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The role of innovation in merger control

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Background

- Defining innovation (product, process, sustaining vs disruptive, incremental vs breakthrough)
- Benefits of competition for innovation
- Is innovation better promoted by increased competition or by increased market power ?
  - Economic theory offers two seemingly opposing responses
  - Attempts to reconciling them (contestability, appropriability, synergies)
  - EC's theoretical approach; competition policy needs to:
    - Promote contestability (i.e. keep markets open and competitive)
    - Not negatively affect equitable appropriability (i.e. allow for an adequate return on investment through strong protection of IPRs)
    - Acknowledge synergies that enhance the ability to innovate (if and where appropriate)

Standard theory of harm

- Reduction/loss of innovation = anticompetitive effect of a merger (on equal footing with price increases or a reduction of output, consumer choice or quality)
- EC traditional approach in practice:
  - Existing overlaps: substantive analysis conducted at ATC3, ATC4 or molecule level
  - Pipeline products: analysis of Phase III (i.e. advanced stage) projects, whether both parties have a pipeline, or where one party has a marketed product and the other a pipeline product
- Analysis mostly relies on the closeness of competition between the (existing and/or pipeline) products and the elimination of an important competitive constraint
- Analysis usually framed on loss of actual or potential competition grounds
  - Horizontal Merger Guidelines: paras. 8, 20(b), 37-38, 60

Evolution of decisional practice in pharma

- Horizontal effects on innovation - Recent pharma cases
  - Pfizer/Hospira
  - Medtronic/Covidien
  - Novartis/GSK oncology business *(…expansive approach?)*
    - Earlier Phase I & Phase II products (skin cancer)
    - Risk of Novartis abandoning broad clinical trial program for LGX818 & MEK162
    - Analysis expanding into assessment of risk of exit from future markets
  - J&J/Actelion *(…expansive approach cont'd)*
- Vertical & conglomerate effects on innovation
  - No pharma cases, but Dentsply/Sirona
    - Prospective foreclosure strategy may reduce incentives of competitors to innovate
  - Several ICT cases

Towards a more aggressive enforcement

- GE/Alstom *(…divergence from traditional approach?)*
  - Removal of competitive pressure to invest
  - Risk of Alstom discontinuing innovation pools
- Dow/Dupont *(…divergence from traditional approach more discernible)*
  - No delineation of specific (existing or tangible pipeline) products, but assessment of competition in so-called "innovation spaces"
  - Prediction of exit from an innovation space, albeit not possible to identify precisely which early pipeline product or lines of research would likely be discontinued
  - The parties would find it profitable to reduce overall R&D efforts/investments post-merger causing a reduction in the number of innovative products (as yet unidentified) at some (unspecified) time in the future
- Emphasis also on overall levels of innovation and R&D in the industry

New theory of harm articulated

- Concerns not necessarily based on specific products or a pipeline of innovative products, but on competition in "innovation spaces" and overall innovation competition intensity
- Focus not only on current overlaps between the merging parties (i.e. existing products or clearly foreseeable future products), but also on intensity of dynamic competition for future products (i.e. on the basis of their R&D activities and innovation capabilities, and those of their actual or potential rivals).
- Economic underpinnings:
  - Standard unilateral effects analysis
  - Appropriability factor
  - Anti-competitive cannibalization effects are most likely to dominate pro-competitive appropriability effects

Criticism leveled against new theory

- Assessing the impact of mergers on innovation is more of a balancing exercise of a number of factors that affect the incentives to innovate (notably, cannibalisation and appropriability)
- Case-by-case and fact-intensive counterfactual analysis required
- No general presumption that mergers harm innovation
- Strict efficiency regime does not allow a proper balancing exercise
- Appreciability discounted
- No credible measure or proxy for R&D power
- Exit from innovation spaces is not similar to standard unilateral effects in price (post-merger price competition not the same with post-merger R&D investments) because…
- Bringing together complementary research programs may allow for cross-pollination

EC rejects criticism

- Analysis is still about systematic anticompetitive factors that affect market outcomes
- Always acknowledged that competition may be lessened not only because of a reduction in (static) competition on current products, but also because of a reduction of (dynamic) competition on future products (at least partly)
- Recent decisions simply an evolution of standard decisional practice
- Consistent with US approach
- In practice, when examining a horizontal merger with innovation effects, there are 2 questions to ask:
  - Will a merger between two rivals significantly reduce their ***incentive*** to innovate ? *(unilateral effects & appropriability)*
  - If so, will the merger enhance their ***ability*** to innovate sufficiently to offset the reduced incentive ? *(synergies)*

Potential consequences

- Legal uncertainty ?
- Even more front-loaded notification procedure ?
- Increased scope of 3rd parties frustrating a deal or extracting benefits?
- Tendency to impose remedies broader in scope, increasingly aimed at preserving capacity and incentives to innovate ?
  - Not only divestment of overlap drugs (incl. clinical trial program, development and manufacturing rights, associated IPRs, technology and know-how to be sold or licensed, transitional manufacturing and distribution arrangements), but also including more and more innovation capabilities
  - More far-reaching remedies
- Transposing new innovation theory of harm to Article 101 EC Treaty analysis (self-assessment of R&D agreements, technology transfer agreements etc.) ?

Far-reaching remedies

- More and more innovation capabilities included
  - Large part of associated personnel *(Medtronic/Covidien + GE/Alstom*
  - Co-funding of clinical trials *(Novartis/GSK oncology business)*
  - Production plants *(Teva/Allergan Generics)*
  - R&D facilities associated with overlaps *(+GE/Alstom)*
  - Measures to preserve integrity of perceived innovation hubs – more holistic approach *(Novartis/GSK oncology business)*
- Similar trend in other industry sectors
- In view of new innovation theory of harm:
  - R&D facilities in a broader context, so as to maintain competing innovation hubs independent and competitive (without a causal link to a specific overlap existing/pipeline drug) ?