Christine A. Varney
212-474-1140
cvarney@cravath.com

FTC Clears Express Scripts' Acquisition of Medco

April 10, 2012

On April 2, 2012, the FTC announced that it had closed its eight-month investigation of Express Scripts, Inc.'s proposed acquisition of Medco Health Solutions, Inc. Since the deal was announced in July 2011, there has been vocal criticism from consumer groups, trade groups and lawmakers that the combination of two of the top three pharmacy benefit managers ("PBMs") would have an adverse impact on consumers, health care plan sponsors, pharmacies and other constituents. Though stating it "was not an easy decision," the FTC concluded that the evidence had failed to demonstrate that the proposed combination was likely to substantially lessen competition in violation of the Clayton Act, 15 U.S.C. § 18.

Despite arguments by opponents of the deal that the combination should be viewed as a 3-to-2 merger and an impermissible consolidation in the market for the provision of PBM services to large employers, the FTC analyzed the effects of the merger more generally on the market for the provision of PBM services to all health care benefit plan sponsors. The FTC determined that the merger was unlikely to result in any unilateral effects in this market for several reasons. The FTC found that the market is "moderately concentrated and consists of at least ten significant competitors." Therefore, the post-merger market still would have nine significant competitors, with the merged company having a market share of just over 40%. Additionally, the FTC found that the evidence demonstrated that Express Scripts and Medco were not particularly close competitors—the parties' documents and bid data analysis revealed different customer bases, and diversion rates between Express Scripts and Medco were "substantially lower than the market shares would predict."

The FTC focused on the significant and growing competition from both health plan-owned PBMs and standalone PBMs, whose growth was spurred in part by the passage of healthcare reform and the creation of Medicare Part D. The FTC noted in particular that in July 2011, United HealthCare, Medco's biggest client representing 17% of Medco's net revenue for 2011, announced that effective December 31, 2012, it would take all of its PBM services in-house under its newly-branded PBM, OptumRx. Thus, the FTC explained, its investigation "revealed a competitive market for PBM services characterized by numerous, vigorous competitors who are expanding and winning business from traditional market leaders," a market where "the high market shares of the parties do not accurately reflect the current competitive environment." Analysts and commentators on the FTC's decision have focused on the weight the FTC appears to have given to the emergence of United HealthCare and other mid-sized PBM players and to their effect on the competitive landscape.

The FTC also found that the market was not conducive to coordinated interaction, noting the "multifaceted and opaque" nature of pricing in the PBM industry, CVS Caremark's recent success in the marketplace, the high number of market participants, and employers' and health plans' frequent use of industry consultants, who are uniquely well-positioned to detect coordinated activity between PBMs.

Contrary to expectations, the FTC wholly rejected the argument that the merged company was likely to exercise monopsony power over retail pharmacies to drive down reimbursement rates below competitive levels. The FTC's primary justification was that the combined entity's share of retail pharmacies' sales, at 29%, would be smaller than usually is considered necessary for the exercise of monopsony power. The FTC went on to explain that even if the merged entity exceeded this theoretical threshold for the exercise of monopsony power, there was no reason to believe that the merger would lead to lower reimbursement rates for

pharmacies, as the data showed "little correlation between PBM size and the reimbursement rates paid to retail pharmacies." And, even if the merged firm were able to reduce the reimbursement it offers to retail pharmacies, the FTC found no evidence that this would lead to "reduced output or curtailment of pharmacy services generally." In fact, citing "contractual . . . reasons" and "competitive pressures" that have made pass-through pricing arrangements more common in the industry, the FTC found it "likely that a large portion of any of these cost savings obtained by the merged company would be passed through to the PBM's customers," which "could benefit consumers by lowering health care costs". Generally, however, claims of passed-through cost savings are not recognized when it is possible that the merging parties may reap higher profits rather than sharing the savings with customers, particularly where the elimination of a top-tier competitor PBM would only diminish the need and incentive to pass on the savings.

Finally, the FTC stated that it had considered whether the merger might harm consumers of specialty pharmaceuticals due to the power of the merged entity to demand more exclusive distribution arrangements from manufacturers, but had found that the "evidence shows otherwise." Assuming that specialty pharmacy services were a relevant market, the FTC found that the merged firm's share of the market—a market that "is substantially less concentrated than the overall market for PBM services"—would be approximately 30%, and there was little evidence of direct competition between the parties' respective specialty pharmacies. The FTC's statement did not explain how it arrived at this 30% market share figure, which is significantly less than the roughly 52% share argued by opponents of the deal based on the combined market share of the parties' respective specialty pharmacies—the two largest specialty pharmacy businesses. Additionally, the FTC's investigation found that exclusive distribution arrangements between manufacturers of specialty drugs and PBMs were rare.

Notably, the FTC's statement largely ignored the possibility of a separate relevant market for mail-order drugs. Many opponents of the merger had focused on this market, noting that the merged entity would control approximately 60% of mail-order drug orders in the United States and expressing concern that the combined entity could use its increased power in the PBM and specialty drug markets to steer patients to its own mail-order service.

In her separate statement dissenting from the FTC's decision to close the investigation, Commissioner Brill emphasized that the $29 billion "game changer" transaction is a "merger to duopoly," where the merged entity would be over five times larger than the third-largest firm. While finding that the merger would create a highly concentrated market under any definition, Commissioner Brill noted that a market definition limited to large employers "is consistent with the approach taken in other FTC PBM merger investigations," such as the FTC's investigation of the 2004 Caremark/AdvancePCS merger. Commissioner Brill was highly skeptical of the FTC's characterization of the market as "moderately concentrated," stating that the "significant competitors" cited by the Commission were too small to be "anything other than a fringe when compared to the Big Three."

Commissioner Brill also took issue with the Commission majority's reliance on the diversion analysis and bid data showing that the parties are not each others' closest competitors to disprove the likelihood of unilateral effects, pointing out that "it is insufficient to say, as the majority does, that unilateral effects are unlikely to result from the merger merely because the data indicate that the closest competitor for each of Express Scripts and Medico is not the other, but rather CVS Caremark." Commissioner Brill pointed to the *H&R Block* court's recent statement that the fact that two merging firms might have another firm as their closest competitor "does not necessarily prevent a finding of unilateral effects."

However, it was in the area of coordination that Commissioner Brill found the greatest danger of anticompetitive effects, finding that the post-merger concentration levels "establish a *prima facie* case of coordinated effects under existing case law" and that neither party had produced evidence of "structural market barriers to collusion" sufficient to overcome the presumption of collusion in such a concentrated market. In particular, Commissioner Brill cited statements by the Express Scripts and Medco CEOs that she believed demonstrated that the PBM market is susceptible to coordination and evidence suggesting that, "absent the acquisition, Medco is positioned to play a maverick role in the marketplace."

Finally, while Commissioner Brill conceded that the fact that customers had not expressed strong concerns "gives me the most pause for thought," she explained that where there is a danger of coordinated effects, customers may not be in the best place "to provide evidence regarding what is in essence opaque activity—customer allocation among competitors, or at the least refraining from bidding for each other's customers." Commissioner Brill also disagreed with the Commission majority that entry in the PBM market was likely, timely and sufficient. In closing, Commissioner Brill called on the FTC to demonstrate that the majority's hypothesis of no competitive effects is true by conducting a "thorough analysis" of the PBM industry in three years "to determine if prices to employers in fact have gone down."

Groups such as the National Association of Chain Drug Stores ("NACDS") and the National Community Pharmacists Association ("NCPA") have criticized the FTC's decision, insisting that the merger will lead to fewer choices, higher prescription drug costs and diminished competition in the community pharmacy and PBM markets. The NACDS and NCPA, along with several retail

pharmacies, have brought suit in Pennsylvania federal court to block the deal, and have stated that "there is no evidence to believe that any supposed savings will be realized by patients, plan sponsors and health plans."

The FTC's decision to close its investigation and not to challenge the merger is somewhat surprising, given the concentration among the top three PBMs, the FTC's prior treatment of the PBM market and the vocal opposition to this deal. The FTC's decision to define the market more broadly as PBM services to all health care plan sponsors, rather than PBM services to large employers only, appears to have played the most influential role on its analysis. Thus, despite the FTC's claims that its decision not to challenge the transaction "did not turn on market definition," because the "analysis does not vary significantly whether or not the market is limited to large employers or broadened to include all PBM services," the FTC's conclusion of its investigation findings nonetheless highlights the often decisive impact of market definition on the merger analysis. In particular, the FTC's note that its initial concerns were overcome by what the evidence of its lengthy investigation revealed demonstrates the importance of the documents, market analysis and other evidence that parties to a merger can provide to the reviewing agency, and the value of taking an engaged and proactive approach to the merger review process.

New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212-474-1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com