

Sleeping with the Enemy: Inter-firm Product Combinations in the Pharmaceutical Industry

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Abstract

There is a substantial literature in economics on intra-firm product combinations such as bundling and tying. Little is known, however, about the economic implications of inter-firm product combinations. We propose and estimate a model to study pricing strategies and the welfare effects of this practice, focusing on the pharmaceutical industry. We find that firms increase their profits by participating in inter-firm product combinations. A less competitive equilibrium arises in this situation as the firms are able to partially internalize the externality their pricing decisions impose on their competitors. We also find that profit increases from the inter-firm product combinations could be as large as profit increases from mergers. Our results should help policy-makers evaluate the antitrust implications of the merger in the pharmaceutical industry.

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1 Introduction

There is a substantial literature in economics focusing on product combinations such as bundling or tying. This literature offers explanations of why a firm would want to bundle two or more of its products into one package. Bundling may allow a firm to engage in price discrimination (McAfee and Whinston, 1989), to leverage monopoly power in one market by foreclosing sales and discouraging entry in another market (Whinston, 1990; Chen, 1997; Carlton and Waldman, 2002; Nalebuff, 2004), or alter a pricing game among oligopolists even when entry is not deterred or no firms exit (Carlton, Gans, and Waldman, 2007). A common theme in this literature is that bundled products are produced by the same firm.

However, there are markets in which consumers use a combination of products produced by competing firms to exploit complementarity that they provide. Making a gin and tonic by combining those two drinks is a prominent example. In the internet browser market some consumers use both Microsoft's Explorer and Mozillar Firefox. In the personal computer market some consumers use both an MS Window compatible computer and Apple's Mac computer. Also, some households have multiple cars together that are very different like a minivan and a sports car.

In this paper we analyze the pricing and welfare effects of the inter-firm product combination, focusing on the pharmaceutical market. This market provides a nice setting to study this phenomenon as combined products are well defined and standardized so that we observe their market shares. It is not the case in other markets because consumers can come up with their own ways of combining products. On the other hand, combined products in the pharmaceutical market, so called "cocktail" regimens, should be approved by the Food and Drug Administration (FDA) for

their superior efficacy and/or fewer side effects relative to existing drugs. They also come with a "recipe" that recommends an amount of each drug used in them. This is usually determined during clinical trials and available to physicians.

The inter-firm product combination is prevalent in the pharmaceutical market. It is common for patients to be treated with a regimen of two or more drugs approved for the same condition and produced by different firms. Most HIV/AIDS patients receive a cocktail regimen, such as efavirenz, lamivudine, and zidovudine (better known as AZT). Six of the nine breast cancer regimens with the largest market share in 2007 were cocktails containing two or more distinct component drugs.

It should be noted that most drugs that are components of a cocktail regimen are also available as stand-alone regimens, and firms are constrained to set a single price (e.g., per milligram of active ingredient) for a drug rather than setting a different price for the drug in each regimen. This constraint exists because physicians usually (e.g., in the case of oncology) purchase each component drug and then infuse the regimen into a patient. The single pricing constraint also exists in other markets for the same reason, that is, product combinations take place on the consumer side, and is an important difference from the intra-firm product combination.

It is a firm entering a market, rather than an incumbent, that bundles its new product with an existing product. This is possible because the entering firm can buy other products in the market to perform clinical trials. Considering high costs of the clinical trial, we expect the entering firm to be better off with the inter-firm product combination. However, its impact on the incumbent is unclear. With the cocktail regimen firms at least partially internalize externalities

their pricing strategy imposes on their competitors, but at the same time the cocktail regimen steals market share from the existing regimens. Depending on which effect is larger, it can render the market more collusive or more competitive.¹

For an empirical analysis we focus on the market for colorectal (colon) cancer chemotherapy drugs. In 2006, seventy-nine percent of U.S. colon cancer patients receiving chemotherapy treatment were administered cocktail regimens. We estimate demand system at the regimen level using the unique market share data from IntrinsicQ, a company that provides information systems to oncologists to help them determine the proper chemotherapy dosing for their cancer patients. This demand system is then combined with a Nash-Bertrand equilibrium assumption to generate equilibrium prices and quantities. We explicitly model a game firms play and allow the price that each firm sets to affect all regimens through the estimated demand system.

We use our model to perform counterfactuals to better understand the economic consequence of the inter-firm product combination. In the first counterfactual we take out a cocktail regimen one at a time and compute new equilibrium prices. In the data we observe that multiple cocktail regimes were introduced at the same time, and this counterfactual exercise enables us to isolate the effects of an individual cocktail regimen. We find that in general offering inter-firm product combinations is profit-enhancing for all participating firms and detrimental for consumers, compared to an equilibrium with no product combination. This result is driven by firms' setting higher drug prices when their drugs are used in cocktail regimens. This shows that the effect of internalizing externalities dominates the business stealing effect.

¹We abstract away from modeling a firm's decision on whether and how to combine its product with others' and take existing combinations as given.

In the second counterfactual we compare a market with the inter-firm product combination with collusive markets resulted from mergers. We consider two merger scenarios. In the first scenario we take out one cocktail regimen and let its participating firms merge instead. By doing so we assess whether firms can achieve the same collusive outcome with a cocktail regimen as with merger. We find that firms can earn more profits from the product combination than from the merger (without the product combination.) In the second scenario we let a pair of firms merge while letting them keep their cocktail regimen. The profit that firms make in this scenario is the maximum profit they can make pairwise, and we compare this profit with the current profit firms make with the cocktail regimen. We find that the merger increases the participating firms' profits as expected but only marginally.

In the third counterfactual we allow a firm to set two separate drug prices, one for its stand-alone regimen and the other for cocktail regimens. This is equivalent to a case where a firm has two separate drugs, one for the stand-alone regimen and the other for the cocktail regimens. Setting two prices introduces a strategic incentive that we observe in other parts of the pharmaceutical market. A prominent example is the AIDS drug market. In this market, a company called Abott offered two drugs, Norvir and Kaletra. Norvir had been used in a cocktail regimen to boost its competitors' drug performance and Kaletra was a new launch. The firm's pricing strategy shortly after the new launch was to increase the price of Norvir by 5 times while pricing Kaletra more competitively. Although we do not observe this in the colorectal cancer market, we use this exercise as an out-of-sample validation test for our model. We find similar pricing behaviors in our counterfactual. In addition, we confirm that the firm setting two prices earns a higher profit by doing this. However,

this pricing scheme may or may not hurt its competitors.

The paper is organized as follows: Section 2 presents an overview of colorectal cancer, followed by data description in section 3. Section 4 presents our model and section 5 analyzes simple numerical examples where two firms have one stand-alone regimen each and have the third regimen by combining their drugs. Section 6 presents the results from our estimation and the counterfactual exercises and section 7 concludes.

2 Overview of Colorectal Cancer

Colorectal cancer is the fourth most common cancer based on the number of new patients, after breast, prostate, and lung cancers. About one in 20 people born today are expected to be diagnosed with colorectal cancer over their lifetime. The disease is treatable especially if it is detected before it has metastasized, or spread, to other areas of the body. Between 1996 and 2003, colorectal cancer patients had a 64 percent chance of surviving for five years. According to the National Comprehensive Cancer Network (NCCN), the probability a patient will survive for five years ranges from 93 percent for those diagnosed with Stage I cancer to eight percent for those diagnosed with Stage IV (or metastatic) cancer.²

Six of the 12 major regimens for which we have complete data are cocktail regimens, composed of two or more drugs produced by different firms. One cocktail regimen is a combination of irinotecan, produced by Pfizer, and capecitabine, produced by Roche. Another is a combination of oxaliplatin, produced by Sanofi, with capecitabine. Bevacizumab, a drug produced by Genentech,

²Cancers are classified into four stages, with higher numbers indicating that the cancer has spread to the lymph nodes (Stage III) or beyond its initial location (Stage IV).

is combined with oxaliplatin in one regimen, with irinotecan in second, and with oxaliplatin and capecitabine in third. Cetuximab, which is produced by ImClone, is combined with irinotecan.

Four of the remaining six regimens are stand-alone regimens and they are just the same individual drugs used in the cocktail regimens. One of the remaining two regimens is 5FU/LV which is a generic regimen and the other is Pfizer's Irinotecan combined with 5FU/LV. We take the generic regimen's price as given and assume that its price does not react to firms' strategic pricing. So we treat the latter regimen as Pfizer's second stand-alone regimen whose price is always the same as that of its other stand-alone regimen plus the generic regimen's price. The table in the appendix provides a complete dosage description of the twelve regimens we have data on.

Since each drug is sold separately to physicians who combine them into cocktail regimens in their offices, the only variable that a firm controls is the price of its own drug. However, this has an impact on the demand and profits for all the cocktail regimens the firm's drug is used in. We explicitly account for this impact in our supply side (pricing) model in section 4.

Most oncology drugs are infused into a patient intravenously in a physician's office or an outpatient hospital clinic by a nurse under a physician's supervision. Unlike drugs that are distributed through pharmacies, physicians (and some hospitals on behalf of their physicians) purchase oncology drugs from wholesalers or distributors (who have previously purchased the drugs from the manufacturers), store the drugs, and administer them as needed to their patients. Physicians then bill the patient's insurance company for an administration fee and the cost of the drug. In our model we assume physicians are imperfect agents for their patients, and the details of the imperfect agency will be explained in section 4.

3 Data

We use a number of different data sources to collect four types of information: drug prices, regimen market shares, the amount/dose of each drug typically used in a regimen, and regimen attributes from clinical trials (e.g., the median number of months patients survived when taking the regimen in a phase 3 clinical trial). IMS Health collects information on the sales in dollars and the quantity of drugs purchased by 10 different types of customers (e.g., hospitals, physician offices, retail pharmacies) from wholesalers in each quarter from 1993 through the third quarter of 2005. Prices and quantities are reported separately by National Drug Classification (NDC) code, which are unique for each firm-product-strength/dosage-package size. We calculate the average price paid per milligram of active ingredient of a drug by averaging across the different NDC codes for that drug. IMS Health reports the invoice price a customer actually pays to a wholesaler, not the average wholesale price (AWP) that is set by a manufacturer and often differs substantially from the true transaction price.

The price we calculate does not include any discounts or rebates a customer may receive from a manufacturer after purchasing the product from the wholesaler. Based on interviews with oncologists, we do not believe that manufacturers offered substantial rebates during this period. Although we have information on 10 different types of customers, we focus on the prices paid by the two largest customers - hospitals and physician offices - because most colon cancer chemotherapy drugs are infused in a physician's office or hospital clinic.³

³Based on data from IMS Health, 59% of colorectal cancer drugs in the third quarter of 2005 were purchased by physician offices/clinics and 28% by hospitals. The remainder was purchased by retail and mail order pharmacies, health maintenance organizations, and long-term care facilities.

We then compute the price of each regimen for a representative patient who has a surface area of 1.7 meters squared (Jacobson et al., 2006), weighs 80 kilograms, and is treated for 12 weeks. Regimen prices are derived by multiplying the average price per milligram of active ingredient in a quarter by the recommended dosage of each drug in the regimen over a 12-week period.⁴ The NCCN reports the typical amount of active ingredient used by physicians for the major regimens.⁵ Dosage information is reported in the appendix. For example, the standard dosage schedule for oxaliplatin+5-FU/LV, the regimen with the second largest market share in 2005, is 85 milligrams (mg) of oxaliplatin per meter squared of a patient’s surface area infused by IV on the first day of treatment, followed by a 1,000 mg infusion of 5-FU per meter squared of surface area on the first and second treatment days, and a 200 mg infusion of leucovorin (LV) per meter squared on the first and second treatment days. This process is repeated every two weeks.

The IMS Health data contain information on market share by drug, but not market share for combinations of drugs (regimens). We rely, therefore, on two different sources for regimen-specific market shares, where market share is defined as the proportion of colorectal cancer chemotherapy patients treated with a particular regimen. IntrinsiQ collects monthly data from its oncology clients on the types of chemotherapy drugs administered to patients. Based on these data, we derive monthly market shares for each regimen between January 2002 and September 2005.

Since IntrinsiQ’s data only go back to 2002, we rely on the Surveillance Epidemiology and End Results (SEER) data set for market shares for the 1993 to 2001 period. SEER tracks the health and treatment of cancer patients over the age of 64 in states and cities covering 26 percent

⁴The regimens are priced using price data for the contemporaneous quarter only.

⁵We supplement this where necessary with dosage information from drug package inserts, conference abstracts, and journal articles.

of the United States population.⁶ Based on Medicare claims data available in SEER, we calculate each colorectal cancer regimen’s market share in each quarter.⁷

In order to homologate market shares between the pre- and post-2002 periods, we take advantage of the fact that the two data sets overlap for the four quarters of 2002. We apply a regimen-specific factor to adjust the pre-2002 market shares based on the ratio of total (from IntrinsiQ) to Medicare-only (from SEER) market shares for the four quarters of 2002. Our underlying assumption in this adjustment is the proportion of total patients represented by Medicare does not vary over time for any regimen.

In our analysis, we include as inside goods all regimens that contain drugs that were approved by the FDA for colorectal cancer and had a market share greater than one percent at the end of the sample period. The outside option includes off-label drugs, regimens with less than one percent market share at the end of the sample period, and regimens with missing attribute data.⁸

Market shares for the 12 regimens in our sample and the outside option are plotted in Figure 1. Between 1993 and 1996, about 95 percent of colorectal cancer patients were treated with 5-FU/leucovorin, a generic regimen, with the remainder treated with off-label drugs or regimens with very small market share. Irinotecan (brand name Camptosar) was approved by the FDA for treating colorectal cancer in 1996, and over the next several years the market share of irinotecan and irinotecan combined with 5-FU/LV grew at the expense of 5-FU/LV.⁹ Capecitabine (Xeloda),

⁶SEER contains data on the incidence rate of cancer among the non-elderly, but only has medical claims available for Medicare patients.

⁷According to IntrinsiQ’s data, approximately 48 percent of all colorectal cancer patients treated with chemotherapy were 65 years or older in October 2003.

⁸Off-label use occurs when a physician treats a colorectal cancer patient with a drug that has not been approved by the FDA for colorectal cancer.

⁹Because it takes Medicare a while to code new drugs into their proper NDC code, for several quarters a new drug

a tablet that produces the same chemical response as 5-FU/LV, was approved for treatment of colorectal cancer in April 2001 and was administered as a stand-alone therapy or combined with irinotecan. Besides capecitabine, all other drugs for treating colorectal cancer in our sample are delivered intravenously (IV) under the supervision of a physician or nurse.

Oxaliplatin (Eloxatin) was introduced in August 2002, followed by cetuximab (Erbix) and bevacizumab (Avastin) in February 2004. By the third quarter of 2005, two of the regimens created by these three new drugs (oxaliplatin + 5-FU/LV and bevacizumab + oxaliplatin + 5-FU/LV) surpassed the market share of 5-FU/LV, whose share had fallen to about 14 percent.

We obtain most of the attribute information from the FDA-approved package inserts. These inserts describe the phase 3 clinical trials and include the number and types of patients enrolled in the trials, the health outcomes for patients in the treatment and control groups, and the side effects experienced by those patients. Often there are multiple observations for a regimen, either because a manufacturer conducted separate trials of the same regimen, or because a regimen may have been used on the treatment group in one clinical trial and the control group in a subsequent trial. In these cases we calculate the mean attributes across the separate observations. Where necessary, we supplement the package insert information with abstracts presented at oncology conferences and journal articles.

The attribute information is summarized in Table 1, averaged across regimens in each quarter and then averaged for each year. We record three measures of a regimen's efficacy: the median number of months patients survive after initiating therapy (*Survival Months*); the percentage of

will appear in the outside option.

patients who experience a complete or partial reduction in the size of their tumor (*Response Rate*); and the mean number of months (across patients in the trial) before the cancer advanced to a more serious state (*Time to Progression*.)

The side effect variables indicate the percentage of patients in phase 3 trials who experienced either a grade 3 or a grade 4 side effect for five separate conditions: abdominal pain, diarrhea, nausea, vomiting, and neutropenia. Although many more side effects are recorded for most regimens, these five were consistently recorded across the 12 regimens in the sample. Side effects are classified on a 1 to 4 scale, with grade 4 being the most severe. Higher values for the side effect attributes should be associated with worse health outcomes although regimens that are relatively toxic are likely to be both more effective and have more severe side effects.

Table demonstrates that there was a huge price increase in 1998. The average regimen price for a 24 week treatment cycle increases from about \$100 to over \$11,000. This jump is due to the introduction of Pfizer's irinotecan. Since then the average price continued to rise with significant jumps in 2002 when Sanofi's oxaliplatin was introduced and in 2004 when bevacizumab and cetuximab were launched. New regimens tend to be more efficacious than the existing regimens, with side effect profiles that are sometimes more and sometimes less severe than earlier regimens (Lucarelli and Nicholson, 2008).

4 Model

4.1 Supply

We assume that firms play a static Nash-Bertrand game with differentiated products. A distinctive feature of our model is that additional product differentiation is achieved when the FDA approves a combination of drugs in a new regimen. Therefore, the equilibrium conditions are different from a situation where products are consumed separately or where firms produce multiple products.

A static Nash-Bertrand game may not fully describe pharmaceutical firms' behavior because these firms do more than set a profit-maximizing price. The most important non-price action is where pharmaceutical representatives market products to physicians (i.e., detailing). We do not observe detailing activity and do not attempt to include it in the model. We also do not explicitly model decisions by some pharmaceutical firms to provide a rebate to certain physicians if their purchased volume exceeds a certain threshold for the quarter or year. We are not aware of any study that documents the size of oncology rebates or how physicians react to such rebates, presumably because firms do not disclose rebates. Although these two features are not considered in the supply side model, we introduce a shock in the demand model to capture physicians' reaction to them.

Let p_f be the price firm f charges for its drug/product. Consistent with our data, we assume that each firm produces only one drug, and therefore, p_f is the only endogenous variable in the firm's optimization problem. We denote mc_f as the marginal cost for firm f , and $q_f(p)$ the quantity produced by firm f . Profits for firm f are

$$\pi_f = (p_f - mc_f)q_f(p),$$

where $q_f(p)$ is obtained from the aggregation of quantities across the regimens in which the firm participates. Formally, if firm f participates in R_f regimens, and $r = 1, \dots, R_f$, then $q_f(p)$ can be written as

$$q_f(p) = \left(\sum_{r=1}^{R_f} s_r(p) q_{rf} \right) M,$$

where $s_r(p)$ is the share of patients treated with regimen r , q_{rf} is the dosage of the drug produced by firm f used in regimen r , and M is the market size. p_k^R , the price of regimen k , is determined by p_f and q_{rf} . For example, if regimen 1 is firm 1's stand-alone regimen, $p_1^R = q_{11}p_1$; if regimen 3 is a cocktail regimen, comprised of drugs from firm 1 and firm 2, $p_3^R = q_{31}p_1 + q_{32}p_2$.

The equilibrium conditions can then be written as

$$\frac{\partial \pi_f}{\partial p_f} = \sum_{r=1}^{R_f} s_r(p) q_{rf} + (p_f - mc_f) \sum_{k=1}^{R_f} \sum_{r=1}^{R_f} \frac{\partial s_r(p)}{\partial p_k^R} \frac{\partial p_k^R}{\partial p_f} q_{rf} = 0 \quad (1)$$

Equation (1) shows that a firm will take into account the effect of its drug price on the overall price of each regimen ($\partial p_k^R / \partial p_f$), and how changes in regimen prices impact the market shares of all regimens in which a drug participates ($\partial s_r(p) / \partial p_k^R$). The former effect is determined by the quantity of a drug used in a recommended regimen "recipe;" the latter effect is determined by the regimen's price elasticity of demand and is estimated using regimen-level data. We can recover the marginal costs for each drug by re-writing equation (1) for these costs.

Equation (1) highlights that an analytical analysis is not straightforward. Consider the simplest case where firm 1 and firm 2 each sell a stand-alone regimen and there is one cocktail regimen that combines the two firms' drugs. If all three regimens are substitutes for one another,

the profit-maximizing first order condition for firm 1 becomes

$$\frac{\partial \pi_1}{\partial p_1} = (s_1(p)q_{11} + s_3(p)q_{31}) + (p_1 - mc_1) \left(\frac{\partial s_1}{\partial p_1^R} \frac{\partial p_1^R}{\partial p_1} q_{11} + \frac{\partial s_1}{\partial p_3^R} \frac{\partial p_3^R}{\partial p_1} q_{11} + \frac{\partial s_3}{\partial p_3^R} \frac{\partial p_3^R}{\partial p_1} q_{31} + \frac{\partial s_3}{\partial p_1^R} \frac{\partial p_1^R}{\partial p_1} q_{31} \right) = 0 \quad (2)$$

Note that while $\partial p_k^R / \partial p_f$ is fixed by the recommended recipe, $\partial s_r / \partial p_k^R$ is a function of price unless one assumes a constant elasticity demand. We rely, therefore, on numerical and empirical analyses to study the economic implications of cocktail regimens.

4.2 Demand

We obtain our demand system by aggregating over a discrete choice model of physician behavior. Following the Lancasterian tradition, products are assumed to be bundles of attributes, and preferences are represented as the utility derived from those attributes. As mentioned in section 2, we assume physicians are imperfect agents for their patients. A physician's objective is to extend a patient's life expectancy by administering patients to the most effective regimen. Because a physician also cares about a patient's financial status, price enters her utility function. However, physicians' decisions are also affected by elements other than regimen attributes, such as the profit earned by acquiring and administering a regimen. The rebate from pharmaceutical firms is a good example. To capture this aspect we include an idiosyncratic error term additively in the utility function.

The indirect utility of physician i over regimens $j \in \{0, \dots, J_t\}$ at time (market) t is characterized as

$$u_{ijt} = -\alpha p_{jt} + \beta x_j + \xi_t + \Delta \xi_{jt} + \varepsilon_{ijt} \quad (3)$$

where p_{jt} is the price of regimen j at time t , x_j are observable regimen attributes, ξ_t is the mean of unobserved attributes for each period, and $\Delta\xi_{jt}$ is a time-specific deviation from this mean. ε_{ijt} is an idiosyncratic shock to preferences and is assumed to have a Type I Extreme Value distribution as in McFadden (1981) and Berry (1994).

In this model all the individual-specific heterogeneity is contained in the idiosyncratic shock to preferences and, therefore, it suffers from the well-known independence of irrelevant alternatives criticism.¹⁰ Berry and Pakes (2007) propose an alternative demand model that removes the idiosyncratic shock from the indirect utility function and assigns a random coefficient to at least one product attribute. In our pharmaceutical context, this pure characteristics model implies that physicians are perfect agents for their patients and are not affected by detailing or rebates. The pure characteristics model has a "local" substitution pattern, while the model with the idiosyncratic shock has a global pattern.¹¹ However, based on numerical simulations similar to those in Section 5, we conclude that the vertical model (the one-random-coefficient-pure characteristics demand model) does not correctly characterize the market with cocktail regimens. We find that firms charge lower price and earn lower profit with a cocktail regimen.

We estimate ξ_t using quarterly indicator variables. $\Delta\xi_{jt}$ which represents demand shocks or regimen attributes that physicians observe but we do not, is likely to be correlated with price. That is, price is endogenous as in most demand models. All terms other than ε_{ijt} represent patient

¹⁰Although we could alleviate this problem by allowing for random coefficients on price and product attributes following Berry, Levinsohn, and Pakes (BLP) (1995), we are unlikely to identify the random coefficients with our existing data set. Usually one needs consumer distribution from multiple markets, as in Nevo (2000), or micro choice data as in Petrin (2002). We, on the other hand, observe the same market over time and lack micro choice data on physicians' decisions.

¹¹See Berry and Pakes (2007) and Song (2007) for more discussions on the differences between these two models.

utility (e.g., patient co-payments, observed and unobserved attributes of the treatment) and ε_{ijt} captures any unobserved elements that affect a physician's choice independent of patients' utility. The outside option ($j = 0$) includes of-label colon cancer treatments, regimens with small market shares, or regimens without a complete set of attributes. The utility of the outside options is set to zero.

Market shares for each regimen j are defined as

$$s_{jt} = \frac{\exp(-\alpha p_{jt} + \beta x_j + \xi_t + \Delta\xi_{jt})}{1 + \sum_{k=1}^{J_t} \exp(-\alpha p_{kt} + \beta x_k + \xi_t + \Delta\xi_{kt})}$$

This leads to the following demand equation

$$\ln s_{jt} - \ln s_{0t} = -\alpha p_{jt} + \beta x_j + \xi_t + \Delta\xi_{jt}. \quad (4)$$

Berry (1994) provides details of this derivation.

5 Numerical Analysis

Before we apply the models to data, we examine the inter-firm product combinations numerically in the simplest setting. In the benchmark case, firm 1 and firm 2 sell one stand-alone regimen each without having the inter-firm product combination (i.e., no cocktail regimen.) The firms compete a la Bertrand and consumer demand is based on the utility function in equation (3). Assuming a price coefficient of -1 and a certain product quality, which we denote δ_j for $j = 1$ and 2, the firms

set price to maximize static profits.¹² In the empirical analysis we use actual market share data and observed regimen attributes to estimate product quality and fix its value, but in the numerical analysis we change quality to study how quality differentiation affects prices, profit, and consumer surplus.

We introduce a cocktail regimen by allowing the two firms to combine their drugs, given δ_1 and δ_2 . We assume that this third regimen's product quality, say δ_3 , is the maximum of δ_1 and δ_2 .¹³ The cocktail regimen can be produced using different combinations of the two drugs. Recall from Section 4 that q_{rf} is the dosage of a drug produced by firm f used in regimen r . For simplicity we set $q_{11} = q_{22} = 1$ such that $p_1^R = p_1$ and $p_2^R = p_2$. For the cocktail regimen we let r_{31} and r_{32} be proportions of drugs 1 and 2 used in regimen 3 such that $r_{31} + r_{32} = 1$, $0 < r_{31} < 1$, and $0 < r_{32} < 1$. The price of regimen 3 will be determined by

$$p_3^R = r_{31}p_1 + r_{32}p_2.$$

We also allow r_{31} to vary in order to study its impact. The profit-maximizing first order condition is identical to equation (2) with $q_{11} = q_{22} = 1$ and $q_{31} = r_{31}$. The marginal cost is assumed to be one-tenth of the stand-alone regimen's quality, *i.e.*, $mc_j = \delta_j/10$ for $j = 1, 2$.

In our first numerical analysis we fix $r_{31} = 0.5$ and $\delta_1 = 1$, and allow δ_2 to change from 1 to 3 so that the quality difference between regimens changes from 0 to 2. For each value of δ_2 a new equilibrium is computed. This simple exercise allows us to understand how firms' incentives change

¹²Product quality is a linear function of observed and unobserved product attributes in equation (4), *i.e.* $\delta_j = \beta x_j + \xi_t + \Delta \xi_{jt}$.

¹³The FDA is not likely to approve a cocktail that is inferior to both already-approved stand-alone regimens.

as the difference in regimen quality increases. Figure 2 compares firms' profit between cases with the cocktail regimen versus the benchmark case (no cocktails). The x-axis is the quality difference between firm 2's stand-alone regimen and firm 1's stand-alone regimen, *i.e.*, $\delta_2 - \delta_1$, and the y-axis measures profit. Figure 2 demonstrates that the presence of the cocktail regimen increases profit for both firms relative to not having a cocktail. Higher profit occurs as firms decide to charge higher prices with the presence of a cocktail regimen. This is similar to a case where a firm that produces multiple substitute products earns higher profit by being able to charge higher prices. An interesting difference is that the cocktail regimen serves a multiproduct function for both firms at the same time.

Figure 2 also shows that the low-quality firm's profit increases faster as the quality difference becomes larger. This occurs because the low-quality firm "free-rides" on the relatively high quality provided by the cocktail regimen. In the benchmark case the low-quality firm decreases its price while the high-quality firm increases it as the quality difference grows. With the cocktails present, however, the low-quality firm increases its price as the quality difference becomes larger, and it does so such that the market share for its stand-alone regime becomes negligible. But it still earns considerable profits from the cocktail regimen. The high-quality firm also increases its price, but not as dramatically as the low quality firm, so that it sells both its stand-alone regimen and the cocktail regimen together.

Consumers experience offsetting effects. They benefit from having one more product available in the market but are hurt by the resulting higher prices. In our case the latter (negative) effect is larger than the former (positive), so consumers are worse off with the cocktail regimen, and

further worse off as the quality difference increases. Compared to the benchmark case, consumer surplus is about 0.4 percent lower when $\delta_2 - \delta_1 = 0$ and about 8.0 percent lower when $\delta_2 - \delta_1 = 2$.

We next ask whether the two firms can earn larger profits with a cocktail regimen or by merging without participating in a cocktail regimen. Figure 3, which compares firms' profits between the cocktail regimen case and the merger case demonstrates that both firms earn larger profits with a cocktail regimen versus a merger. Firm 1's profit is about 20 percent higher when $\delta_2 - \delta_1 = 0$, and the profit difference grows as the quality gap increases. Firm 2's profit is also about 20 percent higher when $\delta_2 - \delta_1 = 0$ but the profit difference falls as the quality gap increases. This result is driven by firms charging higher prices with the cocktail regimen than in the merger case. Firm 2 charges a higher price as soon as $\delta_2 - \delta_1$ becomes larger than 0.05 and firm 1 charges a higher price when $\delta_2 - \delta_1$ becomes larger than 0.5. Despite higher prices, consumer surplus is 29 to 36 percent higher with the cocktail regimen due to the benefit of having another product available.

Interestingly, when we let the two firms merge while allowing them to keep the cocktail regimen, the merger provides small incremental benefits. The combined profit is less than one percent higher. This implies that firms almost fully internalize externalities with the cocktail regimen. Thus, firms may not have a strong incentive to merge once they participate in a cocktail regimen, particularly if there are transactions costs associated with merging. Consumers are clearly worse off with the merger.

In the next numerical analysis we allow one of the two firms to set two separate prices: one for the stand-alone regimen and another for their drug in the cocktail regimen. This situation is equivalent to a case where a firm has two separate drugs, one used in a stand-alone regimen and

the other used in a cocktail regimen. We first let firm 1, the low-quality firm, to set two separate prices while varying δ_2 from 1 to 3. Figure 4 compares the two prices that firm 1 sets with its single price in the first numerical analysis. This figure demonstrates that the firm sets a much lower price for the stand-alone regimen (Price1_Single) than for the cocktail regimen (Price1_Cocktail). Over the entire range of the quality difference the former price is about a 50 percent lower than the latter.

Compared to the single price (Price1_Single) the firm sets about a 14 percent lower price for the stand-alone regimen price and a 66 percent higher price for the cocktail regimen when $\delta_2 - \delta_1 = 0$. As the quality difference increases the single price increases much faster than the other two prices. Recall that with the single pricing firm 1 sacrifices its stand-alone regimen's market share as the quality gap increases and earns profit mostly from the cocktail regimen. Now with more flexible pricing, firm 1's stand-alone regimen's market share is larger than that of the cocktail regimen, although it still free-rides the cocktail regimen's high quality by curbing the price increase for the cocktail regimen. (It is only 27 percent higher when $\delta_2 - \delta_1 = 2$ as compared to 66 percent higher when $\delta_2 - \delta_1 = 0$.)

Not surprisingly, firm 1 is better off with the more flexible pricing, while firm 2 is worse off. Firm 2 now charges about 89-90 percent of what it used to charge. Firm 1's profit is about 6 percent higher than in the single pricing case and it does not change much as the quality gap changes. Firm 2's profit is about 12 percent lower when $\delta_2 - \delta_1 = 0$ and 9 percent lower when $\delta_2 - \delta_1 = 2$. However, its profit is still higher than in the absence of the cocktail regimen (the benchmark case.)

We next let firm 2, the high quality firm, set two separate prices. Firm 2 also sets a much lower price for the stand-alone regime than for the cocktail regimen. However, both prices increase as the quality difference increases. This price increase seems to prevent firm 1 from free-riding on the cocktail regimen's high quality. Similarly as in the previous case, firm 2 is better off with the more flexible pricing while firm 1 is worse off.

We also fix $\delta_1 = 1$ and $\delta_2 = 1$, and let r_{31} change from 0.5 to 0.9. This exercise helps us understand how the incentives to participate in making the cocktail regimen change when for chemical and/or biological reasons, one firm's drug constitutes a higher percentage of the cocktail recipe. We find, not surprisingly, that the profit for firm 1 increases as its mixture ratio increases, and the reverse is true for firm 2 as its mixture ratio decreases. Compared to the benchmark case, firm 1's profit is always higher and firm 2's profit is higher up to $r_{31} = 0.8$ and then becomes lower as r_{31} becomes higher. We repeat this exercise by varying r_{32} from 0.5 to 0.9 while fixing δ_1 and δ_2 and obtain qualitatively same results.

6 Empirical Analysis

We estimate equation (4) using regimen-level market share, price, and attribute data. Our identifying assumption is that regimen attributes other than price are not correlated with the contemporaneous demand shock. The price endogeneity problem requires using instruments to consistently estimate the demand equation. We consider two sets of instruments. The first set consists of counts and sums of attributes of other regimens in the market as in Berry, Levinsohn, and Pakes (1995) and Bresnahan, Stern, and Trajtenberg (1997). A crowded product space will shift price markups,

all else equal. The price changes should not be correlated with the regimen’s unobserved quality or demand shocks as long as product attributes are exogenous, as the literature usually assumes. Still one concern about these instruments is that they do not vary much over time due to infrequent product entry and exit. That is, the instruments may be weakly correlated with price.

The second set of instruments are constructed with the lagged prices of other regimens. In particular, instrument for the price of regimen j in period t with the average price in period $t - 1$ of all regimens other than regimen j and the average price in period $t - 1$ of regimens produced by firms whose drugs are not used in regimen j . We assume that these instruments are uncorrelated with the current period demand shock, but are correlated with the current period price. The latter part is obvious as all regimen prices are correlated in the same period through oligopolistic interactions and the price of a given product is usually autocorrelated. The former assumption requires that a demand shock for regimen j in period t is uncorrelated with a demand shock for regimen k in period $t - 1$, and is likely to hold true. However, this condition could be violated in the presence of a time persistent market level demand shock.

We use the generalized method of moments with $(\mathbf{Z}'\mathbf{Z})^{-1}$ as the weighting matrix, where \mathbf{Z} includes the instrumental variables, all the observed regimen attributes other than price and the time indicators.¹⁴ The estimates are presented in table 2. The first column shows the results of the OLS logit model. The second column, labeled IV Logit I, corresponds to the estimation with the product attribute instruments, and the third column, labeled IV Logit II, corresponds to the lagged price instruments. In all specifications we use the log of price.

¹⁴Our sample size is not large enough to use the optimal weighting matrix.

The price coefficients across the columns show that there is a positive correlation between price and the demand shock, and the instrumental variables mitigate this problem. However, the attribute instruments do not seem to correct the price endogeneity as much as the lagged price instruments. We suspect this is mainly because the regimen attributes do not change over time. The price coefficient changes from -0.733 without instruments to -0.841 with the attribute instruments. The lagged price instruments, on the other hand, change the price coefficient from -0.733 to -2.176.¹⁵

The efficacy attribute coefficients such as the response rate and survival months show the expected positive signs and are statistically significant in OLS logit and IV logit I. The response rate coefficient becomes much larger in IV logit II, but the sign of the survival month variable becomes negative, although it is not statistically significant. Time to progression has an unexpected and statistically significant negative sign in all three specifications.

Among the side effect variables, only two of them are statistically significant and only one of these two is negative as expected. This may be due to the fact that cancer patients often take drugs that ameliorate the impact of certain side effects, such as pain, nausea, and diarrhea. If a physician prescribes anti-pain and antiemetic drugs in conjunction with the anti-cancer drugs, she may downgrade the importance of these side effects when choosing a regimen. Another possible explanation is that the toxic drugs are more likely to cause side effects but have other favorable unmeasured attributes.

Given the demand estimates, we can recover the marginal cost of each drug from equation

¹⁵The F-statistic from the first stage F-test for the lagged price instruments is 12.0, which confirms that our instruments are not weak.

(1) , and given the marginal cost and demand estimates we can compute hypothetical equilibrium prices under various counterfactual scenarios. We focus on the last six quarters of the sample period, i.e., from the second quarter of 2004 to the third quarter of 2005. That is a period in which all 12 major regimens are present in the market. All results are averaged over these six quarters.

6.1 Counterfactual I

In the first counterfactual exercise we remove one cocktail regimen from the market at a time, find the new Nash equilibrium prices for all branded drugs, estimate profits for all major firms, and compute consumer surplus. This exercise is similar to the welfare counterfactual in Petrin (2002) . Because there are six cocktail regimens, we evaluate six hypothetical cases. The results are reported in Table 3. The baseline in the first row, which is what is actually observed in the market, is normalized to 100. Therefore, the table reports estimated percentage changes in prices, profits, and consumer surplus when one particular cocktail regimen is removed compared to the observed situation. The numbers in bold typeface are percentage changes for firms that participate in the removed regimen (which we refer to as "participating firms" hereafter.) The rows are ordered from the oldest to the most recent cocktail that entered the market, and the columns are ordered from the earliest firm at the left to the most recent at the right.

The first panel of the table reports the estimated price of each firm's drug, relative to the baseline situation (100.0), when the particular regimen in a row is absent. For example, the final row corresponds to a scenario where the cocktail regimen by Sanofi and Genentech, which had the highest market share of all regimens in 2005, is removed. Without this regimen, Sanofi and Genentech are predicted to decrease their drug prices by 44.0 percent and 10.4 percent, respectively.

There are several notable features of the first panel. In five out of six cases, prices of the participating firms' drugs fall as a regimen is removed. In all six cases, the price of the incumbent firm's drug in the cocktail is predicted to fall by more than the price of the entering firm, which indicates that incumbents may be setting prices to try to protect the market share of their stand-alone regimens. With a few notable exceptions, prices of drugs not used in the removed regimen generally go down as well.

The exceptions in the first panel, such as the predicted price increases in the second row, could be an outcome of having much more complicated structure of the inter-firm product combination. In the numerical analysis when the cocktail regimen is removed, each firm has one stand-alone regimen. In the market, on the other hand, all drugs other than ImClone's are used in multiple cocktail regimens. When one cocktail regimen is removed, therefore, participating firms will still consider their other cocktail regimens when setting prices.

The second panel of Table 3 reports estimated profit changes due to the removal of a particular regimen. No participating firm is better off without a regimen. Profit losses are sometimes substantial, especially when the market share of a cocktail is large relative to the market share of a firm's stand-alone regimen. ImClone's profit (second to last row), for example, is predicted to fall by over 80 percent if its regimen, which has a market share three times larger than the market share of its stand-alone regimen, is removed. Non-participating firms are generally worse off too, although there are some exceptions like Roche in the Sanofi-Genentech case and ImClone in the Pfizer-Genentech case.

The final column of Table 3 reports changes in consumer surplus. The effect of removing a

regimen on consumer surplus is not clear a priori. On the one hand, consumers are worse off with one fewer available product choice. In fact, the logit demand model allows variety to provide the maximum benefit. On the other hand, the lower prices that result from removing a regimen help consumers. Table 3 demonstrates that on net consumers would be better off without the cocktail regimens except in the Pfizer-Roche case, where the prices of all drugs increase. In general, the gains from the price decrease tend to outweigh the losses from having less variety.

The evidence on prices, profits and consumer welfare in Table 3 indicate that these particular inter-firm product combinations create a less competitive market that harms consumers. When firms set prices in the presence of cocktail regimens they consider the demand for the cocktail regimen as well as the demand for their stand-alone regimens. In doing so, they internalize part of the externalities they impose on their competitors, which results in a less competitive outcome.¹⁶

6.2 Counterfactual II

Table 4 reports the joint profit of the merging firms and consumer surplus when different pairs of firms merge, where the two firms' joint profit under the current situation of offering the cocktail regimen is normalized to 100. For comparison, the joint profit from the first counterfactual exercise is reported in the second column, which is labeled *Removed*. Recall that the profit loss can be as large as 49 percent when the Sanofi-Genentech regimen is removed.

In the next column labeled *Removed+Merger* we report the joint profit when the two firms merge without the cocktail regimen. This joint profit should be larger than the joint profit in the

¹⁶This is similar to the outcome of a multiproduct monopoly which produces multiple substitutes, and sets its price maximizing total profits instead of having multiple subsidiaries (see Tirole (1998) p.70)

Removed column because firms have more market power after merging. However, this profit is not necessarily larger than the current profit with the cocktail regimen. In fact, in four of five cases the joint profit of the merger is smaller than the joint profit with the cocktail regimen; firms gain more from cocktail regimens than from mergers.¹⁷ The difference is quite substantial in the last three cases where mergers are estimated to increase joint profit by less than 10 percent whereas cocktail regimens increase profit by at least 30 percent.

In the column labeled *Merger* in Table 4 we report the joint profit when two firms merge and maintain their cocktail regimen. This joint profit provides the maximum profit that two firms can earn pairwise because the merger allows them to fully internalize the externalities and the number of products offered is unchanged. Interestingly, this maximum joint profit is not much higher than the current joint profit. The largest increase (8.7 percent) occurs when Pfizer and Roche merge. Compared to the profit change from adding the cocktail regimen (column 1 - column 2), a merger increases the joint profit only marginally. This result confirms our finding in section 5 that cocktail regimens allow firms to almost fully internalize externalities.

As expected, consumer surplus decreases when firms merge without the cocktail (going from *Removed* to *Removed+Merger*) and increases when firms add the cocktail regimen while being merged (going from *Removed+Merger* to *Merger*), as displayed toward the right of Table 4. In the former case consumer surplus falls as the market becomes less competitive; in the latter case consumer surplus rises as another product is added to the choice set.

Consumer surplus actually increases in two of the five cases where two firms offering a

¹⁷There are five instead of six cases in this counterfactual exercise because we do not model a three-firm merger.

cocktail regimen are allowed to merge (going from *Current* to *Merger*.) Although the market becomes less competitive and the number of products is unchanged, drug prices sometimes fall. In the Pfizer-ImClone merger case, ImClone's drug price decreases by almost 30 percent. This reduces the profit of ImClone's drug but increases the profit of Pfizer's drug by more. In the Sanofi-Genentech merger case, Genentech's drug price decreases by 40 percent but the joint profit increases due to higher profits on Sanofi's drug. Consumers benefit from these price decreases, although the market becomes less competitive.

6.3 Counterfactual III

In our third counterfactual exercise, we allow one of the participating firms in a cocktail to set two separate prices for the same drug: one for its stand-alone regimen and one for its drug in the cocktail. This is the same exercise as the two-price setting case in section 5. Table 5 reports price, profit, and consumer surplus in these scenarios, where the baseline levels are indexed to 100. The column labeled *Solo* reports the optimal drug prices for the stand-alone regimen and the numbers in bold typeface are prices for the drug used in the cocktail regimen. In the second row, for example, Pfizer reduces the price of irinotecan by about eight percent for the stand-alone regimen while increasing the price of irinotecan by 40 percent for use in three cocktail regimens in which it participates.

Table 5 shows that the drug price for cocktail regimens can go up dramatically with additional price flexibility. Roche increases its drug price for cocktail regimens by a factor of 9 (in the fourth row) and Sanofi does so by more than three times (in the fifth row). Drug prices for the stand-alone regimens usually decrease substantially, ranging from an eight to 18 percent. The

exception is Sanofi, which increases its price by 14 percent. The other firms' reaction to the new price scheme is mixed . Roche decreases its price in all cases while the other firms increase their prices.

The second panel of the table shows that firms earn higher profits by setting two prices in all cases, which is consistent with the numerical example. However, the other firms are not necessarily worse off. Genentech is the only firm that becomes worse off in all cases. Roche and Sanofi are better off in all cases, and Pfizer and ImClone's profit changes depend on who sets two prices. This is not consistent with the numerical example where a firm's setting two prices makes the other firm worse off. The much more complicated structure of the inter-firm product combination may explain these mixed results.

We report consumer surplus in the last panel of Table 5. Since the regimen qualities do not change in this counterfactual, the only variable affecting consumer surplus is price. Consumer surplus is lower in all cases simply because consumers pay higher prices for the same quality regimens.

These counterfactual results suggest that Abbott's pricing strategy with Norvir and Kaletra is not necessarily detrimental to its competitors. It depends on how firms are interconnected by other cocktail regimens. However, consumers will be hurt by Abbott's pricing strategy if it drives its competitors to increase their prices significantly.

7 Conclusions

This paper is the first attempt to understand the economic decisions that firms need to make when their products are consumed with their competitors' products. The firm controls only the price of its own product, and therefore, it needs to take into account the effect of its pricing strategy on all the bundles its product is used.

We apply our framework to the pharmaceutical industry, in particular to colorectal cancer drugs. We estimate the regimen level demand using the unique data from IntrinsicQ and perform counterfactual exercises using the estimated demand parameters and marginal cost. First of all, we find that inter-firm combinations are profit enhancing for all firms that participate in the combination, as the effect of internalizing externalities dominates the business stealing effect. However, consumers are worse off with the combined products, despite more variety, because they pay higher prices.

We also find that firms can earn higher profit with product combinations than with mergers. Even if firms that already have product combinations merge, the joint profit increases only marginally. Surprisingly, consumers are necessarily worse off as the merged firm may lower prices to fully internalize the externalities. These results suggest that the anticompetitive merger effects would be smaller when the products of merging firms are already consumed together in the market, and should help the government authority evaluate expected outcomes of the recent merger waves in the pharmaceutical market.

In addition, we find that if any of the firms has two drugs, one for the stand-alone regimen and another for the cocktail regimen, it sets a much higher price for the cocktail regimen, while

setting a lower price for the stand-alone regimen, compared to the single price setting. This more flexible pricing brings in higher profits, but the other firms are not necessarily worse off as they may respond by increasing their prices. However, consumers are hurt by this price increase.

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Table 1: Regimen Attributes: The Sample Average

| Time | Regimen Price (24 week treatment) | Efficacy | | | Grade 3 or Grade 4 Side Effects (%) | | | | |
|------|--------------------------------------|--------------------|------------------|------------------------|-------------------------------------|----------|--------|----------|------------------|
| | | Survival Months | Response Rate | Time to Progression | Abdominal Pain | Diarrhea | Nausea | Vomiting | Neutro- penia |
| 1993 | 120.93 | 12.48 | 20.80 | 4.73 | 5.50 | 10.40 | 4.80 | 4.40 | 33.70 |
| 1994 | 119.42 | 12.48 | 20.80 | 4.73 | 5.50 | 10.40 | 4.80 | 4.40 | 33.70 |
| 1995 | 115.95 | 12.48 | 20.80 | 4.73 | 5.50 | 10.40 | 4.80 | 4.40 | 33.70 |
| 1996 | 125.91 | 12.48 | 20.80 | 4.73 | 5.50 | 10.40 | 4.80 | 4.40 | 33.70 |
| 1997 | 94.38 | 12.48 | 20.80 | 4.73 | 5.50 | 10.40 | 4.80 | 4.40 | 33.70 |
| 1998 | 11,272.91 | 12.53 | 23.73 | 5.21 | 8.93 | 21.80 | 11.23 | 8.13 | 33.07 |
| 1999 | 12,122.11 | 12.53 | 23.73 | 5.21 | 8.93 | 21.80 | 11.23 | 8.13 | 33.07 |
| 2000 | 12,871.24 | 12.53 | 23.73 | 5.21 | 8.93 | 21.80 | 11.23 | 8.13 | 33.07 |
| 2001 | 12,955.49 | 12.78 | 23.83 | 5.14 | 8.85 | 20.72 | 10.00 | 7.49 | 28.13 |
| 2002 | 17,087.39 | 14.03 | 27.76 | 5.81 | 7.99 | 20.56 | 9.93 | 7.53 | 27.33 |
| 2003 | 20,181.95 | 14.81 | 30.02 | 6.28 | 7.66 | 20.24 | 9.94 | 7.67 | 26.31 |
| 2004 | 37,434.78 | 14.71 | 30.90 | 6.66 | 7.88 | 20.49 | 7.87 | 6.83 | 19.97 |
| 2005 | 37,169.33 | 14.71 | 30.90 | 6.66 | 7.88 | 20.49 | 7.87 | 6.83 | 19.97 |

See the text for variable explanations.

Table 2: Demand Estimation Results

| Variable | OLS Logit | IV Logit I | IV Logit II |
|---------------------------------|---------------------|---------------------|---------------------|
| $\log(\textit{price})$ | -0.733** (0.098) | -0.841** (0.117) | -2.176** (0.448) |
| Survival (months) | 0.179** (0.052) | 0.155** (0.058) | -0.138 (0.120) |
| Response Rate (%) | 0.285** (0.058) | 0.341** (0.069) | 1.030** (0.232) |
| Time to Progression (months) | -1.265** (0.215) | -1.398** (0.224) | -3.051** (0.599) |
| Diarrhea | 0.011 (0.018) | 0.015 (0.014) | 0.057 (0.034) |
| Nausea | 0.081 (0.065) | 0.088 (0.067) | 0.167 (0.098) |
| Abdom_pain | 0.186** (0.061) | 0.236** (0.071) | 0.851** (0.208) |
| Vomiting | -0.111 (0.097) | -0.107 (0.096) | -0.053 (0.143) |
| Neutropenia | -0.058** (0.010) | -0.066** (0.011) | -0.161** (0.032) |

Table 3: Counterfactual Simulation I

| | Price Changes (per mg) | | | | | Profit Changes | | | | | CS |
|-----------------|------------------------|--------------|-------------|-------------|-------------|----------------|-------------|-------------|-------------|-------------|-------|
| | Pfizer | Roche | Sanofi | ImClone | Genentech | Pfizer | Roche | Sanofi | ImClone | Genentech | |
| Current | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| No Pf + Ro | 101.9 | 113.0 | 100.3 | 100.3 | 100.1 | 94.4 | 95.8 | 100.2 | 100.1 | 99.7 | 99.6 |
| No Ro + Sa | 92.4 | 70.1 | 89.1 | 97.8 | 93.4 | 91.8 | 80.3 | 87.1 | 89.8 | 96.3 | 107.6 |
| No Pf + Ge | 47.8 | 187.1 | 97.4 | 89.3 | 78.3 | 76.0 | 88.6 | 90.2 | 106.6 | 67.4 | 113.1 |
| No Ro + Sa + Ge | 97.7 | 88.9 | 96.4 | 99.3 | 96.0 | 97.2 | 94.9 | 97.7 | 95.9 | 96.7 | 102.8 |
| No Pf + Im | 59.7 | 234.9 | 92.0 | 71.6 | 95.5 | 85.5 | 94.5 | 90.1 | 19.8 | 102.2 | 107.5 |
| No Sa + Ge | 86.9 | 230.2 | 56.0 | 96.2 | 89.6 | 80.9 | 106.7 | 80.5 | 79.4 | 18.6 | 118.1 |

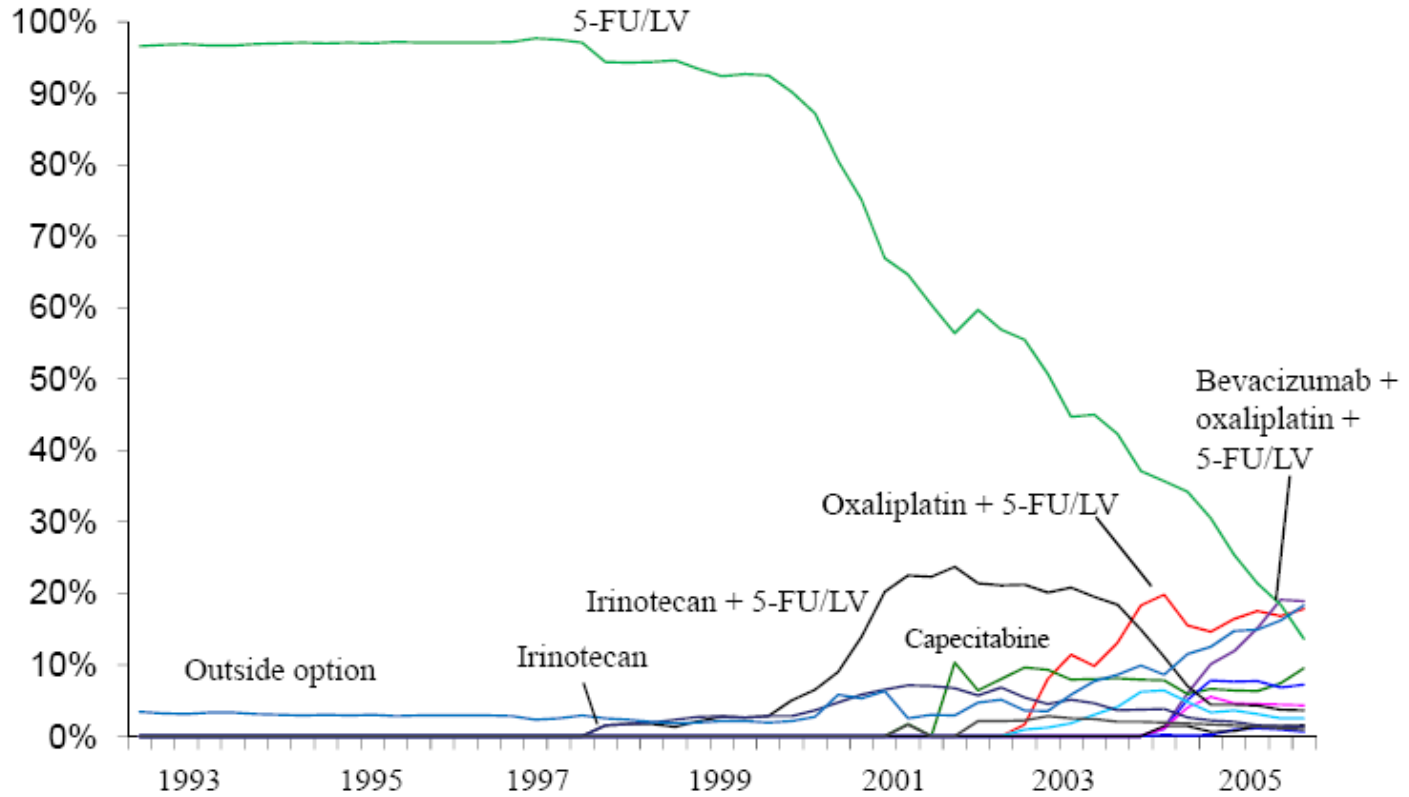
Table 4: Counterfactual Simulation II: Merger

| | Two Firms' Joint Profit Changes | | | | Consumer Surplus Changes | | | |
|--------------------|---------------------------------|---------|----------------|--------|--------------------------|---------|----------------|--------|
| | Current | Removed | Removed+Merger | Merger | Current | Removed | Removed+Merger | Merger |
| Pfizer + Roche | 100 | 94.6 | 105.5 | 108.7 | 100 | 99.6 | 85.7 | 87.3 |
| Roche + Sanofi | 100 | 86.7 | 99.0 | 105.5 | 100 | 107.6 | 88.0 | 90.7 |
| Pfizer + Genentech | 100 | 70.1 | 78.4 | 100.0 | 100 | 113.1 | 89.1 | 98.3 |
| Pfizer + ImClone | 100 | 63.2 | 64.6 | 102.2 | 100 | 107.5 | 102.9 | 105.0 |
| Sanofi + Genentech | 100 | 51.0 | 53.4 | 103.5 | 100 | 118.1 | 102.6 | 110.7 |

Table 5: Counterfactual Simulation III

| | Price Changes (per mg) | | | | | | Profit Changes | | | | | CS |
|----------|------------------------|--------------|--------------|--------------|--------------|-----------|----------------|--------------|--------------|--------------|-----------|-------|
| | Solo | Pfizer | Roche | Sanofi | ImClone | Genentech | Pfizer | Roche | Sanofi | ImClone | Genentech | |
| Current | | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Pfizer 1 | 92.4 | 139.2 | 91.2 | 171.1 | 112.7 | 152.7 | 120.1 | 116.4 | 101.3 | 116.6 | 87.5 | 83.0 |
| Pfizer 2 | 85.0 | 225.2 | 90.4 | 176.1 | 123.7 | 157.8 | 120.5 | 125.3 | 108.4 | 96.2 | 85.1 | 78.0 |
| Roche | 87.4 | 211.0 | 935.3 | 186.7 | 122.7 | 162.5 | 113.3 | 179.6 | 100.4 | 105.8 | 86.1 | 75.2 |
| Sanofi | 113.7 | 197.3 | 82.3 | 371.3 | 120.4 | 218.7 | 96.5 | 114.0 | 107.2 | 98.8 | 47.3 | 80.9 |
| ImClone | 82.1 | 187.8 | 91.3 | 176.4 | 140.8 | 158.4 | 107.9 | 126.4 | 108.8 | 113.9 | 88.6 | 77.7 |

Figure 1: Regimen Market Shares, 1993-2005



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Source: IntrinsicQ and SEER.

Market share is measured as the percentage of colon cancer patients who are treated with drugs that are treated with a specific regimen.

Figure 2: Profit Comparison between the Cocktail Regimen and the Benchmark Cases

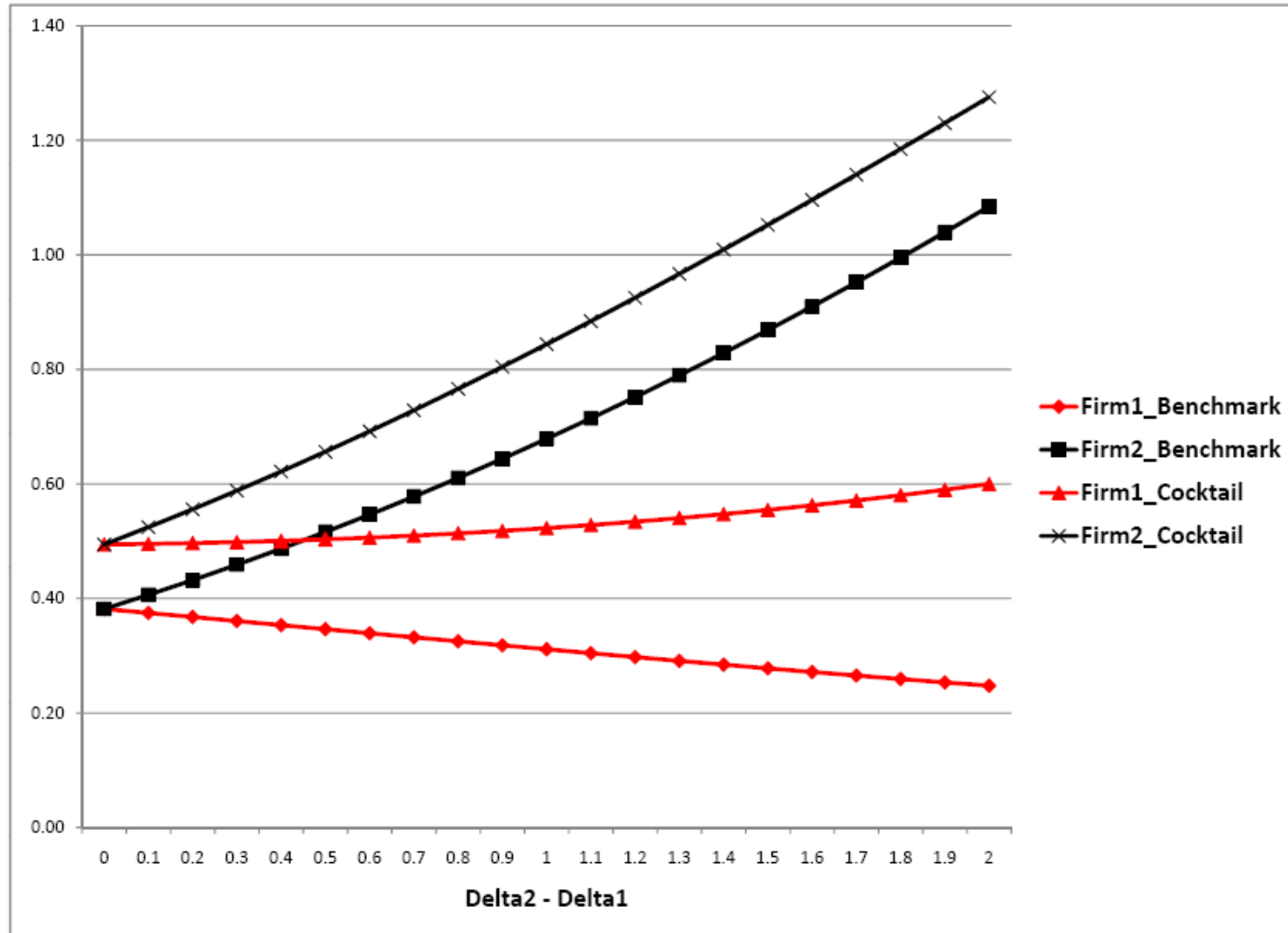


Figure 3: Profit Comparison Between the Cocktail Regimen and the Merger Cases

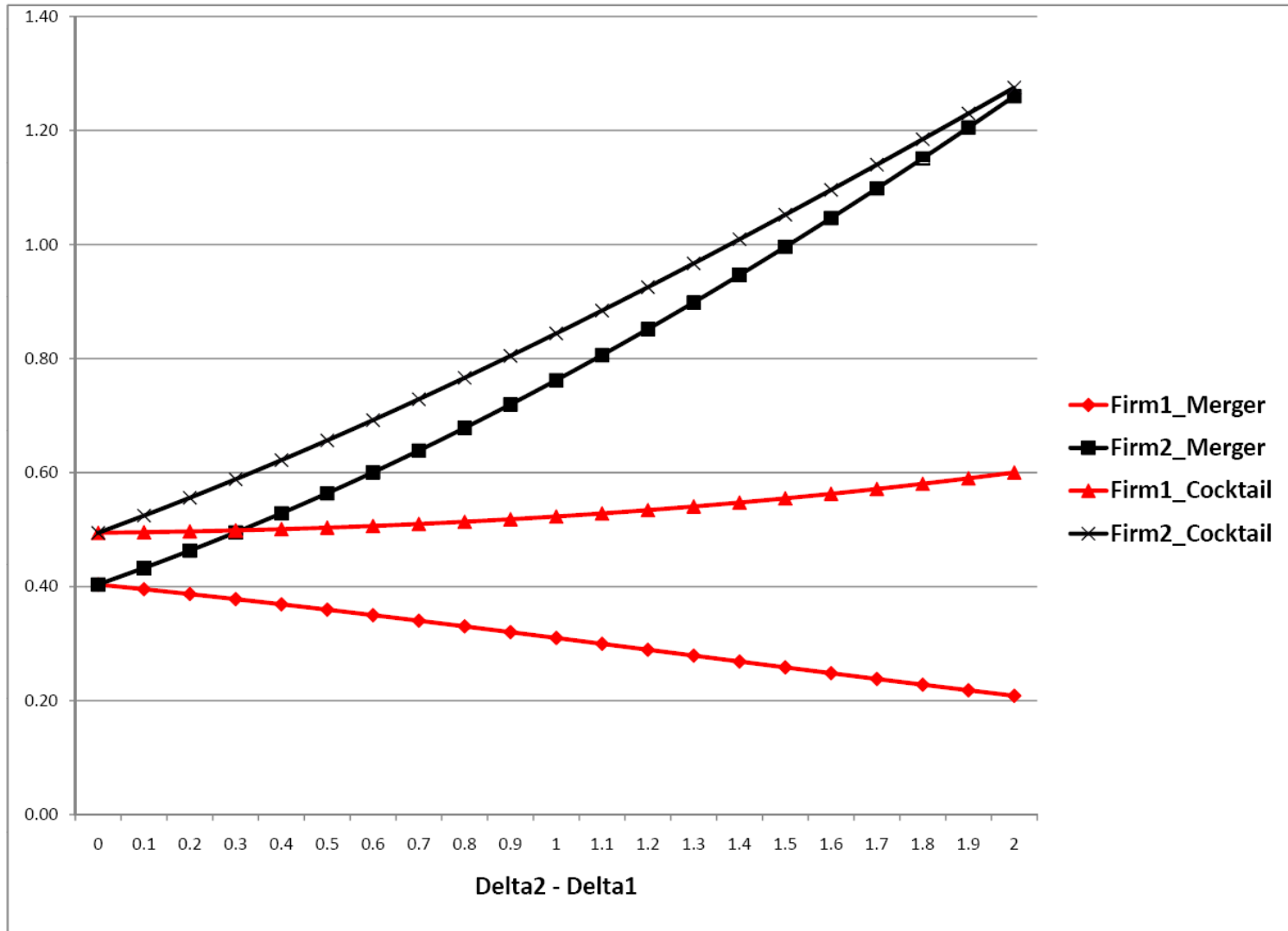


Figure 4: Price Comparison: The Low Quality Firm Setting Two Prices

