



An Inside Look at Monopsony Issues in the FTC's Express Scripts-Medco Merger Investigation

By Rani Habash and John Scalf¹



Introduction

After an intense eight-month investigation by the Federal Trade Commission (FTC), both chambers of Congress, and 32 state attorneys general, Express Scripts, Inc. closed its \$29 billion acquisition of fellow pharmacy benefit manager (PBM) Medco Health Solutions, Inc. without any conditions on April 2, 2012. The transaction created the largest PBM in the nation despite unprecedented levels of public opposition.

The most highly-publicized and politically-charged issue during the investigation was whether the merger would give the combined firm monopsony power over retail pharmacies. Various pharmacy groups, fearful that the combined firm would reduce the reimbursement rates they received for filling prescriptions, did everything they could to try to stop the merger: they launched an extensive public relations campaign; they advocated to the FTC in several meetings; they lobbied members of Congress to hold congressional hearings and to pressure the FTC in its investigation; and they even filed a

last-minute lawsuit seeking to enjoin the merger.

As the majority of the Commission ultimately determined, however, the facts did not support the pharmacy groups' monopsony theory. Quite the opposite, the FTC found that any reduction in reimbursement rates was likely to result in cost savings to be passed through to PBM customers, benefiting consumers through lower healthcare costs.² This article summarizes and analyzes the monopsony issues raised during the Express Scripts-Medco merger investigation.

Background on PBMs and Pharmacy Reimbursement Rates

PBMs help employers, unions, government agencies, health plans, and other plan sponsors design and manage prescription drug plans for their insured members. As part of this service, PBMs establish pharmacy networks at which their clients' members can fill their prescriptions at negotiated rates. These pharmacy networks are established through individual negotiations between PBMs and pharmacies throughout the

¹ Rani Habash is an Associate in Dechert LLP's Washington, D.C. office who provided antitrust counseling to Medco Health Solutions, Inc. in its merger with Express Scripts, Inc. John Scalf is a Senior Consultant at NERA Economic Consulting's San Francisco, California office who performed economic analyses relating to the transaction on behalf of Medco.

² Statement of the Fed. Trade Comm'n. Concerning the Proposed Acquisition of Medco Health Solutions by Express Scripts, Inc. at 8, FTC File No. 111-0210 (Apr. 2, 2012) [hereinafter "Express Scripts/Medco Closing Statement"], available at <http://www.ftc.gov/os/2012/04/120402expressmedcostatement.pdf>.



United States over the reimbursement rate that the PBM will pay to the pharmacy for filling the PBM members' prescriptions. Reimbursement rates generally have two main components: (1) the ingredient cost, *i.e.*, the cost of the dispensed drug; and (2) dispensing fees, *i.e.*, the fee paid to the pharmacy for processing the prescription.

PBM clients balance cost and convenience to their members in choosing the breadth of their pharmacy network. Some clients opt for broader pharmacy networks that provide greater access and convenience for their members, but at a higher cost to the client because the network includes pharmacies that negotiate higher reimbursement rates. Other clients opt for narrower pharmacy networks that consist of fewer pharmacies, but at a lower cost to the client because the network consists mostly of pharmacies that are willing and able to accept lower reimbursement rates than their pharmacy competitors in exchange for access to the PBM's narrower network. In this way, PBMs offer clients a cheaper network option to reduce the cost of their pharmacy benefits. Some pharmacies that are not included in the narrower networks, however, allege that these networks are anti-competitive in that they reduce patient access to patients' preferred pharmacies. This allegation often forms the basis of pharmacy groups' monopsony claims.

Agencies' Precedent on Monopsony

The agencies have provided helpful guidance on analyzing whether increased purchasing power harms consumers. As a general matter, transactions that reduce input costs are likely to create an incentive for firms to lower prices, thereby benefiting consumers.³ In special circumstances, however, increased power to

negotiate input prices can adversely impact consumers by reducing output or services.⁴

According to the agencies' *Merger Guidelines*, in evaluating a transaction's effects on the buying side of the market, the agencies "employ essentially the framework" used to evaluate market power on the selling side.⁵ For example, relevant markets are defined by "focus[ing] on the alternatives available to sellers in the face of a decrease in the price paid by a hypothetical monopsonist."⁶ The FTC has explained that "[a] buyer has monopsony power—or a group of buyers has oligopsony power—when it can profitably reduce prices in a market below competitive levels by curtailing purchases of the relevant product or service."⁷ In such cases, competitive harm can result if purchases are shifted to a less efficient source and/or if the buyer(s) "supply too little output to the downstream market."⁸

Importantly, however, the agencies stress that mergers resulting in decreased prices paid by the merged firm are not necessarily anticompetitive, but often create pro-competitive efficiencies that lower prices for consumers.⁹ The FTC's closing statement in

³ *Id.* at 8.

⁴ U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines § 12 (2010), *available at* <http://www.justice.gov/atr/public/guidelines/hmg-2010.pdf> [hereinafter "Merger Guidelines"]; Express Scripts/Medco Closing Statement, *supra* note 2, at 7.

⁵ Merger Guidelines § 12.

⁶ *Id.*

⁷ Statement of the Fed. Trade Comm'n. In the Matter of Caremark Rx, Inc./AdvancePCS, FTC File No. 031-0239 at 2 (Feb. 11, 2004) [hereinafter "Caremark/AdvancePCS Closing Statement"], *available at* <http://www.ftc.gov/os/caselist/0310239/040211ftcstatemnt0310239.pdf>.

⁸ *Id.* at 2.

⁹ Merger Guidelines § 12.



Caremark's 2006 acquisition of its PBM rival AdvancePCS illustrates this point. Although the FTC believed that the transaction might increase the bargaining power of the merged PBM vis-à-vis retail pharmacies, the FTC stated that the PBM's increased bargaining power was likely to benefit consumers even if it meant that pharmacies made less money.¹⁰ The FTC found that "vigorous" post-merger competition among PBMs was "likely to cause PBMs to pass on at least some of their cost savings" from the increased bargaining power to customers.¹¹

Analysis of Potential Monopsony Power Arising from the Merger

Express Scripts and Medco raised a number of arguments countering the pharmacists' claims of monopsony power arising from the merger. Ultimately, the FTC agreed with the parties that the merger would not establish monopsony power.

Monopsony Power vs. Buyer Power

Pharmacy groups argued that Express Scripts would obtain monopsony power through the merger and therefore would be able to unilaterally reduce the reimbursement rates that pharmacies received. They argued that this reduction in reimbursement rates would particularly push small independent pharmacies out of the market. However, these pharmacy groups failed to recognize that the antitrust laws are designed to protect against harm to competition and consumers due to monopsony power, not harm to producers and competitors due to buyer power.

By itself, a reduction in the reimbursement rates to pharmacies would not fall under the

definition of monopsony. In cases of a buyer having market power sufficient to compel an upstream producer to price their product below competitive prices, monopsony power can only exist if there is a concomitant decrease in the output or services in the buyer's downstream selling market. If there is no reduction in output or services to consumers, the exercise of buyer power simply represents a transfer of wealth, not harm to competition.¹² In this case, Express Scripts' power falls under the definition of buyer power, not monopsony power, because in Express Scripts' competitive downstream selling market, other PBMs could fill the residual demand created by a hypothetical reduction in output.¹³

To further highlight this point, as the *Merger Guidelines* explain, "Market power on the buying side of the market is not a significant concern if suppliers have numerous attractive outlets for their goods or services."¹⁴ Here, the evidence showed that the merged firm's purchasing share of retail prescription dispensing would be less than 25 percent, falling well below levels necessary to create a presumption of monopsony power. Given this low share, along with the facts that the FTC has rarely found that a merger would result in monopsony power and has consistently recognized the consumer benefits of PBMs in reducing prescription drug prices to end users, there was little support for a monopsony theory in this merger.¹⁵

¹² Philip E. Areeda and Herbert Hovenkamp, *ANTITRUST LAW*, ¶ 575 (3d ed. 2009).

¹³ As the FTC concluded, there are "at least ten significant competitors" capable of providing full PBM services. Express Scripts/Medco Closing Statement, *supra* note 2, at 8.

¹⁴ See *Merger Guidelines*, *supra* note 4, at § 12.

¹⁵ See, e.g., Caremark/AdvancePCS Closing Statement, *supra* note 7, at 2 (stating that "bargaining power is

¹⁰ Caremark/AdvancePCS Closing Statement, *supra* note 7, at 3.

¹¹ *Id.* at 3 n.6.



Countervailing Buyer Power

Pharmacy groups also argued that Express Scripts would stand to gain monopsony power particularly over independent pharmacies, as independent pharmacies did not hold the negotiating power enjoyed by the large, multi-location chain pharmacies. However, independent pharmacies also have significant countervailing buyer power as a result of their ability to act collectively through Pharmacy Services Administration Organizations (PSAOs) and because independent pharmacies often enjoy disproportionate buying power due to the lack of pharmacy competitors in their immediate geographic area.

The evidence demonstrated that it would be difficult to exercise monopsony power because of the countervailing buyer power that smaller pharmacies have over PBMs. Over 80 percent of independent pharmacy owners participate in PSAOs. The typical PSAO represents thousands of pharmacies and provides benefits typically associated with the scale of larger, multi-location chain pharmacies. Among these benefits is the ability to collectively bargain on behalf of all pharmacies in the PSAO so that the negotiating power of the independent pharmacies with PBMs is more akin to that of the large chain pharmacies. Indeed, PSAOs often tout their ability to increase reimbursement rates from PBMs for independent pharmacies.¹⁶

Furthermore, independent pharmacies frequently possess significant buyer power even abstracting from their ability to pool their collective buyer power in a PSAO. This power

procompetitive when it allows the buyer to reduce its costs and decrease prices to its customers”).

¹⁶ Statement of Adam J. Fein to the U.S. Senate Judiciary Comm. Subcomm. on Antitrust, Competition Policy, and Consumer Rights, at 6 (Dec. 6, 2011).

exists because PBMs are more attractive to clients if they are able to offer a better and broader network of pharmacies that provide convenient access for a client’s members. If a PBM is not able to attract a sufficient number of pharmacies to participate in its network, an attempt by a monopsonist in the PBM industry to limit consumer access to independent pharmacies could quickly degrade the quality of its PBM services, which would encourage clients to seek out other PBMs.

In addition, many large clients (*e.g.*, TRICARE) contractually specify the level of member access to pharmacies, thereby requiring PBMs to include many independent pharmacies in less densely populated areas within their networks. The potential to lose these large clients would far outweigh any savings Express Scripts might enjoy from reducing reimbursement rates. In addition, various state and federal laws and regulations, including Medicare, also require PBMs to meet certain access standards in their pharmacy networks, making independent pharmacies a necessity.

The Importance of Independent Pharmacies

Pharmacy groups also argued that a reduction in the reimbursement rates they would be able to negotiate—particularly the reimbursement rates paid to small independent pharmacies—would push these pharmacies out of the market. This outcome would likely represent a loss to consumers since independent pharmacies typically serve rural areas and other areas that lack the presence of large chain pharmacies. However, this argument ignores the importance of independent pharmacies to PBMs in decreasing the countervailing buyer power of large chain pharmacies such as CVS and Walgreens.

The evidence showed that it would be against a PBM’s economic interests to reduce



reimbursement rates to independent pharmacies to the point that these pharmacies exit the market. The exit of a significant number of independent pharmacies would only enhance the market power of the remaining large pharmacy chains and therefore weaken a PBM's negotiating power with these pharmacies. For these very reasons, many independent pharmacies have been able to negotiate higher reimbursement rates than large chain pharmacies. Indeed, Express Scripts' recent dispute with Walgreens over reimbursement rates likely made independent pharmacies even more important to the company so that it could meet the access standards of many large clients and state and federal regulations.

Moreover, if a PBM were to limit consumer access to retail pharmacies in favor of, say, mail order services, the result would be a reduction in the quality of PBM services that would not be justified by the cost savings that would be obtained by eliminating the higher-cost, but geographically convenient, pharmacies from their network. Offering a comprehensive retail network is an important selling point for a PBM. Indeed, more than 80 percent of all prescriptions are dispensed at retail locations today. In addition, the majority of prescription drugs are used to treat acute conditions, including antibiotics, pain medication, and cold and flu medication, and are not typically dispensed by mail, making retail pharmacies an even greater necessity for PBM networks.

Historical Relationship between Consolidation in the PBM Industry and Pharmacies' Profits

Underlying the arguments of pharmacy groups was the presumption that consolidation within the industry would lead to increased industry concentration and a subsequent increase in monopsony power by PBMs. This result would lead to the concomitant power to reduce reimbursement rates to pharmacists. However,

the historical evidence does not suggest that there is a positive relationship between consolidation within the PBM industry and the gross profits of pharmacies in general or independent pharmacies in particular.

Over the past ten years, the PBM industry has experienced a spate of consolidation. More than 20 PBMs have been acquired since 2002. These have included some of the largest PBMs in the industry, including AdvancePCS, Caremark, WellPoint's NextRx, and Walgreens Health Initiatives. As other PBMs have gained share, however, it is not necessarily the case that consolidation within the industry has in fact led to increased market concentration over time.

If PBMs were to gain monopsony power and subsequently reduce reimbursement rates through mergers, this spate of consolidation would most likely be reflected in the gross profits of pharmacies and the viability of independent pharmacies. Yet as consolidation has occurred within the industry, there has been no evidence of a detrimental impact to pharmacies in general. From 2004 to 2009, annual gross profits of pharmacies have actually increased by 37.4 percent from \$43.5 billion to \$59.8 billion.¹⁷ Moreover, data from the U.S. Census Bureau shows that the gross profit margin of the pharmacy industry has remained relatively constant between 1993 and 2010.¹⁸

In particular, consolidation within the industry has also not had a detrimental impact on independent pharmacies. The number of independent pharmacy locations has remained nearly constant in recent years—20,896 in 2000 versus 20,835 in 2010.¹⁹ The National

¹⁷ 2011-12 Chain Pharmacy Industry Profile, National Association of Chain Drug Stores, August 2011, at 12.

¹⁸ U.S. Census Bureau, 2010 Annual Retail Trade Report.

¹⁹ 2011-12 Chain Pharmacy Industry Profile, National Association of Chain Drug Stores, August 2011, at 12.



Community Pharmacists Association also has reported that gross profit margins remained relatively constant—ranging between 22 and 24 percent—from 2000 to 2010.²⁰ In addition, gross margins on prescription sales increased from 21.5 percent in 2006 to 23.3 percent in 2010.²¹ Based on the continued stability of independent pharmacies in the face of PBM consolidation, there was a lack of evidence showing that the Express-Scripts-Medco merger would harm independent pharmacies. This was particularly true given the empirical evidence that PBM size had little correlation with pharmacy reimbursement rates.²²

The FTC's Assessment of the Express Scripts-Medco Transaction

In a 3-1 decision the FTC concluded that the Express Scripts-Medco merger was “unlikely to lead to the exercise of monopsony power for the retail dispensing of prescription drugs” for three key reasons.²³

First, the FTC stated that the combined firm’s approximate 29% share was lower “than is ordinarily considered necessary for the exercise

of monopsony power.”²⁴ To corroborate this presumption, FTC economists carefully analyzed the merging firms’ and third parties’ data to determine whether there was a relationship between “PBM size and the reimbursement rates paid to retail pharmacies.”²⁵ The FTC concluded that little correlation existed, implying that even if the combined firm’s share grew even higher, it would not necessarily result in the market power necessary to lower reimbursement rates to pharmacies.²⁶

Second, the FTC did not believe that the merger would reduce pharmacy output or services even assuming that the merged firm would in fact be able to reduce reimbursement rates to pharmacies. The FTC had previously observed that the market for the “retail dispensing of brand name and generic prescription drugs” was not susceptible to monopsony power given that “dispensing fees are negotiated individually between each PBM and each pharmacy.”²⁷ Although these individual negotiations make it possible that the merged firm would be able to negotiate a lower purchasing price, “[b]oth the

²⁰ 2011 NCPA Digest, National Community Pharmacy Association, October 2010, 6.

²¹ “The True Economics of Pharmacy Ownership,” Drug Channels, October 18, 2011, available at <http://www.drugchannels.net/2011/10/true-economics-of-pharmacy-ownership.html>.

²² Express Scripts/Medco Closing Statement, *supra* note 2, at 8.

²³ *Id.* at 7-8. In the lone dissent, Commissioner Julie Brill did not address monopsony issues. Dissenting Statement of Commissioner Julie Brill Concerning the Proposed Acquisition of Medco Health Solutions Inc. by Express Scripts, Inc. at 1-8, FTC File No. 111-0210 (Apr. 2, 2012), available at <http://www.ftc.gov/speeches/brill/120402medcobrillstatement.pdf>.

²⁴ Express Scripts/Medco Closing Statement, *supra* note 2, at 7-8.

²⁵ *Id.* at 8.

²⁶ *Id.*

²⁷ *Id.* at 8 n.15; Caremark/AdvancePCS Closing Statement, *supra* note 7, at 3 n.4 (explaining that “[i]n conventional monopsony and oligopsony models, all sales take at a single price. A reduction in price is associated with a movement downward along the supply curve to a lower quantity. By contrast, each contract between a PBM and a pharmacy company is subject to individual negotiation. Both the PBM and the pharmacy have the incentive to contract for the efficient quantity, while bargaining on the price in order to determine how the gains from the transaction are divided between them. In this situation, an increase in the bargaining power of the buyer may lead to a lower price, but there is no reason to expect a lower price to lead to a lower quantity.”).



PBM and the pharmacy have the incentive to contract for the efficient quantity,” making it unlikely that the reduced price would actually reduce output.²⁸ Without a likely reduction in output, monopsony power was not likely to be created by the merger.

Finally, the FTC found that “for contractual and competitive reasons,” it was likely that “a large portion” of any pharmacy cost savings obtained by the merged firm were likely to be passed through to PBM customers.²⁹ The FTC recognized that although retail pharmacies would be “concerned about this outcome,” any reduction in reimbursement rates was likely to be passed on to clients and lower healthcare costs.³⁰ This finding was supported by the fact that Express Scripts and Medco faced competition from “at least ten significant competitors” and that this competition had made pass-through pricing arrangements “commonplace in the industry.”³¹

Conclusion

After a thorough investigation that left no stone unturned, the FTC correctly determined that Express Scripts’ acquisition of Medco would not provide the merged firm with monopsony power to the detriment of consumers. As the *Merger Guidelines* explain, monopsony enforcement should only arise under a limited set of special circumstances. Otherwise, beneficial strategic transactions such as Express Scripts-Medco that create purchasing efficiencies and lower costs to benefit consumers would be inefficiently deterred.

²⁸ Caremark/AdvancePCS, *supra* note 7, at 3 n.4.

²⁹ Express Scripts/Medco Closing Statement, *supra* note 2, at 8.

³⁰ *Id.*

³¹ *Id.* at 2, 8 n.16.