California AG Considers Cross-Market Effects in Merger Review and Conditional Approval of USC Health System and Methodist Hospital Affiliation

As federal agencies including the FTC and DOJ step up antitrust enforcement efforts in response to Biden's executive order to revamp competition in the healthcare market, more and more healthcare entities are turning to less traditional consolidation that did not previously trigger antitrust scrutiny, such as "cross-market" mergers, which involve providers that do not directly compete in the same geographic market.[1] This month in Litigation and Enforcement Highlights, we take a look at the latest merger review and conditional approval of a proposed cross-market transaction in California, the third of its kind in the past year.

California continues to be on the forefront of state healthcare antitrust enforcement. Pursuant to California law, the attorney general has the authority to review nonprofit hospital transactions in the state based on criteria that includes whether the merger will serve the public interest and its potential effects on the availability or accessibility of health care services to the affected community.[2] Following the AG's landmark antitrust action against Northern California health system Sutter Health for anticompetitive conduct, the AG's office is further using its merger review authority to scrutinize healthcare mergers in the state to prevent consolidation before they could lead to anticompetitive effects. In recent months, the rise of cross-market transactions has not escaped the AG's attention. Based on empirical evidence and theoretical foundations, antitrust experts have increasingly raised concerns about potential anticompetitive cross-market effects of mergers. Following the conditional approval of the cross-market mergers of Cedars-Sinai and Huntington Memorial and Acadia Healthcare and Adventist Vallejo in 2021, the AG similarly imposed conditions based on cross-market concerns on a third merger, between USC Health System and Methodist Hospital of Southern California.

Initially announced in November 2021, the affiliation would combine the 348-bed Methodist Hospital (MHSC), which is a non-profit based in Arcadia, California in the San Gabriel Valley, and USC Health System (USCHS), a non-profit subsidiary of the University of Southern California that operates facilities in Los Angeles County including Keck Hospital and Verdugo Hills Hospital. To assess the competitive impact of the proposed transaction, the AG's office commissioned independent experts Richard Scheffler and Dan Arnold of UC Berkeley's Petris Center, with whom The Source closely collaborates on various research projects.[3]

Competitive Impact Analysis

Defining the relevant product market and geographic market as general acute care (GAC) services in San Gabriel Valley, the expert analysis issued in April 2022 indicated that while the transaction poses no significant horizontal competition concern based on pre- and post-merger HHI analysis, it creates the risk of cross-market price effects. According to the expert report, USCHS (specifically Keck Hospital) is considered a must-have in-network provider to health plans due to its market power in LA County, even though its facilities are outside of the San Gabriel Valley, where MHSC is located. Examining the entities' rates, the report also noted that USCHS's Keck has the fourth highest commercial hospital prices in LA County, while MHSC 's prices are half of Keck's. Given USCHS's market power and bargaining leverage, the acquisition of MHSC would allow USCHS to tie the hospitals together in insurance negotiations, leading insurers to expect MHSC prices to increase post-transaction.

Based on this analysis, the report recommended a number of competitive impact conditions to reduce the risk of anticompetitive cross-market effects from the transaction.

Conditions Imposed on Transaction

Following the recommendations of the expert report, on June 3, the AG gave conditional approval to the proposed transaction with a list of conditions to address competition, quality, and access concerns. The conditions imposed in this case mirror those in both the Cedars-Sinai/Huntington and Acadia/Adventist conditional approvals, which include price caps and bans on anticompetitive contract terms. Specifically, the competitive impact conditions that address competition require:

1) Prohibition of anticompetitive contracting practices (for 10 years with potential 3-year extension)

1. Prohibition of anticompetitive practices including "bundling" or "all-or-nothing" contracting;
2. Prohibition of penalizing a payer for contracting with only individual hospitals instead of all affiliated hospitals;
3. Prohibition of interference with payer benefit designs that reward providers for affordability or quality such as narrow, tiered, steering, or value-based benefit designs;

2) Price cap: Annual price increases for contract renewals not to exceed 4.8% per year (for 5 years with potential 3-year extension);

3) Monitor and Reporting:

1. Independent monitor appointed by the AG's office to oversee compliance with competitive impact conditions (for 10 years with potential 3-year extension);
2. Detailed reporting of compliance with conditions each year (for 10 years).

Other conditions imposed in the conditional approval also address concerns of access and quality, such as requirements for the entities to maintain services and investments, participate in Medicare and Medicaid programs, provide charity care and community benefits, and continue capital improvements. All of these conditions are designed to prevent USCHS from leveraging its market power to demand higher reimbursement rates at MHSC or Keck in insurance negotiations, and thereby raise prices for consumers.

Following the model of Cedars-Sinai/Huntington and Acadia/Adventist, it appears that California has forged a new path in its merger review with a set of competitive impact conditions aimed to address and reduce potential anticompetitive effects of healthcare consolidation in the state. Notably, its review and analysis consider not only traditional horizontal effects, but also cross-market effects that many enforcement agencies tend to overlook. With three conditional approvals based on cross-market analysis, California is leading the way and could serve as a model for other state and federal agencies in their enforcement guidelines of non-horizontal provider consolidation.

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[1] *See* Jaime S. King & Erin Fuse Brown, The Anti-Competitive Potential of Cross-Market Mergers in Health Care, 11 ST. LOUIS U. J. HEALTH L. & POL'Y 43 (2018); Dafny, Ho and Lee, The Price Effects of Cross-Market Mergers: Theory and Evidence from the Hospital Industry, RAND Journal of Economics (April 2019); Matthew S. Lewis & Kevin E. Pflum, Hospital systems and bargaining power: evidence from out-of-market acquisitions, Rand Journal of Economics (August 2017).

[2] Cal. Corp. Code §§ 5914 et seq.

[3] See the Market Consolidation and Provider Contracts key issue pages and the forthcoming Cross-Market Transactions key issue page on The Source on Healthcare Price & Competition at http://sourceonhealthcare.org.