives' near total inability to constrain the OSSs is evident in their demonstrable lack of success in the enterprise market.<sup>36</sup> Publicly available information suggests that, with rare exceptions, the national co-operatives have consistently lost out to OSSs because of substantial purchasing power disadvantages and other inefficiencies that have prevented them from

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<sup>32</sup> See *Saving Time and Money Through Consolidation*, WHAT'S NEW IN SPEND MANAGEMENT 20, MY PURCHASING CENTER (Staples Advantage Sponsored Case Study), [http://www.mypurchasingcenter.com/files/4714/0354/8637/Staples\\_Advantage\\_eGuide\\_5.pdf](http://www.mypurchasingcenter.com/files/4714/0354/8637/Staples_Advantage_eGuide_5.pdf) (last visited July 20, 2015) ("Guild has gone from managing 20 suppliers to 1, and has reduced the number of invoices they process per week by 80 percent. Consolidation in the office supply category alone has resulted in \$30,000 in savings per month through improved product standardization. And workload has been reduced by 40 hours a month."); see also Staples Advantage Brochure, available at <http://www.staplesadvantage.com/assets-sa-unification/pdfs/capabilities-brochure.pdf>. ("Managing multiple suppliers could be costing your organization hundreds or even thousands of dollars. Instead, a comprehensive supply program from a single provider will provide negotiating power and cost-efficiencies.")

<sup>33</sup> We encourage the Commission to interview procurement officers at Guild, as well as other companies that have switched from a patchwork approach to an OSS platform or vice versa, regarding the challenges of substituting a patchwork approach for an OSS.

<sup>34</sup> Closing Statement, *supra* note 4.

<sup>35</sup> Point Nationwide, for example, advertises that "We have a Microsoft based, state-of-the-art ERP system that provides visibility and flexibility. We provide scalable and customizable reporting, billing, and delivery solutions via one platform at Internet speed across the nation." POINT NATIONWIDE, *About Us*, <https://www.pointnationwide.com/about-us.html> (last visited July 20, 2015). But it does not appear to be PunchOut certified. See *infra* note 37.

<sup>36</sup> See Horizontal Merger Guidelines § 9 ("The Agencies consider the actual history of entry into the relevant market and give substantial weight to this evidence.")

constraining what were once the “big three” and are now the “big two.” Publicly available information thus suggests they would stand no chance at all against the “big one.”

At first blush, rapid entry or potential competition from large suppliers in adjacent markets, such as industrial and janitorial supplies, may appear to pose a competitive threat. These firms likely can provide ample nationwide geographic coverage, may use very similar or overlapping e-procurement technology solutions,<sup>37</sup> and likely have existing sales relationships with many enterprise customers who make contract purchases in several categories. Moreover, these customers would stand to realize internal efficiencies by working with a single supplier for all of their office supply needs in addition to industrial or janitorial needs.<sup>38</sup> However, to be credited in merger analysis, rapid entrants must be “very likely [to] provide rapid supply responses with direct competitive impact . . . without incurring significant sunk costs,” while entry by potential competitors must be “timely, likely and sufficient in magnitude, character and scope.”<sup>39</sup> Here, each seems doubtful.

To compete effectively for enterprise customers, these adjacent firms would not only have to enter the market nationally across a huge number of different office supply categories, but they would have to invest enormously in those categories to become capable of offering comparable volume discounts and rebates. They would also have to invest heavily in re-branding their entire business and learning how to adequately deliver a different set of unique products and services to enterprise office supply customers, which would likely exceed reasonable boundaries of inventory management given the huge number of products across both industries.

We are not aware of any firm that has ever even tried to fully compete as *both* an OSS *and* a comparably large industrial or janitorial supplier simultaneously, and certainly none that has ever done so successfully.<sup>40</sup> While there is some evidence of entry by industrial and janitorial supply firms and OSS’s in each others’ businesses at the margins, neither has expanded to compete in the other’s market *beyond* the margins, and sophisticated large customers continue to do contract business with both kinds of firms despite the prospect of additional savings through supplier consolidation.<sup>41</sup> We see no evidence to suggest that large suppliers in adjacent industrial and

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<sup>37</sup> A variety of third parties offer e-procurement software solutions that allow procurement officers to purchase products on the Internet by connecting them through intermediaries. Ariba, a subsidiary of SAP, markets a solution called “PunchOut” to enterprise-level suppliers and customers. When buyers and sellers integrate into the PunchOut platform, a buyer can access the seller’s inventory from within its own procurement system and place orders and gather pertinent information. At present the merging firms are the only two office supply sellers that are “Ariba Ready” at the highest “Platinum” level. However, Grainger is also an Ariba Ready Platinum Seller. *See* ARIBA, *Ariba Ready Platinum Sellers*, <http://www.ariba.com/suppliers/subscriptions-and-pricing/b2b-e-commerce/ariba-ready-platinum> (last visited July 20, 2015). The extent to which the Ariba product alone, or another similar product, might serve as a viable substitute for an OSS platform’s solutions and services is not apparent based on our review of publicly available information.

<sup>38</sup> *See* MITCHELL & SAWCHUK, *supra* note 25 at 3 (encouraging firms to try to seek cost savings by consolidating suppliers even beyond traditional categories, such as by relying on industrial suppliers for office supplies or vice versa).

<sup>39</sup> Horizontal Merger Guidelines §§ 5.1, 9.

<sup>40</sup> *See id.* § 9 (“The Agencies consider the actual history of entry into the relevant market and give substantial weight to this evidence.”).

<sup>41</sup> *See* Horizontal Merger Guidelines § 9.3 (entry that is sufficient must “replicate at least the scale and strength of one of the merging firms”); *cf.* U.S. Dept’t of Justice & Fed. Trade Comm’n, Commentary on the Horizontal Merger Guidelines 31 (2006) (“The Agencies rarely find evidence that repositioning would be sufficient to prevent or reverse what otherwise would be significant anticompetitive unilateral effects from a differentiated products merger. Repositioning of a differentiated product entails altering consumers’ perceptions instead of, or in addition to, altering its physical properties. The former can be difficult, especially with well-established brands, and expensive efforts at doing so typically pose a significant risk of failure and thus may not be undertaken.”).

janitorial supply markets ever have or ever will serve as a rapid entrant or potential competitive constraint on OSSs in the enterprise market, except at the margins.<sup>42</sup>

#### 4. Amazon Business Likely Does Not Count as an Enterprise Market Participant

The Commission did not identify any other actual or potential alternative sources of supply for the broader contracting channel in 2013. Here, however, it will likely consider the potential disciplining force of Amazon's business-to-business marketplace. Amazon launched an online business-to-business wholesale platform for office supplies and other products called "Amazon Supply" in April 2012, which it rebranded and relaunched as "Amazon Business" in April 2015.<sup>43</sup> With its vast network of wholesale fulfillment centers, Amazon likely could provide nationwide geographic coverage (and timely shipping) to enterprise customers on par with, or approaching, the OSSs. Although it may not have existing enterprise relationships comparable to those of adjacent firms in industrial or janitorial supplies, Amazon appears to be working toward providing adequate technological solutions, and as an e-commerce superpower, it likely brings talent, capital and expertise to the task.<sup>44</sup> Furthermore, because its marketplace is bolstered by a large network of competing third-party sellers, it also likely has the capacity to offer deep inventory across a broad class of office supply categories.

Notwithstanding these capabilities, however, in the near term Amazon Business is at best likely to be a potentially disruptive force for the merged firm's business-to-business Quill customers, not its enterprise contract customers. That is because Amazon cannot meet either of what the Commission identified as contract customers' core needs: to "receive discounted pricing based on actual or anticipated purchase volume" and to "order office products at previously negotiated prices."<sup>45</sup>

First, although Amazon may have tremendous purchasing power as a firm, it likely has no prospects of ever matching (or perhaps ever coming close to matching) the OSSs' purchasing power in the office supply category. At present Amazon obviously lacks the necessary demand to buy large volume, but in the long run it is unlikely ever to generate this demand, even if it is successful. Amazon's own business model is to offload much of its demand to a network of third-party sellers who are welcomed onto its platform in exchange for a percentage of their sales. Consequently, it

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<sup>42</sup> Of course, enterprise customers could incorporate an industrial or janitorial supplier's limited line of office supplies as part of a patchwork approach, but as discussed *supra*, patchwork approaches are inexorably a losing proposition because of substantial foregone volume discounts and far too many inefficiencies that likely make it unrealistic for enterprise customers to switch away from an OSS in response to a SSNIP. See *supra* Section III.A.3.

<sup>43</sup> AMAZON, *Introducing Amazon Business: Everything You Love About Amazon, For Your Business*, Press Release (Apr. 28, 2015), [phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2040634](http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2040634). Amazon's original "Amazon Supply" site is no longer available, but apparently the platform has carried office supplies dating back to 2012. See Sarah Leung, *Amazon Wholesale Scales up with the Launch of Amazon Business*, HANDSHAKE (May 1, 2015), <https://www.handshake.com/blog/amazon-wholesale-scales-up-with-the-launch-of-amazon-business/> (noting Amazon Supply carried 2.25 million products "which were largely confined to categories like hardware, scientific/lab equipment, and office supplies").

<sup>44</sup> Among other things, Amazon Business advertises that its customers can "create approval workflows to enable better spending controls," "integrate leading third-party procurement solutions," and "add purchase order or reference numbers to assist with reporting and account reconciliation." AMAZON, *Introducing Amazon Business: Everything You Love About Amazon, For Your Business*, Press Release (Apr. 28, 2015), [phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2040634](http://phx.corporate-ir.net/phoenix.zhtml?c=176060&p=irol-newsArticle&ID=2040634). It also supports PunchOut. AMAZON, *Amazon PunchOut*, [http://www.amazon.com/gp/help/customer/display.html/ref=b2b\\_ppi\\_2990?nodeId=201722990](http://www.amazon.com/gp/help/customer/display.html/ref=b2b_ppi_2990?nodeId=201722990); see *supra* note 37.

<sup>45</sup> Closing Statement, *supra* note 4.

seems unlikely that Amazon will ever be able to offer especially large volume discounts at all, let alone on par with the OSSs. Indeed, information we collected as part of our research indicates that large enterprise customers are unlikely to consider Amazon a credible alternative to the merging parties to meet their unique demand for office supply products and services.

Second, because Amazon cannot negotiate on behalf of its third-party sellers, it has no ability to offer contract service. To be sure, Amazon could go after the contract business of enterprise customers on its own, but without its network of third-party sellers, Amazon is a smaller competitor in the office supply space. And to do so it would likely have to depart from its longstanding business model and embrace all the encumbrances of contract selling, including dedicated support staff and customer service, and working much more closely with customers one-on-one. This seems highly unlikely at a time when Amazon is just entering the business-to-business market in earnest, it has no experience or past history of making contract sales, and there is tremendous “low hanging fruit” in ordinary (i.e. non-contract) online wholesale sales.

Looking far ahead, even if Amazon were to quickly and successfully scale up its new platform in the office supply market and vastly improve its integration and technological capabilities, it would likely still be many years before Amazon could demonstrate the kind of pricing, availability and service stability and consistency needed to induce enterprise customers into a shift away from an established business model. It would be speculative to expect Amazon will constrain the merged firm in the enterprise contract market in the near term.<sup>46</sup>

#### **B. The Proposed Merger Threatens a Range of Anticompetitive Effects, Including Higher Prices and Lower Quality, Diminished Data Security, and Diminished Supply-Channel Stability**

The primary anticompetitive threat posed by Staples/Office Depot is the loss of head-to-head competition between the two merging firms in either the enterprise market or the broader contract market. This is a very different scenario than Office Depot/OfficeMax, where the Commission found that the merging firms were rarely each other’s closest competitors in the broader contracting market, and the merged firm would continue to face strong competition from Staples.<sup>47</sup> Here, publicly available information suggests the enterprise market (and perhaps the better part of the broader contract market) is dominated by the two merging firms, that they are by far each other’s closest competitors, and that one is nearly always the runner up to the other when both submit contract bids in response to requests for proposals from enterprise customers.<sup>48</sup>

As discussed above, there may well be a relevant product market for the sale of consumable office supplies to large enterprise customers, and it is possible that none of the conceivable candidates for substitution can be counted as market participants that would constrain the merged firm. If that is

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<sup>46</sup> Of course, Amazon Business could be part of a patchwork approach, but the inefficacy of patchwork approaches has already been established. *See supra* Section III.A.3 & note 42.

<sup>47</sup> Closing Statement, *supra* note 4.

<sup>48</sup> *See* Horizontal Merger Guidelines § 6.1 (“The extent of direct competition between the products sold by the merging parties is central to the evaluation of unilateral price effects. Unilateral price effects are greater, the more the buyers of products sold by one merging firm consider products sold by the other merging firm to be their next choice.”); *id.* § 6.2 (unilateral effects in markets characterized by bargaining and negotiation “are likely in proportion to the frequency or probability with which, prior to the merger, one of the merging sellers had been the runner-up when the other won the business. These effects also are likely to be greater, the greater advantage the runner-up merging firm has over other suppliers in meeting customers’ needs. These effects also tend to be greater, the more profitable were the pre-merger winning bids.”).

the case, the proposed transaction is a merger to monopoly that should be easily condemned.<sup>49</sup> However, even if there are additional market participants in the enterprise market, or in the entire contract market, the merger still may threaten a range of significant unilateral anticompetitive effects.

Most obvious is that without its closest competitor, Staples will not have to compete nearly as hard on price or non-price terms to win or keep the business of enterprise and other contract customers. As discussed above, those customers demand the requisite mix of purchasing power, geographic coverage, technological integration, stability, and volume discounting that OSSs provide. With the loss of competition will inevitably come higher prices and diminished quality and service.

Given the role of volume discounting in the enterprise market, price effects from the merger require particularly close scrutiny. Because there is no precedent for a nationwide OSS monopoly, the Commission does not have a perfect natural experiment to make a direct comparison based on past experience. However, it can seek other useful evidence of price effects by reviewing previous transactions, including not just Office Depot/OfficeMax, but also Staples/Corporate Express in 2009. Subsequent to that merger, Staples apparently offered ultimatums to former Corporate Express customers and refused service to those who would not meet its terms.<sup>50</sup> Any price increases or degradation in service that may have resulted from previous acquisitions by either merging firm would constitute powerful evidence of post-merger adverse effects under the Horizontal Merger Guidelines.<sup>51</sup> The AAI urges the Commission to interview former Corporate Express customers who received ultimatums from Staples and avail itself of any other information that may lead to direct evidence of anticompetitive price effects.

The Commission also should consider harm along various dimensions of quality competition. For example, there is cause for concern that the proposed transaction threatens harm to cyber security and privacy competition between the merging firms. In an expansive e-commerce environment, OSSs and other providers must compete hard to be the most secure stewards of sensitive data for all of their customers. In December 2014, Staples was victimized by a massive retail data breach caused by malware believed to be uploaded through point-of-sale terminals at many of its retail locations. It responded by emphasizing in press releases that “Staples is committed to protecting customer data,” and “in light of Staples’ commitment to protecting its customers,” it offered a variety of complimentary identity protection, credit monitoring, and identity theft services to affected customers.<sup>52</sup> Both before and after the recent retail breach, the merging firms have competed on security and privacy in the contract market as well.<sup>53</sup>

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<sup>49</sup> See *id.* § 6.0.

<sup>50</sup> See *Staples, Inc., Q3 2009 Earnings Call Transcript*, SEEKING ALPHA (Dec. 1, 2009, 3:34 PM), <http://seekingalpha.com/article/176001-staples-inc-q3-2009-qtr-end-10-31-09-earnings-call-transcript> (“Selectively we have given ultimatums to [some former Corporate Express] customers to change their behaviors or we in fact walk away. There have been some of those. In some cases some of those have gone to our competitors. That doesn’t worry us.”) (quoting Joseph Doody, President of North American Delivery).

<sup>51</sup> See Horizontal Merger Guidelines § 2.1.2 (historical events that are “informative regarding the competitive effects of the merger” include “recent mergers . . . in the relevant market”).

<sup>52</sup> STAPLES, *Staples Provides Update on Data Security Incident*, News Release (Dec. 19, 2014), <http://investor.staples.com/phoenix.zhtml?c=96244&p=irol-newsArticle&ID=2001185>.

<sup>53</sup> Office Depot has emphasized in advertising to BSD customers, for example, that its “dedicated, secure website offers a fast, convenient and secure way to order everyday office products.” OFFICE DEPOT, *Learn about BSD: Service Capabilities*, <https://business.officedepot.com/specialLinks.do?ID=servicecapab&TITLE=Service+Capabilities&template=login> (last visited July 20, 2015). Staples has emphasized to contract customers overseas that “We know that when ordering

Eliminating Office Depot eliminates any non-price competition between the merging firms to win business through the provision of superior cyber security to enterprise and other contract customers. To be sure, every online business has independent incentives to meet high cyber security and privacy standards for reasons that have nothing to do with competition. And if cyber security competition is robust in the retail market, contract customers may stand to benefit indirectly from that competition. But to the extent the merging firms compete to win business by exceeding cyber security expectations for contract customers in particular, that valuable competition would be lost after the merger.

Another threatened non-price harm is the introduction of extreme fragility into what is likely the only supply channel capable of serving enterprise customers.<sup>54</sup> The formation of a single monopoly OSS will have a whipsaw effect on enterprise customers, because it not only creates a stronger, more dominant *supplier*, but it simultaneously creates a weaker, more fragile supply *channel*, by eliminating all remaining redundancy in the channel.<sup>55</sup> In the event of a short or long term disruption to the merged firm's operations, enterprise customers likely would have no ability to switch to a stable alternative capable of meeting their needs. If Staples Advantage customers rather than retail customers were to be impacted by another data breach, for example, these customers likely would be put to the Hobson's choice of continuing to make sensitive data available on a compromised platform or else enduring a serious internal disruption for not being able to adequately source office supplies.

As AAI has argued in other contexts, “[s]upply chains featuring only a few competitors and high entry barriers at critical junctures are excessively exposed to the risk of disruption and collapse following an exogenous shock,” such as “input-market disruptions, political events, weather, or quality control problems.”<sup>56</sup> Post-merger, enterprise customers likely would bear the full risk of this exposure in a monopolized OSS channel, and therefore would be forced to internalize the increased risk of the channel's collapse.

Even if the Commission determines there is not a distinct relevant product market for the sale of office supplies to enterprise customers, or that such a market includes additional market participants beyond OSSs, increased fragility in the OSS channel nonetheless threatens significant

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online you need a secure ordering environment; you need to have confidence that your payment transactions and personal information are protected. We work closely with specialists in online payment and data protection to ensure all of your transactions are safe and secure. Our information privacy policy and eBusiness expertise means your transactions have the highest security levels, whether you use our online Webshop or a third party procurement platform.” STAPLES, *Staples Advantage Secure Ordering: Protecting Your Privacy Online*, <http://www.staples.eu/what-we-do/staples-advantage/secure-ordering/> (last visited July 20, 2015).

<sup>54</sup> See *supra* section III.A.2-4.

<sup>55</sup> See Norman W. Hawker & Thomas N. Edmonds, *Avoiding the Efficiency Trap: Resilience, Sustainability and Antitrust*, Antitrust Bull. (forthcoming) (draft on file with the author); see also G. A. Zsidisin et al., *An Institutional Theory Perspective of Business Continuity Planning for Purchasing and Supply Management* 43 INT'L J. PRODUCTION RES. 3401 (2005) (“recent events have emphasized the risk that exists in business and the increasingly fragile nature of the modern supply chain”); Walid Klibi et al., *The Design of Robust Value-Creating Supply Chain Networks: A Critical Review* 203 EUR. J. OPERATIONAL RES. 283, 285 (2010); N. Salehi Sadghiani et al., *Retail Supply Chain Network Design Under Operational and Disruption Risks*, 75 TRANSP. RES. PART E: LOGISTICS & TRANSP. REV. 95, 97 (2015); Adrian E. Coronado Mondragon & Christian E. Coronado Mondragon, *Rethinking the Management of Technological Innovations, Product Complexity and Modularity: The Effects of Low-Probability, High-Impact Events on Automotive Supply Chains*, in DRIVING THE ECONOMY THROUGH INNOVATION AND ENTREPRENEURSHIP 525, 528 (Chiranjit Mukhopadhyay et al. eds. 2013); Mandal Santanu, *Supply Chain Resilience: A State-of-the-Art Review and Research Directions*, 5 INT'L J. DISASTER RESILIENCE BUILT ENV. 427, 428 (2014).

<sup>56</sup> See Diana L. Moss & C. Robert Taylor, *Short Ends of the Stick: The Plight of Growers and Consumers in Concentrated Agricultural supply chains*, 2014 WIS. L. REV. 337, 359 (2014).

anticompetitive effects. The Commission should inquire, for example, whether the remaining alternative supply channels would even have the capacity to meet market demand in the event of a disruption to the merged firm. If they would not, or if a temporary or long term disruption to the only firm in the OSS channel (and hence to the channel itself) would result in significant cost increases and inefficiencies, the broader contract market would be exposed and forced to internalize the increased risk of collapse. The Commission should ensure that allowing the proposed transaction would not expose the nation's business-to-business supply of office products to this kind of systemic failure.

### C. Entry

If there is a relevant market for enterprise customers, and repositioning by existing firms is unlikely to counteract the proposed transaction's anticompetitive effects in this market (or the broader contract market), the Commission will consider whether new entry would be timely, likely, and sufficient in magnitude, character and scope so as to discipline any post-merger price increase. In 1997, Judge Hogan concluded that barriers to new OSS entry were insurmountably high. He explained:

A new office superstore would need to open a large number of stores nationally in order to achieve the purchasing and distribution economies of scale enjoyed by the three existing firms. Sunk costs would be extremely high. Economies of scale at the local level, such as in the costs of advertising and distribution, would also be difficult for a new superstore entrant to achieve since the three existing firms have saturated many important local markets.<sup>57</sup>

If anything has changed since Judge Hogan's opinion, barriers to new OSS entry have become significantly higher, because new challenges in the retail market make it much harder to enter both the retail and contract markets. First, there are now two remaining OSSs that dominate the retail market. Second, the retail market presents very little opportunity for growth, as revenues and margins have been declining while traditional superstores continue to close in record numbers. Meanwhile, pens, paper, ink, toner and other traditional office products are becoming increasingly obsolete for retail (though not necessarily business) customers, and the market as a whole is being widely written off by analysts, which is why OSSs are looking for growth in the contract channel and in products and services other than traditional office supplies. New OSS entry is likely impossible.

Perhaps a new OSS entrant might operate exclusively online, or exclusively in the contract market, in which case it would avoid costs associated with achieving a large retail footprint nationally. However, such an entrant would still have to acquire or build a vast network of distribution facilities nationally, and it would be extremely difficult if not impossible for such an entrant to rapidly achieve the necessary economies of scale to compete with the merged firm in saturated markets. With a fraction of the merged firm's purchasing power prior to generating the necessary demand, a new "online-only" or "contract-only" entrant would have no meaningful prospects of winning enterprise business from the merged firm. Even if such hypothetical entry would be sufficient in magnitude, character and scope, which it likely would not, entry barriers would be extremely high.

Of course, if a new entrant were to enter only partially, offering a limited line of office supplies rather than the full line offered by OSSs, it too could avoid significant upfront costs. However, as discussed *supra* in the context of identifying market participants in the enterprise market, a partial entrant offering a limited line of office supplies is likely incapable of meaningfully competing, except

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<sup>57</sup> Fed. Trade Comm'n v. Staples, 970 F. Supp. 1066, 1087 (D.D.C. 1997).

as part of a patchwork approach. And patchwork approaches are likely unrealistic for enterprise customers because of substantial foregone volume discounts and direct and indirect cost-savings.<sup>58</sup> Partial entry likely would be insufficient in magnitude, character and scope to discipline the merged firm.<sup>59</sup>

#### D. Efficiencies

Staples has stated that it expects the strategic combination of the merging firms “to deliver at least \$1 billion of synergies by third full fiscal year post-closing,” as well as “[o]perational efficiencies and cost savings” that will accelerate Staples’ strategic plan, along with the ability “to optimize [its] retail footprint, minimize redundancy, and reduce costs.”<sup>60</sup> It predicts the transaction will be “[a]ccretive to [Earnings Per Share] in first year post-closing after excluding one-time integration and restructuring costs and purchase accounting adjustments.”<sup>61</sup>

Efficiencies are unlikely to rescue the proposed transaction because “[e]fficiencies almost never justify a merger to monopoly or near-monopoly.”<sup>62</sup> Even in a broader contract market, however, the proposed transaction is very unlikely to meet the agencies’ high bar for efficiencies claims. Efficiencies must be merger-specific, verifiable, and quantifiable to be cognizable.<sup>63</sup> And while “claims substantiated by analogous past experience” may be credited, “[p]rojections of efficiencies may be viewed with skepticism” for a number of reasons.<sup>64</sup>

First, while the AAI does not have access to the internal projections submitted by the merging firms, sweeping and vague efficiencies claims raise natural questions as to whether they would be merger-specific and demonstrably reduce marginal costs. Given the size of the standalone companies, it is fair to assume that both Staples and Office Depot have already achieved sizeable scale economies. While any claimed economies of coordination and improved opportunities for dynamic efficiency (i.e. innovation) are appealing in theory, it is well known that they are difficult to verify and to validate as merger-specific.<sup>65</sup>

Second, “efficiencies are most likely to make a difference in merger analysis when the likely adverse competitive effects, absent the efficiencies, are not great.”<sup>66</sup> When potential adverse competitive effects may be substantial, “extraordinarily great cognizable efficiencies would be necessary to prevent the merger from being anticompetitive,” and “the more they must be passed through to

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<sup>58</sup> See *supra* section III.A.3 & notes 42, 46.

<sup>59</sup> See Horizontal Merger Guidelines § 9.3 (entry that is sufficient must “replicate at least the scale and strength of one of the merging firms”); *id.* (entry is insufficient where products offered by entrants “are not close enough substitutes to the products offered by the merged firm to render a price increase by the merged firm unprofitable,” such as where there are “limitations on the capabilities of the firms best placed to enter” or “reputational barriers to rapid expansion by new entrants”); *cf.* U.S. Dept’t of Justice & Fed. Trade Comm’n, Commentary on the Horizontal Merger Guidelines 31 (2006) (discussing the challenges of repositioning).

<sup>60</sup> STAPLES, *Staples Inc. Announces Acquisition of Office Depot Inc.*, Slide Presentation at 7 (Feb. 4, 2015), <http://investor.staples.com/phoenix.zhtml?c=96244&p=irol-eventDetails&EventId=5184237> (scroll to “Supporting Materials” and download “Presentation”).

<sup>61</sup> *Id.*

<sup>62</sup> Horizontal Merger Guidelines § 10.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> See, e.g., *United States v. Oracle Corp.*, 331 F. Supp. 2d 1098, 1173-1175 (N.D. Cal. 2004); *Fed. Trade Comm’n v. H.J. Heinz Co.*, 246 F.3d 708, 722-724 (D.C. Cir. 2001).

<sup>66</sup> Horizontal Merger Guidelines § 10.

customers,” principally in the form of lower prices.<sup>67</sup> In light of the competitive problems discussed *supra*, the proposed transaction is unlikely to pass this test. In the enterprise market in particular, but also in the broader contract market, the merged firm would have little incentive to pass on any gains from the merger. If the bulk of claimed cost synergies are fixed-cost savings, they are much more likely to go to shareholders, as opposed to being passed on to consumers, in the short run. And even if savings were passed on in the longer run, they should not be assumed to benefit consumers in markets where there is probable competitive harm.

Third, cognizable efficiencies are assessed net of the costs incurred in achieving them.<sup>68</sup> There is mounting, demonstrable evidence that mergers often create difficult system integration problems, particularly as mergers of larger and larger systems have been proposed and poorly executed.<sup>69</sup> As a result, integration costs are often underestimated and integration times protracted, which should reduce a priori efficiencies estimates at the time of merger review.<sup>70</sup> That is certainly true here.

Not just in office supplies, but in many important industries throughout the United States,<sup>71</sup> skepticism toward mega deals claiming cost efficiencies, consumer benefits, and enhanced investment and innovation is increasingly appropriate. A 2004 McKinsey study found that 70 percent of examined mergers failed to achieve expected revenue synergies, and managers in 40 percent failed to fully deliver on estimated cost savings.<sup>72</sup> As managers struggle with the complexity of integrating large and complex operations, merged firms can fall short of efficiencies targets and lose customers in the process – thus sacrificing revenue synergies. Many of these problems reduce claimed efficiencies and increase integration costs. They may even go the step further of creating merger-related *inefficiencies* or spillovers in the form of consumer inconvenience and degraded quality. Such failures are likely to be felt by consumers through higher prices, lower quality, and less innovation. We encourage the Commission to be highly skeptical of claimed efficiencies in Staples/Office Depot.

## E. Remedies

The merger agreement reportedly includes a provision obligating Staples to divest assets that delivered up to \$1.25 billion of Office Depot’s domestic revenues in 2014 as a condition of securing antitrust approval.<sup>73</sup> However, divestitures that would adequately replace the competition lost in the enterprise market do not seem feasible. Indeed, the Commission should be extremely skeptical of a

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<sup>67</sup> *Id.* In the 1997 *Staples* case, the court concluded that the magnitude of the likely pass-through rate was insufficient to rebut the presumption that the proposed merger would substantially lessen competition. *See* Fed. Trade Comm’n v. Staples, Inc., 970 F. Supp. 1066, 1090 (D.D.C. 1997).

<sup>68</sup> *See* Horizontal Merger Guidelines § 10.

<sup>69</sup> *See, e.g.,* Scott A. Christofferson et al., *Where Mergers Go Wrong* 2-3, MCKINSEY ON FINANCE (2004), available at <http://www.ceoexpress.com/asp/mckinseyalls4.asp?id=m0286>; *see also* DIANA L. MOSS, DELIVERING THE BENEFITS? EFFICIENCIES AND AIRLINE MERGERS (Nov. 21, 2013), <http://www.antitrustinstitute.org/content/aai-issues-white-paper-delivering-benefits-efficiencies-and-airline-mergers>.

<sup>70</sup> MOSS, *supra* note 70.

<sup>71</sup> *See* Eduardo Porter, *Concentrated Markets Take a Big Toll on Economy*, N.Y. TIMES, May 28, 2014, at B1, available at [http://www.nytimes.com/2014/05/28/business/economy/concentrated-markets-take-big-toll-on-economy.html?src=rechp&\\_r=2](http://www.nytimes.com/2014/05/28/business/economy/concentrated-markets-take-big-toll-on-economy.html?src=rechp&_r=2).

<sup>72</sup> Christofferson et. al, *supra* note 69.

<sup>73</sup> *Staples: Were Shareholders Sold A Bill Of Goods? Office Depot Shareholders Are The Real Winners*, SEEKING ALPHA (Mar. 2, 2015, 2:52 AM), <http://seekingalpha.com/article/2963036-staples-were-shareholders-sold-a-bill-of-goods-office-depot-shareholders-are-the-real-winners>.

divestiture package designed to transform a regional supplier into a legitimate national enterprise competitor.

In 2014, Staples reported \$16 billion in domestic sales and 51 domestic distribution facilities, while Office Depot reported \$12.1 billion in domestic sales and 66 domestic distribution facilities.<sup>74</sup> W.B. Mason, the next largest regional supplier, reportedly has only \$1.5 billion in total annual sales, and according to a map on its website, it has 28 warehouses in 23 states.<sup>75</sup>

Post-merger, and prior to divestitures, Staples therefore would have a \$28.1-billion-to-\$1.5-billion revenue advantage over W.B. Mason, and a 117-to-28 distribution facility advantage. These disparities have grave implications for the ability of any proposed remedy to restore competition in light of economies of scale in the enterprise market.

For perspective, consider that the district court in *Sysco* had grave concerns about a divestiture package where a putative buyer would have nearly one half the merged firm's \$48.2 billion in post-divestiture sales and one-third of the merged firm's over 100 post-divestiture distribution centers.<sup>76</sup> The court concluded that the putative buyer, post-divestiture, would have faced "a significant disadvantage in competing for national customers."<sup>77</sup>

In contrast, the merged firm here would have to divest over \$8 billion in domestic sales and nine distribution facilities to W.B. Mason *just to get to* the nearly-one-half-sales and one-third-distribution-center ratios that the *Sysco* court definitively rejected. A proposed divestiture package that would not obviously derail the transaction, including the full amount of the \$1.25 billion commitment in the merger agreement, seems likely to be severely inadequate if there is a distinct relevant product market for enterprise contract customers.<sup>78</sup>

#### IV. The Retail Channel

The Commission's 2013 Closing Statement concluded that the Office Depot/OfficeMax merger was unlikely to substantially lessen competition in the retail market. First, the Commission found that mass merchants like Wal-Mart and Target and warehouse clubs like Costco and Sam's Club had proliferated and expanded their product offerings and sales of office supplies. Second, online sellers like Amazon had taken away substantial in-store sales. In the wake of these developments, the Commission found that OSS price zones and retail pricing were no longer dictated by the presence of other local OSSs. Instead, the Commission found that a majority of OSS products were being priced nationally, and products priced locally were accounting for non-OSS competition.<sup>79</sup>

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<sup>74</sup> Staples Inc., Annual Report (Form 10-K) 2015 (at C-43, 15); Office Depot, Inc., Annual Report (Form 10-K) 2015 (at 120, 62).

<sup>75</sup> Drew Fitzgerald & Liz Hoffman, *Staples Inks Deal to Buy Office Depot for \$6.3 Billion*, WALL ST. J. (Feb. 4, 2015, 6:40 PM), <http://www.wsj.com/articles/staples-agrees-to-buy-office-depot-1423051654> (reporting W.B. Mason revenues); W.B. MASON, *Locations*, <http://www.wbmason.com/AboutUs/locations.html> (last visited July 20, 2015) (identifying warehouses with blue dots).

<sup>76</sup> See Fed. Trade Comm'n v. Sysco, 2015 U.S. Dist. LEXIS 83482, \*173-74 (D.D.C. June 29, 2015); Memorandum in Support of Plaintiff Federal Trade Commission's Motion for Temporary Restraining Order and Preliminary Injunction at 35, Fed. Trade Comm'n v. Sysco, 970 F. Supp. 1066 (D.D.C. 1997).

<sup>77</sup> *Sysco*, 2015 U.S. Dist. LEXIS 83482 at \*174.

<sup>78</sup> Publicly information does clarify the viability of a divestiture remedy in an all contract customers market.

<sup>79</sup> Closing Statement, *supra* note 4.

The Commission did not address certain distinguishing factors among the different retail channels through which OSSs sell their products, however. Staples and Office Depot sell retail office products online, in traditional superstores, and via “omnichannel” stores, which offer a personalized buying experience that attempts to seamlessly deliver information, discount and reward offers, and products and services across all channels.<sup>80</sup> Omnichannel retailing also offers sellers unique insights into customer behavior through the ability to combine big data analytics with insights from in-store sales. While the merging firms’ pure-online business likely faces adequate competition from Amazon and other online retailers, the impact of the proposed transaction on the sale of office products through both traditional and omnichannel superstores requires closer scrutiny.

**A. The Transaction Is a Merger to Monopoly in Local Geographic Markets Where Traditional OSSs Are Unconstrained by Online and Non-OSS Competition**

AAI encourages the Commission to explore whether relevant markets for the sale of consumable office supplies through traditional OSSs, as defined in *Fed. Trade Comm’n v. Staples* in 1997, may exist in certain local geographic markets after 3-1 consolidation. In 2013, the Commission was able to measure the disciplining effect that online and non-OSS competition was having on traditional OSSs primarily in two- and three-firm local geographic markets. Here, the Commission should measure the disciplining effect of online and non-OSS competition in two-firm versus monopoly OSS markets, both before and after the Office Depot/OfficeMax transaction was cleared. Measuring pricing by OSSs in local geographic markets where one of the merging firms maintained a traditional OSS monopoly during the years before and after the Office Depot/Office Max merger, relative to pricing by OSSs in two- or three-firm local geographic markets during that time, would be instructive.

Where Staples and Office Depot have resorted to national pricing schemes or otherwise succumbed to competitive price discipline from online and non-OSS competition, the important question is whether the merged firm would have the ability and incentive to depart from these disciplined schemes to extract supracompetitive profits from local monopolies. The Commission should be particularly concerned if the merged firm would have the ability to switch to local monopoly retail pricing in local geographic markets that are under-served by non-OSS alternatives, such as rural areas where other mass merchants do not carry a full line of office supplies and customers may not have Internet access or be able to rely on prompt online delivery.

The Commission should explore whether the merged firm would have the ability and incentive to institute a dual strategy to price competitively in local markets that are more susceptible to online and non-OSS competition and to extract monopoly profits in local markets that are less susceptible to online and non-OSS competition.<sup>81</sup> Indeed, the merging firms apparently were pursuing cross-

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<sup>80</sup> Staples’ and Office Depot’s omnichannel stores integrate the online and in-store experiences in a variety of ways, including by providing in-store Internet kiosks that allow customers to shop for a wider variety of products, the ability to buy online and pick-up in store, a mobile platform that facilitates reward tracking and spending, and more. *See* STAPLES, *Staples’ Omnichannel Stores Showcase the Future of Retail*, News Release (Jun. 20, 2013), <http://investor.staples.com/phoenix.zhtml?c=96244&p=irol-newsArticle&ID=1831576>; OFFICE DEPOT, *New Purchase and Pick-up Options Provide Office Depot Customers with Even More Ways to Shop*, News Release (Jul. 17, 2013), <http://news.officedepot.com/press-release/products-and-services-news/new-purchase-and-pick-options-provide-office-depot-customer>.

<sup>81</sup> *See, e.g.*, Jennifer Valentino-Devries et al., *Websites Vary Prices, Deals Based on Users Information*, WALL ST. J., Dec. 24, 2012, , available at <http://www.wsj.com/articles/SB10001424127887323777204578189391813881534> (“A Wall Street

channel price discrimination online and in stores tied to both geography and the presence of other OSSs as recently as 2012.<sup>82</sup>

Post-merger, if Staples would find it economically rationale to switch away from disciplined pricing schemes to take advantage of traditional OSS monopolies in local geographic markets, consumers and small businesses in these markets stand to be heavily victimized by higher prices, diminished quality and diminished choice. For these customers, the merger could represent a return to the “bad old days” of the late 1990s, when OSSs had demonstrable local pricing power relative to the presence of other OSSs, except now it would be an even more pernicious monopoly market structure.<sup>83</sup> The Commission should be wary of the risk that approving the proposed transaction would facilitate this de-evolution in local geographic markets that are underserved by online and non-OSS alternatives.

## **B. The Commission Should Evaluate the Competitive Effects of Merging the Two Leading Omnichannel Suppliers of Office Products**

In 2013, the Commission correctly recognized that “in-store and online channel boundaries are blurring as OSS[s] seek to create a seamless customer experience by offering in-store pickup for online orders and using in-store Internet kiosks to order products online.”<sup>84</sup> However, the Commission did not address whether this development is a potentially important driver of differentiation between the OSSs and some of their brick-and-mortar and online counterparts.

Business and marketing experts recognize that we are currently in the early stages of a transition from single- and dual-channel retailing to omnichannel retailing.<sup>85</sup> Omnichannel retailers are developing distinctive competitive strategies that separate them from traditional and pure-online retailers,<sup>86</sup> and studies are beginning to show that they may have advantages, as well.<sup>87</sup> The merging firms happen to be two of the leaders in this ongoing transition and the only two omnichannel

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Journal investigation found that the Staples Inc. website displays different prices to people after estimating their locations. More than that, Staples appeared to consider the person’s distance from a rival brick-and-mortar store, either OfficeMax Inc. or Office Depot Inc. If rival stores were within 20 miles or so, Staples.com usually showed a discounted price.”).

<sup>82</sup> See *id.* (“Statistically speaking, by far the strongest correlation [in Staples’ online-pricing formula] involved the distance to a rival’s store from the center of a ZIP Code. That single factor appeared to explain upward of 90% of the pricing pattern.”); *id.* (“In the Journal’s tests, ZIP Codes whose center was farther than 20 miles from a Staples competitor saw higher prices 67% of the time. By contrast, ZIP Codes within 20 miles of a rival saw the high price least often, only 12% of the time.”); *id.* (“Staples.com showed higher prices most often—86% of the time—when the ZIP Code actually had a brick-and-mortar Staples store in it, but was also far from a competitor’s store.”); *id.* (“Prices varied for about a third of the more than 1,000 randomly selected Staples.com products tested. The discounted and higher prices differed by about 8% on average.”).

<sup>83</sup> As discussed *supra*, this market also is protected by extremely high entry barriers. Unlike in the enterprise contract channel, however, divestitures might ordinarily be a suitable remedy. However, because the proposed transaction is a merger to monopoly in the retail OSS market, it may be impossible to find a suitable buyer.

<sup>84</sup> Closing Statement, *supra* note 4.

<sup>85</sup> See, e.g., Erik Brynjolfsson et al., *Competing in the Age of Omnichannel Retailing*, MIT SLOAN MGMT. REV., Summer 2013, available at <http://sloanreview.mit.edu/article/competing-in-the-age-of-omnichannel-retailing/>.

<sup>86</sup> See *id.* (“To succeed in an omnichannel environment, retailers should adopt new strategies in areas such as pricing, designing the shopping experience and bundling relationships with customers.”).

<sup>87</sup> See David R. Bell et al., *How to Win in an Omnichannel World*, MIT SLOAN MGMT. REV., Fall 2014, available at <http://sloanreview.mit.edu/article/how-to-win-in-an-omnichannel-world/> (discussing results of regression analyses showing that eyeglass seller Warby Parker’s transition from only-only to multi-channel distribution strategy resulted in 9% increase in total sales, a significant decline in returns and associated shipping costs, and overall increased efficiency).

retailers principally devoted to the office supplies market. Although certain mass merchants and warehouse clubs have successfully begun transitioning to omnichannel retailing as well, they face distinct challenges in offering an integrated experience across a wider array of product categories. Moreover, several of the firms the Commission identified as competitive constraints in 2013 have not transitioned to omnichannel retailing at all. Amazon, in particular, has not meaningfully transitioned away from its pure-online model, nor have many other online sellers.

AAI encourages the Commission to examine the competitive effects of the merging firms' advantage as omnichannel retailers relative to many of the retail competitors identified in 2013. If further advances in omnichannel retailing lead to greater qualitative differences in the shopping experience at the merged firm, not to mention the merged firm's insight into customer behavior and ability to implement superior dynamic pricing and price discrimination strategies, the proposed transaction may have substantial and longlasting anticompetitive effects in retail markets, which the Commission would not have anticipated in 2013. This risk may be even more acute as the office products industry moves to incorporate consumer electronics, office furniture, and other items customers may want to touch, feel or test in person before purchasing online or in store, whether for pick-up or delivery. Omnichannel retailing strategies hold the most promise for these very products, and the merged firm can be expected to try to maintain its advantage going forward.

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For all of these reasons, AAI encourages the Commission to give particularly close scrutiny to the proposed combination of Staples and Office Depot.