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The Oracle Decision and Evidentiary Issues on Substitutability in Merger Cases

By J. Stephen Stockum and O. Andrew Garibaldi

In a decision that contains a remarkably detailed and thoughtful exposition of eco- nomic theory and the government's evidentiary burden, Judge Vaughn Walker, o the U.S. District Court in San Francisco, recently ruled that the Justice Departmen failed to meet its burden in its attempt to enjoin Oracle Corporation from acquir- ing PeopleSoft, Inc. The Department had alleged that the acquisition would reduce competition in certain markets for enterprise application software.

The issue of the degree of substitutability is at the heart of both market definition and uni- lateral effects analysis, and it plays a central role in Judge Walker's decision. In some cases, substitutability can be measured through rigorous econometric analysis of detailed transaction data, such as supermarket scanner data. When such data are not available, as in this case, less rigorous methods must be employed. Judge Walker's decision stresses however, that the Justice Department's evidence on substitutability must go beyond being merely suggestive. The evidence must be conclusive to support an allegation of a well- defined product market or the isolated product grouping that supports an allegation of uni- lateral effects. The mere existence of some customers who consider the merged products to be close substitutes and the fact that each party's internal documents mentions the other as its closest competitor are insufficient as a matter of economics to establish an isolated market. Judge Walker explains that such evidence also is insufficient as a matter of law.

The Justice Department relied heavily on the testimony of customers in its attempts both to define a narrow product market and to demonstrate anticompetitive unilateral effects Many customers testified that they considered no vendors beyond Oracle, PeopleSoft, and one other competitor, SAP, and that they would not substitute to other options even if prices increased by ten percent. In addition, five customers and two consulting firms claimed that Oracle and PeopleSoft are each other's closest substitute and represent better alternatives than SAP.

The court found that evidence to be insufficient. The assertions of a selected group of cus- tomers are not enough to define a product market or to prove any unilateral anticompeti- tive threat. As Judge Walker explains in his decision, "drawing generalized conclusions about an extremely heterogeneous customer market based upon testimony from a smal sample is not only unreliable, it is nearly impossible." The plaintiff's burden is not to prove that there are customers who are willing to absorb a price increase, but rather to prove tha there are not enough customers who would defeat an attempted price increase. While the testimony confirmed that some customers prefer Oracle, PeopleSoft, and SAP over other options and that Oracle and PeopleSoft are often viewed as close substitutes, the testimo- ny did not disprove that a significant number of consumers at the margin would substitute to competitive alternatives to defeat an attempted price increase. Nor did DOJ show tha the merged firm would be able to price discriminate by increasing pricesonly to the cus- tomers who considered Oracle and PeopleSoft to be each other's closest substitute.

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The Economics of the *DOJ v. DFA* Summary Judgment Decision

By Barry C. Harris and David D. Smith

A recent court decision has important implications for the antitrust analysis of partial acquisitions. In April 2003, the Department of Justice (DOJ) filed a complaint in federal court opposing a February 2002 transaction that gave the dairy farmer cooperative Dairy Farmers of America (DFA) 50 percent ownership of the Southern Belle dairy in Somerset, Kentucky. The complaint was amended in March 2004. DFA already was a 50 percent owner of the Flav-O-Rich dairy in nearby London, Kentucky. DFA's partners in the two dairies are economically independent of each other. On August 31, 2004 the court granted the summary judgment motions of DFA and Southern Belle. In its summary judgment decision, the court found that because of the limited and passive nature of DFA's ownership interests in each of the dairies, the incentives and opportunities for collusion are not substantially changed by DFA's dual ownership interests. DFA's history has been to make investments in downstream processors that give it a partial and passive ownership interest, similar to the ownership structures at the two Kentucky dairies.

The structure of DFA's partnership agreements involving the Flav-O-Rich and Southern Belle dairies was the focus of the court's decision. These agreements substantially limit DFA's ability to affect the competitive behavior of the dairies. For example, the Southern Belle agreement vests DFA's partners with the full, complete and exclusive right, power and authority to manage and control the company. Moreover, DFA has virtually no ability to affect investment, is explicitly prohibited from obtaining confidential competitive information or participating in competitive activities, and does not establish its partner's compensation. In its decision, the court noted that DOJ's arguments focus on the incentives and opportunities facing the parties rather than on the extent of DFA control. DOJ argues that DFA's partial ownership in both dairies gives it incentives to reduce competition between the dairies and that the dairies will reduce their head-to-head competition in school milk bidding because of pressure from DFA's common ownership interest.

Without a persuasive argument about control, the DOJ argument reduces to a truism that applies with or without the DFA/Southern Belle transaction. Assuming the existence of certain market conditions, economic theory recognizes that DFA's profits would increase with reduced competition, as would the profits of its partners in the two dairies. The fact that reduced competition would increase profits, however, is not affected by DFA's ownership. DFA's passive ownership also does not affect the incentives of its two partners. DFA's ownership is, in effect, a tax on the profits each of its partners receives. As with a tax, each of DFA's partners maximizes its profit at the same price and quality levels as it would if it were a 100% owner in its respective dairy.

> "For the transaction to reduce competition there must be some mechanism through which the alleged anti-competitive results will occur."

As the court observed, for the transaction to reduce competition there must be some mechanism through which the alleged anti-competitive results will occur. Absent such a mechanism, the transaction has no effect on DFA's two independent partners' incentives and ability to compete. DOJ alleges three basic mechanisms: (1) DFA's access to increased information; (2) DFA's ability to control decisions within the two dairies, and (3) DFA's ongoing relationships with its partners. With regard to the first two mechanisms, the Court found that ". . . with respect to school milk, DFA's involvement and even its access to information regarding same, is almost nil."

With regard to DFA's relationships with its partners, DOJ argued that the partners have incentives to make decisions that are in DFA's interest in order to be included in future deals with DFA. There are several deficiencies with this theory, but the most interesting (though probably unintended) aspect of it is that it logically would extend Section 7 to transactions between non-competitors. For example, in the current case, this logic implies that competition would have been harmed even if DFA's partner in Southern Belle had bought 100% of the dairy, rather than partnering with DFA. Under the DOJ theory the partner's 100% ownership of Southern Belle would harm competition because the partner presumably would have the same incentives to behave anticompetitively to ingratiate itself with DFA and thus increase the prospects of future deals with DFA. Such logic is beyond the scope of accepted Section 7 enforcement.

Baker & Miller retained EI Board Chairman Barry C. Harris and Vice-President David D. Smith on behalf of DFA.

Dr. Harris testified at deposition on the competitive impact of DFA's partial and passive ownership

Competition in Proprietary Aftermarkets

By Robert D. Stoner

The term proprietary aftermarket describes a situation when the original equipment manufacturer (OEM) of a durable good restricts the number of aftermarket suppliers. A proprietary aftermarket is typically created when the OEM makes it difficult for non-authorized suppliers to produce a fully compatible aftermarket product, thus limiting the aftermarket to itself and its licensees. For example, recently a number of ink jet printer suppliers allegedly have tried to limit the supply of lower-priced non-OEM replacement cartridges for their printers. By contrast, in an open system, many different manufacturers can supply aftermarket components, so there is greater availability of low-cost alternatives.

Antitrust cases in which proprietary aftermarkets are challenged often focus on whether competition in the durable equipment market necessarily prevents manufacturers from exercising market power in related aftermarkets. This focus likely stems from the original argument put forth by defendant Kodak in the seminal antitrust case *Kodak v. Image Technical Services*. Kodak argued that its relatively low share in the foremarket precluded any consumer harm in the aftermarket. Plaintiffs who challenge proprietary aftermarkets often argue that consumers can be harmed by restrictive aftermarket policies because they are locked in to a durable product they have already bought and because they are unable to perform the complicated lifecycle pricing calculations that would allow them to avoid high-cost aftermarket solutions in the first place. But the usual arguments of defendants and plaintiffs do not shed much light on the underlying rationale for proprietary aftermarkets or their likely competitive effects.

OEMs have conflicting incentives to want proprietary or open aftermarkets. An OEM may prefer an open aftermarket because consumers would be more likely to buy its product if they knew that aftermarket components were readily available and reasonably priced. Consumers are sensitive to aftermarket cost issues. For example, advice to printer buyers available on the Internet cautions consumers to stay away from a particular printer because that printer's supplier has imbedded a chip in the cartridge that makes it difficult for aftermarket firms to sell cheaper remanufactured cartridges. Nonetheless, several reasons may cause suppliers to favor proprietary aftermarkets. Durable goods suppliers often argue that a proprietary aftermarket assures product compatibility and avoids the possibility a third-party component could cause a failure that the customer would attribute to the OEM. Proprietary aftermarkets also may enable price discrimination against high-intensity users who can be identified after, but not before, they purchase. High-intensity users typically are willing to pay higher prices for a product, but a manufacturer that only controls the price of the initial durable good will be unable to raise price to higher-intensity users without raising price to low-intensity users as well. Suppose, however, that manufacturers also control the price of an aftermarket component, and high-intensity users buy more of that component. For example, customers who use their printer more need more cartridges. Then the manufacturer may be able to target a price increase to high-intensity users by charging higher prices on the aftermarket component.

The essential policy issue in these situations is to determine under what circumstances a proprietary system will produce a less desirable outcome for consumers than an open system. The answer does not seem to hinge primarily on the manufacturer's share of the foremarket, since firms with high market share may adopt less aggressive proprietary aftermarket stances than smaller competitors. Nor does the answer depend closely on the degree to which consumers are locked in or whether consumers are capable of effective lifecycle pricing. Some degree of lock-in is ubiquitous in durable goods markets; typically one expects that purchase of a durable product, such as a printer, will lead to an extended period of use. With regard to lifecycle pricing, most consumers, even sophisticated ones, are capable of making no more than a rough calculation of how long they will keep a particular durable product, such as a printer, and how intensively they will utilize associated consumables. Thus, neither lock-in nor the degree to which consumers can do lifecycle pricing will vary enough between industries to be a sufficiently defining characteristic.

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EI News and Notes

Nayantara Hensel Joins EI as Special Consultant

Nayantara Hensel has joined EI as a Special Consultant. Professor Hensel, who received her BA, MA and PhD in Economics from Harvard, teaches at the Naval Postgraduate School in Monterey, CA. She has previously consulted with NERA and Ernst & Young. Among her areas of interest and specialization are corporate finance and international banking as well as regulation, transportation economics, and industrial organization.

Indiana Michigan Co. v. United States of America

Jonathan A. Neuberger and Manny A. Macatangay recently testified in the US Court of Federal Claims in Washington DC. on behalf of the US Department of Energy. Dr. Neuberger testified with respect to damages claims arising from contract breach. Dr. Macatangay testified with respect to long-term energy market forecasts and energy market analysis. Judge Robert H. Hodges, Jr. ruled against plaintiff's claims for damages.

Pentair Acquisition of WICOR Industries

The Federal Trade Commission allowed Wisconsin Energy Corporation's sale of its subsidiary, WICOR Industries, to Pentair, Inc. to proceed without any divestitures. Wicor and Pentair both sold pool equipment, pumps, and water filters. Philip B. Nelson, William P. Hall, and Henry B. McFarland of EI worked with attorneys from Foley and Lardner and Skadden Arps on this transaction.

Merger of Enterprise and GulfTerra Energy Partners L.P.

Philip B. Nelson, John R. Morris and David D. Smith of EI recently worked on a merger involving GulfTerra Energy Partners L.P. and Enterprise Products Partners L.P. Akin Gump represented GulfTerra, and Vinson & Elkins represented Enterprise. The merger involved offshore pipelines, onshore pipelines, processing plants, fractionators, and storage facilities. After an investigation involving a large number of energy-related markets, the FTC agreed to a consent order that only required the divestiture of an interest in a gas pipeline system and a propane gas terminal and storage facility.

The Oracle Decision and Evidentiary Issues. . . (Continued from Page 1)

The Justice Department based part of its unilateral effects claims on evidence from internal business documents and information on bidding competition. While this evidence confirmed that Oracle and PeopleSoft do "compete frequently" and "that competition can be fierce," it did not prove that Oracle and PeopleSoft do not also compete with SAP. The Justice Department presented an analysis of 25 case studies that showed that competing bids from PeopleSoft affected the discount level that Oracle was willing to offer. This analysis, however, neglected to examine whether SAP had a similar effect on Oracle's pricing. The Justice Department further pointed to internal documents from Oracle that explicitly state that PeopleSoft is Oracle's closest competitor. These same documents, however, highlight that competition with SAP is nearly equally strong. If PeopleSoft is indeed Oracle's closest competitor, then SAP is not far behind. It is not enough to show that the merging firms are each others' closest substitutes to demonstrate a unilateral anticompetitive threat. The Justice Department needed, but ultimately failed, to prove that there is localized competition limited to the merging parties and that substitution to SAP would not be enough to defeat an attempted price increase.

Judge Walker ultimately rejected the Justice Department's product market definition and unilateral effects claim. He concluded that SAP and a number of other competitive alternatives will continue to constrain Oracle's pricing after the merger. SAP's high market shares and history of strong competition for bids persuaded Judge Walker that there is a high degree of substitutability between the products of SAP and those of Oracle and PeopleSoft. In addition, other competitive alternatives also present "reasonable interchangeability" with the products of the merging parties. Several sophisticated customers (including the Justice Department itself) have chosen software from "mid-market vendors," such as Lawson and AMS, above the three market leaders. Other sophisticated customers have avoided purchasing from the three market leaders by hiring outsourcing firms to handle their human resource and financial management needs. Another source of competition comes from so-called "best-of-breed" vendors that specialize in individual software "pillars" instead of selling integrated software bundles, as the merging parties do. The range of viable competitive alternatives and the fact that many sophisticated customers have already opted for them strongly indicate that enough customers would substitute away from Oracle's products to make a post-merger price increase unprofitable.

The important lesson from the Oracle decision is that the government will not succeed in defining a narrow product market or substantiating a theory of unilateral effects without a comprehensive and conclusive analysis of substitutability.

EI Senior Vice-President Stephen Stockum co-authored an article on unilateral effects analysis that was cited repeatedly in the Oracle decision. He and EI Analyst Andrew Garibaldi have worked on a number of mergers and other antitrust cases in which substitutability was a central economic issue.

Competition in Proprietary Aftermarkets. . . Continued from Page 3)

What appears to matter most regarding the competitive effects of proprietary systems competition is the tradeoff between the positions of different user groups. All else equal, proprietary systems competition, relative to open system competition, will tend to feature lower prices for the initial product and higher prices for consumables. As a result, low-intensity users, who buy fewer consumables, are better off with a proprietary aftermarket; high-intensity consumers are worse off. The net effect on consumer welfare depends on (a) the relative size of these groups; (b) the alternatives consumers may have to buying the aftermarket consumables; and (c) the increase in sales due to decreases in the initial price. It may be difficult to determine these magnitudes in practice.

One element that can help practitioners recognize possible instances of proprietary aftermarkets that may hurt consumers is noted in the Kodak decision. The distinguishing characteristic of potentially pro-competitive proprietary aftermarkets is low prices for the initial durable good. Where proprietary aftermarkets are imposed by a change in policy after the initial purchase, there will be no decrease in the price of the initial durable good, and consumers are more likely to be worse off on net. Arguably, this post-purchase imposition of a proprietary aftermarket is what happened in Kodak. Because such a change in policy results in higher aftermarket pricing without lower initial product pricing, it is more likely to indicate anticompetitive proprietary aftermarkets.

Senior Vice President Robert D. Stoner has recently advised clients on matters involving proprietary aftermarkets. He is based in EI's San Francisco Bay Area office.

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