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A BRIEF ANALYSIS OF POLICY AND LITIGATION

Federal Judge Rejects Merger Challenge Based on Actual Potential Competition Theory

David D. Smith

EI Vice President David D. Smith has dealt with antitrust issues in a wide range of industries. Before joining EI, he was an economist at the Antitrust Division of the U.S. Department of Justice.

A federal judge in Ohio recently refused the Federal Trade Commission's (FTC's) request that he preliminarily block the $1.9 billion merger of Steris Corporation and Synergy Health PLC, the second- and third-largest sterilization companies in the world. The FTC alleged that the merger would violate Section 7 of the Clayton Act under the actual potential entrant doctrine. Defendants argued that this doctrine had been rejected by many courts, including the Supreme Court. Since the FTC has endorsed the doctrine, and it would be used in any administrative proceeding, the district court judge assumed the doctrine was valid.

The Food and Drug Administration requires that many healthcare products be sterilized. Most manufacturers contract for sterilization of their product with outside firms, such as Steris, Synergy, and the largest sterilization company, Sterigenics. The three leading methods of contract sterilization are gamma radiation, e-beam radiation, and ethylene oxide gas. Gamma sterilization is the most effective and economical technology for most healthcare products because it is the only viable option for dense products, such as implantable medical devices.

In the United States, only Steris and Sterigenics provide contract gamma sterilization services. They account for about 85% of all U.S. contract sterilization services. Synergy, a British company, is the largest provider of e-beam services in the United States. It operates 36 contract sterilization facilities outside the United States, which are primarily gamma operations.

The FTC alleged that prior to the proposed merger, Synergy had been planning to enter the United States with an emerging fourth type of sterilization technology, x-ray. The FTC alleged that x-ray sterilization is a competitive alternative to gamma sterilization because it is "comparable, and possibly superior," in its depth of penetration and speed. Thus, the FTC argued that the market included gamma and x-ray sterilization.

Some Synergy documents showed that the company initially believed the x-ray technology would be "lower cost than gamma, and would beat the gamma service on every other operating metric." But as the company continued to evaluate the technology, it thought less of it. Synergy ultimately decided not to build x-ray facilities in the United States.

The judge concluded that the FTC had not shown that it was likely to succeed in an administrative trial because it could not show a likelihood of proving that, absent the merger, Synergy soon would have entered the market by building an x-ray facility. He found that no customers would agree to use the x-ray technology because of the high cost of switching, and that Synergy was unwilling to risk the investment needed to build x-ray facilities in the United States. The FTC responded to the decision by ending the administrative proceeding thus stopping its attempt to block the merger.

Cross-Market Theories of Harm to Competition in Healthcare

David A. Argue

EI Principal David A. Argue has extensive experience in antitrust healthcare matters, including testimony on behalf of the defendants in St. Luke's. He co-authored, with Scott Stein of Sidley Austin, a more detailed article on this topic in the Fall 2015 issue of Antitrust.

One of the bedrock principals of the Merger Guidelines may be nudged further aside with new theories of harm to competition in "cross-market" transactions. These theories, which have captured the attention of antitrust enforcers, attempt to explain how harmful competitive effects can arise from mergers involving firms in separate product or geographic markets. For decades, the Guidelines and court decisions (including the Ninth Circuit's decision in *FTC v. St. Luke's*) have recognized the importance of market definition in competition analysis. But complaints by health plans that hospital systems have increased bargaining strength in multiple markets have recently drawn antitrust enforcers' attention. An examination of the nascent theories and empirical research shows that they currently do not support increased antitrust enforcement.

Cross-market theories of competitive harm are founded on a concept of economic "linkages" between markets that enable a merger of suppliers selling in different markets to increase market power. In healthcare, these theories have gained the most attention in provider geographic markets, but they have also arisen in product market contexts, as in St. Luke's. For hospital services, the linkages between geographic markets supposedly arise when an employer purchases health insurance for its employees who reside in distinct geographic areas and who do not consider hospitals outside of their area to be acceptable substitutes. The theories postulate that a merger that creates a cross-market hospital system can create market power because employers choose a single network of hospitals to cover all of their employees, notwithstanding that employees care only about the hospitals in their geographic area. By withholding its hospitals from a network, a hospital system creates "holes" in the network that make it less profitable for a health plan to market its product to cross-market employers. Thus hospital systems ostensibly gain bargaining leverage over the health plan by their ability to withhold hospitals in more than one market simultaneously.

A key hypothesis of the theories is that a health plan's profits are affected disproportionately by a cross-market hospital system's refusal to contract with the plan (e.g., the refusal by a two-hospital cross-market system to contract with a health plan is more harmful to the health plan than the refusal of the two hospitals individually). In one version of the theory, each additional hole in a hospital network has a greater incremental effect of reducing the probability of employers' choosing the network. In another, as the health plan adjusts its premiums in response to network holes, its profits decline at an increasing rate as the number of holes increases.

"Absent sound economic models of cross-market competitive effects, antitrust enforcers should remain skeptical of health plans' complaints that cross-market hospital system transactions harm competition."

Numerous assumptions undergird these models, several of which do not withstand scrutiny. In the "Employer Choice" model, the competitive danger arises from merging hospitals into one system that, through cross-market linkages, gains incremental market power over customers that purchase in both markets simultaneously. Notably, purchasers that do not require hospital services in both markets (i.e., single-market health plans or employers) are not subject to the exercise of market power created by cross-market linkages. Because the lack of employee substitution between local markets means that single-market employers are immune to cross-market leverage, cross-market employers can prevent cross-market systems from increasing their bargaining leverage simply by offering single-market network options to each set of employees. As long as employers acquire health insurance through a health plan rather than purchasing services directly from the hospital, the hospital system would not be able to identify cross-market employers and price discriminate against them.

The theories also frame the economic transaction as a purchaser contracting for the option to use a single bundle of hospitals. The implications of that framing, however, conflict with market realities. Substitution in the bundle

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Court in Tying Case Finds that Unfulfilled Desire is Not Foreclosure

John M. Gale

EI Vice President John M. Gale has written extensively on telecommunications issues including retail availability of navigation devices and program bundling.

A jury decision against Cox Communications (Cox) in a tying case was recently overturned by the U.S. District Court in Western Oklahoma. The court's decision turned on the difference between unfulfilled desire and foreclosure. Manufacturers expressed a desire to sell the tied product, but "...never was there any evidence the desire was prevented or blocked by actions from Cox."

In 2009, plaintiff Cox subscribers filed a class action alleging that Cox had tied rental of a cable box to premium cable services. To receive some two-way services (pay-per-view, video-on-demand), subscribers needed a cable box that was only available from Cox. The initial national class was not certified when the judge did not support a national geographic market, but regional cases were certified in 2014. After some procedural disputes, the case went to trial in western Oklahoma in September of 2015. The plaintiffs proposed a tying market as premium cable services sold in an Oklahoma City geographic market. The tied market was cable boxes (sometimes termed multichannel video programming distribution (MVPD) navigation devices). Whether the plaintiffs proposed the same geographic market for cable boxes was in dispute.

"Plaintiffs had failed to offer any evidence that Cox had foreclosed any manufacturer that tried to sell a cable box at retail."

The jury found that Cox had tied the sale of a product in one market to a product in a separate market, that Cox had market power in the tying market (premium cable services), and that Cox prevented competing cable box suppliers from participating in the tied market, which caused a substantial foreclosure of commerce. Plaintiffs argued that absent the tie, they would have paid much less for cable boxes, as they could have purchased them from competing retailers. The jury awarded the Oklahoma class $6.31 million in damages before trebling.

Cox argued that it did not have market power in premium cable services due to competition from Direct TV, Dish, broadcast, and Internet-delivered video. Moreover, Cox subscribers could receive many, though not all, of its services through third-party devices, such as Tivo or Moxi. In addition, Cox claimed that it had told subscribers that they could purchase a cable box if they could find one. Cox also claimed that it took steps to assist manufacturers in making cable boxes to sell at retail, though no devices were commonly available for sale in Oklahoma City. Cox argued that there was no evidence it had hindered manufacturers from entering the cable box market.

In overturning the jury verdict, the court determined that plaintiffs had failed to offer any evidence that Cox had foreclosed any manufacturer that tried to sell a cable box at retail. Therefore, there was no evidence that absent the tie a substantial number of subscribers would have bought a cable box at retail (that Cox had foreclosed a "substantial volume of commerce"). The court found some evidence that manufacturers expressed a desire to sell cable boxes at retail in Oklahoma but no evidence that they had tried and failed due to actions by Cox.

In addition, the court found that plaintiffs had failed to show that they were harmed, since Cox had not foreclosed competition for the sale of cable boxes. When the court previously ruled on summary judgement motions, it rejected Cox's argument that because no one else sold the tied product there could be no illegal tie. In that ruling, the court pointed out that Cox's tying could have precluded entry and thus caused the lack of alternative providers of the tied product. That ruling seemed to invite plaintiffs to introduce evidence of how Cox's actions foreclosed entry. In overturning the jury verdict, the court stated that plaintiffs had not introduced any evidence on this point. (Plaintiffs are appealing the court's decision.)

This specific case is part of a long history of attempts to regulate the provision of cable boxes. With the introduction of premium services on cable systems in the 1980s, cable boxes were required for service. Pursuant to the 1996 Telecommunications Act, the Federal Communications Commission (FCC) promulgated rules mandating the retail availability of cable boxes. Cable Labs developed the CableCARD standard, which was designed to allow cable

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Cross-Market Theories of Harm

implies that an employer would accept a less favorable network for employees in one hospital service market if it could get a sufficiently more favorable network in the other market. The employer as the bundle purchaser would view that trade-off as an overall improvement, even though its employees with the less attractive local network would be worse off. This conclusion is at odds with employers' common practice of treating employees equitably. Further, the employer would likely find it difficult to internalize a trade-off of hospital options among its employees.

The "Employer Choice" model relies on additional assumptions that are not likely to be generally valid. For example, the disproportionate effect of a network hole on the probability of a network's being chosen by an employer depends on the employer's having a strong pre-existing preference for that specific health plan. Absent that strong preference, the disproportionate effect is no longer evident and the cross-market linkages disappear.

In the "Health Plan Pricing" version of the theory, a cross-market system that creates network holes by withholding its hospitals causes the health plan to have lower premiums and profits. One of this model's restrictive assumptions requires the health plan to offer an employer the same premium in all markets, regardless of the strength of the local network. That assumption means that a cross-market hospital system has greater bargaining power by threatening to cause a plan's premiums and profits to decline across all markets even if it creates a hole in just one market.

Empirical tests of these theories have attempted to capture a cross-market impact attributable to hospitals' forming systems. Some of these studies have identified higher prices paid to cross-market hospital systems, but they fail to account for other factors that could increase hospital prices without signaling competitive harm. These factors include systems having more sophisticated bargaining teams backed with high-quality contract analyses, the value a single system adds to multiple local networks, improvements in hospital quality, and improved ability to bear contracting risk. In addition, these studies may inaccurately measure the hospital price variable and omit non-price contract terms.

The novel economic theories of cross-market competitive effects currently are insufficient to support an extension of the frontier of antitrust enforcement beyond the bounds of the Merger Guidelines. The models rely on some important assumptions that both limit their applicability and undermine their validity. Likewise, numerous plausible alternative explanations need to be accounted for before the empirical analyses supporting these models are given credence. Absent sound economic theories of cross-market competitive effects, antitrust enforcers should remain skeptical of health plans' complaints that cross-market hospital system transactions harm competition. More compelling analytical approaches exist in the Guidelines framework and the *St. Luke's* appellate decision that require market power to be shown in well-defined markets.

Unfulfilled Desire is Not Foreclosure

systems to maintain secure access through a proprietary device (the cable card). Consumers could purchase a cable box, or a cable card-ready television, at retail. Cable cards were never a popular alternative to renting a cable box from the service provider, partly because they did not allow two-way services. The device manufacturers never embraced the follow-on standard designed to allow two-way services, Tru2Way. In 2010, the FCC issued a notice of inquiry for a new standard, known as AllVid. As proposed, an AllVid device available at retail would operate as an interface between any service provider (cable, satellite, over the air, Internet) and any consumer device (TV, DVR, game console, computer, pad, etc.). While the FCC did not continue to promote a separate AllVid standard, it has attempted to include a retail availability standard as part of the Downloadable Security Technology Advisory Committee process.

Cable service providers have long been accused of tying device rentals to service and profiting from that tie. Service providers have argued that they need to maintain security through the cable box and that they have a stronger incentive than consumers to upgrade the cable box to provide new and enhanced services. They have argued that they would rather consumers purchase a device, as then consumers would bear both the risk the device would break and the cost of upgrades. More recently, many service providers are making their signals available on third-party devices. Subscribers can now access many services through a DVR, game console, or dedicated interface, such as Fire TV, Apple TV, or Roku.

Plaintiffs acknowledged that new ways of integrating multi-channel video sources into home networks are being introduced, but claimed that during the class period (February 1, 2005 through the present) there were no viable alternatives to renting a Cox-provided cable box. The court's decision indicates that the lack of retail alternatives may not be the fault of service providers.

EI News and Notes

Mortgage-Related Litigation

EI Vice President Stuart Gurrea testified at trial concerning damages claims stemming from alleged recording errors on a mortgage account. Dr. Gurrea testified on behalf of a defendant bank. His analyses of loan payment records and escrow account allocations showed that payments were fully accounted for. Dr. Gurrea's analyses also helped show that Plaintiff's definition of the damages periods was flawed and led to erroneous conclusions. The jury ruled unanimously in favor of defendants. The bank was represented by Severson & Werson in San Francisco.

EI Economist Receives Writing Award

EI Vice President Su Sun won an antitrust writing award from the journal *Concurrences*. The award was for the Best Antitrust Business Article in the Asian Antitrust Category. Dr. Sun's article, which he coauthored with Fei Deng, "Rainbow v. Johnson & Johnson: RPM Litigation in China," discusses the analytical framework adopted by the Shanghai High People's Court to adjudicate resale price maintenance cases. That article originally appeared in *Distribution*, the newsletter of the Distribution and Franchising Committee of the ABA Antitrust Section.

Study on The Internet's Contribution to the U.S. Economy

EI Principal Stephen E. Siwek recently completed a study entitled "Measuring the U.S. Internet Sector." The study, which was conducted on behalf of the Internet Association, is believed to be the first to measure the Internet's contributions to Gross Domestic Product (GDP), employment, and employee compensation in the United States. The study found that the Internet sector was responsible for over $966 billion, 6%, of U.S. GDP. The Internet sector employed approximately 2.9 million U.S. workers. Average wages in the Internet sector were approximately 29% higher than average wages in the overall economy. The study can be accessed at www.ei.com/download/measuring-the-u-s-internet-sector/.

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OFFICES:

2121 K Street, NW
Suite 1100
Washington, DC 20037
phone: (202) 223-4700
fax: (202) 296-7138

101 Mission Street
Suite 1000
San Francisco, CA 94105
phone: (415) 975-5510
fax: (415) 281-9151

1276 Metropolitan Blvd.
Suite 303
Tallahassee, FL 32301
phone: (850) 558-6030

www.ei.com

President
Jonathan L. Walker

Editor
Henry B. McFarland

in association with
The Allen Consulting Group in Australia