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Monica Noether

CRA International

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Economic Issues Relating to the *Evanston* Merger Remedy Order

Monica Noether*

Any remedy imposed on a merger that is thought likely to enhance market power is designed to restore competition in the market place to the level that would exist but for the combination of firms in question. However, the issues involved when a remedy is imposed prospectively can differ from those that are relevant when the remedy is mandated some time after a merger has taken place and the market has evolved, perhaps because of both the merger and the actions of other competitors and of consumers.

In the first situation, the pro- and anticompetitive effects of the merger are at least somewhat speculative, but the costs of undoing an integrated entity need not be considered. In the case of a consummated merger, it is more difficult to assess how the market would be functioning absent the merger, particularly if a substantial time period has elapsed. More importantly, restoring the ability of the merged firms to compete with each other and others may be difficult and costly if they have been substantially

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* The author served as an economic expert to the hospitals in the FTC's administrative proceeding challenging the merger. As such, she testified that it was her opinion that the merger had not harmed competition. Her comments here on the remedy do not reflect a change in position, but rather address the issue of whether the remedy is optimal in a world in which the FTC's conclusions about the merger's effect are true. The author thanks Sean May of CRA International for extensive assistance in the preparation of this paper.

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integrated. As a result, in this situation developing a remedy that completely "restores" competition may be impossible.

Mergers can have both pro- and anticompetitive effects. They can allow firms to function more efficiently or to increase the quality and scope of their offerings, thereby benefiting consumers. Conversely, they may permit anticompetitive increases in price or reductions in quality that harm consumers. The optimal remedy preserves the benefits of the merger, while mitigating the harm. Unfortunately, it is not always possible to achieve both of these objectives completely and simultaneously. This is particularly the case post-consummation, when the merged entity may have made operational changes to affect benefits. As a result, in some situations, merger remedies must balance multiple objectives and may not represent the "first best" solution to any single objective.

This clearly applies to the remedy that the Federal Trade Commission ("FTC") has ordered in the Matter of Evanston Northwestern Healthcare Corporation ("ENH"), which challenged a merger between Evanston and Glenbrook Hospitals ("Evanston") and Highland Park Hospital ("Highland Park") more than four years after the transaction was completed. Among other provisions, this order requires Evanston and Highland Park to establish separate negotiating teams so that Managed Care Organizations ("MCOs") are able to play the two facilities off against each other. It also prevents either hospital from making a contract with it contingent on the MCO also contracting with the other facility.

Many commentators have criticized the separate negotiating teams as being insufficient to restore meaningful competition. These views are summarized in an amicus

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curiae brief submitted by a number of professors of economics in opposition to the order initially proposed by the FTC ("economics professors").[1] They argued that, as a matter of basic economic principle, the separate negotiating teams proposed in the order would each have unilateral incentives not to price aggressively, given their common ownership structure. The economics professors accept the FTC's finding that Evanston and Highland Park had been viewed by MCOs who were building hospital networks as sufficiently close substitutes that they substantially constrained each other pre-merger. Based on this premise, they argued that post-merger, the separate negotiating teams will behave differently than they had before the combination when, allegedly, they believed that they could lose substantial volume to the other if they did not price their services competitively. Post-merger, each negotiating team will recognize that at least some of the volume that its hospital will lose by offering only a supra-competitive price will go to the other hospital, and as a result, the implied loss from such pricing is less than it would be if the two hospitals had remained independent. While this economic principle is undisputed in the context of the assumption that the hospitals were close substitutes to many consumers implied in the FTC's decision, it ignores any competitive repositioning that other hospitals in the area have undertaken, or any shifting in patient preferences, as both have responded to the alleged anticompetitive behavior that has occurred since merger took place over eight years ago.

The economics professors also worry about the enhanced probability for coordinated behavior with respect to service allocation between the two hospitals. In

[1] Brief *Amicus Curiae* of Economics Professors, In the matter of *Evanston Nw. Healthcare Corp.*, FTC Docket No. 9315 (Oct. 16, 2007), *available at* http://www.ftc.gov/os/adjpro/d9315/071017econprofsamicusbrief.pdf.

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particular, they suggest that the order does not prevent the combined institution from creating two campuses that specialize in different services—for example, ENH could eliminate cardiac surgery at Highland Park Hospital, while moving all obstetrics there. In this way, they argue, both hospitals would become "must haves" to MCOs. This argument flies in the face of the substantial resources—more than US$120 million—that ENH has invested to upgrade and integrate the Highland Park facility into Evanston. These resources were expended despite the substantially enhanced market power supposedly resulting from the merger.

The substantial benefits from the merger of Evanston and Highland Park, combined with the time that has passed since it was consummated, make a divestiture remedy particularly costly to the ultimate consumers: the patients. While the FTC downplays the importance of efficiencies or quality enhancements that resulted from the merger, it acknowledges that:

> [T]his is a case in which a critical improvement was made to Highland Park after the merger was consummated (namely, the development and implementation of a cardiac surgery program). Second, and most important, this case involved a retrospective challenge that was made after the key improvement had already been made at Highland Park.[2]

Indeed, the city of Highland Park expressed substantial concern over a possible divestiture, arguing that divestiture creates "the substantial possibility that the benefits of the merger to the Highland Park community will be lost."[3]

[2] Opinion of the Commission on Remedy (by T. Rosch), In the matter of Evanston Nw. Healthcare Corp., FTC Docket No. 9315 (Apr. 24, 2008), *available at* http://www.ftc.gov/os/adjpro/d9315/080428commopiniononremedy.pdf.

[3] Motion of the City of Highland Park for Leave to File Brief Amicus Curiae in Support of Evanston Northwester Healthcare Corporation, In the matter of Evanston Nw. Healthcare Corp., FTC Docket No.

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Both of these factors indicate that, even if divestiture would more completely restore competition between Evanston and Highland Park Hospitals to its pre-merger state, it would not be the optimal outcome for consumers. Rather, the substantial costs imposed by divestiture must be counterbalanced against its benefits. In this case, at the very least, Highland Park Hospital would lose its cardiac surgery (and associated interventional cardiology) program, its access to EPIC, the sophisticated medical record system implemented by ENH post-transaction, and its integrated academic medical staff. Since "Highland Park Hospital's operations have been so thoroughly integrated into ENH […] it would be difficult, if not impossible, to separate the hospitals without diminishing Highland Park Hospital and harming consumers."[4]

The fact that the merger occurred over eight years ago is also relevant. This is not a situation in which a merger has not yet occurred and it is evident that two competing facilities are each viable firms. Instead, given the extent to which the two facilities have been integrated and the financial resources that have been spent to upgrade Highland Park Hospital, it is not all obvious that Highland Park could today be an effective competitor as an independent facility or as a part of a different hospital system. As the FTC notes, "a long time has elapsed between the closing of the merger and the conclusion of the litigation. This […] would make a divestiture much more difficult, with a greater risk of unforeseen costs and failure."[5] Regardless of whether the improvements

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9315 (Dec. 16, 2005), *available at* http://www.ftc.gov/os/adjpro/d9315/051216mohighlandparkfileamicus.pdf.

[4] *Id.* at 6.

[5] Opinion of the Commission (by D. Majoras), In the matter of Evanston Nw. Healthcare Corp., FTC Docket No. 9315 (Aug. 6, 2007), at 89, *available at* http://www.ftc.gov/os/adjpro/d9315/070806opinion.pdf.

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to Highland Park Hospital were "merger-specific", they have benefited consumers and undoing them at this point would impose substantial costs.

The ideal remedy both restores competition to its pre-merger state and maintains the benefits of the merger. However, it may not be possible fully to accomplish both of these objectives. In this situation, the appropriate remedy goes as far as possible toward each objective while not undoing the other. The FTC's remedy, which requires Evanston and Highland Park Hospitals to use separate, fire-walled negotiating teams to deal with MCOs, should enable MCOs to play one facility off against each other nearly to the same extent that they could before the merger, particularly since the Order also forbids ENH from bundling its facilities in MCO contracting. At the same time, while the separate negotiating teams will raise the costs of managed care contracting for ENH, the vast majority of the benefits that the merger provided should be preserved.

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