Economists' Perspective on the Efficiency Defense in Provider Consolidations: What Works, What Doesn't Work, and What We Still Don't Know

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The Patient Protection and Affordable Care Act of 2010 (ACA) provides financial incentives that encourage health care providers to reduce the cost and improve the quality of patient care.[1] Among other things, the ACA links Medicare payments to patient outcomes ("risk-based reimbursement"). It also introduces Accountable Care Organizations (ACOs) that compensate hospitals based on bundled services and preventable Medicare readmissions, instead of the traditional fee-for-service model. In response, many health care providers have sought to consolidate—giving rise to hospital-hospital and hospital-physician group mergers—in hopes that joint ownership and the clinical integration that goes with it will enable them to satisfy the requirements of the ACA and qualify for the associated financial incentives.

Large or small, these providers must satisfy state and federal antitrust enforcers (collectively, the "agencies"). The agencies will evaluate whether the consolidation is likely to have an adverse effect on competition and result in higher prices for patient care. Inevitably, the merging providers will argue that consolidation is necessary to reduce costs, improve coordination of patient care, and ultimately improve patient outcomes and that these efficiencies more than offset any competitive concerns.

To date, no provider has convinced an antitrust enforcer that the claimed efficiencies are cognizable and sufficient to offset competitive concerns. To credit efficiencies, the agencies require them to be merger-specific and verifiable, and the courts have consistently set a high standard for meeting those requirements. This article reviews the antitrust oversight of provider mergers, and takes a closer look at the efficiency defense. What do parties mean by efficiencies? How do the agencies assess an efficiency defense? How does it work in practice? Looking at the lessons from litigated cases, what works and what doesn't?

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Antitrust Oversight of Provider Mergers

Most federal merger enforcement actions, whether involving health care providers or any other types of firms, are based on Section 7 of the Clayton Act, which prohibits mergers and acquisitions where the effect "may be substantially to lessen competition, or to tend to create a monopoly."[2] Mergers also may be challenged under Section 1 or Section 2 of the Sherman Act[3] or Section 5 of the Federal Trade Commission Act.[4] The Clayton Act was amended in 1976 by the Hart-Scott-Rodino Antitrust Improvements Act to require companies planning large mergers or acquisitions to notify the government of their plans in advance. Practitioners often refer to "reportable transactions" as those for which parties must notify the government under Hard-Scott-Rodino, and "non-reportable transactions" as those that do not meet the notification requirements. Both reportable and non-reportable transactions, however, can receive state and federal antitrust scrutiny.

Merger enforcement involves a complex interplay between state and federal agencies that sometimes coordinate to bring actions in the federal courts. If after review under the Merger Guidelines, an agency concludes that a proposed merger violates the law, the agency may attempt to obtain voluntary compliance by entering into a consent order with the parties. If a consent agreement cannot be reached, the agency may seek a preliminary injunction to block a proposed merger pending a full examination of the proposed transaction in the federal courts.

The 2010 Merger Guidelines issued by the Department of Justice and the Federal Trade Commission (FTC) are intended to provide a roadmap to the agencies' review of mergers.[5] As explained in the guidelines, the agencies "consider any reasonably available and reliable evidence to address the central question of whether a merger may substantially lessen competition." This evidence can include experience from prior transactions, information on the extent of head-to-head competition between the merging parties, and market shares and concentration in a relevant market. The agencies weigh evidence of adverse competitive effects against the likelihood of entry and the potential for efficiencies that might offset these concerns. They also factor in, if appropriate, the possibility of a flailing or failing firm argument.

Recent agency actions, both in health care and outside of health care, shed light on the standards the agencies apply to the efficiency defense.

What Are Efficiencies?

Efficiencies refer generally to improvements in the firms' production of output that leads to either lower costs or improved product quality (or both). In health care, providers seeking to merge have described a host of potential improvements from consolidation. These include the ability to engage in more risk-based contracting because of the ability to pool risk across a larger patient population.[6] They also include improved coordination of patient care, alignment of physician incentives, and incentives to invest in technologies like electronic medical records (EMR) software.[7] Some providers describe reductions in total medical expenditures from keeping care from going to more expensive academic medical centers, when a less expensive community hospital can provide the same care.[8] Others describe reductions in cost from exploiting economies of scale or reducing duplicative expenditures.[9]

Efficiencies offset concerns about anticompetitive effects only when the benefits of the contemplated improvements are likely to benefit consumers. Simply arguing that a merger reduces costs without connecting it to patient benefits is like saying the merger allows the providers to become more profitable. In order for efficiencies to translate to consumer benefits, they must lower quality-adjusted prices, through either lower prices or higher quality, or result in enhanced service or new products. In this regard, the agencies and the courts have adopted a consumer welfare standard.[10]

Efficiencies in the Merger Guidelines

In order to credit them under the Merger Guidelines, the agencies require efficiencies to be "cognizable."[11] Cognizable efficiencies are merger-specific and verifiable. That is, the efficiencies cannot be reasonably achieved through some less restrictive, alternative arrangements that do not create the competitive concerns arising from merger. Further, the efficiencies should not arise from anticompetitive reductions in output or service.[12] Moreover, they should not be "vague" or "speculative," but rather, verifiable by some reasonable means.[13] Such efficiencies are weighed against the potential anticompetitive effects of the merger, and "[t]he greater the potential adverse competitive effect of a merger, the greater must be the cognizable efficiencies, and the more they must be passed through to customers."[14]

The agencies also note that certain types of efficiencies will be regarded more favorably than others. Efficiencies resulting from the consolidation of production facilities that allow for a lower marginal cost of production will tend to be regarded favorably. Conversely, claims of more efficient research and development efforts will be viewed with skepticism, as they are difficult to verify and may be offset by the lack of competitive

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pressure to innovate. The agencies also note that estimates of efficiencies generated outside of the usual business planning process will be viewed with skepticism.[15]

Efficiency Defense in Practice

In practice, the courts have set a high standard for accepting efficiencies claims. Like the Merger Guidelines, the courts require efficiencies to be merger-specific and verifiable. In *Cardinal Health*, for example, although the court agreed that the merger would result in significant efficiencies, it noted that "the history of the industry over the past ten years demonstrates the power of competition to lower cost structures and garner efficiencies as well."[16] The court ruled against the defendants arguing that the immediate efficiencies that would be realized through the merger would not be enough to offset the long-term efficiencies that would not come to pass due to reduced competitive pressure.

Additionally, courts require that the cost savings resulting from a merger be passed along to consumers. In *Staples Inc.*, the defendants argued that two-thirds of the cost savings would be passed along to consumers, while the court observed that historically, only 15-17% of savings were passed along to consumers.[17] The court ruled against the merger in part because of how little of the potential savings might be passed along to consumers.

Discussed below are the key efficiency claims and court rulings for three litigated provider mergers: *Tenet Healthcare*, *Promedica*, and *St. Luke's*, respectively. The thrust of the arguments and outcomes are similar for other attempted provider mergers.[18]

Tenet Healthcare

In *Federal Trade Commission v. Tenet Healthcare Corp.*, Tenet Healthcare Corporation (Tenet) argued efficiencies in its defense of FTC's claim that the merger of two hospitals would harm competition. Tenet argued that the merger would allow the consolidated hospitals to control costs by managing excess capacity and reducing redundant overhead. Tenet also argued that through increased economies of scale, Tenet would be able to introduce previously unavailable procedures to the community, such as open heart surgery.[19]

The district court gave little weight to Tenet's asserted efficiencies, finding them speculative. It ruled that even if the efficiencies were realized, there was no evidence that the cost savings would be passed along to consumers. The court also disregarded arguments for increased service offerings because those were outside of the asserted relevant market.[20]

The Eighth Circuit reversed the district court's decision. The reversal, however, was based on insufficient evidence establishing the relevant market, not because of inappropriate treatment of the efficiency claims. In its ruling, the appeals court stated that "although Tenet's efficiencies defense may have been properly rejected by the district court, the district court should nonetheless have considered evidence of enhanced efficiency in the context of the competitive effects of the merger."[21]

ProMedica Health System

In *Federal Trade Commission v. ProMedica Health System*, the parties also argued efficiencies. The case involved ProMedica Health System, Inc.'s (ProMedica's) acquisition of St. Luke's Hospital, in Lucas County, OH.[22] ProMedica argued that the proposed merger would result in a number of efficiencies, such as avoiding certain capital expenditures and shifting certain types of patient care to less expensive facilities within the new hospital system.[23] The district court ruled against ProMedica, stating that the alleged efficiencies were speculative and not merger-specific. Further, even if the court were to credit some of the efficiency claims, they would not be enough to offset the ensuing harm to consumers from increased market power.

The court explained that efficiencies must benefit consumers and that changes that merely enhanced the parties revenues were *not* efficiencies.[24] As in the *Staples* case, the court found that ProMedica failed to provide sufficient evidence that cost savings would ultimately benefit consumers. The court also ruled that many of the proposed efficiencies were unreliable, not merger-specific, or both.[25] In addition, the court discounted the claimed efficiencies because they "appear[ed] designed for litigation."[26] Consistent with the Merger Guidelines, the court viewed projections of efficiencies generated outside of the normal business process with skepticism.[27] In this case, business planning documents purporting the efficiencies were contained under the header "antitrust review," and the expert report presented in trial was "to provide antitrust guidance." Had ProMedica been able to produce analyses showing efficiencies that were used to motivate the merger, rather than simply defend the merger against antitrust litigation, the court may have been more receptive.[28] Finally, the court also ruled that the health care reforms alone did not justify a merger. Had St. Luke's desired to establish an ACO or implement an EMR system, it could have done so without the merger.[29]

The Sixth Circuit upheld the district court's ruling. On the subject of efficiencies, the appeals court noted that "ProMedica did not even attempt to argue before the Commission, and does not attempt to argue here, that this merger would benefit consumers (as opposed to only the merging parties themselves) in any way."[30] In its ruling, the appeals court reaffirmed the idea that efficiencies may mitigate concerns of increased market power in a merger only if there is credible evidence that these efficiencies will benefit consumers.

St. Luke's Health System

Most recently, the parties argued efficiencies in Idaho-based St. Luke's Health System's (St. Luke's) acquisition of Saltzer Medical Group (Saltzer) in Nampa, ID.[31] St. Luke's is the largest hospital system in the Boise, ID area, with two hospitals in the Boise area and eight primary care physicians (PCPs) practicing in Nampa. Saltzer is an independent physician group with 41 physicians in Idaho, 34 of them practicing in Nampa.

The FTC challenged the acquisition claiming that the transaction would likely result in increased prices for primary care physician services sold to health plans. St. Luke's countered with an efficiency defense, arguing that "the merger will create efficiencies that will far outweigh any anticompetitive effects."[32] Citing the Berkeley Healthcare Report and the real-world examples of Kaiser Permanente in California and the Cleveland Clinic in Ohio, both integrated health systems, St. Luke's explained that the Saltzer acquisition would enable them to lower costs and to improve patient care. In particular, St. Luke's said that with a larger number of PCPs and a larger underlying patient population, they would be able to engage in more risk-based contracting. They also argued that patients would benefit from the more integrated health care delivery system, enabled in part by bringing the Saltzer physicians onto St. Luke's EMR system.

The plaintiffs countered St. Luke's claimed efficiencies. First, they observed that risk-based contracting did not require the employment model or a large employed physician base.[33] In particular, the plaintiffs pointed to smaller, independent physician groups in Idaho that already were engaging in some risk-based contracting and to the example of the VA hospital system, which contrary to Kaiser Permanente and the Cleveland Clinic, delivered integrated care without the employment model. Second, the plaintiffs agreed that EMR interoperability was important, but disputed that the acquisition was necessary to achieve the outcome,[34] pointing to St. Luke's affiliate program through which independent physician groups could join its EMR at some cost. The plaintiffs argued that there was evidence that several physician groups in the area were willing to participate in St. Luke's affiliate program.

The district court rejected St. Luke's claimed efficiencies on the basis that they were not merger-specific, and it concluded that St. Luke's efficiency defense could not overcome the fact that the acquisition was anticompetitive.[35] The court found that St. Luke's acquisition of Saltzer violated the Clayton Act and ordered divestiture.[36] The Ninth Circuit upheld the district court's ruling.[37] According to the appeals court opinion, "It is not enough to show that the merger would allow St. Luke's to better serve patients."[38] Moreover, "[t]he Clayton Act focuses on competition, and the claimed efficiencies therefore must show that the prediction of anti-competitive effects from the prima facie case is inaccurate."[39] This decision likely dampens the ability of health care providers in similar situations to successfully argue pro-competitive efficiencies.

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Key Takeaways: The Dos and The Don'ts

The ACA presents health care providers with incentives to merge, but providers hoping to argue that efficiencies will offset any harm from increased market power should be prepared with credible evidence to support such claims. When structural evidence suggests a presumption of anticompetitive harm, the potential gains from cognizable efficiencies will need to be sufficiently large. If the potential gains in market power are small, arguments for efficiency have a greater chance to be considered by the agencies and courts. However, the standards for such arguments to be considered are still high. To date, no provider has convinced a court that the claimed efficiencies are cognizable and sufficient to offset competitive concerns.

We summarize here the key dos and don'ts of assembling efficiency arguments.

In the "*don'ts*" column, don't:

- Rely on "trust me" arguments. You will need a reasoned basis, be that credible economic evidence or credible fact witness testimony.
- Rely on documents prepared for litigation.
- Assume that experience from outside of your relevant market, particularly if it is from a distant state, will suffice unless you make a reasoned argument for why it is informative.
- Assume that the burden is any less because you are contemplating a relatively novel transaction or business model.

In the "*dos*" column, do:

- Evaluate and debate the structural evidence, incorporating if appropriate why payer strategies like tiering and steering, in the relevant market, can temper competitive concerns.
- Present evidence of efficiencies from documents produced in the normal course of business. It is more persuasive if efficiencies were a motivating factor for the merger, rather than an afterthought to get the deal through.
- Attempt to evidence efficiencies, even if they are prospective. Strategies might involve: (a) looking at the before-after evidence from prior transactions involving one of the merging parties; (b) using evidence from other geographic areas but relating that evidence to the area of interest; (c) simulation modeling that posits the potential benefits; and (d) credible fact witness testimony explaining how and why the merger is necessary to achieve the stated goals.
- Explain how and how much of the claimed efficiencies would be passed on to consumers. Otherwise the efficiencies, even if they are proven to be cognizable, will not be credited as offsetting any potential competitive concerns.

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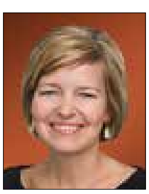

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Endnotes

1 U.S. Department of Health and Human Services, Key Features of Affordable Care Act by Year, *available at* www.hhs.gov/healthcare/facts/timeline/timeline-text.html.
2 Clayton Act § 7, 15 U.S.C. § 18.
3 Section 1 of the Sherman Act declares, "Every contract, combination in the form of trust or other, or conspiracy, in restraint of trade or commerce . . . ." to be illegal. Section 2 of the Sherman Act makes it illegal to "monopolize, or attempt to monopolize, or combine or conspire . . . to monopolize . . . ." *See* 15 U.S.C. §§ 1-2.
4 Section 5 of the Federal Trade Commission Act prohibits "[u]nfair methods of competition . . . and unfair or deceptive acts or practices . . . ."15 U.S.C. § 45.
5 U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, August 19, 2010 (hereafter *Merger Guidelines*), *available at* http://www.justice.gov/atr/public/guidelines/hmg-2010.html.
6 *FTC v. St. Luke's Health Sys., Ltd.*, No. 1:13-CV-00116-BKW, pp. 28-33 (D. Idaho Jan. 24, 2014) (hereafter *St. Luke's-Saltzer*).
7 *St. Luke's-Saltzer*, pp. 33-38.
8 Commonwealth of Massachusetts Health Policy Commission, *Review of Partner's Healthcare System's Proposed Acquisition of Hallmark Health Corporation* (HPC-CMIR-2013-4), Final Report, September 3, 2014 (hereafter *Partners-Hallmark*), Exhibit A: *Partners Healthcare and Hallmark Health's Response to Preliminary Report*, p. 24.
9 *FTC v. Tenet Healthcare Corp.*, 17 F. Supp. 2d 937, 948 (E.D. Mo. 1998) (hereafter *Tenet-Poplar Bluff*).
10 *Merger Guidelines*, §10. Economists describe a total welfare standard that includes both consumer and producer welfare. Total surplus may rise after an anticompetitive merger if the newly merged firms are able to produce more efficiently such that the cost savings would be enough to offset the loss in consumer surplus. *See* Oliver E. Williamson, *Economies as an antitrust defense: The welfare tradeoffs*, Am. Econ. Rev. 18-36 (1968).
11 *Merger Guidelines*, p. 30.
12 *Id.*
13 *Id.*
14 *Id.,* p. 31.
15 *Id.*
16 *FTC v. Cardinal Health, Inc.*, 12 F. Supp. 2d 34, 63 (D.D.C. 1998).
17 *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).
18 *See, e.g.,* Partners HealthCare's attempted acquisition of South Shore Hospital and Hallmark Health. *Commonwealth v. Partners Healthcare Sys., Inc.,* No. SUCV2014-02033-BLS2, 2015 Mass. Super. LEXIS 4 (Mass. Super. Ct., Jan. 30, 2015). *See also* the record in OSF/Rockford. *FTC v. OSF Healthcare Sys.*, 852 F. Supp. 2d (N.D. Ill. 2012).
19 *Tenet-Poplar Bluff* at 948.
20 *Id.*
21 *FTC v. Tenet Healthcare Corp.*, 186 F.3d 1045 (8th Cir. 1999).
22 *FTC v. ProMedica Health Sys., Inc.*, No. 3:11-cv-00047 (N.D. Ohio Mar. 29, 2011) (hereafter *ProMedica*).
23 *ProMedica*, pp. 65-72.
24 *Id.*, p. 67.
25 *Id.,* pp. 70-75.
26 *Id.,* p. 75.
27 *See Merger Guidelines*, p. 30.
28 *ProMedica,* pp. 75-76
29 *Id.,* at pp. 76-77.
30 *ProMedica Health Sys., Inc. v. FTC*, 749 F.3d 559, 571 (6th Cir. 2014).
31 *St. Luke's-Saltzer*, pp.28-38.
32 *Id.,* p. 28.
33 *Id.*, pp. 33-34.
34 *Id.*, pp. 34-38.
35 *Id.,* p. 47.
36 *Id.*
37 *Saint Alphonsus Med. Ctr. v. St. Luke's Health Sys., Ltd.*, No. 14-35173 (9th Cir. Feb. 10, 2015).
38 *Id.*, p. 28.
39 *Id.*

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