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Thomas Hazlett: An antitrust debacle

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Richard A. Epstein: When the facts don’t matter

The US government’s antitrust enforcers have been rebuked. In a stinging rejection of the Department of Justice’s lawsuit to block the acquisition of PeopleSoft by Oracle, federal judge Vaughn Walker handed the antitrust division its collective head. While the DOJ alleged that the merger would substantially reduce competition in enterprise software applications for high-end corporate users, Oracle is now free to pursue its hostile tender for PeopleSoft shares.

The government saw this case as a simple “3-to-2”. A market dominated by SAP, PeopleSoft and Oracle was being reduced from oligopoly to duopoly. Conventional wisdom, if not sophisticated econometrics, posits that in a 3-to-2 merger, antitrust authorities move to block. The DOJ’s economic expert testified that the relevant US market shares were “SAP, 39 per cent; PeopleSoft, 31 per cent; and Oracle, 17 per cent.” Under the government’s merger guidelines the combination was a non-starter.

But the key, as in most antitrust cases, was defining the relevant product space. If the line is drawn tightly only three rivals are seen; encircle a wider economic world and the merger looks inconsequential. Here, the government’s market definition stretched over paragraphs, settling on “enterprise resource planning” software offered to particular types of clients by particular types of vendors. The definition seemed “gerrymandered” to exclude a multitude of viable competitors not named Oracle, PeopleSoft or SAP.

Major software suppliers like Lawson and AMS were ignored because, the government said, they sold primarily to medium-sized, rather than large corporate or government clients. Outsourcing companies such as Accenture, Fidelity or ADP, providing enterprise software via service contracts, were considered irrelevant. Various niche players such as Siebel, making substantial sales in crucial industry segments, were non-factors. And Microsoft, dominant in desktop operating systems and applications and poised - with recent acquisitions - to roar into large-company enterprise applications, was not even a blip on the government’s competitive horizon.

By process of elimination, the market was whittled to three. But the judge became sceptical when the evidence showed that, quite often, large software users opt out of the government’s designated triopoly. The Mayo Clinic bought from Lawson, rejecting bids from Oracle and PeopleSoft, for instance. Target, McDonald’s, Gucci, Safeway, Walgreens, Ralph Lauren, Williams-Sonoma, Johnson and Johnson, Sarah Lee and McGraw-Hill were also Lawson clients. Bank of America, Sony, Motorola and American Express took the outsourcing route.

Perhaps most devastating was the DOJ’s purchase order: its own IT department opted for AMS. Judge Walker was impressed, noting “two weeks after bringing this case, [the DOJ] chose to buy AMS [enterprise software] for $24 million, ranking AMS better than Oracle or PeopleSoft in the DOJ’s view for the DOJ’s needs.” Smart buy, perhaps. Bad exhibit, almost certainly.

The government brought forth several witnesses from companies purchasing enterprise software. They provided testimony that a merger would decrease their bargaining position vis-a-vis PeopleSoft and Oracle and effectively raise prices. Oracle countered with witnesses who testified that their companies had already availed themselves of suppliers beyond the government’s designated triopoly, demonstrating an ability to pick and choose among multiple enterprise software solutions. The judge ruled that this actual experience with market competition was more compelling than the speculation of post-merger powerlessness advanced by others.

But documents introduced in the case reveal an even more persuasive argument for the merger’s efficiency. When Oracle announced its bid for PeopleSoft, both Microsoft and IBM reacted with trepidation, believing that “the competitive landscape would tilt against them,” as the Associated Press reported. Both software giants entertained strategies to block the take-over, Microsoft by buying a minority stake in PeopleSoft. More explosive still was the Microsoft move - laid out in an e-mail sent by Bill Gates to company president Steve Ballmer - to consider acquiring the industry’s sales leader, SAP, a gambit expected to cost about $60 billion.

These mega-players feared loss of market share from a stronger, PeopleSoft-engorged Oracle. Their expert opinion was that the merged entity would launch more intense competition, not raise prices. Yet, just as Oracle’s strongest long-term rivals scrambled to prepare themselves for the prospect of a more efficient Oracle, government antitrust regulators were moving to block the source of these customer-pleasing improvements. This suggests that the DOJ was actually subverting competitive market forces rather than advancing them.

On the day that news of Judge Walker’s decision made it to the market, Oracle and PeopleSoft shareholders became wealthier by $3.5billion. Nothing to sneeze at, but this generous sum is just a small fraction of the total value unleashed when economic resources as important of those in “enterprise resource planning” are put to more productive use. Consumers, and shareholders in other companies, are likely to see gains far outstrip these.

It goes galaxies beyond ironic that the government here took the side of Microsoft and IBM, inadvertently protecting the “monopolists” they had once attacked. The paradox would be welcome if the DOJ’s consumer report card made us proud. Thanks to Judge Walker, the antitrust authority’s failing grade may now - barring appeal - be merely academic.

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It is always a pleasure to witness my friend Tom Hazlett when he is on a roll, as is surely the case with his full-throated endorsement of Judge Vaughan Walker’s demolition of the antitrust claim that the government brought against PeopleSoft. Judge Walker (surely one of our ablest judges) made an impressive case that the government fumbled its case on its opening gambit: the definition of market share. The government’s definition sought to limit the market to “competition in enterprise software applications for high-end corporate users”, a convenient class that had only three charter members. The problem is, that market is much too narrow. In his usual breezy style, Hazlett details the full range of market dynamics that explains why this rigid test of market definition has to be wrong in this particular case. Why, even the government passed over Oracle and PeopleSoft to find a third competitor, AMS, for its own contract. What better evidence is there than an admission by conduct, that is, by engaging in ordinary business that undercuts your own legal theory?

That said, I have a profound uneasiness about the kind of demonstration that Hazlett made. My point here is simply this: this kind of demonstration can, I believe, in practice be made in each and every case that involves the combination and permutation among companies in a high-tech business. The real risk here is that if that kind of demonstration is required on a case-by-case basis, then the government may rebut it with some particularistic argument that says “here at least your identification of competitors is wrong because company X should be excluded for this reason.”

Stated otherwise, why take the chance that these arguments may win, when the most impressive competitor may well be a company that will form within days of a merger precisely because of the entrepreneurial space that it now sees on the commercial landscape. So long as we have confidence in the background rate of dynamism that pervades this market, we are likely to get better results at lower cost by cutting back sharply on any full-scale showings