MARKET POWER AND VERTICAL RESTRAINTS IN RETAILING
PRIVATE AND AN ANALYSIS OF FTC V TOYS "R" US

Dennis W. Carlton
University of Chicago, Chicago, Illinois, & Lexecon, Inc.

Hal S. Sider
Lexecon, Inc.

5.1. Introduction

The FTCs action against Toys "R" Us centers on the implementation by Toys "R" Us of a policy in which it reserved the right not to carry the same toy items sold by a manufacturer to warehouse clubs. The FTC alleges that the Toys "R" Us policy reflects an attempt to exercise market power by impeding competition from warehouse clubs. Toys "R" Us defends its policy as an efficiency-enhancing vertical restriction designed to lessen the ability of warehouse clubs to "free-ride" on services provided by Toys "R" Us. This paper presents the results of several economic analyses designed to distinguish between these hypotheses.

The FTC claims that Toys "R" Us organized a horizontal agreement among toy manufacturers to boycott the warehouse clubs. The FTC also claims that Toys "R" Us engaged in unlawful vertical agreements with manufacturers not to deal with warehouse clubs. According to the FTC, these actions had the result of excluding a more efficient rival and raising the price consumers pay for toys, without affecting the incentive or ability of Toys "R" Us to provide dealer services that promoted industry output. Together with its economics expert, the FTC argued that: (i) Toys "R" Us is a monopsonist purchaser of toys; (ii) Toys "R" Us has monopoly power at retail in many local markets; and (iii) Manufacturers unilaterally would have chosen to sell to warehouse clubs absent the coordination among toy manufacturers engineered by Toys "R" Us.

The paper summarizes the economic analysis presented in expert testimony on behalf of Toys "R" Us. The analysis indicates that the Toys "R" Us warehouse club policy did not harm competition in the toy industry. While a firm's ability to exclude a more efficient rival may reflect an exercise of market power that harms competition in an industry, Toys "R" Us' policy cannot be characterized in this manner. First, Toys "R" Us' policy was limited in its...
The remainder of this paper presents the analytical basis for these conclusions. Section II presents some background on the toy industry and discusses the implications of these industry characteristics for economic analysis. Section III evaluates the ability of warehouse clubs to free-ride on the promotional services provided by Toys "R" Us and discusses the warehouse club policy in the context of free-rider considerations. Section IV evaluates the FTC's claim that Toys "R" Us acted as the hub of a horizontal conspiracy. Section V evaluates the FTC's claim that Toys "R" Us has monopsony power as a toy buyer and Section VI evaluates the FTC's claim that Toys "R" Us has market power as a toy retailer.

5.2. Basic Economics of the Toy Industry and Implications for Antitrust Analysis

This section provides background information on the economics of the toy industry and discusses the implications of these industry characteristics for evaluating the allegations made by the FTC.

5.2.1. Concentration and barriers to entry and expansion in toy retailing

Toys "R" Us is the largest toy retailer in the U.S. In 1995, Toys "R" Us operated more than 600 stores in the U.S. and accounted for about 20 percent of toy sales in the U.S. Toys "R" Us faces competition from other national toy retailers including Wal-Mart, which accounts for 15 percent of industry sales, K-Mart (9 percent), Target (6 percent) and KayBee (4 percent). Toys "R" Us also faces competition from a wide variety of other firms such as regional discounters, department stores, specialty stores, variety stores, drug stores, catalog showrooms, and direct marketers. The Toy Manufacturers of America, Inc., reports that there are approximately 74,000 retail outlets in the U.S. that sell toys. For the U.S. as a whole, the Herfindahl-Hirschman Index (1-UH) of concentration is below 800, a level that the Department of Justice and FTC Merger guidelines would characterize as "unconcentrated."

There are few, if any, barriers to entry or expansion in toy retailing. In addition, any number of retailers -- including warehouse clubs -- can, and do, rapidly expand their toy departments in response to fluctuations in demand. The growth of Toys "R" Us and Wal-Mart provides dramatic evidence of the ease of entry and expansion in toy retailing. The number of Toys "R" Us stores increased from 271 in 1987 to 653 in 1996. The share of toy sales in the U.S. accounted for by Toys "R" Us increased from 10 percent in 1985 to about 20 percent today. Over the same period, toy sales by Wal-Mart grew even faster.

The large number of existing toy retailers and the ease with which retailers can enter and expand implies that Toys "R" Us is unlikely to have meaningful market power as a retailer. Our studies below confirm this implication.

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furniture, and jewelry), they carry a very limited number of stock keeping units (SKUs) in each category. For example, the major warehouse clubs typically carry 4,000 SKUs at any time. This compares with the current practice of Toys "R" Us of carrying roughly 11,000 toy SKUs alone, which is below the roughly 15,000 SKUs, mainly toys carried by Toys "R" Us until 1996. Wal-Mart and Target, in contrast, carry roughly 4,000 toy SKUs.

Warehouse clubs attempt to carry only top selling items in each product line. This approach to retailing has raised free-riding concerns both among other (non-toy) retailers and manufacturers. In a broad number of product categories, manufacturers differentiate the products sold through warehouse clubs from those sold through other retail channels. As discussed in more detail below, a large number of manufacturers refuse to distribute any products through warehouse clubs.

The warehouse clubs' approach to selling toys is similar to their approach to other retail categories, attempting to carry only a limited number of popular SKUs. The number of toys carried by warehouse clubs (or indeed that the clubs ever planned to carry) is a tiny fraction of the number that other toy retailers offer. The major warehouse clubs carry only about 100-150 or so SKUs during the Christmas season and fewer during the rest of the year. In total, warehouse clubs have played a minor role in toy industry sales.

Of the three major warehouse clubs, only PriceCostco and Bys are of practical relevance to this case. This is because Wal-Mart, which owns Sam's Club, rarely allows identical toys in its Wal-Mart and Sam's Club stores. Hence, since Wal-Mart tends to carry the most popular toys (which are the ones the warehouse clubs also say they want), the Toys "R" Us policy winds up having little or no effect on Sam's Club. As discussed in Section III below, Wal-Mart's actions are consistent with Toys "R" Us' concerns that warehouse clubs free-ride on services provided by more traditional retailers.

5.2.4 Seasonality and "hits" in the toy industry

The toy industry is a highly seasonal industry, with roughly 50 percent of industry sales occurring in the last quarter of the year. Even these data, however, fail to capture the extraordinary seasonality of toy sales. Data from Toys "R" Us show that toy sales increase each week beginning in October through Christmas.

The bulk of industry toy sales is accounted for by a relatively small number of products. In 1993, for example, Toys "R" Us sold roughly 15,000 SKUs but 46 percent of its sales were accounted for by the top selling 10 percent of SKUs. In addition, the identity of the top selling toys in the industry changes substantially from year-to-year and is hard to predict. For example, only a small fraction of the top 100 toys in any year remain among the top 100 in subsequent years.

The strong seasonality in toy sales and the hit-driven nature of demand contribute to frequent divergences between anticipated and realized demand. The supply of toys, however, generally does not respond rapidly to unanticipated demand due to the relatively long delivery cycles resulting from overseas production and waterborne international shipments. Prices at both the retail and wholesale level generally do not rise meaningfully for toys that become hits and also do not rise during the peak Christmas season. As a result,
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5.3.1 Free riding and responses by manufactures and retailers

It is often efficient for a manufacturer to sell its products through independent distributors instead of performing these functions itself. Complete separation of manufacturing and distribution can be efficient, problems may ensue because the incentives and goals of independent distributors do not necessarily coincide with those of manufacturers. It is in the interest of both distributors and manufacturers to design distribution policies that mitigate these incentive problems and permit distribution to be organized efficiently.

The incentives of a manufacturer and distributor may diverge when a distributor's investments in promoting and selling a manufacturer's product benefits other distributors. This circumstance enables a distributor who does not invest in promoting the manufacturer's product to "free-fide" on another distributor's investment. This in turn undermines a distributor's incentive to expend resources in promoting a product. As a result, promotion and sales decline to the detriment of the manufacturer.

Distributors promote and sell products in a variety of ways including, for example, creating a showroom, advertising, providing trained sales staffs, and the like. The following summarizes this free-rider problem in the context of distributor-provided showrooms:

Selling many durable goods ... requires a large showroom to display products, so that consumers can select the best model to satisfy their particular needs. Showrooms, of course, cost money as does the inventory on display. If only one distributor has a well stocked showroom, all customers go to that showroom to decide which product to buy, but they can buy from other distributors with less fancy showrooms and smaller inventories. These distributors can charge a lower price than the first distributor because their costs are lower. Thus no dealer has an incentive to maintain a well-stocked showroom. (D. Carlton and J. Perloff, Modern Industrial Organization, 1994, 2nd edition, p. 527-8)

Free-rider problems arise because of the difficulty in pricing the promotional services provided by a distributor separately from physical goods. If a manufacturer could somehow pay a retailer the "appropriate" price for providing promotional services, free-rider problems could be avoided and distributors would face the appropriate incentives for providing services:

Free-riding ... is a problem that arises because distributors are not compensated separately for sales efforts; instead, they are compensated for sales efforts on behalf of a particular product only when they sell that product. (Carlton and Perloff, p. 527, emphasis in original)

The term distributors is used generically in this section and encompasses retailers.
This does not suggest that vertical restraints can never have anticompetitive consequences. It is well recognized that under certain conditions vertical restraints can have undesirable consequences such as facilitating a cartel among manufacturers to raise the wholesale price. (See Carlton and Perloff, pp. 535-6.) These conditions, however, do not apply in this case. For example, the FTC never alleges that manufacturers have attempted to collude for the purpose of raising the wholesale price of toys.

5.3.2 Services provided by Toys "R" Us and their role in generating demand for toys

Toys "R" Us expends considerable effort in promoting and selling toys. As discussed in this section, these efforts include providing a "showroom" for the toy industry, working with manufacturers in developing new products, and providing information that enables manufacturers to evaluate new products and identify sales trends. This section also shows how advertising and promotional efforts by Toys "R" Us significantly affect the sales of other retailers.

Toys "R" Us is the showroom for the toy industry. As noted earlier, Toys "R" Us historically has carried roughly 15,000 SKUs, and even today, following a SKU-reduction program in 1996, continues to carry more than 11,000 SKUs. This is roughly 100 times as many toy SKUs as warehouse clubs seek to carry. As documented above, there is substantial uncertainty associated with toy demand. Toys "R" Us practice of stocking a wide variety of toys is a key factor in identifying and generating the top selling products that drive industry sales. Put simply, a toy is unlikely to become a top selling product if no one carries it early in the year.

Promotional investments by Toys "R" Us (including its stocking policy) also directly benefits other retailers. Consumers accumulate information by shopping throughout the year at Toys "R" Us but demand is often not realized until the Christmas season, and often at other retailers. For example, fully two-thirds of the toys purchased by consumers who purchase at least occasionally at Toys "R" Us were made at other retailers. Other retailers also benefit to the extent that Toys "R" Us generates information that guide purchasing decisions by rival retailers in subsequent months or years.

As discussed in Section 11 above, the Toys "R" Us showroom also benefits a manufacturer by generating the sale of a wide variety of its products. A substantial fraction of toy purchases are not planned. Thus, the Toys "R" Us policy of carrying a broad range of products enables a manufacturer to generate unplanned purchases of a variety of products.

Toys "R" Us works extensively with manufacturers in the development and the market testing of new products. For example, more than 1300 SKUs were on test status with Toys "R" Us in March 1996. (Such products were stocked in a limited number of stores.) Many of these are products being tested by manufacturers for possible widespread introduction, including the testing of advertising campaigns. Toys "R" Us also works directly with manufacturers in developing products. These services benefit other retailers by generating industry demand and helping to identify top selling products.

Toys "R" Us also maintains a sophisticated data management system that enables toy manufacturers to monitor the sales of each of their products. For example, manufacturers can obtain point-of-sale information from Toys "R" Us on a weekly basis that is specific to SKU and individual store locations, as well as data at higher levels of aggregation. Manufac-
5.3.3 The Toys "R" Us warehouse club policy and compensation for provision of services

As discussed above, Toys "R" Us exhibits and promotes a wide variety of products and helps identify and create popular toy items. While Toys "R" Us makes these efforts throughout the year, a large share of toy demand is not realized until the Christmas season and is often realized by other retail outlets, including warehouse clubs. The importance of these spillovers is suggested by the fact that fully two-thirds of the toys purchased by consumers who purchase at least occasionally at Toys "R" Us were made at other retail outlets.

Warehouse clubs free-ride by attempting to sell (but not helping to identify and create) top selling products. The warehouse clubs' strategy of selling a limited number of high-velocity SKUs enables them to avoid significant advertising and promotional expenditures and contributes to their ability to keep costs low. It is well known that in many retail segments, including toys, warehouse clubs attempt to "cherry pick" by carrying only the best selling products. In addition, warehouse clubs can take advantage of information regarding expected demand generated by purchases by Toys "R" Us and others, which generally place their orders earlier in the year than warehouse clubs. For example, Toys "R" Us typically places order with vendors early in the year (at industry's annual Toy Fair in February or before), while warehouse clubs typically order in late spring and early summer. Warehouse clubs also free-ride when, for example, a consumer that sees an item advertised by Toys "R" Us buys that item at a warehouse club.

As discussed above, limitations on product distribution through a variety of forms are commonly used to mitigate free-rider problems. These mechanisms assist in solving what is likely to be an otherwise intractable problem of relying exclusively on payments to an individual distributor to provide promotional services that may also benefit other distributors.

The Toys "R" Us warehouse club policy mitigates free-rider problems by (potentially) limiting the distribution through warehouse clubs of the particular SKUs that Toys "R" Us carries and thus helps promote. Sales by warehouse clubs of top selling products they did not promote or help develop can deprive Toys "R" Us and other traditional retailers of sales and undermine the incentive for these retailers to provide promotional services. These lost opportunities can be especially large for top selling toys and products that are in short supply, since these items play a key role in generating store traffic and sales of secondary products.

The warehouse club policy, especially for hit products on allocation, is comparable to a traditional solution to free-rider problem, whereby a manufacturer induces promotional services "by rewarding [retailers] by sending them larger or more timely shipments when demand is unexpectedly high." (Carlton and Perloff, p. 53.)

Toys "R" Us is not alone in recognizing the problems that arise when warehouse clubs carry the same products carried by retailers that offer more services. As mentioned above, Wal-Mart, which owns Sam's Club, appears to apply on its warehouse club affiliate the same basic restriction embodied in the Toys "R" Us warehouse club policy. The same toy items are rarely carried in both outlets. Wal-Mart's actions are consistent with Toys "R" Us' free-rider concerns. Wal-Mart provides a far broader selection of toys and promotes these toys more extensively than Sam's Club. Allowing identical items to be carried in both
The FTC's view of services provided by Toys "R" Us and free riding

The FTC acknowledges that Toys "R" Us provides valuable services and plays a significant role in generating industry demand but argues nonetheless that free-riding by warehouse clubs is not significant because Toys "R" Us receives "sufficient" compensation for various services it provides in the form of allowances.

The economic relationships between toy manufacturers and traditional toy retailers such as Toys "R" Us are enormously complex. Such dealings involve the establishment of wholesale prices and often an array of other terms including, among others, advertising allowances, "early buy" allowances, "early ship" allowances, volume discounts, dating terms and delivery commitments. Still other contract terms are left unspecified by the parties. For example, retailers receive markdown allowances for certain products that do not sell as well as anticipated but the size and terms of such allowances are typically not specified in advance. To further complicate matters, such adjustments may be tied to the future sale of other products. In effect, the nature of the agreement is enforced by the parties' reputations and the fact that it is in the interest of vendors and retailers to maintain good working relationships.

The FTC has suggested that contract allowances can and do reflect the appropriate price for a particular service provided by Toys "R" Us. Such an inference, however, is incorrect. For example, Wal-Mart provides certain services but negotiates a single "net" price that typically does not include specific allowances. Moreover, Toys "R" Us provides important promotional services, such as providing a showroom for which it receives no specific allowances.

The services provided by Toys "R" Us -- including the display of a wide range of products, marketing guidance, data on sales trends, advertising and promotional support -- help generate and identify the products that become hits in the toy industry. In effect, Toys "R" Us generates information that is of value to both manufacturers and other retailers but is not directly compensated for providing this information. Instead, Toys "R" Us is compensated for providing this information only when it sells a toy. This is precisely the circumstance that raises concerns about free-riding behavior.

While Toys "R" Us receives some compensation for services, this does not imply that free riding is not a significant problem. Free-riding is a consequence of the difficulty in establishing the appropriate price for compensating distributors for providing promotional services. Because of this difficulty, there are ample opportunities for warehouse clubs to free-ride on investments made by Toys "R" Us in providing services that provide spillover benefits to warehouse clubs by stimulating toy demand.

The limited scope of the warehouse club policy and FTC's claims

The Toys "R" Us warehouse club policy is narrow in scope: Toys "R" Us reserved the right not to carry only items that were identical to those sold to clubs. It did not refuse to carry other products sold by a manufacturer that did business with warehouse clubs and it did not refuse to carry products that were sold through warehouse clubs in a differentiated form (e.g., included in a modified form or in a combination package with other items). Instead it chose not to carry only products that were identical to those sold through clubs.
date to support a horizontal agreement: The industry is unconcentrated, with an $1*11$ of less than 800; there are few if any barriers to entry into toy manufacturing and there is a significant level of turnover among the largest manufacturers. These industry characteristics complicate the formation of horizontal agreements among firms because the interests of individual firms in the industry are likely to diverge.

A conspiracy among toy manufacturers makes economic sense only to the extent that the participants in the conspiracy would be expected to benefit from the agreement. The FTC, however, does not claim that the alleged conspiracy among manufacturers was intended to raise the wholesale price that toy manufacturers receive. Instead, the immediate consequence of any conspiracy, according to the FTC, would be to raise manufacturers' distribution costs by limiting sales through low-cost retailers (compared to what costs would be in the absence of the Toys "R" Us policy). With wholesale prices unaffected but distribution costs allegedly raised by the exclusion of the warehouse clubs, retail prices would increase and consumers would buy fewer toys as a result of the alleged conspiracy. Toy manufacturers would have no motive to participate in such a conspiracy because their toy sales would fail.

5.4.2 Manufactures unilateral incentives to restrict sales to warehouse clubs

Many manufacturers have strong unilateral reasons to sell a product to Toys "R" Us and not to warehouse clubs under the Toys "R" Us warehouse club policy. If manufacturers continued to sell identical items to both warehouse clubs and Toys "R" Us, the incentive for Toys "R" Us to provide services to manufacturers would be harmed, in turn harming manufacturers' long-run sales.

As suggested in the above discussion of services provided by Toys "R" Us, these unilateral incentives derive from the fact that Toys "R" Us benefits a manufacturer by:
providing a year-round industry showroom; creating a market for a wide variety of its older toys and secondary products; providing promotional support on a year-round basis, purchasing early in the year and enabling a manufacturer to better forecast demand and plan production; assisting a manufacturer in developing and testing new toy products; and providing detailed sales information to a manufacturer on a weekly basis, enabling the manufacturer to better assess market trends.

The warehouse club policy, in effect, left a manufacturer with a choice of selling a particular item either to warehouse clubs or to Toys "R" Us. The services provided by Toys "R" Us give some manufacturers strong unilateral incentives not to sell to warehouse clubs the identical products sold by Toys "R" Us. No conspiracy theory is required to understand why a manufacturer would decide to deal only with Toys "R" Us.

5.4.3 Interpretation of communications between manufactures and Toys "W" Us regarding the warehouse dub policy

The FTC's evidence of alleged conspiracy is based largely on testimony to the effect that: manufacturers wanted to do business with the clubs and were unhappy with the Toys "R" Us policy; manufacturers complained to Toys "R" Us when they saw other
it about the terms gained by rivals. For example, when someone purchases a car, they are likely to be interested in the price that their neighbor paid. This information is of value in order to understand the negotiating possibilities, not because the customer is engaged in a conspiracy with their neighbors.

As a general matter, unfettered communications between a manufacturer and a distributor serve society's interest by coordinating the efficient distribution and promotion of products. Restrictions on such communications could raise costs and lead to inefficiencies.

5.5 Evaluation of Claims That Toys "R" Us Exercises Monopsony Power As A Buyer Of Toys

The claim that Toys "R" Us has monopsony power as a buyer is a central feature of the FTC's claim. The FTC supports its claim that Toys "R" Us has monopsony power by citing data regarding: the share of sales of some major toy vendors accounted for by Toys "R" Us; the alleged ability of Toys "R" Us to reduce profits of toy vendors by negotiating a low price; and vendors' dependence on Toys "R" Us for sale of non-hit toy products.

This section first reviews the economics of monopsony and shows that, properly interpreted, none of the evidence just discussed indicates that Toys "R" Us exercises monopsony power. Indeed, the evidence indicates that Toys "R" Us does not restrict output, as would be expected under monopsony, but instead indicates that Toys "R" Us plays an important role in expanding industry output. We also present the results of an econometric study that provides further evidence that Toys "R" Us does not exercise market power as a buyer.

If Toys "R" Us does not have monopsony power, its warehouse club policy can be best understood as an efficiency-enhancing device designed to limit free-riding by warehouse clubs. However, even if Toys "R" Us did possess some monopsony power as a toy buyer, the warehouse club policy may still benefit consumers by enabling Toys "R" Us to provide services that it would not have an incentive to profitably offer in the presence of competition from free-riders.

5.5.1 Economics of monopsony

Monopsony exists when there is a single buyer in a market. A monopsonist has the ability to depress the price of the good it purchases by restricting the quantity supplied. Some essential characteristics of monopsony are as follows:

A monopsony's decision on how much to buy affects the price it must pay (just as a monopoly's choice of output affects the price it receives). The monopsony decides how much to purchase by choosing a price-quantity pair on the industry supply curve. Monopsony is the flip side of monopoly. Both a monopoly and a monopsony recognize that their actions affect the market price. (Carlton and Perloff, p. 152)
custom-designed machinery (or new investments in a plant) for a specific buyer if they earn a depressed return compared to what they can earn from making other machines (or building a plant elsewhere). In other words, few resources are specialized in the long run, and therefore it is unlikely that monopsony can persist in the long run. (Carlton and Perloff, p. 156)

Alternatively stated, monopsony power is rare because few resources are specialized in the long run. As a result, suppliers cannot be forced to accept a return below the competitive level. Even a buyer that accounted for 100 percent of a manufacturer's shipments may not be able to exercise monopsony power because the supplier cannot be forced to continue production of that good and accept a return below the competitive level.

The toy industry appears to be a particularly unlikely candidate for monopsony because the technology of toy manufacturing is simple and appears to utilize relatively standard production processes (such as contract manufacturing overseas) that can be deployed rather quickly to alternative uses. Under these circumstances, it is unlikely that Toys "R" Us could force a toy manufacturer to accept a below-competitive return because manufacturing capacity would likely be put to use in other ways.

The FTC confuses the concepts of bargaining with monopsony. It fails to distinguish circumstances in which buyers lower price by reducing output -- an outcome that typically harms consumers -- from circumstances in which a lower price does not reduce output and leaves consumers unharmed or better off. That is, the FTC fails to distinguish monopsony power from the ability of parties to bargain when they enter a contract.

A buyer may succeed through bargaining in inducing a supplier to accept a lower price, but such efforts need not induce the supplier to restrict output. While such bargaining by a buyer may succeed in transferring economic profits earned by a seller to the buyer, it does not reflect monopsony power (and does not result in harm to consumers) unless output is restricted. In most contracts, each side bargains over how the gains from the contract should be split. Such bargaining over price is not evidence of monopsony power.

Similarly, monopsony must be distinguished from a large buyer's ability to obtain a lower price through volume discounts. Volume discounts may reflect the lower cost associated with large purchases or might reflect the desire of a seller to price discriminate. Volume discounts, for example, are standard practice in a great many industries. Unlike monopsony, however, volume discounts do not depress the quantity produced and thus do not imply the presence of monopsony power. To the contrary, volume discounts are typically associated with higher volumes.

One way to avoid mischaracterizing bargaining as monopsony is to ascertain whether the supplier would willingly produce additional units at the current (allegedly monopsony) price. If the answer is yes, then monopsony, with its harmful restriction of output, is not present. As discussed below, toy manufacturers do not appear to be monopsonized according to this standard criterion.

A buyer's bargaining ability need not translate into monopsony power for a variety of reasons, as we have already explained. It is also key to remember that a seller may also have the ability to bargain. Just as sellers face sunk costs in the short run, so too do buyers. Toy manufacturers, for example, have the ability to reduce the profits of Toys "R" Us by shifting
of monopsony power, as the FTC suggests, then economic theory predicts that TOYS "R" Us should incur lower costs of acquiring toys, and thereby generate significantly higher margins, when it accounts for a greater share of a vendor's total sales.

Our analysis is based on data from Toys "R" Us' Vendor Analysis Report for 1994 and 1995. This report, which is prepared by Toys "R" Us in the ordinary course of business, reports the net margin earned by Toys "R" Us by vendor. The vendor-specific net margin figure is defined as revenue received by Toys "R" Us (including allowances) less the cost of goods and other expenses such as advertising and promotion that can be directly related to a vendor's product. Estimates of the share of each vendor's sales accounted for by Toys "R" Us is based on NPDnM data for 1994 and 1995. These data, which report sales through Toys "R" Us and other retailers, are used to calculate the share of each vendor's total sales accounted for by Toys "R" Us.

Table 2 summarizes the results of an econometric analysis of the relationship between the vendor-specific margin earned by Toys "R" Us and its share of vendors' purchases. Regression analysis is used to compare vendor-specific margins earned by Toys "R" Us (the dependent variable in the analysis) with the share of the vendor's sales accounted for by Toys "R" Us. The analysis holds constant a variety of other potential determinants of the vendor-specific margin earned by Toys "R" Us. Specifically, the econometric analysis controls for the total amount of purchases from the vendor by Toys "R" Us and vendor-specific measures of inventory turnover.

None of the econometric specifications reveal statistically significant evidence that Toys "R" Us earns higher margins when it accounts for a larger share of a vendor's sales. Thus, the available data do not support the FTC's assertion that Toys "R" Us exercises monopsony power.

5.5.3 Evaluation of the FTC's claim that Toys "R" Us has monopsony power due to its role in stocking non-hit products and its provision of services

The FTC argues that Toys "R" Us has monopsony power because manufacturers are dependent on Toys "R" Us for sales of non-hit toy products and provision of services. According to the FTC, Toys "R" Us provides the critical mass to support non-hit products. The FTC cites a variety of other services provided by Toys "R" Us as the basis of their claim that Toys "R" Us exercises monopsony power. These services include: support by Toys "R" Us for new product launches and television advertised products; the Toys "R" Us' practice of carrying a broad line of manufacturers' products throughout the year; purchases from manufacturers by Toys "R" Us early in the year; advertising and promotional support provided by Toys "R" Us; and international sales by Toys "R" Us.

The FTC's argument ignores the fact that other toy retailers could, if they chose to, readily purchase non-hit products and provide these services. Moreover, the FTC's argument fails if Toys "R" Us' sales of non-hit products and its provision of services depend upon Toys "R" Us' being able to undertake a distribution policy that protects against free

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12MarginS reported in the Vendor Analysis Report do not include costs relating to product distribution or store operating expenses.
13 We analyze the relationship first for vendors which accounted for at least $5 million in Toys "R" Us sales and then for all vendors in the Toys "R" Us Vendor Analysis.
If a retailer's market power is defined as the ability to raise prices when rivals are located farther instead of nearer, then most retailers can be said to exercise some market power in at least some locations. The ability of retailers to raise prices in such circumstances, however, typically is small because it is constrained by customers' ability to purchase from more distant rivals and by the ability of other retailers to enter and expand in retailing. As discussed above, the ability of firms to expand is particularly relevant in the toy industry, where many retailers expand during the Christmas season.

This does not imply that retail competition is never an appropriate concern of antitrust enforcement. Instead, it suggests that if the benchmark of perfect competition is used, virtually all retailers in the U.S. economy have some market power. Therefore, a sensible antitrust policy must consider carefully the magnitude of price differences resulting from different levels of competition before making inferences regarding the significance of market power.

Toys "R" Us generally establishes the same prices throughout a metropolitan area. These areas are defined on the basis of newspaper circulation areas, which usually coincide with metropolitan areas. The same or very similar prices are generally required for all stores in a metropolitan area because Toys "R" Us catalogs and rotos (which specify prices) are distributed as newspaper inserts. This indicates that any store-specific pricing considerations are too small to justify adopting other approaches to advertising and promotion. Pricing areas generally correspond to ADIs (Areas of Dominant Influence) which are defined by the advertising industry based on areas of media exposure. 14

Toys "R" Us operates in more than 200 ADIs and applies one of about 40 or so pricing schedules (or "versions") in each of these areas. These pricing versions typically are named for the mix of rivals operating in an ADI. For example, Chicago is in a pricing version entitled: "K = Target, Wal-Mart & Best Buy," which indicates that these retailers operate in the Chicago area. Given that Toys "R" Us relies on ADIs in applying pricing schedules, the econometric analyses of retail pricing presented below uses the pricing version area (the ADI) as the basis for analysis.

Toys "R" Us also maintains data on the location of certain rival toy retailers. The database contains information on the drive times between Toys "R" Us and other retailers' stores." Toys "R" Us uses this database in constructing a "competition index," which, in effect, counts the number of rivals located in the general vicinity of each Toys "R" Us location, weighting them by driving time to a Toys "R" Us store. We do not necessarily endorse the "competition index" as an appropriate measure of local competitive conditions. Toys "R" Us uses this index primarily to set sales targets and profitability goals for individual stores.

We have analyzed whether Toys "R" Us currently exercises market power based on ADI-specific measures of margins and competition. Before turning to the statistical analysis, however, it is instructive to examine a simple example of pricing differences in areas with

"There are occasional downward (but not upward) deviations in pricing below area-wide levels in response to local conditions. These are used rarely since lower prices cannot be advertised efficiently in small geographic areas within a metropolitan area-

151n 1995, the competition database included the location of stores operated by Wal-Mart, Target, Baby Superstore, Best Buy, Bradlees, Caldor, Fred Meyer, Hills, Lit' Things, Meijer, Venture. Some but not all K-Mart locations are included, with the determination based in part on the age of the K-Mart store.
Market Power and Vertical Restraints

(Wal-Mart and Target) and whether other firms operate in the ADL’s. The regression model again includes variables relating to the average characteristics of Toys "R" Us stores in the ADL.19

The results indicate that margins in areas in which at least one major rival operates are a bit lower than elsewhere; but prices in areas in which two "majors" operate are not statistically significantly different than those in areas in which only one operates. They also indicate that the presence of other firms in the pricing version area (as identified in the Toys "R" Us competitor location database) has no systematic relationship to margins earned by Toys "R" Us.

As Table 5 shows, the presence of either Wal-Mart or Target in a pricing version area is associated with Toys "R" Us prices that are approximately 1.3 percent lower than those in areas in which neither operates. There is no significant difference in prices in areas in which both Wal-Mart and Target operate compared to areas in which only one is located. The relationship between margins earned by Toys "R" Us and the presence of "other" competitors is not statistically significant (and is trivial in magnitude).

These findings indicate that Toys "R" Us is unable to charge higher prices in areas in which it faces only one major rival instead of two and that the addition of rivals other than majors do not lower prices further. This implies that the same prices prevail in areas in which Toys "R" Us faces competition from only one major rival retailer as in areas where it faces more rivals.20

Even in those few areas in which Toys "R" Us does not face a major rival, which we show below to characterize only 3 percent of Toys "R" Us stores, Toys "R" Us is unable to raise price by a sizeable amount. The elevation in price in these areas is only a little more than one percent. In other words, competition keeps price in different areas within a percent or so of each other.

5.6.2 Retail competition faced by Toys "W" Us stores

The regression results indicate that as long as one major rival is present, prices are the same as when more rivals are present. Moreover, the results show that the magnitude of...

"Wal-Mart and Target are the largest retailers tracked comprehensively by Toys "R" Us, in constructing the competition index. K-Mart, another large toy retailer, is not systematically tracked by Toys "R" Us. This reflects the ubiquity of K-Mart stores throughout the country. Therefore, K-Mart locations included in the database are included with "other" retailers.

19TWs regression specification explains more variation in Toys "IV" Us margins across ADIs than that using the competitive index measures. In particular, the competitive index model explains roughly 30 of this variance (based on the adjusted R2); the alternative model explains roughly 35 of the variance.

20A variety of alternative econometric specifications further confirm these results. For example, an alternative specification which identifies the percentage of Toys "R!" Us stores in a region that face competition from zero, one or two major rivals, yields results that are similar to those reported above. This specification yields estimates of the elevation in price in areas in which Toys "R" Us faces no competition from major retailers to be less than one percent above that in areas where major rivals operate. Other regressions based on changes in prices and competitive conditions over time (i.e., fixed effects models) confirm these results.

21 This small elevation contrasts with the FrCs view in the denied merger between Staples and Office Depot that estimated price effects of five to fifteen percent raised market power concerns. The econometric frame- work we apply here is very similar to that used by the FIT in the Staples matter.
"R" Us has monopsony power as a buyer of toys, and used this power to foreclose warehouse clubs from access to various toys. None of the evidence put forward by the FTC indicates that Toys "R" Us restricts output, as would be expected under monopsony. The evidence instead indicates that Toys "R" Us plays an important role in expanding toy industry output. Analysis of the available evidence on Toys "R" Us's share of vendor sales is inconsistent with the FTC's claim of monopsony. Finally, Toys "R" Us does not have meaningful market power in toy retailing. The analysis indicates that pricing by Toys "R" Us is tightly constrained by competition.
TABLE 5.3:
Sample Comparison of Toys "W' Us Prices in Stores With Unusually High and Unusually Low Values of ComDetition Index 1995 -

<table>
<thead>
<tr>
<th>Store</th>
<th>Competition Index</th>
<th>Retailers in Pricing Version Title</th>
<th>Average Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Totowa, NJ</td>
<td>0</td>
<td>None</td>
<td>$12.26</td>
</tr>
<tr>
<td>Toledo, OH</td>
<td>114</td>
<td>Wal-Mart</td>
<td>$12.16</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Target</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Meijer</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Best Buy</td>
<td></td>
</tr>
</tbody>
</table>

Difference

Percent: 0.8%

Source: Toys "W' Us

TABLE 5.4:
Relationship Between Toys "W' Us Prices and Competition Index 1995

(a)Coefficient estimate relating average Competition Index in region to TRU merchandising margin - .004
Effect of adding one additional competitor five minutes from all TRU stores
(b)Change in Competition Index 9
(c)Estimated change in TRU margin (=a)*b) - .039
(d)Mean Merchandising margin 27.26
(e)Estimated percentage change in price - .05%

Note: Based on regressions which also includes independent variables reflecting: the percentage of stores in ADI that are metropolitan areas and towns, ADI population; the average age and square footage of stores in the ADI; and the percentage of stores with expected volumes of less that $7.2 million.

* (e)+I-{(100-d)/(100-(d+c))})*100.

TABLE 5.5:
Estimated Effect of Presence of Competitors in ADI on Toys "W' Us Merchandise margins 1995

<table>
<thead>
<tr>
<th>Estimated Coefficient</th>
<th>Implied Percentage Change in Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>No major retailers operate in area</td>
<td>-</td>
</tr>
<tr>
<td>One major retailer operates in area</td>
<td>-.912</td>
</tr>
<tr>
<td>Two major retailers operate in area</td>
<td>-1,040</td>
</tr>
<tr>
<td>Other knockoff retailers operate in area</td>
<td>-.925</td>
</tr>
</tbody>
</table>

Notes: Based on regressions which also includes independent variables reflecting: the percentage of stores in ADI that are metropolitan areas and towns; ADI population; the
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Edited by

Daniel J. SLOTTJE
Department of Economics
Southern Methodist University
Dallas, Texas, USA

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