No. 16-2365

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

FEDERAL TRADE COMMISSION *et al.*,
Appellants,

v.

PENN STATE HERSHEY MEDICAL CENTER *et al.*,
Appellees.

On Appeal from the United States District Court
for the Middle District of Pennsylvania
No. 1:15-cv-2362 Hon. John E. Jones III

CORRECTED REPLY BRIEF OF THE FEDERAL TRADE COMMISSION AND THE COMMONWEALTH OF PENNSYLVANIA

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INTRODUCTION AND SUMMARY

The district court, defendants, and the Government agree that the relevant product market is GAC services "sold to commercial payors." Defendants agreed with the Government on how prices for GAC services are set: "[p]ayors and hospitals bargain over prices, and the outcome depends on relative bargaining strength." Def. Br. 17. Defendants also agree that the proper analytical tool for defining a geographic market and answering the question where insurers − the relevant customers for purposes of this analysis − can practically turn for alternative suppliers to the merging parties is the "hypothetical monopolist test" prescribed in the *Horizontal Merger Guidelines* ("*Guidelines*"). Def. Br. 18.

In light of this conceded framework, the district court asked the wrong question and arrived a clearly wrong answer. It failed to ask the relevant question: whether insurers faced with a price increase by a hypothetical monopolist of all Harrisburg area hospitals (applied to at least one of defendants' hospitals) could substitute outside hospitals and form a marketable network without any Harrisburg area hospitals to defeat the price increase. This analytical failing is legal error. The court also failed to apply the hypothetical monopolist test correctly and consistently with precedent. Defendants cannot obscure these errors by asserting that the decision is "fact bound" merely because the court heard several days of testimony and received numerous exhibits into evidence. The court's assessment

of the geographic market is also contrary to the clear weight of the evidence and thus clearly erroneous.

The court's errors are not salvaged by its assessment of the "equities." Had the court correctly analyzed the geographic market, it necessarily would have found the merger presumptively unlawful. Defendants do not claim that the court conducted a proper efficiencies analysis to determine whether defendants had proved the extraordinary efficiencies required to rebut this presumption. The court's cursory review of defendants' claimed benefits of the merger under the guise of equities in no way justifies the transaction.

ARGUMENT

I. THE DISTRICT COURT'S GEOGRAPHIC MARKET ANALYSIS WAS LEGALLY INCORRECT AND CLEARLY ERRONEOUS.

A relevant geographic market is "the area in which a potential buyer may rationally look for the goods or services he or she seeks." *Hanover 3201 Realty, LLC v. Vill. Supermarkets, Inc.*, 806 F.3d 162, 183-84 (3d Cir. 2015). While acknowledging that the hypothetical monopolist test is appropriate for defining the

geographic market,[1] the court failed to apply it correctly and reached a decision untethered to the commercial realities or the relevant evidence.

A. The District Court Failed To Apply The Proper Test For Determining A Relevant Geographic Market.

"Although market definition is generally regarded as a question of fact, a trial court's determination of the market may be reversed where that tribunal has erred as a matter of law." *Amer. Motor Inns, Inc. v. Holiday Inns, Inc.*, 521 F.2d 1230, 1252 (3d Cir. 1975) (concluding that district court "did not apply the proper legal standard" in deciding the relevant product market). Indeed, "the preponderance of authority holds that the determination of a relevant market is composed of the articulation of a *legal* test which is then applied to the *factual circumstances* of each case" and, as a result, the "formulation of the market tests may be freely reviewed on appeal as a matter of law." *White & White Inc. v. Amer. Hosp. Supply Corp.*, 723 F.2d 495, 499-500 (6th Cir. 1983); *see also Allen-Myland, Inc. v. Int'l Bus. Machines Corp.*, 33 F.3d 194, 201-04 (3d Cir. 1994) (reversing district court's product market definition because errors in "formulating

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[1] Courts routinely apply the hypothetical monopolist test to define a relevant market. *See In re Southeastern Milk Antitrust Litig.*, 739 F.3d 262, 282 (6th Cir. 2014) ("the hypothetical monopolist is 'a useful framework for organizing the factors the courts have applied in geographic market definition.'") (quoting 2 Earl W. Kintner, et al., Federal Antitrust Law § 10.15 (2013)); *St. Alphonsus Med. Ctr. Nampa, Inc. v. St. Luke's Health Sys., Ltd.,* 778 F.3d 775, 784 (9th Cir. 2015); *FTC v. Whole Foods Mkt., Inc.*, 548 F.3d 1028, 1038 (D.C. Cir. 2008); *Atl. Exposition Servs. Inc. v. SMG*, 262 F. App'x 449, 452 (3d Cir. 2008).

or applying legal principles constitute reversible error); *Bose Corp. v. Consumers Union of U.S., Inc.*, 466 U.S. 485, 501 (1984) (clearly erroneous standard "does not inhibit an appellate court's power to correct … a finding of fact predicated on a misunderstanding of the governing rule of law."). Here, the court erred in formulating and applying the legal standard in multiple ways.

First, despite acknowledging that this case involves the sale of GAC services *to insurers*, the court failed to connect the dots and apply the hypothetical monopolist test to insurers. Defendants do not and cannot contend otherwise. The court considered only whether hospitals outside the Harrisburg area are alternatives that some *patients* (not insurers) would utilize if defendants (not a hypothetical monopolist of *all* Harrisburg area hospitals) increased prices post-merger. App.13. That approach is divorced from the economic reality of where insurers can go for alternative suppliers. It is also contrary to recent case law, which recognizes that insurers are the relevant customers for purposes of conducting the hypothetical monopolist test. Gov. Br. 36 n.6[2]; *see also Berlyn Inc. v. Gazette Newspapers, Inc.*, 73 F. App'x 576, 583 (4th Cir. 2003) (recognizing importance of applying market definition tests to the correct "relevant consumer").

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[2] In *St. Luke's*, the Ninth Circuit affirmed the district court's finding that the geographic market was the Nampa, Idaho area because "a hypothetical … monopolist could profitably impose a SSNIP on insurers." 778 F.3d at 784-85.

The court thus disregarded the buyer-focused inquiry this Court requires, *i.e.,* where the buyer (insurer) can rationally look for alternative suppliers of GAC services (hospitals). *Pa. Dental Ass'n v. Med. Serv. Ass'n of Pa.,* 745 F.2d 248, 260 (3d Cir. 1984); *U.S. Horticultural Supply v. Scotts Co.*, 367 F. App'x 305, 311 (3d Cir. 2010) (Fisher, J.). If insurers would likely pay a hypothetical monopolist of all Harrisburg hospitals a SSNIP at one of the merging firm's hospitals and could not substitute hospitals outside the Harrisburg area to render the price increase unprofitable, then the Harrisburg area is a proper market. But the court never asked that question, rendering its analysis legally flawed.

Second, the district court applied an economically unsound test for defining the geographic market in holding that the Government's proposed market failed because "it is not one in which 'few patients leave … and few patients enter.'" App.13 (quoting *Little Rock Cardiology Clinic PA v. Baptist Health*, 591 F.3d 591, 598 (8th Cir. 2009)). The court effectively applied the "Elzinga-Hogarty" test, an economic approach that has been soundly discredited in the health-care context and courts have not used to analyze the geographic market for mergers of healthcare providers in over a decade.[3] Gov. Br. 40 n.7. By ignoring the bargaining

[3] Recognizing the court's error and the Elzinga-Hogarty test's shortcomings, defendants insist that the court did not apply it because it did not use those exact words. Def. Br. 33 n.12. However, by requiring that the Government establish a market in which few patients enter and few patients leave, the court applied the textbook definition of Elzinga-Hogarty.

dynamics between hospitals and insurers and attempting to define the geographic market based on patient flows, the court employed an outdated economic model. *Kimble v. Marvel Entertainment, LLC*, 135 S. Ct. 2401, 2412-13 (2015) (antitrust law "necessarily turn[s] on [an] understanding of economics" and must adapt as economic understanding evolves); *Brown Shoe Co. v. United States*, 370 U.S. 294, 336 (1992) (market definition must conform to the "commercial realities" of the industry).

As the Government's expert and *amici* healthcare economists (including Professor Elzinga) have stated, the economic literature rejects the use of the Elzinga-Hogarty model for analyzing geographic markets in hospital mergers. Econ. Br. 12-15. This is because "most insured patients do not face the full reimbursement price of provider services … rather than reflecting responses to price differences, patient travel patterns largely reflect other factors…." *Id*. at 14-15. As a result, the Elzinga-Hogarty method may often lead to defining overly broad geographic markets in hospital cases. *Id.*

Defendants therefore misplace their reliance on older hospital merger cases in which the government attempted to define the relevant market using the Elzinga-Hogarty method. Def. Br. 32-33.[4] In *Freeman* and *Tenet*, the Eighth

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[4] *See FTC v. Freeman Hosp.*, 69 F.3d 260, 269-70 n.14 (8th Cir. 1995); *FTC v. Tenet Health Care Corp.*, 186 F.3d 1045, 1051 (8th Cir. 1999); *California v. Sutter Health Sys.*, 130 F. Supp. 2d 1109, 1120 (N.D. Cal. 2001).

Circuit rejected the government's proposed geographic markets as too narrow because the government had failed to show which hospitals patients could turn to as alternatives to the merging parties. 69 F.3d at 271; 186 F.3d at 1052. Neither case considered a relevant market that focused on commercial insurers which negotiate prices of and pay for GAC services. As the *amici* economists explain, subsequent empirical research revealed that "hospital mergers that combine closely competing hospitals (when sufficient other closely substitutable hospitals are not present) have resulted in substantial post-merger prices increases" even though such mergers would likely be approved if the market were defined using the Elzinga-Hogarty test. Econ. Br. 13.[5] The recent authorities the Government cites reflect this modern economic thinking. Defendants' contention that the older cases they rely on came out differently because of "different facts," Def. Br. 33, is untrue. They came out differently because of a fundamentally different analytical approach. The court's decision employs an outdated methodology.

Raising a strawman argument, defendants protest that the Government has ignored patients outside the Harrisburg area and thereby proposed a theory with

[5] *Amici* States Attorneys General explain these studies in detail. For instance, the *Sutter* case on which defendants rely rejected the government's proposed market based on an assumption that patients' willingness to travel to more distant hospitals would defeat a price increase. That proved incorrect. An FTC staff economist's subsequent study showed that the merger led to 23-50% higher prices. States' Br. 11.

"no limiting principle." Def. Br. 26. They assert that, according to the Government, "it matters only whether a subset of patients – however small – lives near a group of hospitals and prefers to receive care there," and that such an approach can justify markets as small as the square block surrounding a particular hospital. *Id.* (citing *Little Rock Cardiology,* 591 F.3d at 599). However, the hypothetical monopolist test *is* the limiting principle. The test does not simply ask whether a majority of patients in the proposed market use the merging hospitals, but rather whether hospitals outside the proposed market might serve as substitutes in insurer networks to prevent the exercise of market power.

Defendants' claim that the Government's choice of the Harrisburg area is somehow "gerrymandering" is likewise groundless. The Government conducted its inquiry based on an objective analysis of the data, which accounted for patients' preferences *both* inside and outside the Harrisburg area, App.843-44, 327:23-328:17, as well as the documents and testimony. Insurers' testimony made clear that they consider the Harrisburg area a distinct market for purposes of marketing their health plans. They build their provider networks based on the demand of Harrisburg area patients when marketing products to Harrisburg area employers, and do not consider hospitals in other areas, such as York and Lancaster, to be substitutes. Gov. Br. 13-15, 18-19. Defendants' own documents confirm that the

Harrisburg area is a distinct market. Gov. Br. 19.[6] Nor do the results of the hypothetical monopolist test in this case suggest that it might lead to absurdly small markets. The Harrisburg area spans nearly 2,000 square miles and contains approximately 683,000 people. App.355-56. Defendants' professed concern about "limiting principles" is unfounded.

Indeed, it is the district court's improper focus on the size of Hershey's service area that is legally erroneous and lacks a limiting principle. The court stated that a geographic market must "include[] the area in which a defendant supplier draws a sufficiently large percentage of its business." App.12. But this requirement was created out of whole cloth in *Little Rock Cardiology*, a monopolization case, and none of this Court's decisions (or any other's) have taken that approach.[7] A hospital's service area is *not* synonymous with the relevant geographic market. *See Gordon v. Lewistown Hosp.*, 423 F.3d 184, 212 (3d Cir. 2005) ("[a]bsent more, however, a primary service area does not equate to the

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[6] For example, when asked after this action was filed to "further split" patient data in order to minimize the appearance of competition between defendants, a Hershey employee replied "[t]he unfortunate circumstance is that there isn't a big enough other player in the Harrisburg market … there is a natural consumer mindset to go to both organizations, and thus competition exists… *there's no way to spin it to make it look better*." App.912-13 (emphasis added).

[7] The only cases cited in *Little Rock Cardiology* for this proposition do not actually support it. *Morgenstern v. Wilson*, 29 F.3d 1291, 1296 (8th Cir. 1994); *Tampa Elec. Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961).

relevant geographic market"); *Tunis Bros. Co., Inc. v. Ford Motor Co.*, 952 F.2d 715, 726 (3d Cir. 1991) ("the geographic market is not comprised of the region in which the seller attempts to sell its product, but rather is comprised of the area where his customers would look to buy such a product").

B. The District Court's Rejection of the Harrisburg Area as a Relevant Geographic Market Was Clearly Erroneous.

In addition to asking the wrong question, the district court reached the wrong result in concluding that the Harrisburg area is not a relevant geographic market. That finding was clearly erroneous, contrary to the clear weight of the evidence, and "completely devoid of a credible evidentiary basis." *Shire U.S., Inc. v. Barr Labs, Inc.*, 329 F.3d 348, 352 (3d Cir. 2003); Gov. Br. 30.

1. The Record Conclusively Demonstrates That a Hypothetical Monopolist Could Impose a SSNIP.

The district court's decision was unmoored from and completely ignored the record evidence that conclusively establishes that the Harrisburg area is a relevant geographic market. Defendants attempt to obscure this fact by arguing that the court was not required to cite every piece of evidence it relied on (Def. Br. 34), but the fact remains that the court cited *no* evidence presented by the Government, including testimony from insurers and the Government's expert, addressing whether the hypothetical monopolist test was satisfied. The court simply noted that the FTC argued that the two largest insurers "would not exclude the proposed

merged entity from their networks," and observed only that "Defendants heartily disagree" without further analysis. App.11. This failure to even discuss the evidence reveals the court's fundamental misunderstanding of the market and constitutes clear error. *Edwards v. Wyatt*, 335 F.3d 261, 273 (3d Cir. 2003) (district court's failure to consider "highly significant and material" evidence was clearly erroneous).

The evidence the court ignored included consistent sworn testimony and contemporaneous business documents from insurers, and from defendants themselves. The evidence showed that patients living in the Harrisburg area overwhelmingly prefer to receive care at local hospitals. Neither the court nor defendants dispute the data showing that 91% of commercially-insured patients in the Harrisburg area (drawn from roughly 700,000 residents) stay within the area when seeking GAC services, and the median travel time is 15 minutes. App.72, 315:18-20; App.404; Gov. Br. 10. A hypothetical monopolist of Harrisburg area hospitals would own all the hospitals within a 30-minute drive of downtown Harrisburg: Pinnacle's three hospitals, Hershey, Holy Spirit, Good Samaritan, and Carlisle Regional. The relevant question is whether insurers would pay a price increase of 5% (or more) to avoid losing network access to a system comprised of all these hospitals. The answer is unequivocally "yes."

Central Pennsylvania's two largest insurers testified that they would not be able to successfully market a network to Harrisburg area employers that did not include the combined Hershey/Pinnacle. Gov. Br. 37-38. Their testimony was proven correct by the actual experience of one small insurer that was unable to successfully market a network to Harrisburg area employers without either Hershey or Pinnacle, despite having many hospitals in-network outside the Harrisburg area, including in York and Lancaster counties, and offering a substantial discount. *Id.* at 13-14. And testimony from the two largest insurers makes clear that (i) the separate existence of Hershey and Pinnacle has allowed them to negotiate more favorable prices in the Harrisburg area market; (ii) the merger would increase defendants' bargaining leverage; and (iii) as a result of this increased leverage they would be forced to pay or were concerned they would have to pay increased prices to the merged firm. *Id.* at 15-17. This evidence establishes that a hypothetical owner of just two Harrisburg area hospitals (defendants) could profitably impose a SSNIP; thus, so too could a hypothetical monopolist of all five health systems in the Harrisburg area.

2. Defendants' Arguments Do Not Rebut the Government's Evidence Proving the Geographic Market.

a. Insurers' Testimony Shows That the Harrisburg Area Is a Relevant Antitrust Market.

Defendants assert that the Government distorted the insurers' testimony "beyond recognition." Def. Br. 12. Not true.

Payor A: Payor A's representative clearly testified that the separate existence of Hershey and Pinnacle gave Payor A the leverage to obtain lower prices in contract negotiations. Specifically, in 2014, Pinnacle demanded significant rate increases and threatened to go "out-of-network" with the insurer. Payor A countered by threatening to exclude Pinnacle and form a network with Hershey and Holy Spirit.[8] This response helped Payor A obtain lower prices from Pinnacle. App.958-59, 40:16-42:6.

At his deposition, this individual testified how the merger would eliminate this bargaining dynamic:

> Q. Okay. And [Payor A] would be concerned about Hershey and Pinnacle merging because the combined entity would have increased bargaining leverage with [Payor A]. Is that correct?
> A. Yes.
> Q. []In the absence of an agreement, it would be difficult for [Payor A] to credibly threaten that it could exclude a combined Hershey and Pinnacle from its network. Is that correct?

[8] Contrary to defendants' assertion, the individual did not "unequivocally" testify that the insurer was playing Pinnacle against Holy Spirit. Indeed, the individual explained that to resist Pinnacle's rate demands, it needed to threaten to form a network that included Hershey. App.961, 162:25-164:6.

> A. Absolutely.
> Q. Okay, Because if [Payor A] didn't have a combined Hershey and Pinnacle, it would have a significantly less attractive network in the Harrisburg area. Correct?
> A. For all intents and purposes there would be no network without that.

App.491, 48:15-22.

When asked if the insurer would have to pay higher prices if the merged entity raised prices, he answered, "[y]ou wouldn't have a whole lot of choice." App.492, 49:8-15. Despite defendants' protest, Payor A's testimony shows that it would not be possible to market a product in the Harrisburg area without the combined entity, and the merger will substantially increase defendants' leverage to demand higher prices.[9]

Payor B: Payor B's representative similarly testified that Payor B would need to include a merged Hershey/Pinnacle in its network to successfully market a plan in the Harrisburg area. App.317, 64:13-64:20. He explained that Harrisburg has been a "very fortunate market" that has benefitted from competition among health systems. App.220. However, the merger raised "concerns that the new

[9] Defendants attempt to parse Payor A's testimony about what it could do in response to a 25% rate increase five years from now. However, when defendants themselves tried to ask Payor A if it could resist such an increase by refusing to contract with them, Payor A responded, "we would probably lose about 50 percent of our membership in Dauphin County." App.494, 144:6-16.

entity would ultimately have too much leverage and [the insurer] would not be able to negotiate market appropriate pricing and terms." *Id*.

At his deposition, Payor B's representative further testified:

> Q. Okay. And you had concerns that a combined Hershey/Pinnacle merger would have too much negotiating leverage; is that correct?
> A. That was a concern, yes.
> Q. And you were concerned that [Payor B] would have less leverage as a result of that potential merger; is that correct?
> A. That's correct.
> Q. And you were also concerned that because of this increased leverage, [Payor B] would have to pay higher reimbursement rates to the combined entity; is that correct?
> A. That was a concern, correct.

App.458, 34:8-20.

Internally, Payor B estimated that the merger could result in substantial increases in Pinnacle's prices. App. 246. Defendants claim Payor B was only concerned about a mere possibility of price increases, Def. Br. 23, but Payor B expressed concerns that price increases were likely. App.247, 873 ("You make the point that we are likely to see Pinnacle's rates increasing to HMC levels….").

Payor E: Payor E testified that it was able to market a network to Harrisburg area residents with Pinnacle, but not Hershey. When Pinnacle terminated its contract, it found itself unable to sell a viable commercial health plan in the Harrisburg area at any price. Gov. Br. 13-14. Defendants dispute only the magnitude of the price increase that Payor E offered to bring Pinnacle back to

its network. Their argument is wrong[10] and in any event does not undermine the value of this "natural experiment," which demonstrates that employers demand access to local hospitals and that insurers cannot successfully market a network to Harrisburg area residents without Pinnacle or Hershey (much less no Harrisburg hospitals). Gov. Br. 13-14. Moreover, the insurance broker who sold Payor E's products stated that his employer clients who left Payor E's plans paid more to other insurers in order to gain access to networks that included defendants' hospitals. App. 284 ¶13.

b. Insurers Would Likely Pay a SSNIP.

Defendants also attempt to minimize the insurer evidence by characterizing it as "some general 'concern' over the theoretical possibility of some price increase" which purportedly fails to demonstrate that insurers "would" accept a SSNIP. Def. Br. 24. Not only is this criticism at odds with the clear weight of the evidence, it also misstates the standard. A proper analysis is predicated on the *likely* response of buyers to a *hypothetical* price increase from a *hypothetical* monopolist based on "any reasonably available and reliable evidence . . . ." *Guidelines* §4.2.1. This standard was endorsed by the Ninth Circuit, which affirmed a district court decision that "correctly focused on the '*likely* response of

[10] The evidence shows that Payor E did offer Pinnacle a price increase without volume discounts and that it would be willing to pay more than a SSNIP to keep Pinnacle in-network. App.833-35, 4:12-21:19; App.945, 220:3-16.

insurers to a hypothetical demand by all the … [health care providers] in a particular market for a [SSNIP].'" 778 F.3d at 784. The testimony presented plainly meets the standard.

c. A SSNIP Would Be Profitable.

Because we have not used the word "profitable" every time we have referred to a SSNIP, defendants argue that the Government has somehow abandoned the requirement that it prove that a SSNIP must be profitable. The argument is baseless. The insurers' evidence clearly demonstrates that defendants could successfully impose a "non-transitory" price increase post-merger. Indeed, their testimony is premised on the belief that they would not have any viable alternative if the combined entity raised prices. If they did, the insurers would not have been concerned about the merger's likely effects. To argue otherwise, as defendants do, renders the consistent insurer evidence irrational.

Moreover, an empirical analysis presented by the Government's economic expert, Dr. Wilson, found that the merged entity could profitably increase prices by more than 15%. App.528. Even the model presented by defendants' economic expert implies post-merger price increases of at least 6 percent. *Id*. If the merged firms alone could impose those kinds of price increases, a hypothetical monopolist of all Harrisburg area hospitals certainly could.

d. The Government Properly Accounted for Insurer Leverage.

Defendants also argue that the Government ignores the leverage that insurers have. Def. Br. 20. That is flatly wrong. Whatever sources of leverage insurers have now, they use, and this leverage remains the same after the merger. What the merger changes is the hospitals' bargaining leverage, and that is why the bargaining model focuses on the increased leverage that hospitals gain over insurers from the merger. Defendants' argument ignores that the merger increases the hospitals' leverage because their separate existence constrains the other's prices and allows insurers to use this to their advantage in negotiations.

To distract from this unassailable point, defendants cherry-pick a single piece of testimony where Payor A generally discussed the leverage that it currently has. Def. Br. 22. However, this leverage in no way altered Payor A's conclusion that "it wouldn't have a whole lot of choice" but to accept a price increase post-merger. App.492, 49:8-15. Defendants further point to their economic expert's theory that "mutually assured destruction" constrains hospitals and insurers from being overly insistent in bargaining. Def. Br. 21. However, the relative bargaining strengths of the hospitals and insurers determines the outcome. This was clearly demonstrated when Pinnacle threatened termination unless it received a substantial price increase and Payor A responded by threatening to form a network with Hershey and Holy Spirit. It is precisely this source of leverage which will

evaporate post-merger and thereby increase the hospitals' relative leverage over Payor A.[11]

3. The District Court's "Findings" Were Clearly Erroneous.

The court made no finding on the question of whether insurers can substitute hospitals outside the Harrisburg area for Harrisburg area hospitals. The record evidence demonstrates that they cannot. Accordingly, the court incorrectly concluded that the Harrisburg area is a "too narrow" geographic market because 19 hospitals within a 65 minute drive of Harrisburg would "provide a realistic alternative that patients would utilize" if defendants increased prices to insurers post-merger. App.13. This flies in the face of the insurer evidence discussed above, consistently showing that a product lacking Harrisburg area hospitals would not be marketable. The court's conclusion is supported only by its supposition that patients would be willing to travel because Central Pennsylvania is "largely rural and requires driving distances for specific goods and service." *Id.* Defendants did not present any evidence to the district court – and their brief identifies none – suggesting that patients would switch from hospitals in the Harrisburg area to

[11] Another real world example demonstrates the point. While serving as the CEO of Lancaster General Hospital, Pinnacle's current CEO pulled Lancaster General from Payor B's network "for years" after reaching a negotiating impasse. App.904, 137:12-19. Clearly, "mutually assured destruction" did not prevent this result.

hospitals outside the Harrisburg area in response to a price increase imposed on insurers.

The *only* record evidence cited by the court about geographic market are statistics about the travel patterns of Hershey's patients, which the court somehow concludes "controvert" the Government's assertion that patients demand local care. App.12-13; Def. Br. 24. This was clearly erroneous. The record evidence overwhelmingly showed that patients, regardless of location, prefer local care.[12] Neither the court nor defendants dispute the data showing that 91% of Harrisburg-area patients stay within the area for GAC services. Contrary to what the court apparently surmised, Harrisburg area residents' preferences are not idiosyncratic. The data and defendants' brand study showed that patients in counties surrounding the Harrisburg area also travel short distances to receive GAC services, and 92% of residents throughout all of Central Pennsylvania preferred the hospital either closest or very convenient to their home. Gov. Br. 11-12; App.402. Defendants' own witnesses *agreed* that patients prefer not to travel for GAC services, and

[12] Defendants claim the Government failed to demonstrate that "employers in the Harrisburg Area demand local hospitals." Def. Br. 26-28. However, employers testified they could not offer a health plan without a combined Hershey/Pinnacle because it would be "irresponsible" and result in a "serious backlash from very upset employees who would find this unacceptable." App.292 ¶ 12; App.290 ¶ 10. The Government submitted testimony from an insurance broker with decades of experience representing 80-100 Harrisburg area employers who confirmed these employers demand local Harrisburg options. App.282-83 ¶ 3, 9.

defendants' documents corroborate that testimony. Gov. Br. 11-12.[13] The court also ignored testimony from numerous insurers and hospitals (including those located outside the Harrisburg area) clearly stating that patients demand care close to home. Gov. Br. 12.[14]

The mere fact that Hershey draws patients from a number of unidentified counties outside the Harrisburg area does *not* controvert this conclusion.[15] While defendants claim that the Government focused on only a subset of patients (Harrisburg area residents), they argue that the habits of an even smaller subset – a minority of one hospital's patients – can be generalized to the entire population at large. This assertion flies in the face of logic and unambiguous evidence.

4. Defendants' Attempt to Justify the Court's Unsupported Findings Fail.

Finding no other support in the record to salvage the district court's opinion, defendants attempt to read into the court's decision a justification based on so-called "critical loss" theory. They assert, based on their expert's testimony, that a loss of 7.1% of defendants' patients could render a 5% price increase unprofitable,

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[13] *See also* App.853, 860, 866, 923, 940, 979.

[14] *See also* App.260, ¶ 12; App.266 ¶ 7; App.277 ¶ 7; App.880 ¶ 6; App.272 ¶ 6; App.877 ¶ 11.

[15] Economists have a name for this – the "silent majority fallacy." As explained by the *amici* economists, "the fact that a minority of patients currently travel relatively far to receive care says little about what the (silent) majority of "non-travelers" would do in response to a post-merger price increase. Econ. Br. 14-15.

and thus constrain their ability to impose a SSNIP. Def. Br. 19, 28. However, a "critical loss analysis" has no application to a market for GAC services sold to commercial insurers because, as the Government's expert testified, patients do not face posted prices. App.851, 977:10-18; App.419-22. The court never addressed that argument or critical loss at all. Moreover, even if critical loss were valid, no record evidence even suggests a critical loss would actually occur. Indeed, defendants' expert conceded that he never conducted a demand study to determine the price sensitivity of Hershey's patients. App.848, 899:15-18; App.950, 161:18-20.

Defendants speculate that patients are becoming increasingly price-sensitive and that would allow insurers to "steer[] patients away from certain hospitals" through the use of plan design tools (*e.g.,* co-insurance, high deductible plans, and "tiered" networks) or will result in patients switching hospitals in response to higher out-of-pocket costs. Def. Br. 29. But, again, that was *not* the basis of the district court's opinion, and more important, the record does not support defendants' speculation.

To the extent insurers have those tools, they use them today. Defendants merely cite general testimony about industry trends toward price transparency. But no evidence suggests that insurers would even consider attempting to create health plans that would steer Harrisburg or non-Harrisburg area residents away from the

combined hospital, much less that they could do so successfully.[16] Indeed, the fact that insurers agree that they could not profitably market a product in the Harrisburg area without Harrisburg area hospitals and expect defendants' bargaining leverage to increase as a result of the merger shows that any "steering" tools at insurers' disposal are illusory. The insurers would not be concerned about defendants' ability to charge higher prices if they thought they could defeat them through plan design.[17]

Similarly, nothing in the record suggests that defendants would refrain from increasing prices to insurers merely because the insurers *might* pass some part of the increase on in the form of higher out-of-pocket costs and that in turn *might* cause consumers to alter their hospital choice. Such a scenario is contrary to well-accepted economic literature and the case law. As the *amici* economists state, "[b]ecause insurance eliminates or sharply attenuates differences in out-of-pocket costs for patients who choose in-network providers … hospitals compete [for patients] primarily on non-price dimensions like clinical quality, wait times, and patient experience." Econ. Br. 5-6. This is consistent with the Government's

[16] Defendants cite testimony of one of the largest insurers about increased transparency, but omit that he testified that increased cost-sharing by patients has affected "ancillary-type services like lab services, bloodwork, imaging" but has not increased patients' willingness to travel for *inpatient hospital* services. App.960-62, 132:1-12, 164:7-165:4.

[17] The uptake of so-called "narrow network" and "tiered" products has been "slow to catch on" in Harrisburg. App.894, 210:21-211:17; App.982-84.

expert testimony as well as common sense. Out-of-pocket costs represent a very small fraction of the costs of an inpatient hospital admission. App.366, 418, 420-21, 433; States' Br. 11-12. The case law also recognizes that patients do not generally select hospitals based on price. *St. Luke's*, 778 F.3d at 785; *FTC v. ProMedica Health Sys.*, 2011 WL 12192181, at *8 (N.D. Ohio 2011). This comports with the record evidence. Indeed, defendants' brand study showed that only 2% of survey respondents identified out-of-pocket cost as a factor they considered when choosing a hospital. App.978; *see also* App.892, 50:25-51:16, App.310, 61:7-18 (Pinnacle CFO testifying that patients choose hospitals based on convenience, quality, safety, and physician referrals, not price).

C. The District Court Erred By Failing to Consider Whether a Hypothetical Monopolist Could Impose a SSNIP at Pinnacle.

The district court failed to examine whether a hypothetical monopolist could impose a Pinnacle-only SSNIP. Defendants' own expert agreed that the hypothetical monopolist test would be satisfied if the hypothetical monopolist could impose a SSNIP at only one location of the merging firms. App.951, 172:4-15. That failure is not excused on the basis that, as defendants claim, insurers and hospital systems bargain for all the system's area hospitals in a single negotiation. Though parties may jointly negotiate for multiple hospitals, nothing precludes a hospital system from setting different rates for individual hospitals.

The court's failure to address a Pinnacle-only SSNIP was an independent error that warrants reversal.

D. The District Court Improperly Considered Temporary Price Agreements With Insurers in Defining the Geographic Market.

Defendants offer no response to the Government's argument that the court fundamentally departed from the *Guidelines* and contradicted controlling legal precedent by incorporating defendants' temporary rate protection agreements with insurers into its geographic market analysis. Gov. Br. 44-46.

Instead, defendants attempt to deny that the court based its geographic market analysis on these agreements. Def. Br. 36-38. But the court was clear; it addressed these agreements only in its discussion of the geographic market. The court plainly found that defendants' rate agreements with Payors A and B effectively constrained them from imposing a SSNIP and concluded that the "outcome of the hypothetical monopolist test" was not in the FTC's favor. App.14.

Finally, departing entirely from what the court itself found, defendants argue that the rate protection agreements show that no harm will result from the merger. In their telling, the insurers "gladly" accepted rate agreements that were gratuitously offered to them by Hershey and Pinnacle.

However, Payors A and B expressly sought these agreements from defendants because they needed price "protection" from the potential

anticompetitive effects of the merger. App.935-361, 34:7-35:18, 36:25-37:19 ("We had concerns that if we were unable to arrive at an agreeable place in the contract with respect to rate protections and length of access, that we would have concerns about supporting the affiliation of the merger"); App.898, 65:10-66:3, (Payor B was seeking "protection" from the merger); App.874 (noting the need to "ensure that [Payor B]'s members are protected for a significantly long period of time from any adverse economic impact of the Pinnacle-Hershey merger"); App.221. Indeed, the evidence demonstrated that Payor A would have complained to the FTC if it did not secure protections from defendants, and both payors' protections were conditioned on the insurer not complaining to the FTC. Gov. Br. 43; App.914-17; App.337; App.919; App.905-11; App.855; App.318, 77:2-78:8. These facts underscore that the largest insurers did not agree with the district court's faulty conclusion that the existence of alternative hospitals outside the Harrisburg area would prevent post-merger price increases. They solidify, not detract from, the Government's proposed geographic market.

II. THE DISTRICT COURT'S ASSESSMENT OF THE "EQUITIES" WAS INSUFFICIENT AND ERRONEOUS.

Defendants do not even pretend that the court conducted the type of rigorous efficiencies analysis required if the Government is right about the geographic market. Had the court properly found the Harrisburg area to be a relevant geographic market, it would have found the merger presumptively illegal. Then

the burden of proof would have shifted to defendants to prove “extraordinary,” “verifiable,” “merger-specific” procompetitive effects. Gov. Br. 47-48. Instead, defendants assert that even if the district court clearly erred in rejecting the alleged market, it must be affirmed unless the Government showed that the court “also erred in determining that the equities support letting the combination proceed.” Def. Br. 38. They then argue that a rigorous analysis of these “equities,” which includes defendants’ purported efficiencies, is not necessary because there was “no presumption for the Hospitals to rebut.” *Id.* at 39.

Defendants’ arguments are invalid. Neither defendants nor the district court may avoid a proper efficiencies analysis and allow a presumptively unlawful merger to proceed, by recasting unproven efficiencies as “equities.” To be clear, no court has ever found that efficiencies rescue an otherwise unlawful transaction. And even with respect to the equities, where the government has demonstrated a likelihood of success in challenging a merger, no court has ever denied injunctive relief under Section 13(b).

A. The District Court Failed to Properly Analyze Defendants’ Efficiencies.

Defendants concede that the district court made no attempt to verify the magnitude of their claimed capital avoidance efficiency − the avoidance of building a $277 million, 100-bed tower. Def. Br. 42. Accordingly, even if defendants’ claim was legally cognizable, which it is not (Gov. Br. 50), the district

court could not properly have found the bed tower claim "to be a compelling efficiencies argument." App.14

The Government presented overwhelming evidence demonstrating that Hershey's actual bed needs did not support Hershey's claim that it could only solve its capacity issues by building a 100-bed tower.[18] However, instead of rigorously analyzing defendants' claim, the district court simply credited the self-serving testimony of defendants' executives that this $277 million 100-bed tower would be constructed absent the merger. It did so without ever considering what portion of the avoided capital was necessary to address Hershey's actual bed need (*i.e.*, what was merger specific under the *Guidelines*).[19]

Moreover, the Government showed that forgoing the building of additional capacity would result in an anticompetitive reduction in output. Gov. Br. 49-50. Contrary to defendants' argument, Def. Br. 43, it defies logic that the merger, which does not change the total number of hospital beds in the Harrisburg area,

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[18] An analysis by defendants' efficiencies expert showed that Hershey needed just *13* additional inpatient beds to meet the "indisputable" occupancy standard for hospitals. App.885; App.825, Tbl. 1.

[19] Defendants' economic expert admitted that Hershey's plans for adding capacity were a "moving target" (App.949, 61:14-62:2, 63:1-21), and their claims fluctuated wildly leading up to the hearing in this matter. Despite considering a variety of less costly projects to address its modest bed need, Hershey sent out an RFP to architectural firms for the $277 million, 100-bed tower only a matter of weeks before the hearing. App.198, App.296, App.807, App.498, 279:7-280:1. Such made for litigation post-acquisition "evidence" should be given no weight. *See, e.g.*, *Chicago Bridge & Iron Co. v. FTC*, 534 F.3d 410, 435 (5th Cir. 2008).

would increase output. Absent the merger, Hershey would add new capacity, which *would* increase output to the benefit of the Harrisburg area.

Defendants' purported risk-based contracting efficiencies are equally meritless and were not properly analyzed by the district court. The court's finding regarding risk-based contracting was largely based on the general statement by Hershey's CEO that the merger would provide "*some* advantages in terms of size and scale" to defendants' ongoing risk-based contracting initiatives. Def. Br. 46-47; App. 26 (emphasis added). The court ignored empirical evidence (App.964-65) and did not determine whether and *how* the merger would affect defendants' risk-based contracting efforts or what the magnitude of any supposed benefit might be.

B. The District Court Erred in its Assessment of "Repositioning."

Defendants do not deny that repositioning should be "evaluated much like entry, with consideration given to timeliness, likelihood and sufficiency," App.23, from the *perspective of insurers*, the relevant customers. Gov. Br. 55.[20] Had the court considered this evidence, it would have found that "repositioned" hospitals

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[20] Instead of addressing this point, defendants argue that insurers do not play Pinnacle and Hershey off one another. As previously discussed, Payor A relied on the leverage Hershey's separate existence provided to defeat a significant rate increase from Pinnacle. *See supra* page 13.

would not be a viable substitute for the combined Hershey/Pinnacle in insurer networks. *Id.* at 56.

Defendants also fault the Government for claiming that hospitals outside the Harrisburg area should not be considered for repositioning, but in fact, the evidence plainly shows that hospitals outside the Harrisburg area, whether they have "repositioned" or not, could not replace the combined Hershey/Pinnacle in an insurer's network. *See supra* Section 1(b); App.957-58, 33:13-41:5; App.491, 48:17-22; App.990-93.[21]

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[21] Even defendants' example of repositioning, that the University of Pennsylvania affiliating with Lancaster General will "take more … volume away from … Hershey" (Def. Br. 44; App. 24) is at odds with the evidence. With the clever use of ellipses, defendants actually misquote the cited document, which speculates about the theoretical combination of *three hospitals and a health insurer* to create a product targeted at a small subset of patients from Hershey and other hospital systems. App. 686.

CONCLUSION

The Court should reverse the decision below and enjoin the proposed merger between Hershey and Pinnacle pending the outcome of the administrative adjudication.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH TYPE-VOLUME LIMITATION, TYPEFACE REQUIREMENTS, AND TYPE STYLE REQUIREMENTS

I. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because the brief contains 6,951 words.

II. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word 2010, in 14-point Times New Roman.

/s/ Michele Arington

June 20, 2016

CERTIFICATE OF IDENTICAL COMPLIANCE OF BRIEFS

I certify that the text of the electronically filed brief is identical to the text of the original copies that were sent on June 20, 2016, to the Clerk of the Court of the United States Court of Appeals for the Third Circuit.

/s/ Michele Arington

June 20, 2016

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I certify that on June 20, 2016, I performed a virus check on the electronically filed copy of this brief using Symantec Endpoint Protection Version 12.1.6867.6400 (last updated June 20, 2016). No virus was detected.

/s/ Michele Arington

June 20, 2016

CERTIFICATE OF SERVICE

I certify that on June 20, 2016, I filed the foregoing Corrected Reply Brief for the Federal Trade Commission and the Commonwealth of Pennsylvania via the Court's electronic filing system. All parties have consented to receive electronic service and will be served by the ECF system.

/s/ Michele Arington