COMMENTS OF THE

NATIONAL GROCERS ASSOCIATION

PRESENTED TO

THE FEDERAL TRADE COMMISSION
AND
THE ANTITRUST DIVISION OF THE DEPARTMENT OF JUSTICE

FOR THEIR

JOINT WORKSHOP ON MERGER ENFORCEMENT

WASHINGTON, DC
FEBRUARY 17 – 19, 2004

The National Grocers Association (N.G.A.) is pleased to have this opportunity to express its views on a number of issues of particular interest and importance to its members, the retail food companies and wholesalers that comprise the independent sector of the food distribution industry. The issues addressed here are among those identified in the notice of the joint workshop on merger enforcement ("Notice"). N.G.A. applauds the objective of the Commission and the Division (together, "the Agencies") to provide greater transparency to the process by which they analyze the potential competitive effects of horizontal mergers.

Before addressing some of the specific legal and economic questions posed in the Notice, N.G.A. feels it important to set forth a context in which it responds to the specific, and often technical, issues. N.G.A. has always supported, and argued for, compliance with all of the antitrust laws. Those laws, in N.G.A.'s view, were enacted to protect consumers by creating a code of competitive rules by which business must be conducted, and, ultimately, provide consumers with the benefits of a diverse marketplace in which they can purchase the types, variety, selection and quality of products and services they desire at the lowest possible prices. To achieve that broad objective, Congress banned: contracts among business partners that imposed unreasonable restraints on competition; attempts to monopolize whole industries and their actual monopolization; various forms of discrimination and predatory practices that threaten the ability of small businesses to effectively compete with their larger rivals; mergers and acquisitions that may dampen the competitive process in particular industries and geographic areas; competing companies from having common officers and directors; and other practices deemed to constitute unfair methods of competition. In all of these enactments, the underlying theme was to allow all who wish to compete the opportunity to do so, with success or failure determined by how well one is able to compete, rather than by factors that give one competitor an unfair advantage over another, or permit a competitor to take actions that have the sole purpose of eliminating competitors from the market.

This congressional vision is easier to state than to achieve. But one thing is clear: a truly diverse marketplace is the one factor without which the goal will never be reached. All of the statutes that Congress created are designed to produce, promote and preserve diversity, directly or indirectly. But they will do so only if those statutes are viewed as an integrated whole. N.G.A. does not oppose all mergers. Most mergers present no competitive problems; they are an essential means of growth by whitioch local and regional firms can achieve scale economies, and maintain their ability to compete effectively with their national and international competitors. What N.G.A. does oppose, are the mergers of those national and international rivals that result in no scale economies or efficiencies that will benefit consumers, and mergers that concentrate purchasing power over the supplier community. Therefore, each statute governing competition must receive the attention of the agencies entrusted with their enforcement, lest the mechanism for preserving diversity get out of balance and consumers suffer the consequences.

HHIs, Concentration and Market Shares

The current Merger Guidelines[1] view concentration in relevant markets through the lens of the Herfindahl-Hirschman Index ("HHI"), focusing on two objects: the post-merger HHI and the increase in the HHI that the merger would produce. Using these two indices, the Guidelines then sort mergers[2] into three market groups:

- those in which the post-merger HHI would be below 1,000 – unconcentrated markets, in which anticompetitive effects are unlikely and further analysis is not ordinarily needed;
- those in which the post-merger HHI would fall between 1000 and 1800, or moderately concentrated markets, in which anticompetitive effects are unlikely if the HHI would be increased by less than 100 points, but in which concerns might arise if the HHI increase is more than 100 points;
- and, finally, those in which the post-merger HHI would exceed 1800 – highly concentrated markets, in which significant competitive concerns can arise if the HHI increase is more than 50 points.

In highly concentrated markets the Guidelines raise a presumption that if the HHI is increased by more than 100 points, the merger will create or enhance market power or make it easier to exercise that power.[3]

In announcing the current workshop, the Agencies seek comments on whether this analytical framework has significant value as an indicator of the likelihood that an investigation will be conducted and that it will be challenged. To assist the development of comments on this question, the Agencies released a study of their merger challenges over the last five years, showing the post-merger HHI levels, the HHI increases and the number of relevant markets involved. To the extent that §1.51 of the Guidelines has been interpreted as subjective indications of the likelihood of a merger investigation or challenge, the data in the study shed little light on the likelihood of investigations; they deal only with challenged mergers. In addition, the analysis of concentration and increases therein, is not keyed to the number of mergers involved, only the number of relevant markets, which in some transactions exceeded sixty.[4]

However, the data can be read to suggest that the likelihood of investigation and challenge are most likely to occur at concentration levels and HHI increases that are far above the floor of the highly concentrated market category. For example, using the number of markets as a proxy for the number of challenged mergers, an admittedly problematic assumption, only 6.7% of the total involved HHI increases up to 299 points. Virtually half show up at the high end of the HHI increase scale – 1,200 points and

[1] 1992 Department of Justice and Federal Trade Commission Horizontal Merger Guidelines ("Guidelines").
[2] The term *mergers* as used in these comments also includes acquisitions and consolidations.
[3] Guidelines, §1.51.
[4] Tables 1 and 2 of the data reveal that a total of 173 mergers were challenged by the Agencies during the five fiscal years covered by the study, and those mergers involved 1,263 markets, an average of 7.3 markets per merger.

above. Looking at the array of the post-merger HHIs, roughly 14% are below 2,400, and slightly more than 70% fall above 3,000.

What is really needed, in N.G.A.'s view, is for data, similar in format to Table 1, to be published using the number of challenged transactions, rather than the number of markets. Transparency being the objective, those numbers would give a much better idea of how closely actual practice tracks the matrix of the Guidelines. And to be more transparent, another table should be created based on the number of formal investigations commenced.[5]

Closely related to the questions regarding market shares and concentration is the number of competitors that will remain in the relevant market after the merger, and whether they will be sufficient to keep the relevant market competitive.[6] There is no easy answer to that question, especially an answer that works in all merger situations. In retail markets, such as groceries, the number of competitors needed may be far different from the number needed in a manufacturing product market. Much of the difference is a function of the size of the geographic markets involved in retailing and manufacturing markets. In retail markets, especially those involving consumables or repeatedly used services, consumers, especially those in urban areas, traditionally travel relatively short distances – to go to the supermarket, the drug store (if not in the supermarket), the bank, or the dry cleaner.

In manufacturing markets, buyers are often able to shop in a world-wide market with far more supply alternatives than someone needing a quart of milk.[7] Buyers in manufacturing markets often do not visit their suppliers in order to make a purchase. We are not suggesting that N.G.A.'s retail and wholesale members are not also concerned about growing concentration at the manufacturer level that results from mergers. Those transactions may involve direct competitors in various product categories, and one of the merging parties may be the number one or two firm in the category. The Agencies should closely scrutinize such transactions, and take action when necessary to assure that an affected category is not left with one overwhelmingly dominant supplier that would have the ability to profitably limit production or raise prices. It may be that the question posed in the Notice can be answered, if at all, on a case-by-case basis.

Another complicating factor on the retail side is the rural area that is incapable of supporting the number of competing retailers one finds in an urban or suburban area. If there *is* a magic number of retailers needed to keep an urban market competitive, that number may make no sense in many rural markets that do not have the population to support that number.

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[5] A proxy for that purpose could be the number of transactions in which second requests were issued under the Hart-Scott-Rodino Act.

[6] The loss of a single competitor in even the most atomistic market is bound to lessen competition among the remaining firms. The purpose of §7 is only to interdict those mergers in which the lessening of competition is *substantial.*

[7] N.G.A. has previously pointed out the need to use different approaches when dealing with mergers in retail and manufacturing markets. *See*, Transcript of FTC Merger Workshop, October 23, 2002, at 28-29 (hereafter "2002 Transcript").

New technologies are resulting in tremendous changes in purchasing patterns in both consumer and production markets. As e-markets continue to increase their share of total sales in various product lines, traditional notions of geographic markets will have to change. There was a day not long ago when bookstores were a familiar part of the neighborhood retail mix. Amazon.com changed that. If it has not already made the U.S. retail book market a national market, that day cannot be far off. There is no doubt that the growth of sales on the Internet, as well as catalog and telemarketing sales will soon require new approaches to the definition of relevant markets in many lines of business.

From a policy perspective, N.G.A. is less interested in a bright-line test for an elusive number of competitors required than it is in the fundamental principle that the consumer is best served by a diverse marketplace that provides alternative mixes of price, quality, product selection and service. Perhaps the answer is that to keep a market optimally competitive, it should have as many profitable competitors as it can support.[8]

Treatment of Uncommitted Entrants

The introduction into the Guidelines of the notion of "uncommitted entrants" has done little, in N.G.A.'s opinion, to clarify the merger analysis process. As the Notice points out, the Guidelines do not tell how to assign market shares to these entrants, nor is there any indication of how the Agencies will evaluate the competitive effects of their existence. The advantage gained by having renamed *potential entrants* as *uncommitted entrants* is far from obvious. Therefore, N.G.A. believes that merger analysis would be made somewhat simpler if the Agencies were to return to the practice of examining the existence of *potential entrants* as part of the competitive effects analysis, rather than attempting to include them as participants in the relevant market when they are not. At the minimum, this would obviate the need for assigning them market shares, which if done, would have to be done on some basis other than sales or actual production. In theory, at least, this could result in less than optimal market measurements.

The Guidelines already contain criteria for evaluating the competitive significance of potential entrants.[9] The primary characteristic in the Guidelines' definition of an uncommitted entrant is that such an entrant would not incur significant sunk costs in entering (or departing from) the relevant market. That definition would fit nicely into the evaluation of a potential entrant under the criteria for examining potential entrants under the Guidelines.[10]

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[8] Those who sell below cost, or at prices above cost but that do not result in a profitable operation, are not literally profitable competitors. The Agencies must determine whether these practices result from inefficiency or from an objective of eliminating competition. In these cases, enforcement action is necessary to prevent other competitors from being forced out of business due to the predatory practices of others and the loss of otherwise profitable retailers.

[9] Guidelines, §3, more specifically §§3.2, 3.3 and 3.4.

[10] *Id.*

The Notice also asks whether the present distinction between uncommitted entrants under §1.32 of the Guidelines, and committed entrants under §3, has any practical value. N.G.A. suggests that the value of the distinction is not sufficient to warrant its retention. In practical terms, an uncommitted entrant makes its presence felt in the relevant market within a year; the committed entrant has two years. The difference in treatment is that the former is viewed as a market participant, necessitating the assignment of market share, which is often a problem. Evaluating both committed and uncommitted entrants under §3 on the basis of when entry would occur could be dealt with under §3.2, the *timeliness* factor. Similarly, the magnitude of the sunk costs involved could become a *likelihood* issue under §3.3, and perhaps a question under §3.4 affecting the *sufficiency* of the entry to beat back a price increase.[11]

The task of analyzing the likely competitive effects of a merger would be simplified by eliminating the notion of uncommitted entrants and by their inclusion as participants in the relevant market.

Reductions in Non-Price Competition

The Notice cites product diversity as one of the ways in which a merger might reduce non-price competition in a relevant market. It is N.G.A.'s position that marketplace diversity is a major factor that must be examined in every merger, especially those in or affecting the grocery industry, because diversity is essential at every level of the production and distribution chain for a market to be truly competitive. Diversity of product is first affected at the production level. But the fact that a product is available from the supplier is no guarantee that it will be readily available to consumers. It must first be accepted by wholesalers and retailers. Thus, mergers at all levels – manufacturer, wholesaler and retail – can affect the diversity of products available to the consumer. But, diversity does not stop there. There are the diversities of store format, service, innovation, product quality, flavor and size, packaging, advertising and promotion, and others that shape the non-price competitive arena. And mergers at any level can have just as dramatic an effect in these critical non-price areas as they can have on the prices consumers pay. Indeed, all of these price and non-price factors on which manufacturers, wholesalers and retailers compete affect the overall diversity of the marketplace and the *value* that consumers receive and the choices available to them.

N.G.A. believes that the independent sector of the food distribution industry is the primary source of diversity in the retail grocery marketplace. The Agencies are the gatekeepers of that diversity and, therefore, of *value* and the choices available to the consumer. The Agencies' mission is to maximize both diversity and value when examining mergers, especially those involving consumer goods. The Agencies must be

[11] N.G.A. does not question the use of the §3 entry criteria – timeliness, likelihood and sufficiency – when the Agencies formulate their opinion on the likely competitive effects of a merger. However, N.G.A. notes the position of the U.S. Court of Appeals for the D.C. Circuit, set forth in *United States v. Baker Hughes,* 908 F.2d 981 (1990), that the government cannot shift the burden to the merging parties to prove that new entry *will be* timely, likely and sufficient.

concerned not only with price competition and product diversity, but also with the other competitive factors that consumers consider in deciding where to shop and what to buy.

Buying Side Market Power

The Agencies ask how they should treat the creation of buying market power in assessing the likely competitive effects of a merger.[12] The Notice suggests that the Agencies' concern is limited to the effect on suppliers "who also are entitled to the protection of the antitrust laws."[13] N.G.A. is pleased to have the opportunity to address this question, because, at least in the grocery industry, a recent series of mergers has allowed the creation of a handful of power buyers. If these mergers continue, buying side market power will eventually end marketplace diversity as we know it today. Therefore, the issue is of critical importance to N.G.A.'s members, and it will be addressed in the context of mergers at the retail level of the food distribution chain.

During 2002, the FTC conducted a series of merger-related workshops, a number of which were devoted to issues focused on improving merger investigations and remedies. At the workshop held in New York City on October 23, 2002, N.G.A.'s written submission contained the following:

> A handful of chains now control a share of the national market that is unprecedented in our history. There are predictions that unless something is done to reverse the present trend, the top five chains could represent seventy-five percent of all grocery sales by the end of this decade. Today it is necessary to analyze retail grocery mergers by looking at more than the market shares of the merging parties in a local geographic market, the proximity of the merging parties' retail outlets, and a merger's effects on competition in selling groceries in the geographic markets that are directly affected – the micro, or selling-side, analysis. In order to understand and, when warranted, curtail the anti-competitive effects of growing national concentration, we encourage the FTC also to analyze the merger's effects in the macro market – the potential impact on the buying side in the form of practices that can, and often do, result in mega-retailers receiving preferential payment terms, packaging, promotional allowances, product availability and pricing. These advantages on the macro side injure

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[12] N.G.A. reads the question to include the enhancement and facilitation of using buying market power, as well as its creation. The question also seeks guidance on whether the treatment of buying and selling market power should be different. The nature of buying and selling market power are different in their marketplace effects, but the potential for consumer injury from the exercise of that power exists in both markets. The fundamental notion of §7 of the Clayton Act is that mergers having the potential to adversely affect competition in any relevant market should be prevented before actual anticompetitive affects occur. Thus, if the creation, enhancement or facilitation of market power flows from a merger, the Act is equally applicable to the possible exercise of market power in both buying and selling markets.

[13] N.G.A. assumes that the Agencies did not mean to limit the request for comments to the adverse affects that buyer market power can have on suppliers, because, obviously, those buyers' *competitors* "also are entitled to the protection of the antitrust laws."

> competition in the micro – selling side – markets just as surely as high concentration. But traditional merger analysis does not consider competitive injury in the micro markets that stems from mergers viewed in the macro markets. Today, effective merger enforcement of Section 7 of the Clayton Act must consider both.[14]

A footnote indicated that between 1993 and 2001 the top five grocery chains' share of U.S. supermarket sales grew from 17% to 40.4%. The N.G.A. position was amplified during its oral presentation.[15] Should present concentration trends continue the diversity discussed earlier will gradually decline to the point at which consumers will have few choices. As the shares of surviving chains grow, manufacturers of grocery products will also disappear, further concentrating the production level market, and reducing diversity and new product innovation. The decline in the number of manufacturers, and the accompanying increases in concentration, will take two paths. First, defensive mergers will occur (we have already seen a number of them), as producers seek to maintain or regain some parity of bargaining power with the mega-buyers. Second, smaller manufacturers, many of them suppliers of local and regional brands, will be unable to meet the demands of the power buyers for price and other concessions, and will be forced out of the market N.G.A. believes that the Agencies must address this issue before it is too late to reverse current trends.

The buying market power problem is not limited to the prices that retailers pay for products to be resold to consumers. Many of the *services* purchased by grocery retailers represent significant costs of doing business. The advantages of buying power in this area are illustrated most vividly by the fees paid by grocers to Visa for various electronic fund transfers (EFT). In an apparent attempt to dominate the PIN debit[16] segment of the EFT market, Visa announced a new debit fee schedule, which took effect on January 31, 2004.[17] But, according to reports in the financial press, Visa has also entered into private agreements with some of the country's highest volume retailers that reduce those retailers' transaction costs below the new publicly announced schedule. It is widely

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[14] N.G.A. Submission at 2. The current problem of buying power growth has been triggered by the growth in Wal*Mart's increasing share of grocery sales. Although buying power issues must be addressed in merger analysis, N.G.A. believes that the Agencies must also address the broader question of buying power itself *and its abuse,* even when that power has not resulted from a merger.

[15] Transcript at 29. The written submissions of all participants, as well as transcripts of all workshop sessions are available at the FTC web site www.ftc.gov/bc/bestpractices.

[16] PIN (personal identification number) debit, or on-line debit transactions are those in which the customer enters a PIN in a key pad at the point of sale. No signature is needed. The other type of debit transaction is the signature, or off-line, debit transaction, which uses a process similar to that used for charge purchases, including a receipt signed by the customer. Concord EFS (in the process of being acquired by First Data Corp.) is the largest processor of PIN debit transactions. The signature debit sector is dominated by Visa, which also dominates the credit card segment of the EFT market.

[17] These fees are somewhat higher than those charged by Visa during the previous five months, following the settlement of a suit brought by Wal*Mart and many other retailers against Visa and MasterCard. The new fees are lower, however, than those in effect prior to the settlement of the private litigation. As part of that settlement, Visa agreed to an interim price reduction for PIN debit transactions. It also agreed to discontinue the "honor all card rule," which forced retailers that accepted Visa's credit cards also to accept its debit cards, mainly signature debit cards.

believed that those agreements, such as one with Wal*Mart, reduced transaction fees on all types of Visa card payments, signature and PIN debit, as well as credit card transactions.

The result of these special deals for the largest grocery chains has widened the cost-of-doing-business gap between retailers with buying side market power and the rest of the retail grocery industry. Currently, this cost differential is one of the critical issues facing independent grocery retailers, as well as other large grocery chains that operate on a local or regional basis. Industry estimates place the cost of debit and credit transaction fees at .5% of sales in supermarkets, a cost that exceeds the net profits of some retailers, and represents between 25% and 50% of profits for most others. Because the use of plastic, especially PIN debit, is growing dramatically in supermarkets, the disparity in costs of transaction processing service places the majority of supermarket firms at an unfair competitive disadvantage.

There is another aspect of this situation that warrants examination – the question of whether there are any real savings in the cost of servicing these largest retailers, as opposed to the cost of serving others, savings that would arguably justify lower transaction costs, including interchange rates,[18] to customers like Wal*Mart. It appears that the overwhelming amount of processing costs are *fixed*, rather than *variable* costs.[19] Assuming that a processor has sufficient volume to cover its fixed costs, processing additional transactions add virtually nothing to the cost of doing business.[20]

Variable costs do exist in the processing stream, but their amounts are, at most, minute. In some instances, variable costs might include communication services, which often are not based on the number of transactions at all, but on the time the communications system is used. Other examples of variable costs can include software licenses and outsourcing costs. However, one source stated that its total variable costs are well below one cent per transaction. What we have, therefore, is a predominantly fixed-cost-per-transaction system in which retailers are charged for processing, at least in part, based on their size – the number and dollar value of the transactions to be processed. There is no difference in the cost of processing a transaction that is related to the size of the retailer in which the sale occurred, or to the dollar value of the transaction processed.[21] The cost of

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[18] Interchange rates represent the largest portion of total transaction fees paid by retailers. Interchange rates are set by the credit card associations, such as Visa and MasterCard. Processors collect the interchange fees from the retailers and transmit them to the credit card associations.

[19] N.G.A. is indebted to members of the processing community for their cooperation and candor in answering questions about processing costs, fees and related issues. Discussions were held on the promise of anonymity.

[20] This statement further assumes that the processing system is not operating at its transactional capacity. Should additional transactional volume require additional investment, that cost would also be a fixed cost, not a variable cost.

[21] Virtually all fees in this country have a component that is based on the dollar value of the transaction. For example, Visa's most recently announced fee schedule, effective January 31, 2004, establishes a cost for supermarkets on POS debit transactions of 1.23% of the value of the transaction. On a $40.00 purchase, this amounts to $0.48, and $1.23 on a $100.00 purchase. Despite this percentage formula, however, Visa caps the charge to supermarkets at $0.35, regardless of the size of transaction size. Perhaps the only area in

processing a $5.00 transaction from a one-store grocery operator is the same as the cost of processing a $5,000.00 transaction from a Wal*Mart outlet. And there is no additional transaction-based cost for processing transactions generated by a new retail customer. Therefore, we see no rational justification for lower prices to high volume retailers, like Wal*Mart. The number of transactions to be originated, or their value, does not reduce the processor's dollar cost on a per-transaction basis.[22]

N.G.A. urges the Agencies to consider not only the creation, enhancement or facilitation of buyer power when examining mergers, but also to investigate the obvious anticompetitive effects of Visa's special pricing agreements, and to take appropriate remedial action.[23]

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which it can be argued that there is a relationship with the size of the transaction is the risk factor, especially in the use of charge cards. But the risk of fraud falls on the banks, not the transaction processors.

[22] The EU has recognized the "disconnect" between transaction fees and processors' costs, and has ordered drastic reductions over a five-year period on all cross-border transactions. Interchange rates on debit transactions will have to be at a fixed rate; no portion of the fee can be based on the value of the transaction.

[23] In N.G.A.'s view, the legality of these Visa agreements can be challenged and remedied as violations of §1 of the Sherman Act. The remedy would not be subject to the type of criticism that has been leveled at the traditional remedy for differences in prices paid for goods to be resold. Some argue, although N.G.A. disagrees, that in the latter situation, the favored retailers' retail prices are forced to rise, thereby injuring consumers. In the case of EFT transaction fees, there is no evidence that Visa's favored retailers are passing the savings in transaction fees through to consumers in the form of lower grocery prices or other identifiable and measurable benefits. Ending the price disparity, therefore, would have no adverse effect on consumers. Of course, the issue can be avoided altogether by a remedy that requires Visa to lower its prices to all customers, rather than prohibiting the lower prices to the favored few.