July 2003

RBB Brief 10

RBB | Economics

The Genzyme Case and the OFT's Margin Squeeze Muddle

In March 2003 the OFT decided that Genzyme had infringed the UK Competition Act's Chapter II prohibition (the UK analogue of EC Article 82) by bundling its product with associated home care services, and by imposing a margin squeeze on competing firms.[1] Based on the case law and the OFT's published guidelines, this decision might appear at first glance to be a straightforward case of dominant firm abuse. But a closer analysis of the economic issues raises some interesting and as yet unanswered questions about the nature of dominant firms' obligations under competition law.

The Facts

Genzyme is a US-based global research-pharmaceutical company whose product portfolio includes Cerezyme, a drug used for the treatment of a rare medical condition known as Gaucher disease that affects only 180 patients in the UK. Cerezyme is one of the most expensive drugs bought by the NHS, the UK public health care system, with an average cost per patient of some £100,000 per annum. One explanation for the high price tag is the extremely limited potential market for the product. The high fixed costs associated with R&D in creating the drug need to be spread across a comparatively small number of customers.

The other key feature of Cerezyme is that, in contrast to conventional medicines that are sold by suppliers to pharmaceutical wholesalers, it is delivered direct to the patient's home, and sometimes administered by a visiting nurse. In 1998 Genzyme appointed Healthcare at Home (HH) to provide this home care service on a contracted out basis, paying HH a fee out of the price at which Cerezyme was sold to the NHS (the sole buyer in the UK market). In effect, therefore, the price charged to the NHS by Genzyme for Cerezyme represented a "bundled" price for the drug itself and the home care service.[2]

Genzyme's problems started in May 2001 when its contract with HH came to an end and Genzyme decided instead to perform the home services in-house under the name Genzyme Homecare.[3] HH then sought supplies from Genzyme in order to continue to operate as a provider of Gerezyme to patients, but was told that it would have to pay the full "bundled" price. Since HH could only obtain remuneration from the NHS at the same price, it is clear that this situation left HH with zero margin to cover the costs of performing home care services. HH therefore complained to the OFT that Genzyme's actions resulted in an unfair "margin squeeze" on HH, and constituted a move whereby Genzyme had "extended" its monopoly power over Cerezyme into the related activity of providing home services for the product. This, in essence, was the complaint upheld in the OFT decision.

Key Economic Issues

The analysis of the Genzyme decision rests on three main economic issues:

- The approach to market definition and dominance
- The assessment of abuse
- The approach to, and the deterrence effects of, fines

Market definition and dominance

Genzyme was unable to resist the OFT's case on market definition and dominance in the relevant product market. Cerezyme was the clearly preferred treatment for Gaucher

1 Decision of Director General of Fair Trading No CA98/3/03 Exclusionary Behaviour by Genzyme. Genzyme has appealed the OFT's decision to the Competition Appeals Tribunal (CAT), and the CAT's verdict is awaited at the time of writing

2 This fact was underlined by correspondence between Genzyme and the NHS during price control discussions. Genzyme had argued that the true price of the drug was only a part of the total price, and that the price control measures proposed at that time by the NHS should apply only to the pharmaceutical component.

3 The HH contract was terminated in accordance with the notice arrangements laid down in the contract.

disease, facing only marginal competition from other secondary line or not in kind alternatives. The very nature of the choice process for treating rare medical conditions such as Gaucher disease accentuated this problem, since all the UK patients were under the care of just 4 consultants who followed a common best practice approach to medicine choice.

Genzyme tried to argue that a more dynamic approach should be taken to defining the market, in which Genzyme would be seen as facing effective rivalry in the *ex ante* process of developing new medicines in the general field of metabolic disorders. However, the OFT took a simple *ex post* approach in which the clear medical preference for Cerezyme and the absence of actual competing products was considered decisive. Cerezyme's share in this product area was put at more than 90%, and high entry barriers caused by R&D demands and Genzyme's patent protection underlined the OFT's conclusion of dominance. Genzyme's argument that price regulation via the NHS price control regime prevented the ability to behave independently also fell on deaf ears.

The OFT also defined a separate market for the downstream activity of distribution and home services. Although other providers of home-based medical services exist, the OFT chose to define this market narrowly as the market for these services specifically in relation to Cerezyme. It argued that a service provider with all the necessary physical attributes of chilled vans and trained nurses could not, given the existing policy of Genzyme, constrain a monopoly downstream supplier of Cerezyme because it would be unable to operate in that market without access to the drug on terms that allowed it a margin to compete. Although HH's continued operation in the market meant that Genzyme Homecare was not (yet) dominant in this narrowly defined downstream activity, this aspect of the OFT's decision proved to be the final nail in Genzyme's coffin.

This approach to downstream market definition is troubling. The real competition in the downstream market operates at the time when the product supplier chooses to put the contract for home services out to tender, and at that point there is no suggestion that choice or competition is limited. Any firm active in medical homecare services could mount a credible bid to provide the kind of services required by Genzyme, and this reveals that the true scope of the market for the downstream activity is much broader than that defined by the OFT. The OFT's narrow downstream market definition appears to have been reverse-engineered to fit the OFT's conclusions on abuse.

Genzyme's first abuse – extension of monopoly power

The first criticism levelled at Genzyme was the tendency of its bundled price to extend its monopoly from the upstream product market to the downstream market for associated home services. The OFT argued that this alleged abuse foreclosed prospective service providers from the downstream service market and deprived the customer (i.e. the NHS) of the benefits of competition in this activity.[4] However, the OFT decision is largely formalistic and shows very little interest in the underlying economic issues or the circumstances in which the "extension" of monopoly power through bundling can have anti-competitive effects.

Before the onset of the various high profile monopoly leveraging cases in the last decade such as US v Microsoft, GE/Honeywell and TetraLaval/Sidel, the base line for this assessment would have been the Chicago School argument that there is only "one monopoly profit". In Genzyme's case, this concept is easily illustrated because the starting point is the (regulated) price for the bundled product that is fixed between Genzyme and the NHS. Let's represent that bundled price as 100 and imagine that, under the HH contract, Genzyme paid HH a fee of 5 per unit, leaving 95 for Genzyme.[5] How could Genzyme improve that position by extending its monopoly to the downstream activity?

By integrating downstream, Genzyme could certainly capture the fee that it was formerly paying to HH, but only by taking on the cost of performing the home care services. So

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The OFT held that this abuse was present throughout, even during the time when HH was the sub-contractor and enjoyed a "monopoly" in the downstream activity as defined by the OFT throughout the contract with Genzyme.

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The published decision does not identify the exact breakdown of the bundled price between its components, but it appears that the element attributable to the home care services was a small proportion of Genzyme's full bundled price.

the move would be profitable only if Genzyme Homecare had costs lower than the fee that had been paid to HH. If its own costs are higher (10 say) then this apparent act of monopoly power extension harms Genzyme. And since the NHS price stays fixed throughout at 100 there is no chance of the consumer paying a higher price as a result.

In the post-Chicago world, however, the elegant simplicity of the "one monopoly profit" result has been disturbed, and various economic models have been developed that provide theories of anti-competitive harm from tying, leveraging and bundling. These post-Chicago theories have become a part of the armoury of competition authorities and complainants, but these models do not invalidate the basic insight of the Chicago School theory. In a case such as Genzyme it should still be necessary for the competition authority to explain why a valid exception to the one monopoly profit result applies.

The closest the OFT comes to meeting this requirement is in its theory of bundling as a means to raise barriers to entry to a competing treatment for Gaucher disease. In the lexicon of post-Chicago theories, this would fall within the "monopoly maintenance" heading, similar to the arguments used against Microsoft's bundling of the Windows Operating System and Internet Explorer. The theory here is that Genzyme's bundling of the product with home services raised the stakes for a new entrant which would thereby be deprived the chance to distribute its product via the established home care supplier. To the extent that this makes entry more costly, it could in theory protect Genzyme's market position.

However, the OFT decision makes no serious attempt to test this theory against the available evidence, and there are very strong *a priori* grounds for doubting its applicability. First, no assessment is made of the relevance of UK distribution conditions to the incentives to create a new product. The barriers to entry for a new competitor to Cerezyme are no doubt formidable given the modest market size, but the idea that an apparently small inconvenience in the UK market (which itself can only represent a modest proportion of the global market potential) could dissuade new entry seems far-fetched. Second, the fact that there are only 4 decision-makers in the entire UK market makes it highly implausible that gaining access to the patient would be a problem in this market once a rival supplier had established the existence of a better product.

In short, the decision seems to display all of the classic problems with mis-use of post-Chicago theories of exclusionary effects. It is now established that these problems must be taken seriously in merger analysis, but that requirement is no less relevant in the case of alleged dominant firm abuse.

The decision also dwells on the question of whether there is an "objective justification" for Genzyme's decision to bundle the drug and the homecare services. Given the very small number of patients across the UK there must be strong efficiency justifications for having a single provider of these services, and there are also plausible rationales for Genzyme itself taking control over the performance of the homecare element, but these arguments appear not to have been rehearsed at length. In the absence of any compelling anti-competitive motive, however, it is not clear why Genzyme should be under any obligation to provide a positive reason for its approach. After all, under the one monopoly profit theory any excess costs associated with Genzyme's preferred approach to home services will primarily harm Genzyme's commercial interests rather than the consumer.

Genzyme's second abuse – margin squeeze against HH and others

The second abuse cited in the OFT decision is that of a "margin squeeze" by Genzyme against HH. A margin squeeze occurs when an integrated firm adopts a pricing structure whereby independent downstream firms who rely on the integrated firm for the upstream input find it impossible to compete with the price charged by the integrated firm for the bundled downstream product. Since Genzyme only made Cerezyme available at the bundled price, the formal margin squeeze conditions were satisfied automatically. HH

would find it impossible to compete with Genzyme Homecare, since HH's buying price would be the same as the selling price of Genzyme in the downstream market.[6]

This, however, highlights a more profound problem with the definition of bundling and margin squeeze. Since almost any productive process involves the supplier combining a series of attributes, almost any product sold can be characterised as a bundle of some kind. A formalistic approach to the investigation of bundling concerns that is not disciplined by the need to identify a substantive competition concern raises the prospect of an epidemic of margin squeeze cases.

Consider the dominant firm that chooses to manufacture its product in-house. Does that decision represent a "margin squeeze" against contract manufacturers who have thereby been denied the opportunity to enter this "market" for contract manufacture? Are the issues any different for logistic services? Or advertising? Does the dominant firm's decision to employ in-house lawyers result in a margin squeeze against independent law firms? These scenarios are (to us at least) ridiculous, but it is hard to see any basis to differentiate them from Genzyme's decision to offer its product in a form that happens to embody home care services.[7]

Fines and deterrence

The final chapter in Genzyme's story is the calculation of the fine. A sum of £6.8m is not a large fine by the standards of the EC Commission, but in the context of Genzyme's UK sales of Cerezyme it is substantial.[8] Part of the stated rationale for the fine is the deterrence effect that such headline-grabbing figures are intended to generate. In the context of classical horizontal cartel cases, in which the offence is generally clear and the prospective commercial gain is substantial, that argument has some force. But what exactly is the deterrence message that flows from the Genzyme case? If it is that dominant firms are obliged to un-bundle every aspect of their products and offer competing suppliers fair terms to supply them with everything from contract manufacture to legal services, then the compliance message is madness. But if there is some more reasoned economic basis for the OFT's intervention in this case, it is not evident from the decision.

Conclusions and Implications

The Genzyme case encapsulates a number of disturbing features in the enforcement of abuse of dominance laws, both in the UK and elsewhere. It appears that an increasingly aggressive enforcement stance is being taken that relies on formal case law precedents rather than substantive analysis of economic effects. This approach consistently fails to draw a decipherable line between normal competitive behaviour and abuse.

As more cases are decided and fines to punish and deter such behaviour grow, an impact on business behaviour is inevitable. But as long as the underlying theory of competitive harm remains obscure, it will remain impossible to provide reliable compliance advice, and the risk that perceived competition law obligations will chill efficient and pro-competitive conduct will increase.

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In other market contexts it is possible that a competing downstream firm might be able to sustain a business in competition with the integrated firm based on superior value-added services that persuaded consumers to pay a premium for the competing firm's product. This was the approach taken by the OFT in its decision (CA98/19/2002, 11 December 2002) not to take action against the UK travel agents' margin squeeze claim against British Airways. Oddly, however, no such consideration was given to the case of the UK cable TV companies in their margin squeeze complaint against BSkyB (CA98/20/2002, 17 December 2002). In the case of Cerezyme, however, there is no potential for the NHS to offer higher remuneration for a homecare services provider that, for example, offered a superior service to Genzyme Homecare.

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Conceivably, one basis for differentiation might be between those cases where the dominant firm had always done the activity in-house and those where a decision had been taken to terminate a contracted-out service. But that distinction, granting "squatters rights" to historic contractual partners, seems not to form a valid basis for competition law intervention in this case, and the OFT decision clearly relates to the bundling even prior to the termination of the HH contract.

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A number of the OFT's fines have been similarly weighty when compared with the businesses involved. See, for example, the John Bruce case (CA98/12/2002, 13 May 2002) and the Hasbro distribution case (CA98/18/2002, 28 November 2002).