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FTC Approves Express Scripts' Acquisition of Medco

Allison I. Holt

EI Senior Economist Allison I. Holt, an empirical microeconomist, specializes in quantitative analysis and assessment of damages in antitrust and class action matters.

The FTC recently decided not to challenge the acquisition of Medco Health Solutions (Medco), the third largest pharmacy benefit management provider (PBM), by Express Scripts, Inc. (ESI), the largest PBM. In the FTC's view, this merger would be unlikely to significantly reduce competition in the market for PBM services, even though the newly merged entity would have a market share of more than 40%.

The FTC found that the merger was unlikely to have unilateral or coordinated anticompetitive effects in the sale of PBM services. Anticompetitive effects were unlikely because the merged firm would face at least ten significant competitors. While there would be only two large PBMs in the market after the merger, larger PBMs do not have a significant cost advantage, and small PBMs have successfully competed with the large PBMs. Moreover, health plans could stop using PBMs and provide PBM services on their own. Unilateral effects were unlikely also because Medco and ESI were not each other's closest competitors; each competed more closely with CVS Caremark (CVS). Coordinated anticompetitive effects were unlikely not only because of the large number of competitors and the possibility that health plans would self-supply PBM services but also because the pricing in the market was far too complicated to allow comparisons of contracts or easier monitoring of prices. Thus, price coordination would be extremely difficult. Moreover, PBMs' different incentive structures made customer allocation highly unlikely.

Finally, the FTC found no evidence that the merger would result in monopsony power in the retail dispensing of prescription drugs. The merged firm would have only a 29% share of retail pharmacy sales. Furthermore, the FTC did not find a strong correlation between PBM size and the rate of reimbursement to retail pharmacies, which indicated that large PBMs were unable to exercise monopsony power.

The merger was controversial. Trade groups and pharmacies filed law suits seeking to block the merger, but they were denied a preliminary injunction. Moreover, Commissioner Julie Brill dissented from the majority FTC opinion. She stated that the merger would essentially create a duopoly comprising the newly merged firm and CVS. The other PBMs would be nothing more than fringe competitors. In her view, diversion ratios suggested the possibility of unilateral anticompetitive effects, and the high post-merger concentration levels established "a prima facie case of coordinated effects." Moreover, she contended that there were significant barriers to entry in the PBM market, as shown by the absence of successful entrants in recent years.

Also In This Issue

Geographic Market Definition: Horizontal Merger Guidelines vs. *Tampa Electric*

Lona Fowdur

A court recently excluded an economist's expert witness testimony because it found that the expert's hypothetical monopolist test to define the geographic market did not conform to the standard that the Supreme Court articulated in 1961 in *Tampa Electric Co. v. Nashville Coal Co.* (*Tampa Electric*). The decision of the U.S. District Court for the Eastern District of Tennessee surprised many observers, since the expert contended that he used the hypothetical monopolist test as it is outlined in the U.S. Department of Justice and Federal Trade Commission's Horizontal Merger Guidelines (Guidelines). Circuit courts have recognized this test as a valid diagnostic tool, and both sides in this case agreed that, properly applied, the test mirrors the *Tampa Electric* standard. The district court judge, however, questioned the expert's application of the test and specifically the equivalence between the expert's methodology and the Supreme Court's standard.

Lona Fowdur is a Senior Economist with EI. She has analyzed geographic markets in the context of mergers and acquisitions as well as in antitrust litigation related to the energy and health care industries.

The case pertains to an antitrust suit involving the sale of fresh milk in the southeastern United States. Defendants had filed a *Daubert* motion to exclude the testimony of plaintiffs' expert witness on the grounds that the methodology that he used to qualify the relevant geographic market was flawed. In his deposition testimony, plaintiffs' expert explained that he had formed his opinion of the relevant geographic market by applying the Guidelines' hypothetical monopolist test. The Guidelines outline the antitrust agencies' general approach towards the enforcement of merger policy and describe the geographic market as a region in which a hypothetical monopolist that was the only supplier of the relevant product could profitably impose a small but significant and non-transitory increase in price (SSNIP). The basic tenet of the test is as follows: If consumers were to respond to a price increase by shifting to an alternate source of supply, and the extent of the shift were sufficient to make the price increase unprofitable, then the geographic market would be too narrow, and additional locations would have to be added.

> "the decision implies that the judge might find even a proper application of the Guidelines' hypothetical monopolist test as being misaligned with T*ampa Electric*. That implication is disturbing..."

In *Tampa Electric*, the Supreme Court defined the relevant geographic market as "the area in which the seller operates, and to which the purchaser can practicably turn for supplies." Further, the Supreme Court explained both in *Tampa Electric* and in *Brown Shoe Co. v. United States* that the relevant geographic market must "correspond to the economic realities of the industry and be economically significant."

The judge acknowledged that antitrust law has recognized that a hypothetical monopolist test is a valid diagnostic tool for market definition, but he indicated that there was no legal precedent that specifically equated the hypothetical monopolist test to the *Tampa Electric* standard. The judge was clear that unless and until the *Tampa Electric* standard was repudiated or modified by the Supreme Court, that standard, and not the definition in the Guidelines, remains the ultimate benchmark against which to evaluate a geographic market test. Since both sides agreed that the hypothetical monopolist test, as it is described in the Guidelines, was an acceptable method of delineating the geographic market for milk sales, the judge was willing to allow such a test, but he sided with the defendants in concluding that the application of the hypothetical monopolist test by plaintiffs' expert was improper and deviated from the *Tampa Electric* standard.

To reach this conclusion, the judge indicated that he was relying on what the expert said in the course of his sworn deposition testimony. In particular, when asked about whether he would agree that "a relevant geographic market is the area in which the seller operates, and to which the purchaser can practicably turn for supplies," plaintiffs' expert responded that he had taken a "different approach" for the purposes of his analysis. The judge based his decision on that statement and refused to consider the expert's subsequently filed

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The European Commission Investigates Motorola Mobility, Inc. for Violating FRAND Commitments

Clarissa A. Yeap

EI Senior Economist Clarissa A. Yeap specializes in empirical microeconomic analysis in the assessment of liability and damages in antitrust, intellectual property and class action matters.

The European Commission (EC) recently launched formal antitrust investigations to assess whether Motorola Mobility, Inc. (Motorola) exploited its standard essential patents (SEPs) related to industry standards in wireless networking technologies to distort competition. An SEP is a patent, the rights to which are required for compliance with an industry standard. These investigations highlight the tension between the potential for efficiency gains and the potential for holdup that are both inherent in efforts by standards-setting organizations (SSOs). These issues are intertwined with the strategic incentives generated by network externalities in the rapidly expanding smartphone and wireless networking industries. Firms' drive to establish their products as leaders in these new markets can generate incentives for anticompetitive strategic behavior, including exploiting patents to raise rivals' costs or foreclose competition.

The EC will investigate complaints from Apple and Microsoft that Motorola violated commitments to license its SEPs under "fair, reasonable and non-discriminatory" (FRAND) terms and required excessively high royalties for its SEPs. Apple and Microsoft were disturbed because Motorola had brought actions alleging that products, such as the iPhone, iPad and Xbox, that depend on the SEPs for compliance with industry standards had infringed its patents. Motorola has won preliminary rulings from administrative law judges at the U.S. International Trade Commission (ITC) against Apple and Microsoft for infringement of its patents related to cellular network standards and the H.264 video compression standard. Under ITC rules, preliminary rulings are subject to review by the full commission. A final ruling is expected in August 2012 and could result in a ban on imports of the infringing products. Motorola also recently won an injunction against Microsoft in a German court and continues to seek injunctive relief against Apple in Germany.

In high-technology industries, SSOs, such as the Institute of Electrical and Electronics Engineers (IEEE) and the International Telecommunications Union (ITU), enable member firms to agree on common technological standards and thus ensure interoperability among devices, networks, and software. Common standards may create cost savings for firms and reduce switching costs for consumers, which in turn can increase price competition. Once a patent has been chosen as part of the standard, however, the patent holder can "hold up" competitors by refusing to grant licenses or by setting very high royalties. SSOs reduce the likelihood of holdup by adopting rules that require members to identify essential patents and to agree to license their essential patents on FRAND terms. These rules can reduce but may not eliminate the risk of holdup. Since complex technologies often involve multiple interrelated patents and each firm often holds a multitude of complementary patents, the disclosure of essential patents may be imperfect and disputes can arise over which patents are adopted as part of the standard. Since patented technology is novel by definition, it can be difficult to determine a reasonable royalty.

The wireless networking and smartphone industries are particularly susceptible to the exploitation of patents in strategic competition because they are characterized by network externalities. Network externalities exist when the value consumers gain from a product or service increases with the number of users of that product or service, or perhaps related compatible products or services. In the case of wireless connectivity, consumers derive greater benefits from cellular technology if it allows them to connect to more people. In the case of smartphone operating systems, consumers benefit more from a more widely-adopted system because the more users there are, the more likely that manufacturers and software writers will make improved phones and new "apps" that can be used with the system. With network externalities, a single technology or group of compatible technologies may come to dominate the market.

Network externalities drive intense competition in winner-takes-all markets. Compatibility issues in devices, cellular networks and software create a need for standards and the risk of holdup at multiple points of these complementary technologies. Indeed, the EC investigations against Motorola take place amid patent litigation battles among

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Market Definition Test

clarifying declaration, in which the expert sought to explain that the approach he had taken did embody a hypothetical monopolist test and that he had indeed considered the area where plaintiffs had bought milk from defendants.

The judge also sided with defendants in ruling that the expert's methodology did not conform to the standard in *Tampa Electric* and in *Brown Shoe* because it did not duly consider the commercial realities of the market for milk sales. The judge noted a number of facts about the market, such as the location of certain retailers, that the expert ignored. The judge also seemed to take issue with a fundamental underpinning of the expert's methodology, i.e., the hypothetical nature of his geographic market test. Specifically, the judge pointed out that the expert had used a theoretical model based on "'estimates' and 'assumptions,'" that economic literature describing the expert's methodology refer to the model's inputs as hypothetical facts that are not necessarily observable in the real world, and that plaintiffs' expert had attested in the course of his sworn deposition testimony that he had attempted to identify an area in which there is potential for the exercise of market power, regardless of how agents actually behaved in the market.

The judge also found that the expert's testimony implied that he in fact had not properly applied the Guidelines hypothetical monopolist test in this case. Interestingly, whether the expert had properly applied the Guidelines test or not, by definition, applying the test would have required some degree of abstraction from the commercial realities of the market, because the test assumes a sole supplier and the market may actually include several suppliers. Thus, the decision implies that the judge might find even a proper application of the Guidelines' hypothetical monopolist test as being misaligned with *Tampa Electric*. That implication is disturbing because the test, which has been accepted by many courts, is now a standard procedure among antitrust economists. Economic experts in future proceedings may have to explain the purpose of the test, including why it is necessary to abstract from "commercial realities" and consider a hypothetical monopolist, how they take those realities into account to establish the actual competitive structure of the market, and how their methods are consistent with the Supreme Court's standard.

FRAND Commitments

Apple, Google, Microsoft, Motorola, Samsung and others that are competing for dominance in these growing markets. Apple and Microsoft reacted to Motorola's infringement complaints by filing separate breach-of-contract cases against Motorola for violation of FRAND terms. In coming months, regulators and courts will have to determine whether Motorola has abused its market power from SEPs or merely sought appropriate rewards from its intellectual property.

The threat of holdup also creates an incentive for firms to amass enormous patent portfolios to gain control of SEPs, either to avoid being held up or as a credible threat to hold up other competitors. This amassing of patents is evident in the wireless networking industry. For example, a consortium that includes Apple and Microsoft, as well as Research in Motion, Sony, Ericsson and EMC, will buy over 6,000 patents and applications covering wireless technologies from Nortel Networks for $4.5 billion. Google is preparing to acquire Motorola and its 17,000 plus patents for $12.5 billion. The concentration of large patent portfolios and SEPs in the hands of a few firms could reduce competition.

Antitrust regulators are paying close attention to the potential abuse of market power from SEPs. Besides the Motorola investigation, the EC is also investigating Samsung's FRAND commitments involving SEPs in 3G mobile telecommunications. U.S. antitrust authorities focused on the possibility of holdup using SEPs in their analysis of the consortium's bid to buy the Nortel patents. They approved the bid, however, in part because of public statements from Apple and Microsoft that they would not seek injunctions in exercising their SEP rights. Both U.S. and EC antitrust authorities voiced concerns that Google's acquisition of Motorola would increase market power in wireless networking markets because of the concentration of patents. They found Google's statement of its SEP licensing commitments to be unclear and were concerned about the potential for abuse. They ultimately decided that the merger in itself would not harm competition and approved the deal, but they promised vigilance on future SEP licensing practices. Developments in the EC investigations of Motorola and in pending litigation will be important in clarifying the antitrust risks involved in using SEPs.

EI News and Notes

ABA Book on Market Definition

A number of EI economists contributed to *Market Definition in Antitrust: Issues and Case Studies*, a book recently published by the American Bar Association Antitrust Section. The book provides a comprehensive analysis of the issues involved in defining markets in antitrust cases. It describes modern methods of market definition and analyzes their application in actual cases. EI Vice President Henry B. McFarland served as the book's economics editor. EI economists who wrote sections of the book were Principals David A. Argue, Barry C. Harris, John R. Morris, and Matthew B. Wright, Vice-President Gloria J. Hurdle, and Senior Economist Erica E. Greulich.

Intellectual Property Rights in China's Antitrust Merger Review

EI Senior Economist Su Sun co-authored an article entitled "The Role of IPRs [Intellectual Property Rights] in China's Antitrust Merger Review," for the March 2012 issue of *International Antitrust Bulletin*. The article discusses the statutes, guidelines, jurisdiction, and cases in which IPRs have been taken into account in China's antitrust merger review. His co-authors were Jing He of ZY Partners in Beijing and Angela Zhang of Herbert Smith in London.

Calculating the Costs of Online Piracy

EI Principal Stephen E. Siwek was interviewed by Kai Ryssdal, host and senior editor of *Marketplace*, public radio's program on business and the economy. The interview concerned estimates of the cost of online piracy to the U.S. economy. Mr. Siwek indicated that, while there is unlikely ever to be complete agreement on a specific estimate of these costs, eventually it will be possible to narrow the estimates to a range that is precise enough for policy making. A text of the interview is available at http://www.marketplace.org/topics/tech/calculating-costs-online-piracy.

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