Federal Trade Commission

THE ROLE OF COMPETITION POLICY IN INNOVATIVE MARKETS

Prepared remarks of
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[1] The views expressed are those of the Commissioner and do not necessarily reflect the views of the Federal Trade Commission or any other Commissioner or staff.

It is a pleasure to have the opportunity to talk with you today. Your organization is of particular interest to me because I believe in the value of business leaders, government officials and academics joining together to engage in regular dialogues on the issues that concern us all. One issue that I find especially intriguing in my new role as a Federal Trade Commissioner, and an issue that we are all facing, is the role that competition policy should play in innovative markets. When I refer to innovative markets, I am speaking in broad terms. I mean emerging markets; those markets where firms are competing in research and development; and those markets that involve developed products, but that are technology driven.[2]

New technologies and the "Information Superhighway" are transforming many aspects of our economic life. Technology has reduced the cost of communications and created a Global Marketplace which was once only imagined. We hear about the paperless office, the Internet, the general convergence of technologies for voice, data, and video services, and about innovation in new drug therapies. These innovations will continue to improve our lives, as well as provide opportunities for economic growth.

As everyone knows, the future is difficult to predict. We do not know today which innovative technologies will create a lasting impact and an enduring demand. We cannot foresee precisely how the new information highways will link the millions of people from around the

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[2] Only for the purposes of my speech today, I am using a broader definition of innovation markets than is utilized in the Justice Department's recently-issued antitrust guidelines on intellectual property. See generally "U.S. Department of Justice Guidelines for Licensing and Acquisition of Intellectual Property," § 3.2.3 (Issued for public comment Aug. 8, 1994).

world or what uses will be made of it. Access and content will drive the demand for these new technologies. The content will be meaningless if the path is unfairly blocked by anticompetitive activities. Focus must be placed on the nature of competition in and among the producers of these innovations.

As a Federal Trade Commissioner, I face the issue of what role competition policy should play in this area. I believe that competition policy has a major role to play because competition promotes innovation. This is especially important as we move toward a more globalized economy. Today we see markets expanding beyond our borders, with more competition from firms located outside the U.S. The evidence suggests that those businesses that are likely to be successful in global markets are those that face fierce rivalry in their home markets.[3] The fear of being left behind, not stable domestic markets, spurs innovation. Therefore, it is important to promote domestic innovation markets so that our products are competitive on the global front.

Promoting competition in innovative markets only benefits those markets by encouraging diversity of technological approaches to innovation. Indeed, promoting competition is one of the primary goals of antitrust policy in any setting. The FTC's mission is to ensure that consumers have the benefit of choices created by competition. We pursue this goal by attacking anticompetitive activities in markets, whether they take the form of anticompetitive mergers, or

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[3] See M. Porter The Competitive Advantage of Nations (1990). Others have suggested that some level of cooperation, albeit at a level that does not usually raise anticompetitive concerns, may also play some role in firms' ability to succeed on a global basis. See generally D. J. Teece "Information Sharing and Innovation," 62 Antitrust L.J. 465, 471-73 (1994).

practices which lead to anticompetitive results. On the consumer protection side, we attack fraud and deceptive practices in an effort to ensure that consumers have real choices.

The antitrust laws we administer were drafted in sufficiently general terms to delegate to the courts and the federal enforcement agencies the task of developing jurisprudence that is consistent with contemporary concepts of economic efficiency and consumer welfare. For example, Section 5 of the FTC Act prohibits "unfair methods of competition" and "unfair and deceptive acts and practices." The FTC and courts have attempted to determine what is "unfair" under the Act using today's economic thinking. Given this flexibility, I believe that we have sufficient tools to implement policies in innovative markets.

These notions of globalization and domestic innovation dove-tail with the fundamental tenet of antitrust enforcement policy: competition fosters innovation and efficiency over the long run. However, in applying competition policy to high-tech markets, we must be cautious not to unwittingly impede innovation. The scale economies and other efficiencies to be derived from integration may be essential to ensure the success of emerging markets. Therefore, our primary goal must be to achieve a balance -- the balance of maintaining competition in, and access to, high-tech markets, while ensuring that innovation is not inhibited.

There are three major principles that I believe will help us maintain this balance. First, our enforcement approach to vertical mergers involving innovative and emerging markets should seek to resolve concerns of anticompetitive effects without diminishing efficiency-enhancing benefits.

Second, where we find the possibility of an anticompetitive effect, flexibility is needed to ensure that demonstrated and substantial efficiency benefits are retained whenever possible. Third, in our general enforcement policy in the area of innovative markets, it is critical that we not lose sight of the importance of promoting diversity in technological approaches at the research and development stage. I will turn to each of these points.

A recent settlement with Eli Lilly highlights the difficult balancing act in curing potential anticompetitive problems without stifling efficiency benefits of new arrangements. In that matter, Eli Lilly, a pharmaceutical drug manufacturer, wished to acquire PCS Health Systems, the pharmacy benefits management subsidiary of McKesson Corp. The concern with this vertical merger was that Lilly, a major pharmaceutical company, was buying last remaining full-service independent pharmacy benefit management companies.

The pharmacy benefit management ("PBM") industry emerged in part as a result of third-party payers' desire to control pharmaceutical drug costs. One of the ways that PBM's control costs is through a formulary, a listing of FDA-approved drug products, by therapeutic category, that is used to guide the prescribing and dispensing of drugs. Formularies may be "open" or "closed": if it is open, all the drugs listed are those preferred for particular conditions; if it is closed, only those drugs listed ordinarily will be reimbursed. PBM's benefit both the third-party payers and consumers, in part, because they negotiate discounts and rebates from drug manufacturers. Also, by restricting reimbursement on certain drugs, the formulary influences the

prescribing patterns of physicians in order to lower drug costs. PBMs were virtually unknown five years ago; now they administer pharmacy benefit plans covering over 120 million lives.

The Commission issued a complaint against Eli Lilly charging that the acquisition would harm competition in several markets.[4] The complaint alleged that Eli Lilly's acquisition of the last remaining independent PBM would reduce competition among drug companies by foreclosing rival drug companies from access to PCS' formulary, by heightening the possibility of coordinated interaction, and by making entry more difficult by requiring new drug companies to enter at both the drug and the PBM level.

However, one of the ways PBMs have been allegedly able to reduce costs is by negotiating special agreements with particular drug companies as part of a so-called "closed" formulary. As the Commission has recognized in other related contexts, contracts that limit the panel of providers in order to secure lower priced by assuring high volume can be efficiency enhancing and, hence, procompetitive.[5] In the same way, pharmaceutical manufacturers may be willing to offer greater rebates in return for the assurance of high volume of closed formularies. Thus, the settlement with Eli Lilly was crafted so as to alleviate the possibility of Eli Lilly foreclosing rival drug companies from PCS' formulary without losing the potential efficiency-

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[4] Eli Lilly & Co., FTC File No. 941 0102 (Consent Agreement accepted for comment Nov. 3, 1994) (Comm'r Azcuenaga dissenting).

[5] See, e.g., Letter to the Hon. William F. Cass, Massachusetts House of Representatives, June 15, 1993 (regarding proposed "any willing provider" legislation on prescription drug benefits).

enhancing benefits of "closed" formularies and PBM's in general. Consequently, under the settlement, Eli Lilly/PCS is required to maintain an open formulary and establish an independent Pharmacy and Therapeutics Committee ("P&T" Committee) with the responsibility of maintaining this formulary in an independent manner. This will prevent Lilly from anticompetitively foreclosing competing drug manufacturers from the PCS formulary. The order further prevents Lilly from refusing to accept discounts and from inaccurately reflecting such discounts on the open formulary. This provision is intended to prevent Lilly from giving its products preference on the formulary or making the open formulary so expensive that no one will use it.

At the same time, Lilly is not foreclosed from offering a "closed" formulary and thus continuing to play the potentially efficiency-enhancing role of reducing pharmaceutical drug costs. There remains the question of the overall competitive effect of pharmaceutical companies owning PBMs. As Chairman Steiger and I said in our public statement regarding Lilly, "[w]e are concerned about the overall competitive impact of vertical integration by drug companies into the pharmacy benefits management market." Our hope is that through monitoring this proposed order and through analysis of these evolving markets, the Commission can better assess all the ramifications of vertical integration in these markets. The proposed order is currently on the public record for comment. I welcome comments that will aid in our understanding of these markets, and the effect of the FTC's consent order may have.

The second principle I believe should guide competition policy in this area is the need for flexibility to ensure that demonstrated and substantial efficiency benefits are retained whenever

possible. One area where these concerns arise is with mergers in the defense industry. The defense industry is undergoing a period of drastic downsizing while continuing to encourage the development of new defense-related technology. When technology issues emerge in the defense context, the Commission's approach to the role of competition policy in this area must be sensitive to issues of national security and whether significant economies of scale or scope are required in a particular market. These factors are all considered when we examine whether the transaction is likely to have an adverse effect on competition in the future.

The Commission recently demonstrated its ability to effectively deal with such mergers in the consent agreement it accepted with Alliant Techsystems Incorporated.[6] Alliant, a significant competitor in the market for ammunition and munitions, proposed to acquire Hercules Incorporated aerospace division, the only U.S. supplier of propellant used in large caliber ammunition. The competitive concern alleged in the complaint centered on the fact that once the merger was consummated Hercules, as the only propellant supplier, would be a conduit for Alliant to get competitively sensitive, non-public information from Alliant's competitors that rely on Hercules for propellant. To alleviate this concern, Alliant agreed to construct a firewall to prevent it from accessing the competitive secrets of other weapons manufacturers. Therefore, the alleged efficiencies to be gained by Alliant owning a propellant supplier can be realized, but Alliant will not harm competition by obtaining anticompetitive information.

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[6] Alliant Techsystems, Inc. FTC File No. 941 0123 (Consent Agreement accepted for comment Nov. 14, 1994).

As I indicated before, diversity is a natural result of promoting competition in innovative markets. In particular, at the research and development stage, diversity is frequently the only way to ensure that innovation is in fact successful. Indeed, having more than one company undertaking research and development has the potential of producing an innovation that might not otherwise be discovered.[7]

The FTC attempted to implement this goal in the consent agreement we accepted with American Home Products Corporation's ("AHP") regarding its acquisition of American Cyanamid Company.[8] The consent order the Commission accepted for public comment is aimed at preserving competition in the markets for tetanus and diphtheria vaccines, for research for a vaccine to treat rotavirus, and certain biotechnology drugs used to treat cancer known as cytokines. However, I want to focus on just one aspect of the consent order: the provision dealing with the research and development of a rotavirus vaccine. Rotavirus is a diarrheal disease that causes thousands of children's deaths annually; finding a vaccine is vitally important to stop the spread of this disease.

In the complaint, we alleged that a market exists for the research and development of rotavirus drugs in which AHP and American Cyanamid are two of only three competitors with

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[7] See R. Pitofsky "Proposals for Revised United States Merger Enforcement in a Global Economy," 81 Geo. L.J., 195, (1992). Of course, at some point, a technological approach will emerge as a recognized standard and, at that point, our antitrust concerns will focus on issues of preventing anticompetitive bottlenecks.

[8] American Home Products Corp., FTC File No. 941 0116 (Consent Agreement accepted for comment Nov. 9, 1994).

research projects either in or near the clinical trial stage required before drugs are approved by the FDA. To assure that both the AHP and Cyanamid rotavirus projects continue independently, the consent agreement requires AHP to license Cyanamid's vaccine research to a Commission-approved licensee and provide the licensee with certain technical assistance. In this way, the Commission sought to ensure the continuation of different approaches to developing this important vaccine which will hopefully speed the day when a vaccine is found.

Turning to the consumer protection side, we need to make sure that we are policing these new avenues of technology for unfair and deceptive practices. The purpose is two-fold: to protect consumers and to protect legitimate businesses. We are accomplishing this by examining the available new technology to determine how consumers could be harmed.

The Commission recently brought its first case targeting advertising on the information superhighway.[9] An individual allegedly offered consumers -- in an ad he distributed through "America Online" -- the chance to establish a new credit identity free of derogatory information. Brian Corzine, doing business as Chase Consulting, advised consumers to take illegal steps in order to repair their credit records, yet represented that his program was "100% LEGAL." Corzine has agreed to settle the charges under an agreement that provides for refunds to all purchasers of his $99 program. There can be little doubt that this is the first of many cases to be pursued by the FTC regarding fraud and deception on the information superhighway.

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[9] FTC v. Brian Corzine, No. CIV-S-94-1446 (E.D. Cal. Sept. 14, 1994).

We are also utilizing the information superhighway to make consumer information more readily available. Recently, we made certain consumer information available on the Internet. Indeed, in less than two weeks, we received six thousand requests on Internet and numerous messages in return thanking us for making the information available. I see this happening more and more in the future.

Conclusion

The Lilly, Alliant, and AHP matters happen to be the first three cases I dealt with as a Federal Trade Commissioner, which leads me to believe that they will not be the last of their kind. You can also see how consumer protection issues fit into the FTC's role in innovative markets, and how we plan to use the information revolution to get the FTC's message out. The information revolution, global integration, and the rise of new and dynamic firms in every industry that are changing the way companies compete -- these forces profoundly influence daily economic events. The changing nature of technology requires government action that is forward-looking, but not ideological or rigid. It requires a framework which promotes innovation and competition.