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The American Antitrust Institute

Whole Foods Proposed Acquisition of Wild Oats: The FTC Has Earned Its Day in Court

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I. INTRODUCTION

The American Antitrust Institute (AAI) has conducted an independent review of the proposed acquisition of Wild Oats Markets, Inc. (Wild Oats) by Whole Foods Market, Inc. (Whole Foods). Whole Foods and Wild Oats are the two largest retailers of natural and organic products, including food, vitamins, health and body care, and household items. The two companies operate (or potentially operate through plans to enter) in 28 geographic markets in the U.S.

After three months of preliminary investigation, the Federal Trade Commission (FTC or the Commission) filed on June 6, 2007 a complaint in the U.S. District Court for the District of Columbia for a temporary restraining order and preliminary injunction to block the proposed merger. ***A hearing is scheduled for July 31, 2007*** to decide whether the FTC's application will be approved. If it is approved, in the normal course of events,

[1] Vice President and Senior Fellow, American Antitrust Institute (AAI). The American Antitrust Institute is an independent Washington-based non-profit education, research, and advocacy organization. Our mission is to increase the role of competition, assure that competition works in the interests of consumers, and challenge abuses of concentrated economic power in the American and world economy. For more information, please see www.antitrustinstitute.org. This briefing paper has been reviewed by individuals inside and outside the AAI and has been approved by the AAI Board of Directors. It should not be taken necessarily to reflect the views of any member of the Advisory Board. A list of our contributors of $1,000 or more is available on request.

the merging parties will walk away from the merger. If the preliminary injunction is denied, the parties may go through with their transaction, but the Commission may nonetheless subsequently challenge it in an administrative trial.

The AAI's review of the proposed merger has been informed by publicly available information. We believe this background provides an adequate understanding to frame the major competitive questions that are likely to be addressed at hearing in order to determine if the merger may tend substantially to lessen competition, thereby violating Section 7 of the Clayton Act and Section 5 of the Federal Trade Commission Act.

There has been a good deal of public criticism of the Commission for bringing this case, both by the parties themselves through an unusual website-based public relations initiative, and by such critics of antitrust as the Wall Street Journal.[2] ***The FTC cites to numerous factors and questions that make a highly compelling case for looking closely at whether a Whole Foods/Wild Oats combination will tend substantially to lessen competition. In our opinion, therefore, there is enough "smoke to suspect a fire." And rather than condemning the FTC--as some pundits have already done--the public should await the results of the hearing.***

The AAI believes that there are at least three major issues that are worthy of investigation at a hearing on the preliminary injunction:

- ***The legality of the proposed merger turns on product market definition.*** The Commission defines a relevant product market centered on the category of "premium natural and organic supermarkets." In such a highly concentrated market in 28 geographic regions across the U.S., the merger would eliminate the second largest competitor or a potential competitor. The merging parties make statements that support this market definition. But they also make statements that the relevant market is centered on full-line supermarkets and mass merchandisers selling natural and organic products, in which case the effect of the merger is *de*

[2] See, e.g., Holman W. Jenkins, Jr., "Whole Food Fight," *Wall Street Journal*, June 27, 2007.

minimis. Given this controversy, the appropriate scope of the relevant market will undoubtedly attract significant attention.

- ***An analysis of the merging parties' pricing data in relevant markets should be viewed as complementary to the parties' statements that the purpose of their merger is to avoid competition.*** Whole Foods' John Mackey has made a number of public statements regarding the motives for the merger. Some of these statements reflect legitimate objectives such as cost savings, but others reflect a clear desire to stifle competition. In light of this, "natural experiments" using price data to determine if existing or potential competition discipline pricing by the merging parties should be viewed as a complement to anticompetitive motives in developing evidence that the merger would tend substantially to lessen competition.

- ***The merger's effect on eliminating a potential competitor deserves equal attention to the elimination of an existing rival in the relevant market.*** Whole Foods' John Mackey clearly acknowledges that one motive for the merger is to eliminate the single competitor which has the scale and brand identity that could serve as a "toe hold" for entry or expansion by a Whole Foods' rival. This possible effect of the merger deserves significant scrutiny.

II. BACKGROUND

On February 21, 2007, Whole Foods and Wild Oats entered into an agreement in which Whole Foods proposed to acquire all of the voting securities of Wild Oats for $671 billion in cash and assumed debt. Whole Foods has acquired 18 other natural and organic retailers since its founding in 1980, including Fresh Fields, Harry's Farmer's Market, and Nature's Heartland. None of these transactions were opposed by the Commission. Whole Foods estimates that 25 percent of Whole Foods' growth has come from acquisitions and 75 percent from opening new stores.[3] In 2006, Whole Foods had estimated revenues of about $5.6 billion across 191 stores in the U.S., Canada, and the United Kingdom. Wild Oats has about $1.2 billion in revenue with 110 stores in the U.S. and Canada.

[3] "Whole Foods Market, Wild Oats, and the Federal Trade Commission." June 19, 2007. Online. Available http://www.wholefoods.com/blogs/jm/archives/2007/06/whole_foods_mar_1.html#2. (wholefoods.com).

III. ISSUES LIKELY TO BE RAISED IN A HEARING ON THE PRELIMINARY INJUCNTION

The three issues likely to be raised at the hearing on the preliminary injunction outlined in the previous section appear frequently in publicly available information regarding the proposed merger. They have generated significant controversy and, in some cases, contradictory statements by the merging parties, as discussed in the following sections.

A. The Legality of the Proposed Merger Turns on Product Market Definition

In a website posting dated June 19, 2007, 13 days after the FTC filed their complaint in federal district court, Whole Foods Chairman and CEO John Mackey reveals a number of reasons for acquiring Wild Oats. He states that these reasons were provided to his Board of Directors prior to the first Board Meeting to discuss the deal. They include, among others:

> "Elimination of a competitor--they compete with us for sites, customers and Team Members."[4]

This statement clearly recognizes a relevant market that includes both Whole Foods and Wild Oats.

The FTC argues in its complaint for a separate category of "premium natural and organic supermarkets" as the relevant product market. It notes, for example, a supporting statement in Whole Foods' 2006 annual report:

> "'We believe our heavy emphasis on perishable products differentiates us from conventional supermarkets. . .'"[6]

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[4] wholefoods.com.

[6] *Federal Trade Commission, v. Whole Foods Market, Inc. and Wild Oats Markets, Inc.*, Complaint for Temporary Restraining Order and Preliminary Injunction Pursuant to Section 13(b) of the Federal Trade Commission Act, Case No. 1:07-cv-01021 (Complaint), June 6, 2007, at 8.

The Commission quotes Wild Oats most recent 10K to similar effect:

> "'. . .[Wild Oats] believe[s] that conventional supermarkets still lack the concentration on a wide variety of natural and organic products, and emphasis on service and consumer education that our stores offer.'"[7]

The FTC complaint goes on to allege that Whole Foods believes that customers do not view other channels that sell natural and organic foods as alternatives. For example, Mr. Mackey states that:

> "'Wal-Mart doesn't sell high quality perishable and neither does Trader Joe's. . .[t]hat is why Whole Foods coexists so well with [Trader Joe's] and it is also why Wal-Mart isn't going to hurt Whole Foods.'" [8]
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> "'Safeway and other conventional retailers will keep doing their thing – trying to be all things to all people . . .they can't really effectively focus on Whole Foods Core Customers without abandoning 90% of their own customers.'" [9]
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> "'Whole Foods is "a company that is authentically committed to its mission of natural/organic/healthy foods. Its core customers recognize this authenticity and it creates a customer loyalty that will not be stolen away by conventional markets who sell the same products. Whole Foods has created a "brand" that has real value for millions of people.'" [10]

However, in a June 19 website posting (after the FTC Complaint was issued), Mr. Mackey argues for a broader all-supermarket market definition. He acknowledges the existence of a "premium natural and organic supermarket" but states that Whole Foods is the only company in that market.[11] At the same time, he asserts that Whole Foods

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[7] Ibid, at 10.

[8] Ibid, at 8.

[9] Ibid, at 9.

[10] Ibid, at 9.

[11] wholefoods.com. Mr. Mackey states specifically: "Is there actually a separate category of "premium natural and organic supermarkets"? Let me state quite clearly up front that there absolutely is!" He goes on

competes with conventional supermarkets that offer some selection of natural and organic foods:

> "Whole Foods doesn't merely compete with other natural foods supermarket companies such as Wild Oats, but also with natural foods discount chain Trader Joe's, upscale perishable supermarkets such as Wegman's and Central Market, new supermarket created natural foods stores such as Green Wise by Publix and Sunflower by SuperValu, over 200 food co-ops around the United States, remodeled upscale supermarket stores such as Safeway's Lifestyle stores and HEB's Platinum stores, Sprouts, thousands of local farmers' markets, and thousands and thousands of supermarkets selling natural and organic foods, and most recently Wal-Mart. Soon Tesco, one of the largest retailers in the world will be opening hundreds of stores in western United States-stores which are rumored will compete with Trader Joe's and Whole Foods. Indeed, Whole Foods faces more competition today than ever before in our entire history!" [12]

Aside from the apparent reversal of Whole Foods' views on relevant markets, the controversy summarized above begs the legitimate question: Which product market is it to be? The answer to this question has significant implications. For example, if the product market is defined as "premium natural and organic supermarkets," the effect of the merger is dramatic. Combining Whole Foods and Wild Oats would eliminate one of only two or three sellers, thereby increasing concentration in already highly concentrated markets beyond the thresholds specified in the Justice/Federal Trade Commission *Horizontal Merger Guidelines (Guidelines)*.[13] In other markets where only Whole Foods and Wild Oats compete, the combination would be a merger to monopoly. But the effect

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to explain, however that the category consists of only one company--Whole Foods—and others such as Wild Oats and Earth Fare have unsuccessfully copied the model.

[12] wholefoods.com.

[13] Department of Justice/Federal Trade Commission, 1992 *Horizontal Merger Guidelines*. Online. Available http://www.usdoj.gov/atr/public/guidelines/hmg.htm.

of the proposed merger in a relevant market centered on all supermarkets selling natural and organic products would be *de minimis*.[14]

In defining the relevant market, Section 1 of the *Guidelines* asks whether consumers would switch to competing products or products produced by sellers at different locations in response to a price increase (over competitive levels) by a hypothetical monopolist. Customer switching to close substitutes would undermine the profitability of a post-merger price increase. The relevant market is therefore the smallest set of products and locations over which a price increase would not result in switching and therefore be profitable.[16] Once the market is determined, market shares and concentration are calculated to determine if the merger increases concentration beyond the *Guidelines* thresholds.[17]

Because a consumer tends to shop at markets within a few miles of their home, geographic markets are very local. The FTC names 21 geographic markets in which Whole Foods and Wild Oats compete head-to-head[18] and seven additional markets in

[14] See, e.g., Whole Foods, "The Proposed Acquisition of Wild Oats by Whole Foods Market Will Not Substantially Lessen Competition in Any Relevant Market," May 30, 2007. (Whole Foods Presentation). Online. Available http://www.wholefoodsmarket.com/ftchearingupdates/presentation5-30_07.pdf, at 10.

[16] The price increase is defined as a small but significant, non-transitory increase in price (SSNIP), usually five to 10 percent above competitive levels.

[17] For example, in a market with three equal size competitors, pre-merger market concentration, as measured by the HHI is 3,267 (the sum of the squared markets shares) and the change in market concentration due to the merger is 2,178 HHI for post-merger concentration of 5,445. In a market with one dominant firm with, 60 percent of the market and two smaller firms each with 15 percent of the market, the pre-merger HHI is 4,050 and the change in market concentration is 1,800 HHI, for post-merger concentration of 5,850 HHI. In either of these examples, concentration levels (changes and post-merger levels) far exceed the thresholds set forth in the *Guidelines*.

[18] These markets include: Albuquerque, Medford (MA), Saugus (MA), Boulder (CO), Hinsdale (IL), Evanston (IL), Cleveland, Denver, Lakewood (CO), Ft. Collins (CO), West Hartford, Henderson (NV), Indianapolis, Kansas City-Overland Park, Las Vegas, Los-Angeles-Santa Monica-Brentwood, Louisville, Omaha, Pasadena, Phoenix, Portland (OR), Portland (ME), Princeton, St. Louis, and Tualatin (OR).

which either Whole Foods or Wild Oats is present but the other may have plans to enter.[19]

In retailing, product market definition has become more complex with the emergence of different channels of distribution. These include: conventional full-line supermarkets such as Safeway or Kroger, warehouse clubs such as Sams and Costco, mass merchandisers such as Wal-Mart, and stores such as Whole Foods and Wild Oats that specialize in natural and organic products. Whole Foods' public statements are replete with the assertion that they are the category leader for natural and organic products, arguably a specialty retailer.

Economic analysis considers a number of factors in defining relevant product markets, including: distinct consumer characteristics, product characteristics, distinct product prices, and specialized sellers and unique production facilities.[20] In alleging a separate category of premium natural and organic supermarkets, the FTC implicitly acknowledges these factors.

For example, the Commission complaint points to Whole Foods' and Wild Oats' marketing philosophy that centers on health and sustainability-oriented "lifestyle" retailing. This approach is built around service, superior quality, amenities, knowledgeable personnel, trustworthiness (e.g., in actually implementing natural, organic, and sustainable strategies in product offerings) and a store "environment" (e.g., ambience and experience) that is very different from conventional supermarket shopping. Both Whole Foods and Wild Oats acknowledge this when they state:

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[19] These markets include: Palo Alto, Fairfield County (CT), Miami Beach, Naples (FL), Nashville, Reno, and Salt Lake City

[20] *Brown Shoe v. United States*, 370 U.S. 294 (1962).

> "We [Whole Foods] are a lifestyle retailer and have created a unique shopping environment built around satisfying and delighting our customers." [21]

> "Wild Oats is more than a retail chain—it's about a lifestyle, and that's how we market ourselves." [22]

In such a market, the creation of brand identity and loyalty, private-label offerings, reputation (e.g., goods plus service), and a one-stop shopping experience are key marketing tools. Presumably, this experience is what consumers seek out, willingly pay higher prices for, and which could prevent them from switching to conventional supermarkets to obtain natural and organic foods. And it is clear that Whole Foods and Wild Oats seek to differentiate their stores from conventional supermarkets.

The FTC has thus alleged what appears to be a strong case for a relevant market defined around premium natural and organic supermarkets, in keeping with other analogous cases. For example, the FTC successfully defended a relevant market for a narrow "superpremium" ice cream in the 2003 merger of *Nestle/Dreyer*. [23] In *Staples/Office Depot*, the relevant market was defined as office products sold through office superstores, which offered a distinct set of products and services.[24] The alternative market definition would have encompassed all retail outlets that sold the same types of products (e.g. paper, pens, paper clips) as office superstores.

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[21] FTC Complaint, at 7.

[22] Ibid, at 3.

[23] Federal Trade Commission, "FTC to Challenge Nestle, Dreyer's Merger," March 4, 2003 (FTC Nestle/Dreyer). Online. Available http://www.ftc.gov/opa/2003/03/dreyers.shtm.

[24] Whole Foods denies any similarities between their merger with Wild Oats and Staples/Office Depot. See, e.g., Whole Foods Presentation, at 12.

In that case, Judge Hogan noted that office superstores were different from other office supply retailers in terms of appearance, size, format, the number and variety of items offered, and the type of customers targeted. He stated:

> "No one entering a Wal-Mart would mistake it for an office superstore. No one entering Staples or Office Depot would mistakenly think he or she was in Best Buy or CompUSA. You certainly know an office superstore when you see one."[25]

Similar comparisons could be drawn between a Whole Foods or Wild Oats and a Wal-Mart or conventional Safeway or Giant supermarket.

Whether the relevant product market is focused on premium natural and organic supermarkets or a broader set of full-line supermarkets or mass merchandisers that offer natural and organic products depends on a number of factors. These include local conditions, consumer perceptions, and competitive interactions between sellers in particular areas. This emphasizes the importance of understanding markets in all their "complexity" and reality for appropriate antitrust assessments to be made.

B. An Analysis of the Merging Parties' Pricing Data in Relevant Markets Should be Viewed as Complementary to the Parties' Statements That the Purpose of Their Merger is to Avoid Competition

The FTC complaint highlights a communiqué from Mr. Mackey to his Board of Directors regarding the purpose of the acquisition. In it, Mr. Mackey states,

> "'By buying [Wild Oats] we will . . . .avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm [Whole Foods'] gross margins and profitability.'"[26]

[25] *Federal Trade Commission v. Staples, Inc.*, No. 97-701 (1997).

[26] FTC Complaint, at 1-2.

This statement explicitly acknowledges that Whole Foods not only makes pricing decisions based on the presence of its rival, Wild Oats, but seeks to avoid such price competition through acquiring its chief rival.

Later, in his June 19 website posting, Mr. Mackey disputes the admission that Wild Oats factors into Whole Foods' competitive strategy. He states instead that:

> "Whole Foods quality, service, and prices are totally unrelated to whether Wild Oats competes with us in any particular market or not."
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> "Whole Foods considers Trader Joe's the national company that we have the most difficulty competing against and it is Trader Joe's, not Wild Oats, against whom we price most aggressively."
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> "Whole Foods Market's prices are much more strongly impacted by competition with Trader Joe's, HEB, Wegman's, and other supermarkets than they are by Wild Oats."[27]

A merger that produces a near monopoly or dominant firm is likely to increase the merged firm's market power so that it can successfully raise prices or reduce output, while acting alone. Such "unilateral effects" are also possible in cases where sellers are close substitutes in a differentiated product market. And in markets where one of the merging firms operates but the other plans to enter, any benefits of potential competition in the form of lower prices, better quality, or superior service are likely to be lost through merger. Mergers in retail grocery markets can present this second category of unilateral competitive effects.

Ultimately, the question of competitive effects can be answered empirically by estimating the likely reactions of rivals in markets in which they compete. In other words, do the merging firms uniquely focus on each other as competitors or do the firms set prices based on whether the other firm is present? If so, then the merger is likely to harm

[27] wholefoods.com.

consumers through higher prices. For example, the FTC demonstrated in the *Nestle/Dreyer* merger that Dreyer's presence “directly and persistently impacted pricing, marketing and product introductions, causing Nestlé to increase promotions and lower prices.”[28]

Similarly, in *Staples/Office Depot*, price data from stores in a number of geographic markets indicated that office supply prices were lower in markets with three office superstores than with only two and that competition between Staples and Office Depot had a significant restraining effect on Office Depot prices.[30] Judge Hogan was thus persuaded by scanning price data and other evidence that demonstrated that the superstores keyed off of each other and that the level of their pricing depended upon whether there were one, two, or three superstore rivals within the same geographic market.

In the case of Whole Foods/Wild Oats, Mr. Mackey denies that Whole Foods and Wild Oats constrain either other’s pricing.[31] Surely, the availability of an enormous quantity of computerized (scanning) retail price data puts the analysis that Mr. Mackey claims already to have done within the realm of reason. At the same time, however, Mr. Mackey has made public statements disclosing the motives for the merger that reflect an intent to stifle competition. Although intent evidence can be based on fantasy or reflect a

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[28] FTC Nestle/Dreyer.

[30] Serkar Dalkir and Federick R. Warren-Boulton. 2004. “Prices, Market Definition, and the Effects of Merger Staples-office Depot,” Case 2 in The Antitrust Revolution, 4th edition (J. E. Kwoka and L. J. White, eds.). Oxford. p. 61.

[31] wholefoods.com.

misleading degree of aggressiveness, it can also help bring into focus the likely effects of a merger. In light of this, “natural experiments” using price data to determine if existing or potential competition discipline pricing by the merging parties should be viewed as a complement to anticompetitive motives in developing record evidence that the merger would tend substantially to lessen competition.

C. The Merger’s Effect on Eliminating a Potential Competitor Deserves Equal Attention to the Elimination of an Existing Rival in the Relevant Market

Mr. Mackey states another reason for the Wild Oats’ acquisition, discussed early on with his Board of Directors:

> “Elimination of an acquisition opportunity for a conventional supermarket--our targeted company is the only existing company that has the brand and number of stores to be a meaningful springboard for another player to get into this space. Eliminating them [Wild Oats] means eliminating this threat forever, or almost forever.”[32]

This reasoning reveals a number of important points. First, it acknowledges that a certain scale and brand identity characterizes the “space” or market in which Whole Foods competes. This lends some significant support to the notion that the relevant market is one for premium natural and organic supermarkets. Second, the rationale for merger also supports the FTC’s argument that entry or repositioning into premium natural and organic supermarkets is “time-consuming, costly, and difficult,”[33] since acquiring Wild Oats would eliminate *forever* the threat that another player could use it to gain a “toe hold” for entry or expansion.

Third, the statement effectively acknowledges that the merger would erect a

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[32] wholefoods.com.

[33] FTC Complaint, at 15.

sizable barrier to entry in the relevant market. Mackey estimates that after sales of some of Wild Oats' farmers' market stores and closures of "redundant" stores, only $700 million of Wild Oats' sales will remain, or around 60 percent of their current annual revenues.[34] By debilitating Wild Oats in this way, further entry into the premium natural and organic supermarket space would be even more difficult. And once the merger is consummated, a dominant Whole Foods/Wild Oats could have the market power to raise prices or restrict output.

Given the magnitude of the foregoing implications, it is not surprising that Mr. Mackey challenges the FTC's assertion that entry is difficult. He argues, for example, in his June 19 website posting that:

> ". . .Trader Joe's has very rapidly expanded by more than doubling its store base in the past five years and has entered into numerous new markets to directly compete against us."[35]

Much of the foregoing debate on entry can be resolved by market definition. At the same time, it is reasonable to expect that an articulated strategy at the Board of Directors level to stifle entry into an admittedly narrow product market should generate serious scrutiny in itself.

IV. CONCLUSION

Based on the information available, the AAI believes that the hearing on the FTC's request for preliminary injunction will address at least three major important issues: relevant markets, evidence that Whole Foods and Wild Oats set prices in response to competition from the other, and entry. Other issues may also arise, including any

[34] wholefoods.com.

[35] Ibid.

claimed efficiencies generated by the proposed acquisition. Given the statements of Whole Foods' Mr. Mackey, it is not surprising that the FTC would bring this case, although such statements are not necessarily determinative of the outcome. And given the precedents such as *Staples/Office Depot* in which close analysis of retail scanning data demonstrated that a narrow market definition makes good economic sense, the FTC deserves to have its day in court to help the judge determine which Mr. Mackey it should believe.