Whole Foods: A View from Europe

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CRA International
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The Whole Foods¹ judgment in the US Court of Appeals for the DC Circuit appears to have shocked many US antitrust commentators. Judge Kavanaugh, dissenting, expressed a view that has echoed through the advisory community, “In the end the FTC’s case is weak and seems a relic of a bygone era when antitrust was divorced from basic economic principles.” While I understand the reaction, as an economist immersed in European antitrust law, Whole Foods does not seem so anomalous. Indeed, both the FTC case and the majority opinion might be founded on better economics than appears at first sight.

Judge Kavanaugh’s dissent and Whole Foods’ argument before the court emphasized repeatedly that there was little or no evidence that prices would increase. Even the D.C. Circuit majority seemed compelled to concede that some evidence of likely increase in prices was a sine qua non for the FTC’s case.

European supermarkets cases are certainly interested, in principle, in potential price increases. Yet price increases are often neither the exclusive nor even the principal focus of concern. Competition authorities have paid keen attention to other possible


* The author is a vice president of CRA International in their London office and is also currently the professor of the economics of competition law at the College of Europe in Bruges.
sources of consumer detriment as well—reductions in variety, quality, and service to consumers being prominent among them.

One reason why antitrust inquiries in Europe can sometimes be price-free zones is that major supermarket chains in Western Europe seem almost never to substantially vary their prices locally. In country after country, pricing is generally uniform and national. Even local vouchering seems not to have much impact. Economically and commercially this price uniformity is a perplexing phenomenon. Surely a supermarket will post higher prices when it has a de facto local monopoly than when it faces numerous competitors? Bafflingly, in the UK, Sweden, and the Netherlands (to my own knowledge) and in most other countries (by hearsay) the answer is no. Glib post hoc explanations abound but in truth this phenomenon has never been explained satisfactorily.

Given that pricing is national, local markets would seem not to matter. Yet competition authorities all over Europe are suspicious of undue local concentration. Their concern cannot be motivated by opportunistic local monopoly pricing—that phenomenon simply does not occur. (There is a faint echo of this in Whole Foods as Whole Foods’ pricing did not vary locally but instead was uniform across each region of the US—perhaps for supermarket purposes US multistate regions correspond roughly to European countries.)

In a recent inquiry, the UK Competition Commission focused largely on product range, quality, service, and availability (how many products were sold out). Consider for a moment a consumer who leaves his home on Saturday morning to go food shopping.
One mile from home he passes a Sainsbury supermarket (noted for midmarket selections and frequently sold out items). He drives a further four miles and stops at a Waitrose supermarket (upscale selections). There he pays, on average, higher prices than he would have paid at the Sainsbury outlet four miles nearer home. This consumer clearly will not be better off if Sainsbury is allowed to buy the local Waitrose store and convert it into a store identical to the other Sainsbury. This consumer achieves greater overall value (or “consumer’s surplus” or “consumer welfare”) by spending more from his limited budgets of time and cash (higher prices, more gasoline, more driving time) than he needed. The leading supermarket chains in Europe compete on product range, service, quality, location—but hardly at all on price. Often this is the hidden secret of antitrust inquiries.

One distinguished economist, also a sometime antitrust enforcer, Joseph Farrell, has several times emphasized that that price in antitrust is only a synecdoche (the figure of speech in which the part stands for the whole). In this context, the term “price” is really shorthand for a long list of possible differences, each of which can affect consumers’ welfare. Adverse effects can arise from reductions in quality, variety, or service equally as well as from higher prices. And they can arise even when price falls—as in the example of a merger affecting my shopping trips in shire England.

The recent UK Competition Commission (“CC”) inquiry eschewed a single focus on price. Instead the CC analyzed price, quality, range, and service (“PQRS”) as variables that could be “flexed” short term and were the key to local competition. The CC also considered location which is not easily changed but is critical to consumer choice—
so PQRSL perhaps. The CC acquired a high quality data set and modeled consumer “shopping-trip behavior”. The CC assembled data on locations of homes and supermarkets, computed drive times, and added data including store size, brand names (stores such as Sainsbury and Waitrose that vary in range, quality, and price), and the number of employees (treated as a proxy for service). The econometric estimation of consumer store choice convinced the CC that product range, availability, and quality of service measurably affected that choice. The 13,000 anecdotes (similar to the one described above) collected in the CC data set amount to solid evidence about revealed preferences—preferences as revealed by actual behavior.

Focusing on price alone could lead to the incorrect conclusion that any UK local supermarket merger wouldn’t matter, because prices don’t vary locally. But, as the CC showed, everything else in the PQRSL matrix does vary. In the CC’s view, supermarkets can profitably flex—increase or reduce costly service, range, or stocking in response to finding more or less competition in the local market. Whether the CC really proved such flexing is hotly contested. But clearly PQRSL matters to consumers, so local mergers can reduce their welfare, at least in the short run. (Longer term responses of repositioning by other rivals—emphasized by Judge Kavanaugh in his Whole Foods dissent and relevant even in hard-to-enter local markets in the UK—are harder to measure, but in principle can be crucial.)

Now let us look at Whole Foods against this European background. The first impression is of a slightly old-fashioned antitrust world. This could as well be a case
from 1984 as from 2008—a world in which a small but significant and non-transitory increase in price ("SSNIP") is king and the "case hinges on the definition of the relevant market." Given the high shares of Whole Foods and Wild Oats in their relevant market, the FTC and the D.C. Circuit drew inferences about likely price rises. The FTC’s theory, supported by the majority, was that the market was premium natural and organic supermarkets ("PNOS") and price rise risks were serious. Both conclusions were supported by evidence that most Wild Oats consumers would switch to Whole Foods if Wild Oats were not available. The dissenting opinion disparaged this evidence as failing to embody the SSNIP procedures as set out in the Guidelines.

One way an outsider can interpret the FTC’s case is to see the FTC looking beyond a mechanistic and potentially misleading focus on price alone. Instead, the FTC and the court majority, feeling instinctively that price in this case did not capture value differences, were directly asking about relevant consumer welfare. Welfare might perhaps be eroded if choice was restricted—even if price hardly changed. In this world the SSNIP question changes into a small but significant and non-transitory erosion of (consumer) welfare ("SSNEW") question. In short, to a European observer, far from instituting a retrogressive revolution to the bad old days, the FTC and D.C. Circuit could be thought of as returning to first principles, much as we observe competition enforcers doing here in Europe.

The judicial majority said—and emphasized—that market definition can include the analysis of effects on core consumers; not only on marginal consumers. At first blush

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2 Id. at 4.
this would seem to contradict the economic approach to antitrust. That market prices are decided by the marginal consumer and producer to the exclusion of the infra- and extra-marginals of both types is a principle so basic that it is taught in all first semester economics courses. The Guidelines-SSNIP approach turns on just such reactions by (usually) a minority of consumers.

That standard exposition in the textbooks and the guidelines works well when we are dealing with a uniform product and consumers who vary only in their willingness to pay. If we focus instead on loss of welfare by heterogeneous consumers from product variety, then the judicial concern for the effects on core customers becomes more explicable. Against a factual background of fixed consumer residences and few and hard-to-create store sites (a feature more typical of Europe than of the US) this could be a valid concern. However, two organic supermarkets seems a harder sell (at least to this observer). Do we know whether many of these core consumers drove miles past a Whole Foods outlet to a Wild Oats in their determination to achieve greater overall value?

UK supermarket inquiries frequently conduct analyses of mergers using isochrones—lines of equal travel time from a supermarket. Competitors within the isochrone-defined area are counted to yield some relevant measure of local markets. But since pricing is national and doesn’t vary locally, local markets aren’t defined by pricing criteria. Instead markets are defined by a plurality of available choices as well as (perhaps), by flexing of PQRS. In a real world of heterogeneous consumers, greater choice is liable to yield greater consumer welfare—my Saturday shopping trip once again
is a simple example.

In an elegant analysis, Farrell and Shapiro have pointed out that standard uses of critical loss analysis as an implementation of the SSNIP test frequently are flawed by the failure to consider the legitimate implications to be drawn from pre-merger pricing behavior. One of their conclusions\(^3\) is that very narrow markets—such as PNOS in *Whole Foods*—are a natural result. But even their analysis assumes that pricing power will be exercised. By contrast, the difficulty in many European supermarket inquiries is that local pricing power is seldom exercised.

The unifying theme here is that a lack of pricing variation—a lack of exploitation of potential pricing power—does not necessarily mean that the relevant antitrust market must be wide and not local. It does not necessarily mean that high market shares and few competitors for one chain do not matter. Nor does it mean that a monopoly in a niche such as PNOS is untroubling as long as price doesn’t increase. Antitrust authorities instinctively find local retail monopoly to be obnoxious (niche product monopoly much less so). They define geographic markets in more-or-less open contradiction to the standard SSNIP procedures. Their reactions can have a sound economic basis. To assess the claim in a particular case we have to concentrate directly on the available choices, heterogeneity, and welfare of consumers and not solely—sometimes not at all—on the single surrogate of a potential to raise prices. Because sometimes a price-based inquiry does not capture the real economic problem that enforcers have to grapple with.

Judge Kavanaugh viewed the FTC’s and D.C. Circuit’s majority focus on high switching between Whole Foods and Wild Oat (as distinct from a focus on price) as a return to the bad old days—to vagueness, bad economics, and meaningless legalistic arguments. I have tried to set out how one could instead interpret the FTC case and the majority opinions as an insistence on a better focused but still economics-inspired decision criterion.

Both Whole Foods in the US and Tesco in the UK will further contest the decisions against them. We may before long find out whether, in the supermarket cases of the future, we will be discussing a SSNIP in, for example, a PNOS market or some SSNEW in a PQRSL matrix.