FTC/DOJ Hearings on Health Care

Hospitals – Post Merger Conduct

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Outline of Topics

- Observations on Post-Merger Pricing Behavior
- Basics of Geographic Market Definition
- Courts’ Pre-Merger Geographic Market Definition Analyses
- Courts’ Analysis of Competitive Effects
- Using Post-Merger Pricing Behavior to Test Courts’ Approach to Geographic Market Defintion & Competitive Effects
- FTC/DOJ’s Unique Position

Changes in Pricing Behavior

- Pre-merger: the acquired hospital charges *lower* rates to private payors than the acquiring hospital
- Post-merger: the combined hospitals charges rates to payors *equal to* the higher rates of the acquiring hospital
- Post-merger: price increases have been by as much 50 %

Market Definition Analysis

- Market is defined using “hypothetical monopolist” test, assuming:
  - all candidate firms behave as one in pricing
  - firms outside the proposed market do not change prices

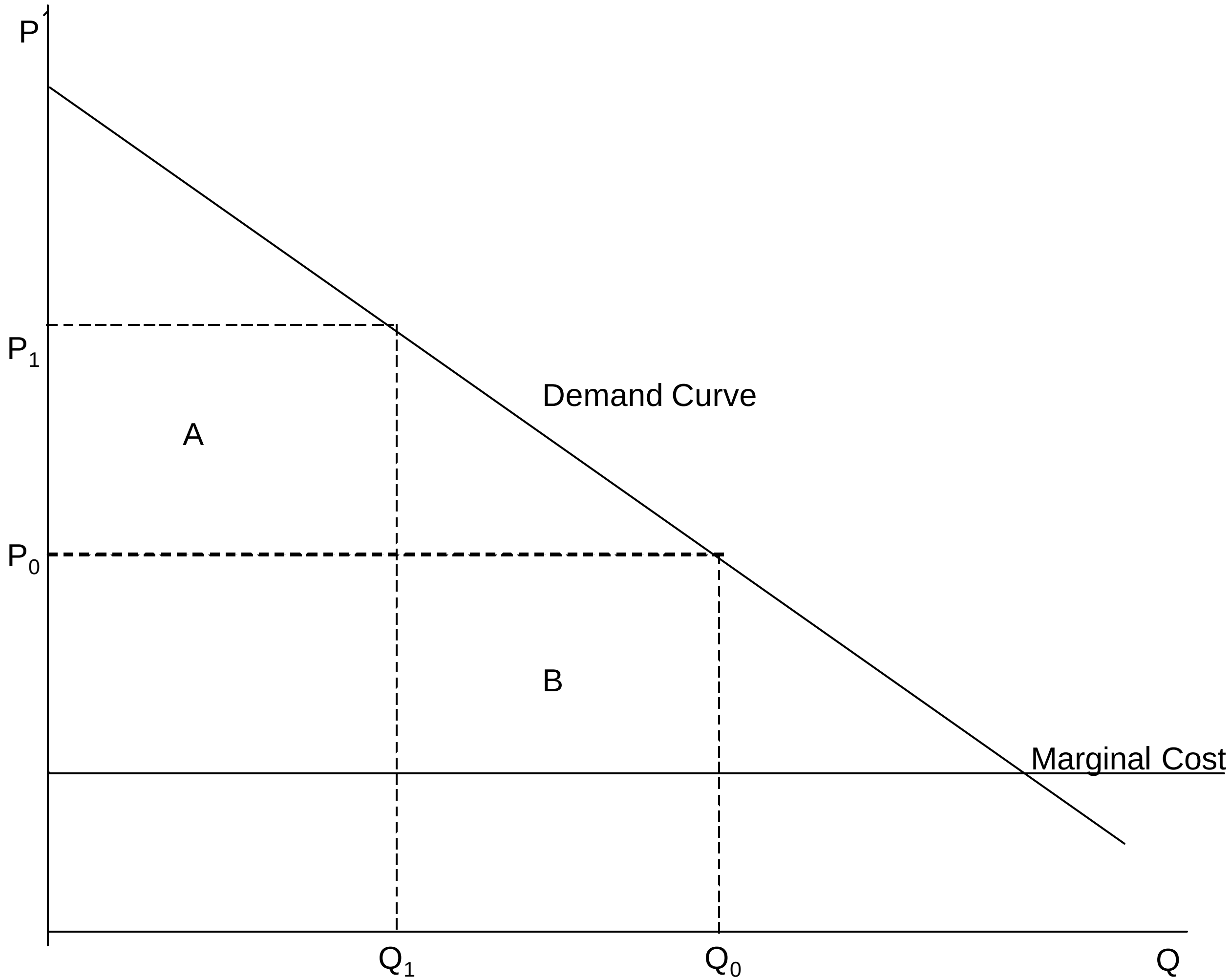


Figure 1

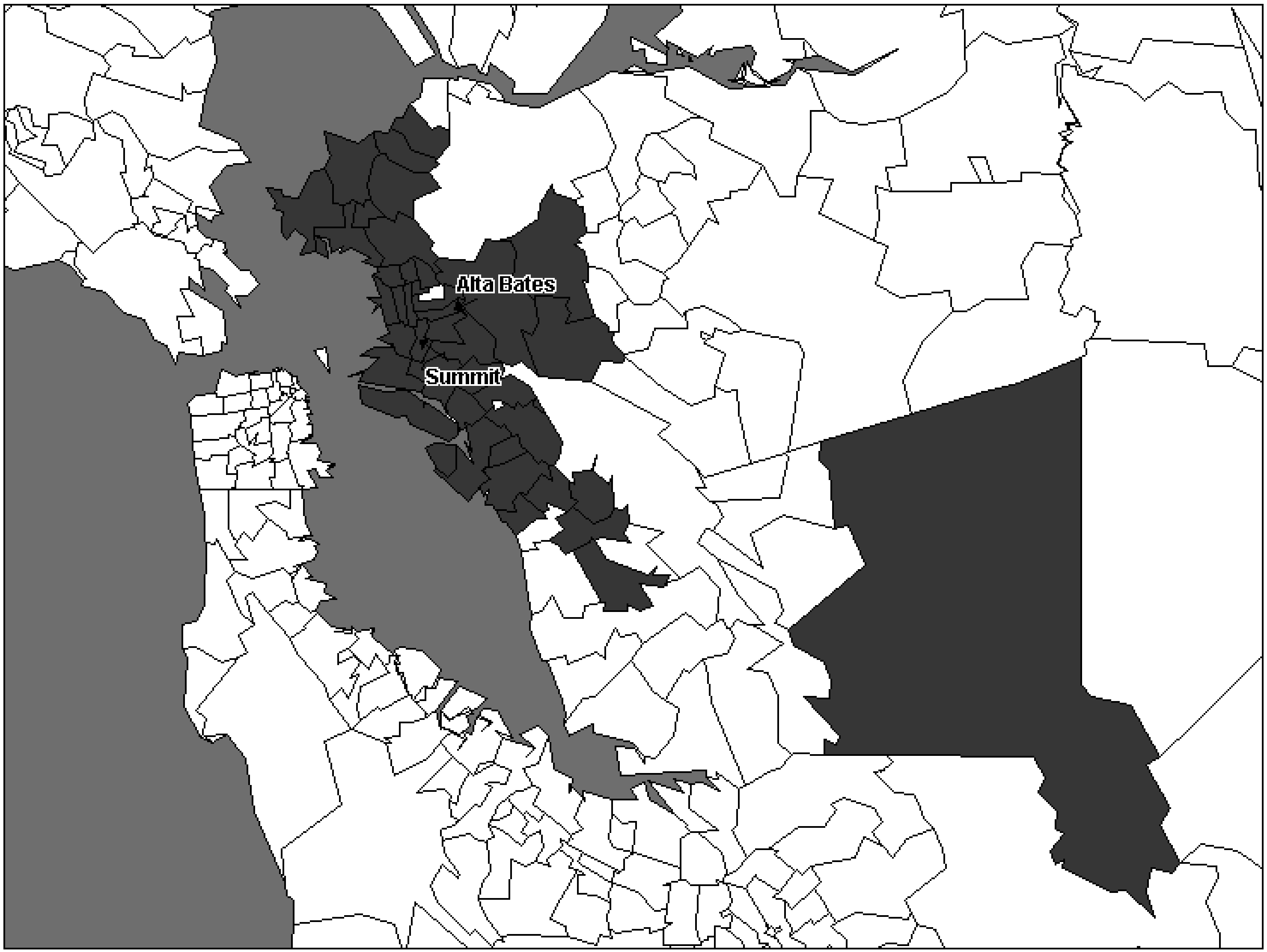
Basic Concept in Market Definition

- Price increase is profitable as long as: $t/(m+t) > \Delta Q/Q$
- Must estimate "m", the existing margin: (P-MC)/P
- <u>Must estimate ΔQ</u>, the change in sales due to a price increase of $t = \Delta P/P$

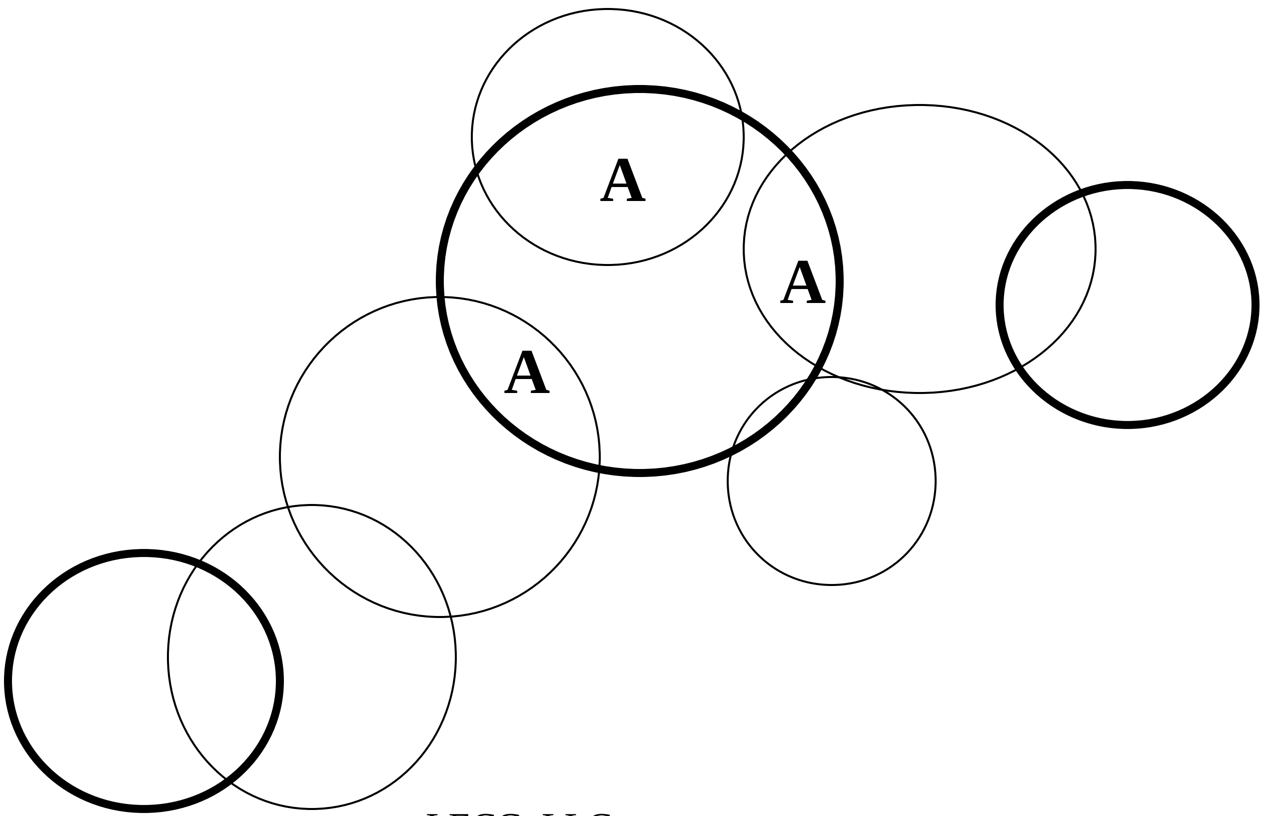
Courts & Geographic Market Definition

- Courts have focused on pre-merger patient migration patterns
  - Elzinga-Hogarty tests
  - Overlapping draw areas
- Inferred profitability of hypothetical price increases from static migration patterns

Alta Bates and Summit Combined 90% Patient Draw Areas
GAC DRGs, All Payers, 1997
Assuming Kaiser Oakland Stay Open
Ranked by Alta Bates and Summit Discharge



Overlapping Draw Area Analysis



Specific Tests of Courts' Geographic Market Definition

- Migration responses to post-merger price increases
- 5 % price test

Payor Induced & Patient Migration Patterns In Response to Post-Merger Price Increases

- Hospital services are not homogeneous
- Patients have non-price related reasons for pre-merger migration
- Payors have limited ability to induce patients to switch to more distant hospitals
- *Should be no presumption that existing migration patterns change in response to post-merger price increases*

Price Increases Greater than 5 Percent

- Courts have rigidly focused on 5 percent price increase test
- *Merger Guidelines* recognize 5 percent test should not always be applied
- Under certain circumstances 10 percent price increase or more will be profitable when 5 percent price increase is not

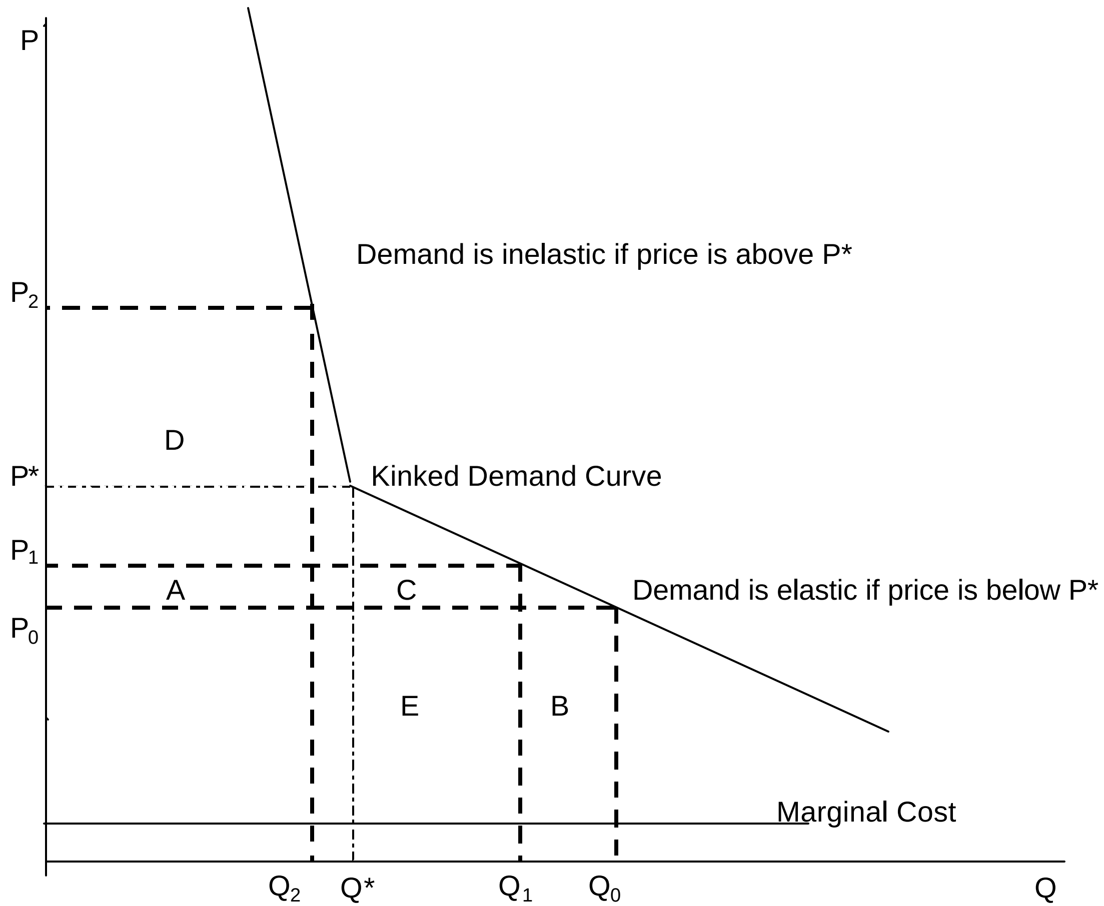


Figure 2

Areas defined by " - - - - - - - - ".
Price increase from P_0 to P_1 <u>is not profitable</u> because area B > area A + area C
Price increase from P_0 to P_2 <u>is profitable</u> because area B + area E < area A + area D.

Courts & Competitive Effects

- Assumed other hospitals would not follow any price increase

- Assumed other hospitals would expand services & geographic coverage in response to any attempted price increase

Specific Tests of Courts' Competitive Effects Analysis

- Asymmetric price increases
- Reactions of other hospitals
  - Pricing
  - Expansion of services
  - Expansion of geographic service areas

Competitive Effects: Asymmetric Price Increase

- Critical loss formula for the merged firm should be adjusted when price is only increased one of the merging firms products
- $ta/[ma+ta-\mathit{mb(Pb/Pa)Dab}] > \Delta Qa/Qa$
- Increases the likelihood of a unilateral price increase being more profitable after the merger

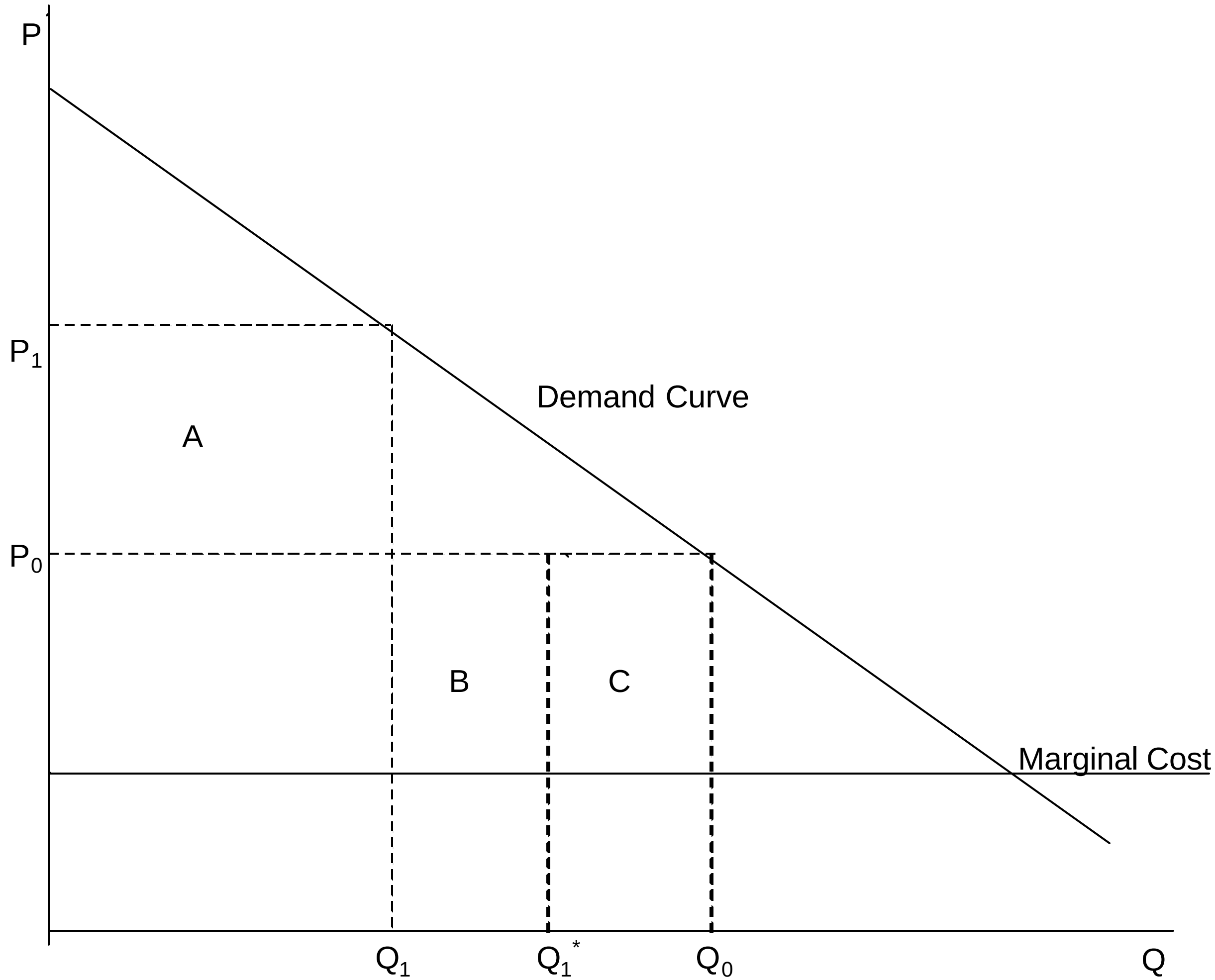


Figure 3

Competitive Effects: Reactions of Other Hospitals

- In general, competitors can be expected to follow *in part* a price increase from a merger that creates a dominate firm
- Critical loss analysis of merged firm price increase should take this into account
- Makes it more likely that a unilateral price increase will be profitable

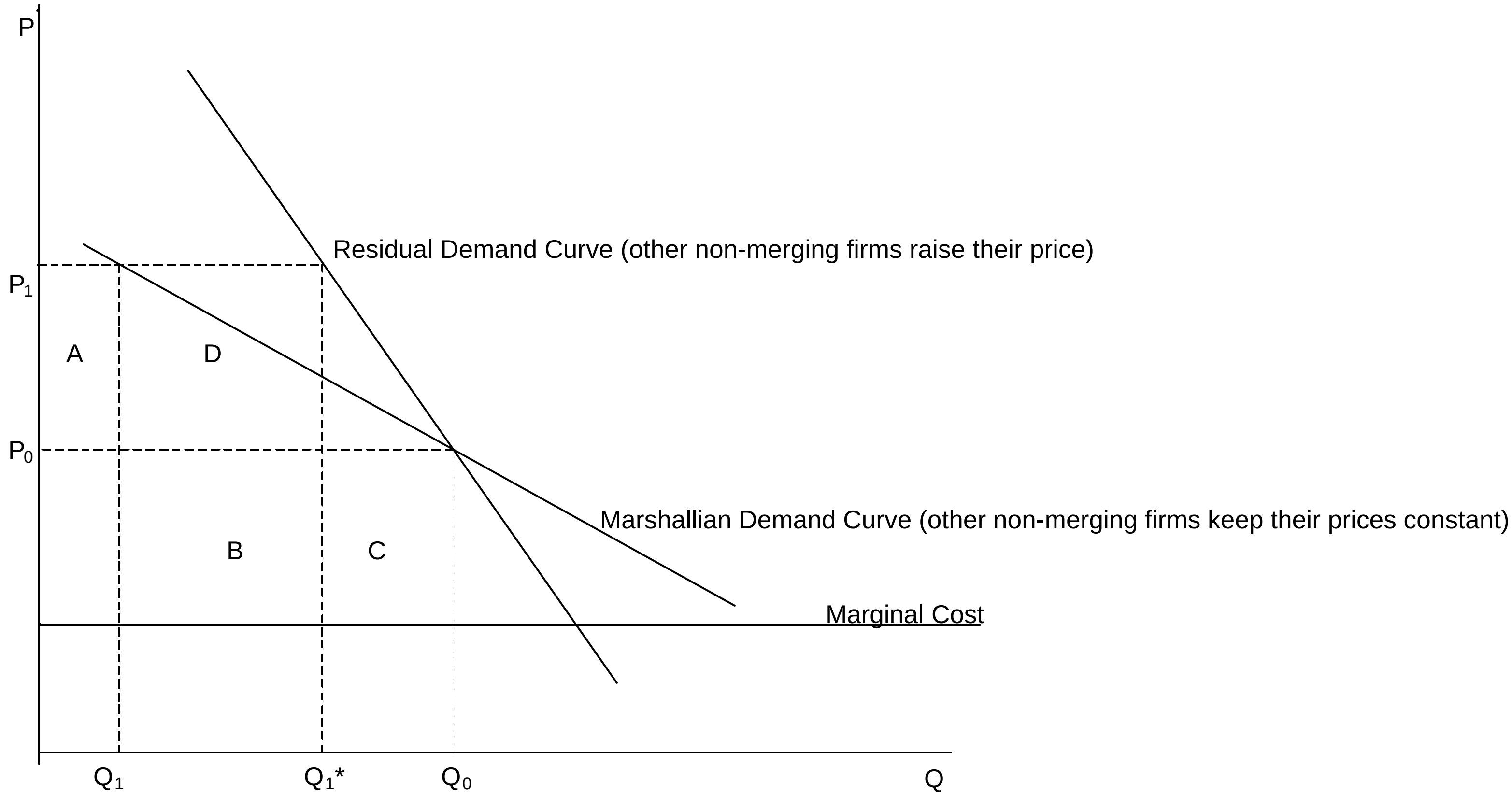


Figure 4

Areas defined by " ---------------- ".

Under the Marshallian demand curve, the price increase from P_0 to P_1 is not profitable because area A < area B + area C.

Under the residual demand curve, the price increase from P_0 to P_1 is profitable because area A + area D > area C.

Competitive Effects: Reactions of Other Hospitals

- Analyze whether other hospitals:
  - Expand their services post-merger
  - Increase their geographic draw areas

Tests of Courts' Analyses With Post-Merger Conduct

- Direct measure of mergers' effects on pricing
- Geographic market definition:
  - Testing whether migration patterns change with increased charges by zip code
- Analyzing competitive effects:
  - Differential price increases by merged firm
  - Pricing and supply responses of other hospitals
  - Check impact on non-price services

FTC Hospital Merger Retrospective

- Agencies are in a unique position to get the information needed to determine post-merger behavior
- Have resources to analyze post-merger behavior
- Can provide key empirical evidence
- Can test the Courts' pre-merger approaches to predicting the impact of a merger