Written evidence submitted by Dr Carmine Ornaghi and Dr Jian Tong, University of Southampton (SBC0003)

Executive Summary:

On the 23rd of September the Business, Energy and Industrial Strategy (BEIS) Committee launched a public inquiry on State Aid and Post-Brexit Competition Policy. This document outlines our views on the first of the three main themes examined in the inquiry, namely the "***UK Competition Policy and the Competition & Markets Authority***".
To facilitate a rigorous discussion, the Committee has listed seven bullet points, each containing specific questions. In this document, we will address two of the seven points. The answer to the first point is based on our recent research paper Tong and Ornaghi (2021). The answer to the second point draws on the extensive work done by Prof Ornaghi on mergers and innovation in the pharmaceutical industry.

The following recommendations are made:

- Competition law in the United Kingdom (UK) should limit practices that harm free and fair competition not only in the product markets, to the detriment of consumers, but also in the labour markets, to the detriment of workers. Including Worker Welfare on a par with Consumer Welfare in the principles of competition law can unlock an important piece of the productivity conundrum and it will help to address the increase of inequalities in income distribution.
- The Competition Market Authority's (CMA) decision not to request further powers to obtain information from business should be re-considered for Mergers and Acquisitions (M&As) in high tech industry. In particular, we believe it is important for the CMA to gather complete and exhaustive information on the overlapping research activities of acquirers and targets. The CMA could introduce a presumption that deals between firms with overlapping research projects are anti-competitive, shifting the burden of proving the pro-competitive effects and efficiency gains of such deals from the CMA to the companies.

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Carmine Ornaghi is Professor of Economics at the University of Southampton. His papers have been published in leading scientific journals, including Energy Economics, Journal of Applied Econometrics, the International Journal of Industrial Organization and the Journal of Industrial Economics. Prof. Ornaghi has done extensive research on the impact of Mergers and Acquisitions (M&As) on innovation [see Ornaghi (2009a) and Ornaghi(2009b)]. In the last three years, Prof Ornaghi has been Principal Investigator in an ESRC funded research on "Mergers and Inventors' Productivity in the Pharmaceutical Industry", which aims at evaluating how mergers influence innovation output of scientists working in the research labs of pharmaceutical companies using patent data.

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Jian Tong is a Lecturer in Economics at the University of Southampton. He has published in leading peer reviewed economics journals such as Rand Journal of Economics, Economic Journal, and International Economic Review, spanning fields from industrial organisation, economic growth, to information economics. Dr Tong's expertise lies in the areas of market structure and market power, technological progress, and endogenous economic growth, and public policy decision under uncertainty and information constraints.

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This response addresses the following questions under the "UK Competition Policy and the Competition & Markets Authority" theme:

1) Is the CMA's statutory duty – to promote competition for the benefit of consumers – the right one?
2) Do the new tools and powers for the CMA proposed by the Government in its two consultations sufficiently equip the CMA effectively to respond to the challenges in the modern economy, and ensure markets remain dynamic and competitive in the years ahead?

1) Is the CMA's statutory duty – to promote competition for the benefit of consumers – the right one?

1. The CMA is the UK's lead competition and consumer authority. The mission of the CMA is to make markets work well in the interests of consumers, businesses and the economy.

2. While the duo duties in the enforcements of both UK competition law and consumer law convey upon the CMA substantial advantage in fulfilling both responsibilities, the elevated weight in consumer protection duty may also cause imbalance in the duty of protecting the process of competition.

3. Competition law in the UK currently aims to limit practices that harm free and fair competition to the detriment of consumers. There is an intellectual case as well as a legal case for broadening the aim of the competition law in the UK to limit practices that harm free and fair competition: (1) not only in the product markets - to the detriment of consumers, (2) but also in the labour markets - to the detriment of workers.

4. In Tong and Ornaghi (2021), we show that in imperfectly competitive markets where firms have both product price mark-up power and wage mark-down power, the introduction of a Worker Welfare standard on a par with the Consumer Welfare standard can boost productivity and reduce inequality, which are both strategical goals of the UK government and parliament (usually referred as improving productivity and "levelling up").

5. The fact that competition policy should also include Worker Welfare in its principles has been discussed among policy makers across the Atlantic for some time. For instance, recognising the detriment to workers from the weakening of merger control, a 2016 report produced by the Council of Economic Adviser of the White House highlighted that "*antitrust laws apply to reductions in competition for employees as a result of mergers as readily as they do to reductions in product market competition*."

6. Proposals from leading legal scholars have emerged for merger control reform to rectify this deficiency (Naidu *et al.*, 2018; Marinescu and Hovenkamp, 2018). For instance, Marinescu and Hovenkamp argued that "*Some mergers may be unlawful because they injure competition in the labor market by enabling the post-merger firm anticompetitively to suppress wages or salaries … under the consumer welfare principle antitrust law is properly directed at output reducing practices no matter what their source, and there is certainly no principled reason for excluding anti-competitive effects in labor markets … the principles being applied are derived entirely from well-established economic doctrine and traditional antitrust rules*

concerning competitive harm. We comprehensively apply these well-established principles to purchasing rather than selling, and to labor rather than products."

7. Our research showed that we need a holistic approach to studying the impact of increasing concentration, driven by mergers, on product market and labour market. One interesting finding is that the creation of highly productive "superstar firms" (as a result of investment in innovation and/or consolidations) do not necessarily lead to as much increase in average productivity and salary as hoped. This is because the labour market share of a superstar firm is lower than its (high) product market share. That is, although the workers employed by the superstar firms have superior labour productivity, the superstar firms hire fewer of them than proportionate to their sales shares. As a result, industry average labour productivity does not rise as much as it potentially can because it is dragged down by superstar firms' laggard rivals, who remain to employ a large proportion of workers, whose productivity is not raised by the superstar firms.

8. The superstar firms naturally have an incentive to entrench their superiority in productivity and market power and dominance. This can be achieved by slowing down the diffusion of innovation and technological progress from their own success examples to their laggard rivals. Consolidating the control over key assets, including intellectual property (IP) rights and other intangible assets, by means of merger and acquisition plays an important role in this.

9. Raising productivity is one of the key economic challenges in the UK. However, drivers and inhibitors of productivity are multiple and not all well understood. We think that including Worker Welfare on a par with Consumer Welfare in the principles of competition law can unlock an important piece of the productivity conundrum and it will certainly help to address the increase of inequalities in income distribution.

10. We conclude this first part by noting that we consider the publication of the "The State of UK Competition Report 2020" an important function undertaken by the CMA and we support it being done on an annual basis. We also propose that the State of UK Competition Report should include metrics such as "labour income share" at both sector and economy levels, as measures of income distribution and equality, as well as the state of labour market competition.

2) Do the new tools and powers for the CMA proposed by the Government in its two consultations sufficiently equip the CMA effectively to respond to the challenges in the modern economy, and ensure markets remain dynamic and competitive in the years ahead?

11. The CMA document on "Reforming Competition and Consumer Policy" published in October 2021, indicates that "*Other metrics that could be considered in the future for*

assessing the state of competition include the following: productivity statistics; innovation statistics (e.g. patent counts, etc.); cross-ownership: extending the work from last State of Competition on this; labour rates/share figures;"

12. The use of innovation statistics is certainly desirable. However, it is not clear that patents are a good measure of innovation. There is now increasing evidence that patents are not only a measure of the innovative activities but also an instrument of entrenching the dominant position of incumbents. For instance, after reviewing empirical evidence by other researchers and producing new evidence of their own, Boldrin et al. (2012) concludes that "*far from fostering and stimulating innovation and productivity growth, patents are likely to hamper them*".

13. A stronger focus should be placed on future markets (products that are currently under development). Particularly concerning the fact that, in some industries (digital markets and pharmaceuticals, among others), an incumbent may deliberately target competitors with similar innovation projects in order to pre-empt future competition (a finding confirmed in a recent study with the suggestive title of "Killer Acquisition" by Cunningham *et al.*, 2021).

14. We note that the proposed jurisdiction test (the proposed threshold value for merger reviews being based on at least one of the businesses involved generating at least £100 million in revenues in the UK and holding a share of supply of 25% or more) can go a long way towards addressing this problem. However, it is still the case that some acquisitions can fly under the radar of antitrust authorities.

15. Because of this, we believe that the CMA decision not to request further powers to obtain information from business should also be re-considered. In particular, we believe it is important for the CMA to gather complete and exhaustive information on the overlapping research activities of acquirers and targets. The CMA could introduce a presumption that deals between firms with overlapping research projects are anti-competitive, shifting the burden of proving the pro-competitive effects and efficiency gains from the CMA to the companies.

16. In the rest of this statement we will focus on M&As in the Pharmaceutical Industry, as an exemplar of our view on the importance of a careful investigation of products under development.

17. For all deals, including those that may fall below the size threshold established by the CMA, we suggest that systematic notification should be triggered any time there is an overlap between targets' new molecules under development and acquirers' drugs already marketed or molecules under development. The notification would allow the CMA to assess whether an antitrust review is warranted.

18. Operationally, we suggest the following:

i- *Overlapping between the target's molecule under development and the acquirer's drug already marketed*.

19. In this case, the acquisition can give the incumbent the opportunity to protect the sales of a successful drug that is close to patent expiration. Concretely, if the target's molecule currently under development gets market approval, the acquirer can strategically use promotion to orchestrate the migration of patients from the drug already marketed to the newly approved drug. This strategy is particularly profitable when the patent on the "old" drug is about to expire and cheap generic versions of such drug can enter the market.

20. There is increasing concern among competition authorities that pharmaceutical companies are engaging in product hoping strategies.[1] We note that, securing the ownership of a new molecule under development in a therapeutic market where an acquirer has already a successful drug can be a more effective way to preserve the steady stream of revenues obtained from the "old" drug than simply introducing a slightly different formulation of such drug.

21. In cases that raise potential concerns, the parties would be required to provide convincing evidence that there are merger-specific R&D efficiencies that significantly increase the chances that the molecule under development will reach the market (R&D efficiencies defence).

22. We also advocate for a post-merger scrutiny if the marketed drug owned by the acquirer (with a market share above the established threshold) still has a long patent life, as the incumbent has an interest in delaying the development of the new technology to avoid cannibalising their existing products. In this case, even if the deal is not opposed on the base of a successful efficiency defence, the parties can be asked to divest the research project if the new molecule were delayed without any medical justification (*e.g.* the molecule has successfully passed a stage II clinical trial but stage III trials are put on hold without a credible reason).

ii- *Overlapping between a target's molecule under development and an acquirer's molecule under development*.

23. In this case, our view is that there should be a *presumption* that the deal can be detrimental to consumers' welfare. An obvious way to address this concern is for the merging parties to divest the molecule and related assets owned by the target where the overlap exists.

[1] Product "hopping", or "evergreening", are expressions used by antitrust authorities and industry, respectively, to describe strategies employed by pharmaceutical companies to protect sales of a successful drug on the verge of losing patent protection

24. As for point *i* above, the parties would have the opportunity to rebuke that presumption by providing convincing evidence that non-divestment would generate cross-fertilisation of ideas and knowledge synergies, which would significantly increase the likelihood of at least one of the two molecules reaching the market (*R&D efficiencies defence*).

25. In the instances where a divestment appears highly desirable for consumer welfare, our view is that the decision of which one of the two projects to divest should not be left to the merging parties. The reason we suggest to divest the targets' research project is that this will encourage potential acquirers to pursuit only those deals that can generate R&D efficiencies sufficiently large to make a successful efficiency defence more likely.

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*****References on following page*****

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