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Federal Trade Commission Approves Merger of Fresenius and NxStage in a Split Decision

Stephanie M. Mirrow

EI Vice President Stephanie M. Mirrow has worked on numerous matters involving vertical issues, including vertical mergers.

The Federal Trade Commission ("FTC") recently approved the merger of Fresenius Medical Care AG & KGaA ("Fresenius") and NxStage Medical, Inc. ("NxStage"). In a split decision, the FTC approved the merger subject to the divestiture of NxStage's bloodline tubing set business. All five Commissioners agreed that the merger would substantially reduce competition in the horizontally overlapping market for hemodialysis bloodlines and that the divestiture remedies this overlap. However, the Commissioners split on whether the vertical aspects of the merger would result in competitive harm.

One point of contention was whether the merger would result in vertical foreclosure – specifically, whether the merger would reduce innovation and entry for in-home hemodialysis machines. NxStage is the largest supplier of in-home hemodialysis machines in the United States. Fresenius is one of the two largest suppliers of dialysis treatments in the United States, for both in-clinic and in-home dialysis, and thus one of the largest purchasers of in-home hemodialysis machines. The majority Commissioners found that the merger would not make entry more difficult, because the evidence indicated that one large corporation, CVS Health, announced its intention to enter the in-home hemodialysis machine market. They also indicated another firm was likely to enter as well. In his dissent, Commissioner Chopra questioned whether entry by just one or two large firms would result in vigorous competition and whether the merger significantly reduces the customers available to and negotiating ability of smaller potential entrants in the in-home hemodialysis machine market.

The split decision in this case raises questions concerning sufficient entry and how to evaluate foreclosure issues in vertical mergers. In the Department of Justice's ("DOJ") recent review of the CVS/Aetna merger, DOJ's conclusion that foreclosure was unlikely to occur considered the competition faced by CVS for both its PBM and retail pharmacy services as well as the competition faced by Aetna for commercial health insurance. In this case, there was only one other large competitor to Fresenius, but the majority Commissioners looked to announced intention of entry to conclude that foreclosure was unlikely. Additionally, in this case, the majority Commissioners found that the merger potentially would expand the in-home hemodialysis market and lead to more sales opportunities for potential entrants. In sum, vertical mergers continue to be examined by both the FTC and DOJ, and different case-specific facts may determine whether foreclosure will be a competitive concern.

Also In This Issue

Class Action Lawsuits with Two-Sided Markets: Is There a Need to Re-Interpret *Illinois Brick*?

Robert D. Stoner

EI Principal Robert D. Stoner has provided expert economic assistance in a number of matters involving class action lawsuits.

In November 2018, the United States Supreme Court heard oral argument in *Apple, Inc. v. Robert Pepper et al.* concerning whether a putative class of iPhone users can sue Apple for alleged monopolization of the market for iPhone applications ("apps"). Specifically, the iPhone users allege that Apple's rules, including a requirement that app producers distribute apps only through the App Store and Apple's 30% fee collected from App developers for each app sale, are anticompetitive. The issue at this stage of the proceeding is whether iPhone users have standing to sue Apple under the *Illinois Brick* and *Hanover Shoe* doctrines that prohibit recovery by indirect purchasers. Both these precedents analyzed more conventional manufacturer/distributor markets, i.e., where there was a "manufacturer" that sold through a "distributor," who in turn sold to "consumers." The underlying assumption was that direct purchasers, the distributors, were in a position to sue the manufacturer, so also allowing indirect purchasers, the consumers, to sue would lead to potential duplicative recoveries or the need to make complex pass-through determinations in order to avoid duplicative recoveries. However, the fact situation in the present case does not fit neatly into the *Illinois Brick* and *Hanover Shoe* framework and suggests that a different framework of analysis may be necessary.

> "One important aspect in this case is likely to be the exact nature of the business relationship between Apple and app developers."

Apple (supported by the United States Department of Justice (DOJ) in an amicus brief) claims that iPhone users do not purchase apps directly from Apple, but rather purchase from app developers, who set the price of apps in the App Store and distribute the product to consumers. In this description, Apple acts only as an "agent" for developers by providing distribution services under rules set by Apple, but developers determine prices in the App Store and are labeled the true "distributors" that make the direct sale to purchasers. By contrast, iPhone users, (and the predecessor Appeals Court decision) contend that Apple is best viewed as the true "distributor" of apps through the App Store, and app developers are more akin to "manufacturers" that sell their apps through a distribution system that Apple has set up. In effect, the opposing views of the parties come down to arguments about who (Apple or app developers) should be considered the true "distributor" and therefore direct seller.

Neither of these descriptions fully captures the nature of the relationships among Apple, app developers, and consumers. A better way to conceptualize the relationship is as a two-sided market. Two-sided markets are characterized by situations where the firm in question, acting as an intermediary, must appeal to users on two or more "sides" that gain value through interacting together, and where users on one side won't be attracted unless there is sufficient participation by users on the other side. Apple needs app developers to formulate the best and most reliable apps for its phones and needs to give app developers the proper incentive to develop those apps by providing a sufficient user market. In a parallel manner, Apple needs to cultivate iPhone users by making sure that the best and most reliable apps are available on iPhones at a reasonable price. Apple brings app developers and iPhone users together through the App Store "exchange," which unites the two-sided market.

Two-sided markets complicate any simple *Illinois Brick* test, since it is less clear who is a direct versus indirect purchaser and which parties are in the best position to sue if there is an antitrust violation. That is because all parties are linked together by the nature of the network effects that underlie the two sides. In that situation, one likely needs to look at specific aspects of the two-sided set up to determine the outcome of the *Illinois Brick* test. One important aspect in this case is likely to be the exact nature of the business relationship between Apple and app developers. Apple sells its exchange services to app developers in return for a percentage commission and a requirement of exclusivity. Each app developer then determines the app price to be charged to consumers in the App Store, and this price may or may not pass through some or all of any

continued on page 4

Hospital Merger Review May Need to Consider the Role of Complementarities

Lona Fowdur and David A. Argue

Economists frequently use the two-stage model of hospital competition to assess the competitive effects of hospital mergers. This model predicts that transactions between hospitals whose products are substitutes will generate higher post-merger pricing incentives as the closeness of substitution between the parties increases. However, empirical studies of post-merger price changes do not corroborate the theoretical prediction consistently. A possible explanation for the disconnect between the theory and real-world evidence is complementarities between the merging hospitals, as explained in a recent article by Easterbrook, Gowrisankaran, Aguilar and Wu. Moreover, hospital complementarities may be especially important in cross-market merger analyses.

An intrinsic assumption of the two-stage model is that merging hospitals are substitutes. In this model, a merger can increase a hospital's bargaining leverage in rate negotiations with health plans, because the substitutability between the hospitals causes each hospital to be *less* valuable when the other hospital is *already* in the network. Intuitively, patients have less need for the second hospital if they already have access to the first. From the perspective of a health plan, whose objective is to construct a network of hospitals that patients find desirable, the plan's willingness to pay for the second hospital is lower when the first hospital already is in the network. If the plan faces a threat of losing both hospitals simultaneously, its willingness to pay for either one of the two hospitals will be higher. These dynamics underlie post-merger upward pricing incentives when hospitals are substitutes.

If the hospitals are complements, however, each hospital is *more* valuable if the other *already* is in the network. The classic heuristic that illustrates complementarities is the left-shoe/right-shoe combination. One shoe alone provides limited value to the wearer, and the pair of shoes is significantly more valuable than the sum of the values of each shoe alone. In the context of hospitals, complementarities may arise when each system offers a critical service that the other does not. For example, one hospital might specialize in women's services while the other hospital offers all other general acute-care services excluding obstetrics. Employers purchasing health plan services may desire networks of hospitals such that all the needs of their insured members can be met somewhere in the network. Since each hospital fulfills a distinct medical need, a network with one limited-service hospital offers low value relative to a network that includes both that hospital and its complement. The addition of the second hospital generates significantly more incremental value when the first hospital already is in-network. Thus, the plan may be willing to pay a high price for either hospital when it knows it can get the other hospital into the network.

Senior Vice President Lona Fowdur has worked on several healthcare transactions between hospitals, physician groups and health insurance companies. Principal David A. Argue has specialized in healthcare competition matters, including hospital mergers, for the past 25 years. They both have written and presented on cross-market theories of hospital competition.

"Moreover, hospital complementarities may be especially important in cross-market merger analyses"

Complementarities also can apply in the context of cross-market mergers. In cross-market analyses, hospitals are considered not to compete for patients from the same areas. Because two hospitals are in separate markets, they are not substitutes for each other from the patients' perspective, even if they offer identical services. Likewise, hospitals in separate markets would not be substitutes from the perspective of an employer purchasing a health plan network. Employers that wish to cover employees in two markets cannot fulfill their network needs by choosing one hospital or the other – they need both hospitals. Employers' needs for both hospitals to serve their employees make the hospitals complements. Thus, health plans that are marketing to employers with employees in multiple markets need complementary hospitals to construct multi-market networks and to attract those customers.

continued on page 4

Class Action Lawsuits

Apple commission. (There is no Apple commission, and therefore no passthrough, if the app is offered for free, as it often is.) This means that on one side of the two-sided exchange, Apple and the app developers are effectively setting up a joint manufacturing/distribution business that divides the rents in connection with app development and distribution, under "rules" set by Apple. It shouldn't matter whether this business arrangement allows Apple or app developers to set the price of apps, or whether Apple or app developers are nominally designated as the "distributor." In either case, one side of the two-sided exchange is an agreed-upon business relationship between Apple and developers to sell apps to iPhone users.

Given this relationship, app developers likely do not have an incentive to sue Apple for damages, and, in fact, none had done so during multiple years of litigation, according to argument before the Supreme Court. One exception is Spotify's recent complaint in the European Union, which accuses Apple of abusing its dominant position by charging a 30% fee on App Store purchases of Spotify's premium version. However, Spotify is a competitor of Apple Music and claims to pass on Apple's fee to consumers. Therefore, iPhone users, whether or not they would formally be deemed "direct" purchasers in a conventional *Illinois Brick* setting, are likely in a position to claim damages without the risk of duplicative recovery by app developers.

Many existing and emerging e-commerce and network industries use two-sided models of distribution similar to Apple. This suggests that the Supreme Court decision in *Apple v. Pepper* will have important ramifications for private enforcement of the antitrust laws, and specifically for the interpretation of *Illinois Brick*, beyond the present case. Of course, whether or not the Supreme Court finds that iPhone consumers should have standing to sue says nothing about the underlying antitrust claims at issue. For an antitrust claim to prevail, plaintiffs would have to show that Apple had market power in a relevant market (where there are presumably other two-sided smart phone "platforms" that have their own sets of app rules) and that the rules Apple set for app developers harmed competition.

Hospital Merger Review

These types of complementarities can affect hospitals' negotiating leverage when competing for inclusion in employer networks and, as a result, the rates hospitals receive, since rates are set at this stage of the competitive process. When hospitals are network complements, each one separately is a critical piece of a health plan's ability to market the network to employers. As such, each hospital can use its threat to leave the network as leverage to negotiate higher rates from the health plan. If complementary hospitals merge and contract as one, they no longer have separate abilities to threaten to leave the network, so their joint incremental value declines, and their negotiated rate declines as well.

Current horizontal merger screening methods do not explicitly account for complementarities, and it is unclear to what extent this limitation drives inaccurate model predictions of price effects. For instance, a recent study by Garmon considers twenty-eight consummated hospital mergers and compares the predictions from current merger screening methods to the actual post-merger price changes for each of these mergers. Garmon's study finds statistically significant price increases in only nine out of the twenty-eight consummated transactions between hospitals that were substitutes for at least some patients. The other nineteen transactions had no statistically significant price effect or showed statistically significant decreases in price. These empirical findings suggest that more detailed hospital competition models, including those that could explicitly account for complementarities, comprise a productive avenue for further research.

Hospital mergers are common and face increasing scrutiny by regulators, Congress, and the public. Some empirical findings suggest that current screening methods have failed to predict post-merger price changes accurately in a large proportion of real-world cases, and researchers are in the process of improving economic tools to deliver more accurate predictions. In the meantime, a qualitative assessment of the presence of complementarities and their potential impact on post-merger prices could provide meaningful insights in both horizontal and cross-market transactions.

EI News and Notes

Antitrust Fines in China

EI Vice President Su Sun has published "What Determines Antitrust Fines in China?" (co-authored with Professor Chenying Zhang of Tsinghua University Law School) in the February 2019 issue of the *European Competition Law Review*. Dr. Sun and Professor Zhang use regression analysis, with data through May 2018, to quantify the impact of several potential factors on non-merger antitrust fines issued in China.

American Health Lawyers Association Antitrust Toolkits for Health Care Mergers and the Pharmaceutical Industry

EI's Michael G. Baumann, Lona Fowdur, Allison I. Holt, Gale R. Mosteller, Matthew B. Wright, and Clarissa A. Yeap authored four of the American Health Lawyers Association Antitrust Practice Group's toolkits regarding the economics of health care mergers and the pharmaceutical industry: *Economics of Hospital Mergers Involving Capacity Constraints*, *Economics of Cross-Market Health Care Provider Mergers, Economics of Vertical Health Care Mergers, and Economics of Pharmaceutical Reverse Payments*. The toolkits provide an overview of the economic tools used to evaluate these issues, as well as provide a summary of other cutting-edge issues relevant to an examination of these issues.

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