

Loyalty Discounts and Pharmaceutical Competition

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Overview

- Economic Analysis of Loyalty and Market-Share Discounts
- Empirical Evidence from Pharmacy Benefit Managers (“PBMs”) and Any-Willing-Provider Laws (“AWPs”)
- Legal Analysis – Price-Cost Test or Rule of Reason?

Types of Discounts

By “Shape”

- All-unit vs. incremental-unit discounts
- Single-tier vs. multi-tier discounts

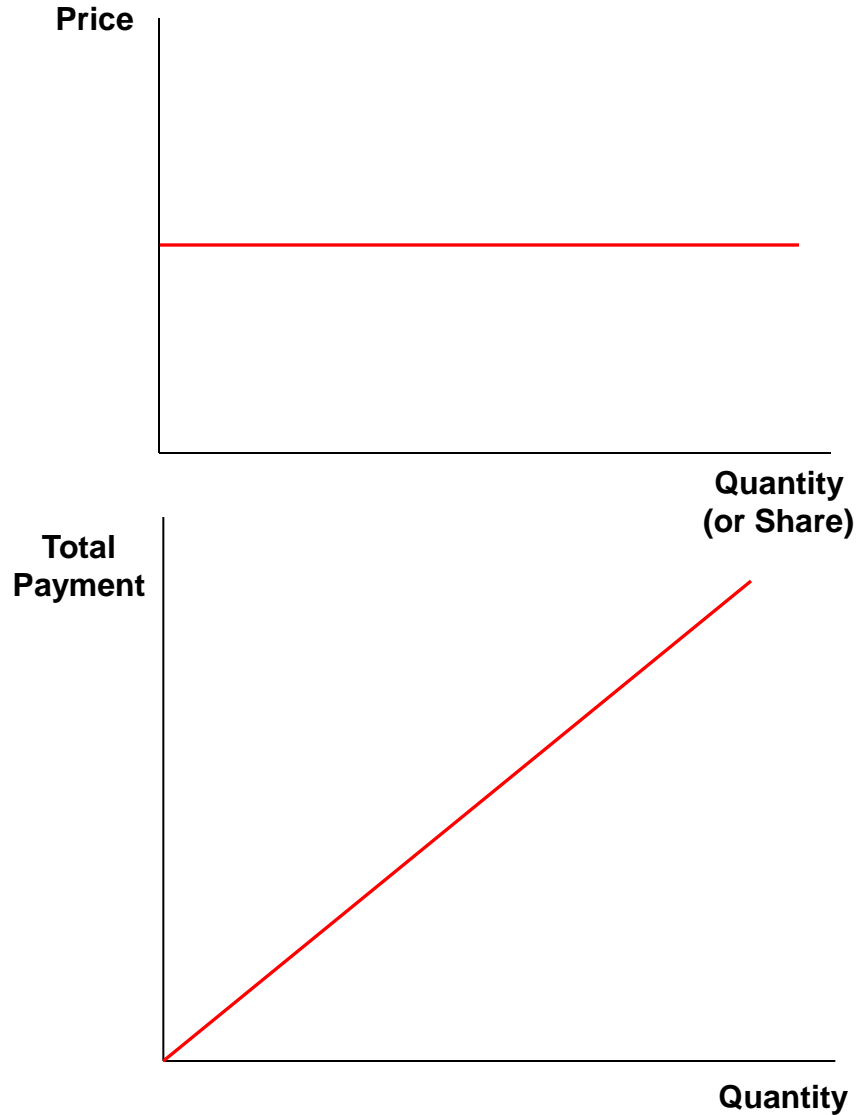
By “Trigger”

- Market-share discounts
- Shelf-space-share discounts (a variant of market-share discounts)
- Exclusive contracts (a special case of market-share discounts)
- Volume discounts (a natural comparator to market-share discounts)

In the pharmaceutical industry, we typically see market share and volume discounts or pure exclusivity

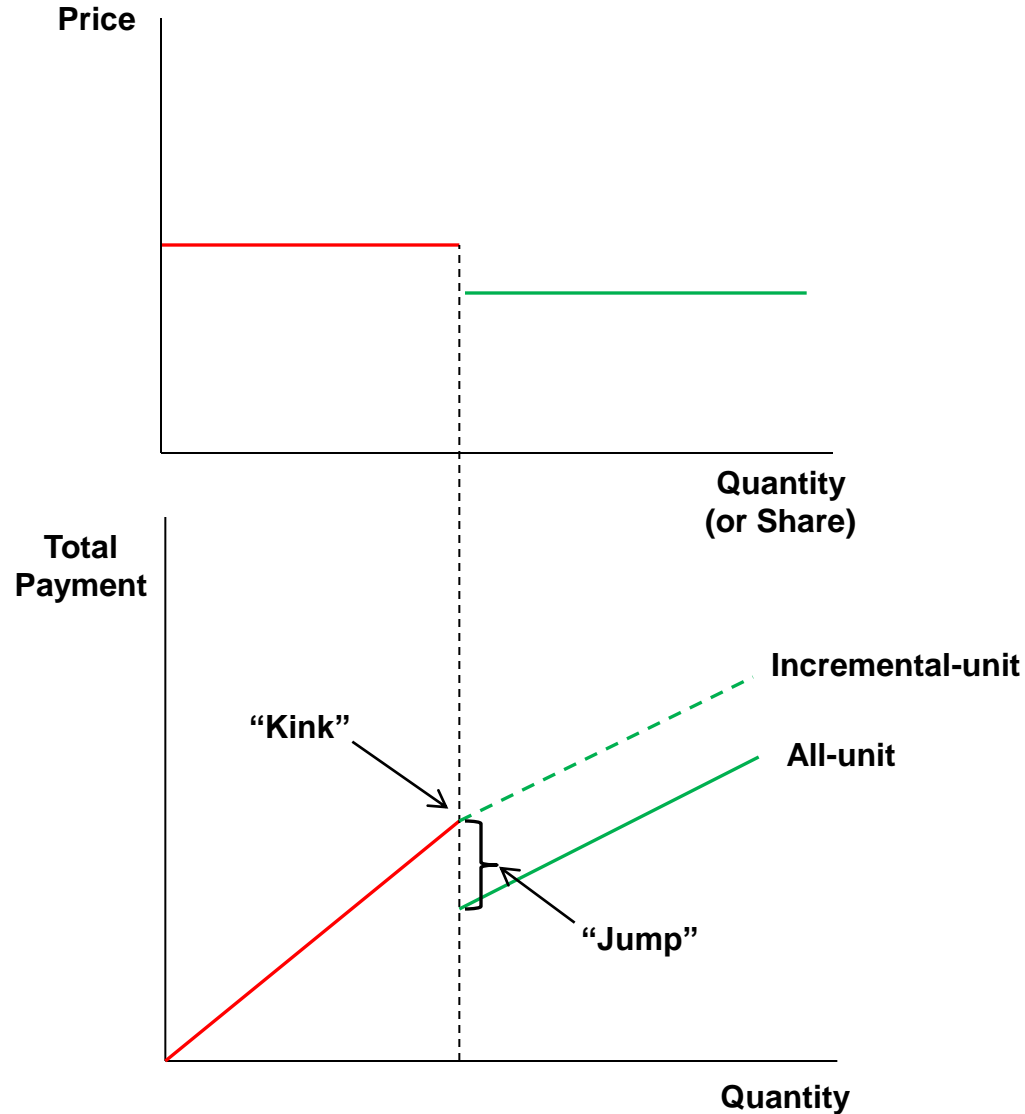
Price and Total Payment Schedules

Linear pricing (standard case)



Price and Total Payment Schedules

Incremental-unit vs. all-unit discounts



Pro-Competitive Rationales

- May lead to lower prices as rival suppliers compete for (partial) exclusivity
 - Competition to be included in PBM network formularies
- May be requested by the customer as opposed to being imposed by the supplier (e.g., convenience stores may want to carry only one brand)
 - Loss of variety can be offset by more favorable contract terms
- May lead to more competition downstream as well
 - The higher profits for retailers can induce entry and/or investments by retailers

Anti-Competitive Theories

Raising rivals' costs

- Raising rivals' costs by “taxing” customers' purchases from rivals
 - The supplier reduces the discount if the customer buys more units from rivals
 - The reduction in the discount is a “tax” that the supplier imposes on its rivals
 - This raises rivals' costs and allows the supplier to raise price
- Exclusion by foreclosing rivals and/or potential entrants
 - Rivals' costs may increase further if rivals are denied scale economies
 - Supply and capacity may fall if rivals are denied minimum viable scale

Anti-Competitive Theories

Predation

- Predation by pricing some units below cost
 - With all-unit discounts, the marginal unit often is effectively priced below cost
 - Unlike traditional predation theories, infra-marginal units are priced above cost
 - Thus, this does not hinge on a “sacrifice today, recoup tomorrow” principle
- Key: there are **two separate paradigms of anticompetitive conduct – exclusion and predation --** which involve different economic mechanisms to create market power

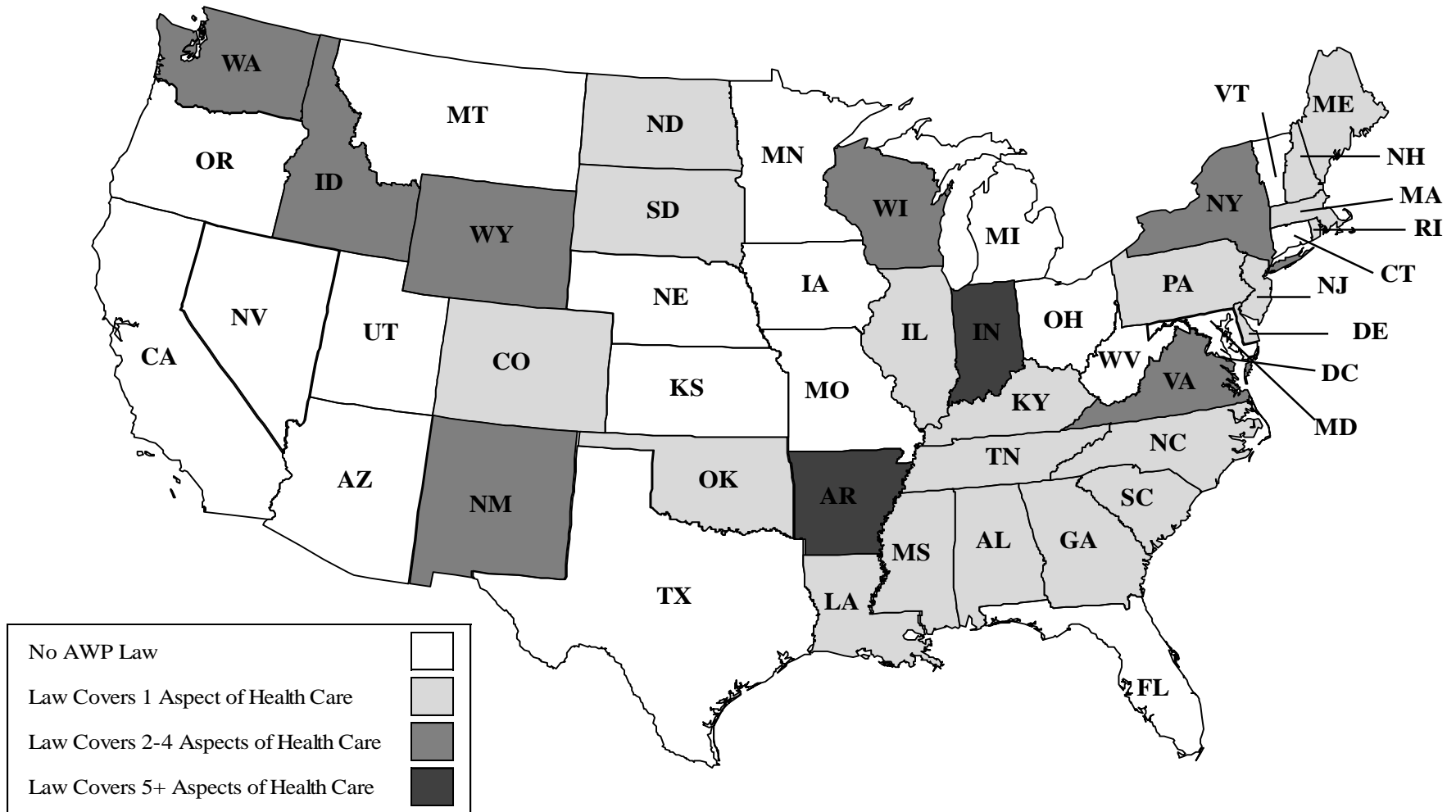
PBMs and Discounts

- PBMs negotiate with pharmaceutical manufacturers on behalf of plan sponsors
 - They obtain discounts from pharmaceutical manufacturers because they have the ability to provide volume purchases of the manufacturers' prescription drugs
- PBM agreements with retail pharmacies often involve a selective or exclusive network created by the PBM
 - The greater a network's exclusivity, the more customers a member pharmacy can expect
 - The prospect of a large number of customers creates intense competition to join exclusive networks
 - This competition leads pharmacies bidding for network membership to offer higher discounts in order to join the network

Any Willing Provider (AWP) Laws

- AWP laws seek to remedy potential concerns about the impact of network exclusivity on consumers
- AWP laws generally require a health plan to include any provider that is willing to participate in the plan in accordance with the plan's terms
- AWP laws as applied to PMBs require plans to reimburse for prescription drugs obtained from any qualified provider, even if the provider is not one of the plan's preferred providers or is outside the plan's network
- Variation in state AWP laws restricting use of discounts to create exclusive networks creates opportunity for empirical study

Figure 1-AWP Laws by State and Breadth of Law



AWP Laws: Empirical Evidence

- Earlier literature finds AWP laws are associated with higher per capital health spending
 - Vita (2001) finds that AWP laws from 1983 – 1997 increase per capita health care spending
 - Durrance (2009) focuses upon pharmacy specific AWP laws and finds that they increase state per capita spending on drugs by more than six percent
- Klick and Wright (2014) improve upon and update these studies to examine AWP laws from 1991-2009
 - AWP laws increase spending on prescription drugs by about five percent relative to preexisting trends and relative to spending growth in other areas of healthcare
 - Implies effective cost savings of at least 15 percent for affected consumers

Antitrust Analysis of Pharma Loyalty Discounts

- The theoretical and empirical analysis of the effects of AWP laws demonstrates that PBM discounting and exclusive dealing should not be prohibited
 - Loyalty discounts facilitating exclusive and selective networks can and often do improve outcomes for consumers
- How should antitrust courts analyze loyalty discounts?
 - Including outside the PBM area, e.g., discounts by pharmaceutical manufacturers to hospital purchasers

Potential Legal Frameworks for Analyzing Loyalty Discounts

- **Option 1: Exclusive Dealing Law**
 - Traditional exclusive dealing framework applied to RRC theories, that is, the conduct will deprive the rival of opportunity to compete for efficient scale
 - Key questions:
 - Is there direct evidence of consumer harm?
 - How to measure foreclosure
- **Option 2: Per se legality for above-cost discounts**
 - Analytical equivalent to importing Brooke Group standard to RRC claims

Potential Legal Frameworks for Analyzing Loyalty Discounts

- **Option 3: Modified Discount Attribution Test**
 - Logic borrowed from bundled rebate context
 - Product A = infra-marginal units
 - Product B = “contestable” units of same product
- **Some Considerations**
 - Matching economic theory of harm to legal standard
 - Administrability
 - Error costs

How Should We Measure Foreclosure?

Relevant Metrics and Tests

Foreclosure rate and contract duration

- Exclusive dealing practices are thought to be less likely to be anti-competitive when:
 - the foreclosure rate (the share of the “market” that is denied from rivals) is low
 - the duration of the exclusive contracts is short
- Courts routinely grant summary judgment when exclusive dealing practices generate foreclosure rates < 40%
- **But, there is not a consensus on how to measure the foreclosure rate**

Relevant Metrics and Tests

An illustrative example

- Upstream there is an Incumbent and a Rival
- Downstream there are **blue** and **red** customers
 - Think of supermarkets and convenience stores; major and small OEMs; etc.
- In the **blue** segment the Incumbent offers a 3% (all-unit) discount provided that the customer buys more than 80% from the Incumbent
- There is uniform linear pricing elsewhere
 - The Incumbent charges **red** customers (and **blue** customers not qualifying for the 3% discount) \$1 per unit
 - The Rival charges all customers (**blue** and **red** alike) \$1 per unit

Relevant Metrics and Tests

An illustrative example (same example, revisited)

- The **blue** and **red** segments are parts of the same antitrust market
- Shares in the **blue** segment (**60%** of market):
Incumbent = 80%; Rival = 20%
- Shares in the **red** segment (**40%** of market):
Incumbent = 55%; Rival = 45%
- Each **blue** customer participates in the Incumbent's discount program

Relevant Metrics and Tests

Foreclosure rate: Alternative definitions

- **Definition 1 (“Naïve” Foreclosure)** The foreclosure rate is the fraction of the market that is participating in the discount program
 - In our example, the foreclosure rate would be 60%, as the entire blue segment (which comprises 60% of the entire market) is participating in the discount program
- **Definition 2 (“But-for foreclosure” rate)** The foreclosure rate is the additional share of the market that the firm **obtained due to the discount practice**
 - Suppose we were to use the Incumbent’s share in the red segment as a proxy for what its share would be in the blue segment in the absence of the discount practice
 - In our example, the foreclosure rate would be $60\% \times (80\% - 55\%) = 15\%$
- **Definition 2b** Same as above, but expressed as a fraction of the “contestable share”
 - Given that the Incumbent’s but-for share would be 55% (in each segment), it can be argued that only 45% of the market is “contestable”
 - In our example, the foreclosure rate would be $33\% (=15\% / (1-55\%))$

These highlight the point that the “right” foreclosure metric must be tied to the theory of harm