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Before Advancing to Go: New Approaches to Gauge Antitrust Scrutiny in Hospital M&As

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Diversion ratios are taking on increasing importance in merger analysis because they provide a measure of the intensity of pre-merger competition between two organizations. Healthcare finance leaders can rely on these types of calculations, which complement commonly used market share analyses, to predict the likely level of scrutiny by antitrust regulators.

Hospitals increasingly run the risk of being dealt a "Do Not Pass Go" card from federal antitrust agencies if a proposed merger is likely to create anti-competitive effects (specifically, monopoly-like pricing power). Fueled by the passage of the Affordable Care Act (ACA) and a variety of industry headwinds, the hospital sector's heightened transaction activity is drawing increasing scrutiny by the Federal Trade Commission (FTC) and the antitrust division of the Department of Justice (DOJ). Recent agency actions, ranging from Albany, Ga., to Rockford, Ill., are sending clear signals that antitrust officials are taking a much more aggressive approach to hospital merger enforcement (see the related sidebar on page 2).

In June 2012, the FTC named its first deputy director for health care and antitrust, Leemore Dafny, PhD, to "enhance the agency's efforts to promote competition in the healthcare sector," according to a FTC press release. Public remarks by Dafny and a review of her scholarly work indicates that the FTC is likely to use new empirical and statistical approaches to screen proposed transactions—which will place a greater emphasis on the "value of diverted sales," or diversion ratios, rather than geographic market share as commonly calculated using the Herfindahl–Hirschman Index.

While there is no single litmus test to perfectly predict the level of antitrust scrutiny that a potential transaction will face, hospitals can run analytical screens that are similar to those used by the FTC to gauge how much interest the federal agencies will have in the proposed transaction. In Monopoly, this would be like playing with a face-up stack of Chance cards.

New Econometric Tests

Citing evidence of anti-competitive effects after hospital mergers, proponents of antitrust enforcement have argued for new analytical approaches to predict the price effects of hospital mergers. In 2010, reflecting substantial economic learning and agency practice, the FTC-DOJ revised the *Horizontal Merger Guidelines* for the first time since 1992. The guidelines outline

how the federal antitrust agencies evaluate the likely competitive impact of mergers and whether those mergers comply with U.S. antitrust law.

Two aspects of the 2010 update are particularly noteworthy, according to a 2010 FTC press release.

A reduced emphasis on market shares. Geographic market share concentration, commonly calculated using the Herfindahl–Hirschman Index (HHI), will continue to be a standard analytic in merger and acquisition assessments, but the HHI is no longer the sole litmus test by which proposed transactions will be measured (see the sidebar at right for a more detailed history explaining why).

The introduction of the value of diverted sales as an indicator of upward pricing pressure. The value of diverted sales (or diversion ratio) is calculated as the ratio of sales diverted from one product line of a merging hospital to a product line of the other merging hospital (the diversion ratio). Per the FTC-DOJ's 2010 Horizontal Merger Guidelines, the value of diverted sales is calculated as follows:

Value of Diverted Sales = (Diversion Ratio × the Margin ÷ Unit for the Product Line that the Sales Are Diverted To)

At an October 2012 American Bar Association event, Dafny reiterated these points. When performing quick-look evaluations of hospital mergers, the FTC will focus on the change in bargaining power for hospitals as measured by diversion ratios, rather than geographic market share (Knox, R., "FTC Official: Diversion Ratios, Not Geographic Markets, Key to Hospital Deals," *Global Competition Review*, Oct. 2, 2012).

Diversion ratios are taking on increasing importance in merger analysis since they provide a measure of the intensity of pre-merger competition between two organizations. The ratio assesses local competitive constraints by predicting the portion of lost sales (i.e., patient volumes) resulting from a hospital's price increase. For example, a diversion ratio from Hospital A to Hospital B represents the proportion of patients who would choose Hospital B as their second choice if Hospital A increased its prices. The higher the diversion ratio between Hospital A and Hospital B, the more profitable a theoretical price increasewould be if the two organizations were allowed to merge.

A Brief History of Hospital Antitrust Enforcement

The FTC and DOJ are responsible for enforcing U.S. antitrust laws. While the FTC does not have authority over the health insurance industry, it can investigate and block mergers between hospitals or between other healthcare providers.

In the 1980s, the FTC-DOJ successfully blocked hospital mergers in all but one case. The wave of hospital consolidation in the 1990s was met with a less aggressive antitrust enforcement climate as only a handful of the more than 1,000 hospital mergers were challenged. Of the few hospital mergers challenged from 1994 to 2000, the FTC-DOJ and state regulators lost seven straight challenges.

During this period, merging hospitals began defining their geographic market definition using the Elzinga-Hogarty (E/H) test (Elzinga, K.G., and Hogarty, T.F., "The Demand for Beer," *Review of Economics & Statistics*, 1972, vol. 195). These E/H tests typically showed a significant portion of local residents out-migrating for care, expanding the service area definition, and reducing pre-merger market share calculations Given the high percentage of out-migrating patients pre-merger, the courts concluded that the merging hospitals would not gain enough power to profitably raise prices post-merger, according to a 2002 article. (Capps, C.S., et al, "Antitrust Policy and Hospital Mergers: Recommendations for a New Approach," *The Antitrust Bulletin*, Winter 2002).

In response to the string of unsuccessful challenges, the FTC renewed its efforts in 2002 and found evidence that some recent hospital mergers had led to significant price increases. In a widely reported case, the FTC issued an administrative complaint in 2004 challenging Illinois-based Evanston Northwestern Healthcare's (ENH) acquisition of Highland Park Hospital four years after the merger had been consummated. The agency alleged that the merger substantially reduced competition for acute inpatient services and significantly increased prices. In what first appeared to be a turning point for the FTC, the district court judge ruled in the Commission's favor and ordered the merged parties to unwind. Ultimately, however, after a lengthy appeals process that ended in 2008, ENH and Highland were not forced to unwind the merger if they agreed to set prices and negotiate with insurers independently as separate entities.

In the past 20 years, academia has produced a significant volume of economic literature that has helped federal agencies and the courts assess the likely competitive effects of proposed mergers. In 2010, reflecting the substantial economic learning and agency practice, the FTC-DOJ revised the *Horizontal Merger Guidelines* for the first time since 1992, putting an emphasis on diversion ratios instead of geographic market share. The guidelines outline how the federal antitrust agencies evaluate the likely competitive impact of mergers and whether those mergers comply with U.S. antitrust law.

In summary, if the new econometric analytical models are able to assess the likely effects of a merger using diversion ratios—without defining a relevant geographic market—then the importance of the flawed Elzinga-Hogarty model in defining relevant markets is diminished, according to 2012 roundtable discussion (Organization for Economic Co-operation and Development, *Roundtable on Market Definition*, June 2012).

Implications for Leaders

During the current period of heightened uncertainty and volatility in the industry, hospital leaders are facing mixed messages sent by government agencies and legislators attempting to "bend the cost curve." On one side, the ACA encourages hospitals and physicians to reduce costs by improving the coordination of patient care by forming accountable care organizations (ACOs) that act like fully integrated delivery systems. On the other side, the FTC is stepping up its efforts to protect consumers by blocking anti-competitive healthcare mergers and, thus, holding down costs.

To help navigate the increasingly complex regulatory environment and achieve the ultimate goal of high-quality care at a low cost, hospital leaders can use the following guiding principles when considering merger and acquisition strategies:

Strategy first: Build a compelling strategic vision and value proposition. Establishing a compelling strategic vision is essential to achieving the following:

- Energize the organization for the difficult work ahead.
- Clearly articulate the potential benefits to the community.
- Engender stakeholder support.

Irrespective of external regulatory considerations, the transfer of ownership of oftentimes a 100+ year old community asset is a high-stakes decision that is sure to be questioned at every stage of the process. The strategic vision will serve as a consistent foundation to stand on as healthy skeptics question, "Do we really need to do a deal?"

Stress test second: Conduct analytical screens to anticipate and mitigate execution risks. Proactively seek experts, early in the process, to assess how likely it is that the proposed transaction will be challenged. Analytic screens can be run to empirically assess the likelihood of antitrust scrutiny. For example, hospitals and health systems can access their state inpatient discharge database to calculate geographic market share concentrations. As such, the HHI analysis can be conducted by either party (the acquirer or the target) at the earliest stages of a merger/affiliation discussion (without sharing any data).

Irrespective of any active merger/affiliation discussions, the HHI analysis can also be highly instructive during strategic planning processes to monitor the level of market concentration in rapidly consolidating markets, such as Boston and Chicago. HHI analysis is one of many important factors for health system leadership teams to consider when deciding whether to seek a larger partner.

The newly emerging, value of diverted sales analysis is a much more detailed academic exercise than the HHI analytic. As such, economic consulting firms are best positioned to conduct this analysis on behalf of two parties considering a merger/affiliation.

Early in the process, a board education session dedicated to antitrust considerations is prudent given the current regulatory climate. Weighting the pros and cons of pursuing a transaction will ensure that decision makers are proceeding with eyes wide open.

Additionally, smaller organizations being acquired should consider negotiating that the larger acquiring system would be responsible for transaction costs associated with any extended antitrust review process. This is particularly true if the hospitals party to the transaction anticipate that the FTC/DOJ will issue a "second request." An FTC/DOJ discovery procedure to investigate proposed mergers, the second request process is typically very time-consuming and expensive, requiring that all organizations party to the transaction produce a substantial number of documents.

Hospital leaders can also somewhat minimize the distraction by forming a small "deal team" that includes representatives from the board, administration, and physician leadership. However, a second request process is certain to increase the workload on middle management in addition to senior leadership.

Proactively manage the communication strategy. As a community asset, not-for-profit hospital transactions impact a wide group of stakeholders, including local community members and political leaders, the hospital workforce, medical staff members, regulatory agencies, and insurers. Consistent and transparent communication is essential to engender stakeholder support at every stage of the transaction.

Additionally, prior to deal closure, a post-merger integration plan should be developed and communicated to clearly articulate short-term action items (i.e., a 30/60/90 day plan), as well as medium- to long-term integration goals to ensure rapid implementation of the strategic vision.

High-Priced Boardwark and Park Place May Not Be the Best Partners

In a February *Wall Street Journal* article, a chief judge at the World Monopoly championships (yes, international tournaments are still held to play the early 1900's board game) reports that the game's best investments are the orange properties—not high-priced Boardwalk and Park Place, which are dark blue properties (Orbanes, P.E., "Go Directly to Success: Monopoly's Lessons," *Wall Street Journal*, Feb. 8, 2013).

Hopefully, the question of how best to organize U.S. providers to bend the healthcare cost curve —more consolidation via tightly integrated ACOs versus a modern-day version of trust busting via heightened FTC/DOJ scrutiny—will be resolved by policy makers in short order. Perhaps we can enlist the World Monopoly championship's chief judge?

In the absence of clear policy direction, healthcare leaders would be well served by

conducting a disciplined and empirical assessment to gauge antitrust risk before marching too far down the altar with a potential merger partner. Lengthy delays, workforce distractions, and significantly higher transaction costs should be expected in an extended antitrust review process. As such, hospital leaders will need to develop a compelling strategic vision and business case to engender support from key stakeholders (e.g., community and political leaders, the medical staff, and local insurers) to successfully pursue a transaction that is likely to face significant regulatory hurdles.

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