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December 29, 2008

Economic Issues in the Ovation Complaint

posted by Mary Coleman at 7:19 am

On December 16, 2008, the FTC filed a complaint against Ovation Pharmaceuticals that challenged its 2006 acquisition of the drug Neoprofen from Abbott. (The acquisition had fallen beneath the HSR thresholds and thus was not subject to an HSR investigation prior to consummation). While the complaint and case itself raises some interesting issues which I will discuss below, the concurring statements of Commissioners Leibowitz and Rosch, particularly the theory laid out in Commissioner Rosch's statement raises more interesting (and potentially troubling) issues – in particular the potential to substantially expand the scope of Section 7.

The complaint involves the acquisition by Ovation of its alleged only other competitor in the sale of drugs used to treat patent ductus arteriosis (PDA), a potentially life threatening heart condition in severely underweight newborn babies. Assuming the facts are as presented in the case (which I am sure defendants will contest), the complaint itself does not raise complex antitrust issues. Given the alleged facts, the acquisition would essentially be a merger to monopoly (at least until a generic version of Ovation's product is on the market assuming one eventually enters) without any other projects apparently in the pipeline to treat this disease (perhaps not surprisingly given the relatively small number of patients per year).

Despite these seemingly routine antitrust issues, this case would be the first time the FTC has challenged in court an acquisition that at least at the time of the transaction involved potential competition. It is unclear, however, whether this case will provide much guidance in this area with regard to the types of matters the FTC routinely investigates and challenges in pharmaceutical acquisitions. First, this is an alleged merger to monopoly. Second, one of the products was already on the market and the other was fairly close to FDA approval (apparently already completing Phase III trials). Thus, the potential competition was relatively close to actually competition. Third, with no other products in the pipeline, the case raises no issue of whether the market would be narrower than all drugs used to treat a particular disease. However, there is likely to be at least some issue as to whether the products would be very close substitutes. Fourth, with hindsight, the drug not yet on the market was brought to market fairly quickly after the transaction and thus no tricky issues about innovation competition and whether one product

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would be cancelled or delayed are raised. Thus, if anything this appears to be a "poster child" for a potential competition case (particularly given the allegations about the increases in price). The FTC routinely investigates and challenges potential competition theories via consent matters that involve less relatively "clear cut" issues and thus it is not clear that will help inform how courts would view such cases.

Of more potential interest is the fact that the FTC is making an important part of its argument the alleged increase in price and is seeking disgorgement of profits gained from the transaction. The FTC is alleging that after the transaction Ovation raised the price of its own product (which was already on the market) from $36/vial to $500/vial – a huge increase. The challenge the FTC is likely to face and where economic testimony is likely to play a central role (as it did in *Evanston)*, however, is attributing some or all of that price increase to the merger. There are at least reasons to think that there might be other reasons for the price increase. First, one would wonder why the threat of competition would keep prices low prior to the competitive drug actually being approved (presumably Ovation would have wanted to charge higher prices when it could and only drop prices when a new product was on the market particularly if the barriers to entry exist as are alleged in the Complaint). Second, I cannot think of an economic model where a duopoly would lead to a price less than 10% of the monopoly price when the two products involved are branded, are not likely perfect substitutes and almost certainly would not be sold only based on price. Thus, determining how much of the price increase can be attributed to the transaction may be challenging for the FTC and this issue will likely be a central role for the economic testimony (although such testimony will almost certainly include other issues as well).

This leads us to Commissioner Rosch's theory (which is endorsed by Commissioner Leibowitz). Commissioner Rosch would also challenge Ovation's original purchase of its product (Indocin) from Merck even though at that time Ovation had no horizontal or vertical relationship with the PDA market because Ovation raised the price when Merck had kept the price low. Ovation's acquisition only changed who marketed and priced the product, not the number of competitors. In fact, at that time, Merck had a monopoly in the alleged market and this was unchanged by the acquisition. Commissioner Rosch's theory is that something must have constrained Merck from charging higher prices for its product (he theorizes that perhaps it could be the reputation effects on other products in their portfolio) whereas Ovation did face such constraints and thus raised prices. Thus Commissioner Rosch's theory appears to be that because the acquisition changed the incentives of the firm owning the monopoly such that it would fully exploit that monopoly this can be a Section 7 violation.

This theory seems far removed from the way we normally analyze merger cases and potentially would have the effect of raising antitrust concerns or at least an investigation with

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almost any transaction where one firm might be argued to have market power even though the structure of the industry (horizontally or vertically) is unchanged. While Commissioner Rosch highlights some potentially limiting principles, such as the fact that this is a consummated transaction, it is hard to see how this fact connects to why the transaction might violate Section 7 (versus potentially discretion as when to pursue the theory). Regardless of whether the merger was consummated, as discussed above, one would presumably need to show that the merger caused the price increase rather than other factors which is likely to be challenging, particularly in a non-horizontal deal.

Moreover, antitrust has generally not been about the exploitation of market power (i.e., charging above competitive prices) but rather the inappropriate acquisition or maintenance of that power. This focus has been for good reason as it prevents antitrust courts and regulators from the business of determining competitive prices and when exploitation of market power is a good thing (because it is the rewards for innovation for example) or a bad thing. Moreover, there is nothing that necessarily limits this theory to a merger but could theoretically be applied to anything that might allow a monopolist to raise price. While this could be a boon to economists it is not clear it is good policy. The FTC complaint does not espouse this theory so apparently some at the agency do not agree with Commissioner Rosch's point of view (or they wished to keep the complaint more straightforward for the second acquisition). It will be interesting to see if this theory begins to appear in any other merger investigations.

Filed under: antitrust , economics , federal trade commission

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1. Would Commissioner Rosch's approach, carried a bit further, reach the situation discussed in a paper by J. Chevalier, "Do LBO Supermarkets Charge more? An Empirical Analysis of the Effects of LBOs on Supermarket Pricing" that, according to the abstract, finds "prices rise following LBOs in local markets in which the LBO firm's rivals are also highly leveraged and that LBO firms have higher prices than their less leveraged rivals, suggesting that LBOs create incentives to raise prices."

   Comment by Bilal Sayyed — December 29, 2008 @ 9:58 pm

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2. Do you need to carry the theory a bit further? Under Rosch's theory it seems that a transaction that means a

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new owner who has different pricing incentives, for whatever reason (reputation or otherwise) is actionable under Section 7.

Just as Ovation did not have the reputational consequences that constrained Merck, an LBO buyer may have an incentive to increase short-term profitability at the cost of long-run growth through more reasonable prices (presumably to allow a quick "flip" or to generate cash flow to pay for financing). I don't see how those two situations are different in any relevant way, so the LBO should be covered as well.

Comment by antitrust guy — December 30, 2008 @ 7:15 am

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3. My own view (as discussed in my earlier post on the theory) is that the theory extends to any transaction (under Section 7) or conduct (under Section 2) that might result in higher prices. So the LBO is in. But so is a lot of other stuff.

   The "evasion of a constraint" theory contemplates any conduct that allows a firm to free itself of pre-transaction/conduct prices as actionable. Thus, not only would the LBO transaction story work, but so would advertising (attempt to evade the constraint on pricing that current demand imposes) or just about any other conduct that you can imagine.

   Here's what I wrote previously about the supposed boundaries of this theory:

   "Well, if that's all that the antitrust laws are about, this is easy. Here are a few examples of conduct the FTC could go after that satisfy the "evading a constraint" theory. Why not a monopolist whose pricing is constrained by current demand. That is, the profit-maximizing monopoly price is $20 but the monopolist would REALLY like to charge $25. It is only the fact that current demand is not high enough to support that price that prevents the monopolist from charging it. So, our monopolist comes up with a plan (lets call it a scheme, it sounds worse) to evade the pricing constraint created by current demand by advertising its product to consumers and touting its virtues. Or perhaps its going to invest in the quality of the product. In either event, the purpose of the advertising is to shift the demand to the right and result in higher prices. No matter that output increases, it doesn't matter because the monopolist is evading a pricing constraint and presumably has violated Section 2. Evading reputational constraints on demand for X is not analytically any different evasion of the constraints imposed on demand by consumer preferences.

But its much worse than that. There is virtually no limit to this evasion theory. Let's run through some examples. What if Merck evaluated its product line and decided that it would be be better off by dropping some of its product portfolio so that it could increase the price of Indocin? Merck's decision to drop products from its portfolio, or even the design of those product offerings, are surely an evasion of pricing constraints and a violation of Section 2 if it has monopoly power — and perhaps even if it doesn't under Section 5. So much for competition as a discovery process. Or what if Merck decided to create a subsidiary to sell Indocin under a different brand name and trade dress to mitigate the reputational costs it would bear from charging a higher price? Or fired the CEO who decided that charging the monopoly price in the first instance would be a bad idea in favor of a new manager who reached a different conclusion and wanted to increase the price? This evasion theory fairly quickly evaporates to the notion that the antitrust law governs prices that are determined to be unreasonable and not the competitive process."

Comment by Josh — December 30, 2008 @ 7:54 am

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4. I agree. While the statement seems to be trying to put boundaries on the use of this, this seems to be more of an issue of prosecutorial discretion rather than limits on the theory itself. Moreover, even if the theory were that this had to be a consummated deal so you could "see" a price increase, this still could open the door in many deals. Prices increase all the time and as you say, it could just be a different philosophy or it could be for many factors so this could open the door theoretically to many investigations of consummated mergers. While I think in likelihood the FTC would in most cases be limited in what it would look at, that may not be true if this were extended to private litigation (which it seems as though it could since Commissioner Rosch is not relying on Section 5 alone).

   Comment by Mary — December 30, 2008 @ 8:01 am

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5. There are, I think, at least two reasons to be dubious of the stated "consummated transaction" limit in addition to Mary's well taken point that this is not much of a limit. Indeed, the constraint potentially turns Section 7 into a merger price regulation statute: wait and see whether prices go up, and challenge since surely some constraint that kept prices lower has been evaded. Prices went up. QED.

   The first additional problem is that there is no statutory hook for such a limit under Clayton 7 with its forward looking language. Of course, one might believe the

Commission's indications that it would not use its prosecutorial discretion to apply this theory except for in consummated transactions.

But that leads to the second problem. In N-Data, which applied a similar evasion of constraint theory, the Commission indicated that there were some limiting principles there too. One was that the conduct took place in what the FTC viewed as the "special" antitrust domain of standard setting. The second was that it was only going to be a Section 5 case. But what's happened? We've got application of the same underlying economic theory in a non-standard setting case under Section 2 and Section 7.

Students of public choice economics everywhere are yawning at the proposition that regulators were interested in expanding the scope of prosecutorial discretion and that perhaps the "limits" were not so limiting.

Comment by Josh — December 30, 2008 @ 9:53 am

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6. Part of the problem here, of course, is the looseness of the Section 7 standard to begin with. But what, exactly, is it about the avoidance of a constraint that equates to "lessening of competition?" The fact that, ex post, prices might have risen is close to zero indication of a substantial lessening of competition. One could even imagine characterizing the avoidance of constraint as an INCREASE in competition–if nothing else one might expect the new, significantly higher price, to induce more R&D spending on other PDA treatments. So what's the doctrinal hook? Or are we in an age of antitrust where all that's required to make out a case (at least sufficient to satisfy the FTC's preliminary injunction standard) is some conduct and a theorized (before consummation) or actual (post consummation) price increase?

   Comment by Geoffrey Manne — December 30, 2008 @ 11:15 am

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