Mergers and Innovation: Competition Policy Practice

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“protecting innovation is important in our merger policy (...) when we look at high-tech mergers, we don’t just look at whether they may raise prices. We also assess whether they could be bad for innovation” M. Vestager

- recent interest of EC in assessing the impact of mergers on innovation (pharma, telecoms, etc...)
- what is a current framework? general presumptions or case-by-case assessment
Horizontal Mergers:

- "Effective competition brings benefits to consumers, such as low prices, high quality products, a wide selection of goods and services, and innovation." Horizontal Mergers Guidelines
- EC has a reason to intervene when:
  - merger combines two important innovators
  - eliminates a firm with promising pipeline products
- innovation potential of merging firms should be taken into account
Legal framework (2)

Vertical mergers:

► NMG acknowledge possibility to consider impact of a merger on innovation

► merger involving innovative companies, that are likely to expand significantly should be investigated even when the post-merger market share is below 30%

► may involve foreclosure scenarios, that might impede innovation by other market players, or entrants

Efficiency: both in horizontal and vertical mergers guidelines acknowledge the possibility of claiming efficiency gains to innovative capacity
Mergers in pharmaceuticals: A pipeline product case

- number of high profile cases: Medtronic/Covidien, Novartis/GlaxoSmithKline, Pfizer/Hospira
- narratives: product cannibalization and race to the market
- identification of pipeline products in overlapping fields
- mergers cleared subject to divestitures
- analysis similar to existing product
Mergers in pharmaceuticals: Novartis/ GlaxoSmithKlein (1)

- Novartis to acquire sole control over GSK’s portfolio of oncology pharmaceuticals products: 10 marketed products and 2 pipeline products.
- Commission recognized that this merger affects competition in existing markets, competition in innovation and competition in new product markets.
- Commission’s claim: In pharma, the process of innovation is structured in a way that it is typically possible at an early stage to identify competing clinical research programs.
- The transaction brings together ownership of two among the only three competing research programs in several markets (e.g. B-Raf and MEK inhibitors).
Mergers in pharmaceuticals: Novartis/ GlaxoSmithKlein (2)

- **pre-transaction:** firms individually decide on investments levels
- **post-transaction:** the firm internalizes the cannibalization effect between the products, if introduced; so expected reduction of total investments or/and discontinuing one of the programs
- **effect:** lessening of competition in future product markets; lower expected number of differentiated products
- **decision:** Novartis to transfer to Array BioPharma assets related to research projects in areas where GSK had competing R&D (B-Raf and MEK inhibitors)
EC Competition policy Brief April 2016 - markets need to remain *contestable* for innovation to flourish, increased *appropriability* will foster incentives to innovate, *synergies* arising for instance from the combination of complementary assets necessary to engage in R&D, will enhance the ability to innovate.

Broader and arguably more speculative argument that parties will find it optimal to reduce R&D efforts in future
Tommaso Valletti EC’s Chief Competition Economist: "Some people said it was a 'quantum leap'. Some said it was 'crystal ball gazing' by the Commission, or that the Commission is 'predicting the winner of the 2022 World Cup,' or that we introduced a new theory of harm based on innovation that had never been done before and that the remedy that we imposed was unprecedented and too far reaching." ¹

¹https://promarket.org/mergers-bad-innovation/
General Incentives to Innovate: Dow/DuPont (2)

- Long trend towards consolidation in agrochemicals: +/- 40 firms in 60s to 5 today
- Only a few have the capability to do innovation at every stage and in every segment
- Innovation by development of new active ingredients (AI); costly and lengthy process partly because of regulatory approval
- Bringing new AI- "fundamental business strategy"
- DuPont and Dow had overlaps, in existing products and in the pipeline. "They also had significant overlaps in the research for new AIs, meaning they had overlaps in fundamental R&D"
European Commission’s argument:

- firms do not innovate randomly- "The best predictor of what [firms] will be doing 10 years into the future is the current portfolio of the patents they have now" (this is also how firms monitor their competitors)
- analysis of patents (weighted)
- identification of areas where both Dow and DuPont had technological advantages to innovate
- decision: divestiture of major parts of DuPont’s global pesticide business, including its global R&D organization
Challenges to dynamic efficiency claims: Telecoms (1)

Several cases in telecoms: H3G/Telefonica Ireland, Telefonica DE/E-plus etc, and others e.g. Deutsche Boerse/Euronext

- merging parties have demonstrate that dynamic efficiencies can lead to benefits to customers which are both substantial to customers and sufficiently predictable

- benefits to customers from dynamic efficiencies typically arise only indirectly, it is necessary to establish casual relationships
Challenges to dynamic efficiency claims: Telecoms (2)

- In the H3G/Telefonica merger the claimed efficiencies were due to the level of financial constraint of H3G; EC:
  - no sufficient evidence to show that fixed cost savings due to the merger could be reinvested
  - parties had not demonstrated the benefits to consumers associated with the alleged additional investments

- in Telefonica DE/E-plus parties submitted an extensive analysis aimed at quantifying the consumer benefits from improved network quality; EC rejected the counterfactual, criticized econometric model

- all claims rejected; except for (old case) TomTom/Teleatlas-unconditionally cleared due to Commission’s acknowledgement of innovation-related efficiencies that were merger-specific and would bring consumer benefits
FTC’s decisions

- also increased interest in analyzing incentives to innovate; similar notions: pipeline products, race to the market, product cannibalization
- controversial decision in Genzyme/Novazyme; 3-1 vote (one abstaining)
- dissenting opinion:
  - Genzyme was willing to pay a substantial sum of money for an unproven research that has not even reached clinical trials
  - merged entity pushed back the project launch date for the Novazyme product four or more years
  - these facts raise the question whether Genzyme’s sole motive was acquiring value found in Novazyme’s R&D, or whether it had an interest in eliminating its only rival innovator

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\(^2\) merger review after the transaction
Conclusion

- Incentives to innovate are becoming a frequent aspect of merger review.
- What’s the EC unified approach?
- Let’s wait and read decision in Dow/DuPont.