UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
SAN FRANCISCO REGIONAL OFFICE

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MAR 1 3 1987

The Honorable Mary George
Hawaii State Senate
State Capitol
Honolulu, Hawaii 96813

Re: Senate Bill 213

Dear Senator George:

The Federal Trade Commission's San Francisco Regional Office and Bureaus of Competition, Consumer Protection, and Economics are pleased to respond to your request for comments on proposed Senate Bill 213.[1] S.B. 213 would repeal Chapter 323D, Hawaii Revised Statutes, thereby abolishing the state health planning and development agency and its functions, including the administration of the certificate of need ("CON") regulatory process.[2] For the reasons described in greater detail below, we strongly encourage repeal of CON legislation. There is no evidence that the CON regulatory process has served its intended purpose of controlling health care costs. Indeed, CON regulation may well increase prices to consumers by restricting supply of hospital services below the level that would exist in a non-regulated competitive environment.

Interest and Experience of the Federal Trade Commission

For more than a decade, the Federal Trade Commission has engaged in extensive efforts to preserve and promote competition in health care markets. The Commission and its

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[1]These comments represent the views of the San Francisco Regional Office, and the Bureaus of Competition, Consumer Protection, and Economics, and do not necessarily represent the views of the Commission or any individual Commissioner. The Commission has, however, voted to authorize their submission.

[2]S.B. 213 contains a number of provisions that primarily delete various references to the state health planning and development agency. These comments address only the issue of the repeal of the CON regulatory process.

staff have been active both in antitrust law enforcement and in advocacy of regulatory reforms, recognizing that competition in health care service markets, like other markets, will benefit consumers by strengthening incentives for providers to meet consumer needs. As a result of Commission antitrust enforcement efforts in the health care industry (including litigated cases and non-public investigations involving markets in many different areas of the United States), as well as economic analysis of CON regulation,[3] the Commission's staff has gained considerable experience with the economics of health care competition, and with the manner in which health planning regulation affects such competition.

CON Regulation is Unnecessary to Constrain Health Care Costs and Repeal of CON Laws Will Promote Competition and Benefit Consumers

CON regulation of hospitals has traditionally been based on the theory that unregulated competition would result in the construction of unnecessary facilities, unnecessary expansion of existing facilities, or unnecessary capital expenditures by hospitals. The assumption underlying this theory was that hospitals had an inherent tendency to expand or purchase unnecessary equipment. This tendency was not constrained by market forces because insured consumers of health care were covered by policies that required little or no out-of-pocket payment, making the consumers insensitive to price. Moreover, hospitals were often reimbursed by third-party payers on a retrospective cost basis, removing whatever incentive they might have to contain costs.

As a result of these forces, competition among health care facilities traditionally took place in terms of quality rather than price, although limited price competition existed.[4] Hospitals had an incentive to expend resources to provide wider ranges of diagnostic and therapeutic services and equipment, and more comfortable facilities. The concern expressed by health planners when CON regulation was created was that the cost of these improved, albeit underutilized, facilities would be passed along to consumers, thereby increasing the cost of health care. The purpose of CON regulation was not to assure that facilities were placed where needed; rather, it was to

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[3] See, e.g., Hospital Corp. of America, 106 F.T.C. 361 (1985), aff'd 807 F.2d 1381 (7th Cir. 1986); American Medical Int'l, Inc., 104 F.T.C. 1 (1984); Bureau of Economics, Federal Trade Commission, Certificate of Need Regulation of Entry Into Home Health Care (1986).

[4] See Hospital Corp. of America, supra at 478-79.

control the perceived tendency to provide duplicative facilities or services.[5]

Many of the assumptions supporting CON regulation are no longer valid.[6] Health care markets have changed substantially in the last few years. Third-party payers and consumers are no longer as insensitive to the prices of health care services. There has, accordingly, been a trend toward increased competition -- and, in particular, price competition -- among hospitals.[7] Such price competition may be stimulated by health maintenance organizations and preferred provider organizations, which are well-positioned to channel subscribers to hospitals offering lower rates. Improvements in conventional health benefit programs also provide subscribers with financial incentives (such as the requirement of co-payments) to channel themselves toward economical providers, including non-hospital providers.[8] Moreover, the recent trend toward use of prospective payments, and reimbursement by Medicare based on diagnostic related groups rather than cost, have required hospitals to become more cost conscious because some costs are no longer reimbursable. In addition, the probable elimination of any remaining incentives toward creation of excess capacity appears likely to deter health care facilities from making long term capital investments, the financial feasibility of which depend on shifting costs to third-party payers.[9]

An additional reason to eliminate CON legislation is provided by empirical evidence that suggests that such laws have not had the intended effect of controlling hospital costs through the prevention of expenditures on unnecessary beds, services, and equipment. Early studies of the effects of CON

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[5]See P. Joskow, Controlling Hospital Costs: The Role of Government Regulation 79 (1981).

[6]The United States Congress recently repealed the National Health Planning Act of 1974. See P.L. 99-660, §701 (1986).

[7]See, e.g., Hospital Corp. of America, supra at 480-82; Hospital Industry Price Wars Heat Up, Hospitals, Oct. 1, 1985, at 69.

[8]See Insurance Coverage Drives Consumer Prices, Hospitals, Nov. 1, 1985, at 91.

[9]See Raske, Association Seeks Sound Capital Pay Policy, Modern Healthcare, Nov. 7, 1986, at 120 (uncertainty about future of reimbursement for capital expenses is encouraging hospitals to make more conservative capital investment decisions for inpatient services).

regulation found that this regulatory scheme had no effect on constraining overall health care costs.[10] Rather, the CON regulatory process may have caused some hospitals to make substantial capital investments in areas not covered by CON controls.[11] Later studies reached similar conclusions, finding that the CON laws did not affect costs per unit of hospital output.[12]

Indeed, CON regulation can raise prices even in markets where incumbents are inclined to engage in vigorous price competition. If the effect of the regulation is to place a binding constraint on the supply of hospital care, market prices will be greater than they would be in an unregulated competitive environment. In markets where hospitals are inclined toward anticompetitive behavior, CON regulation can facilitate the attainment of anticompetitive objectives.[13]

Furthermore, there is evidence that the CON regulatory process may have the effect of increasing prices to consumers because it serves to protect firms in the market from competition from innovators and new entrants.[14] Although the CON process does not prohibit the entry or expansion of hospitals, or the development of new services, it generally places the burden on new entrants to demonstrate that a need is not being served by those currently in the market. Moreover, the process of preparing and defending a CON application is often extremely costly and time consuming. Competitors may even misuse the CON regulatory process for the purpose of

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[10]Salkever and Bice, Hospital Certificate-of-Need Controls: Impact on Investment, Cost, and Use (1979); and Salkever and Bice, The Impact of Certificate-of-Need Controls on Hospital Investment, 54 Millbank Memorial Fund Q. 185 (Spring 1976).

[11]Id.

[12]Policy Analysis, Inc.-Urban Systems Engineering, Inc., Evaluation of the Effects of Certificate of Need Programs (1980). See also Steinwald and Sloan, Regulatory Approaches to Hospital Cost Containment: A Synthesis of the Empirical Evidence, in A New Approach to the Economics of Health Care (1981).

[13]Hospital Corp. of America, supra at 497-98.

[14]Posner, Certificate of Need for Health Care Facilities: A Dissenting View, in Regulating Health Facility Construction 113 (C. Havighurst, ed. 1974).

excluding potential competitors from entering the market.[15] Firms in any given hospital market need not be as sensitive to price or to consumer demand for new services if they know that it will be difficult and expensive for new firms to enter the market and offer competitive prices or services.

The FTC's Bureau of Economics has recently conducted an empirical study that shows that CON laws with respect to home health care agencies increase the cost of health care to consumers.[16] The study analyzed data from over 1700 home health agencies, and found that such agencies do not generally have large unrealized economies of scale. Moreover, the study found that CON regulation, which is premised on the belief that unnecessary duplication of facilities results in diseconomies, did not contribute to the realization of the limited scale economies that may exist.[17] Finally, the study found that costs of providing a given quantity of home health services were higher on average in regulated markets.[18] That is, CON regulation was associated with increased, rather than decreased costs.

Conclusion

In sum, ongoing changes in the health care financing system, including prospective payment mechanisms and increased consumer price sensitivity fostered by private insurers, are eliminating the need for CON regulation. Moreover, the CON regulatory process does not appear to serve its intended purpose of controlling health care costs. Rather, it removes the competitive constraints on costs that might act as a control in the absence of regulation. Market forces are generally far superior to the decisions of governmental planners for allocating society's resources, and should be

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[15] See, e.g., St. Joseph's Hospital v. Hospital Corp. of America, 795 F.2d 948, 959 (11th Cir. 1986) (defendants' misrepresentations to state health planning body concerning plaintiff's CON application not protected from antitrust scrutiny). See also, Hospital Corp. of America, supra at 492.

[16] Bureau of Economics, Federal Trade Commission, Certificate of Need Regulation of Entry into Home Health Care (1986). Hawaii's health planning laws apply to home health agencies. See definition of "health care facility" in § 323D-41(4).

[17] Bureau of Economics, Federal Trade Commission, Certificate of Need Regulation of Entry into Home Health Care, at 65-86.

[18] Id. at 106.

allowed to operate absent demonstrable market failures.

For the foregoing reasons, we strongly support the passage of S.B. 213, and applaud your efforts on behalf of Hawaii consumers. We would be happy to answer any questions you may have regarding these comments, or provide any other assistance you may find helpful.

Sincerely,

Janet M. Grady

Janet M. Grady
Regional Director