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Before the Senate Banking and Insurance Committee

A Public Hearing to Accept Proposed Recommendations for Consideration on the Proposed Merger of Highmark and Independent Blue Cross

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Mr. Chairman, minority Chairman Stack, and other distinguished members of the Senate Banking and Insurance committee, I appreciate the privilege to testify before you today about the anticompetitive effects that likely will result from the proposed acquisition of Independence Blue Cross by Highmark. As I explain in my testimony, the merger will pose a significant threat to competition in the southeastern Pennsylvania health insurance market by eliminating Highmark as a potential entrant into the market. History has demonstrated that Highmark has the incentive and ability to enter into adjacent markets and that competition has benefitted employers, consumers, and providers. The antitrust laws protect not only ongoing competition, but also the potential competition that would exist but for this merger. Simply put this merger should be rejected by the Commissioner of Insurance or the Attorney General should challenge the merger.

I have practiced antitrust law for over 20 years, primarily in the federal antitrust enforcement agencies: the Antitrust Division of the Department of Justice and the Federal Trade Commission. At the FTC in the 1990s I was attorney advisor to Chairman Robert Pitofsky and directed the Policy shop of the Bureau of Competition. In private practice and in government service I assisted in the litigation of numerous merger cases including Staples/Office Depot, British American Tobacco/American Tobacco, Heinz/Beechnut, Nippon Sanso/Semi-Gas, UPM Kymmenne/Mactac, and SunGard Datasystems/Comdisco. In addition, I regularly represent parties that oppose mergers before the Antitrust Division and the Federal Trade Commission. Most recently, I led a coalition of consumer groups, government entities, unions, and healthcare providers that opposed United Healthcare's acquisition of Sierra Health Services. My testimony today is based on my years of reviewing proposed mergers as a government enforcer and providing advice and analysis of mergers as a private practitioner.

<u>The Proposed Highmark/Independence Blue Cross Merger</u>

Today's hearing evaluates the proposed Highmark Independence Blue Cross merger. The merger will combine the two largest health insurers in Pennsylvania and create a firm with over 8 million beneficiaries and $23 billion in revenue. The merger will create the largest insurer in Pennsylvania with over a 73 percent market share, far

outdistancing the next closest competitor. Highmark is based in western Pennsylvania and IBC is based in southeastern Pennsylvania. Highmark also has operations in central Pennsylvania and has an ownership interest in Northeastern Blue Cross.

The most straightforward concerns are raised when firms are direct competitors. In this case, there is some evidence that Highmark and IBC compete directly, even though the commercial business of each appears geographically dispersed:

> Both firms compete for certain Medicaid programs. In the Medicaid managed care market the parties admit that in the Lehigh/Capital zone Highmark and IBC subsidiaries are two of the three competitors with a market share of over 77 percent.[1] These two firms are also direct competitors in the voluntary Medicaid managed care program in several counties.
>
> Many employers in southeastern Pennsylvania must provide coverage in central Pennsylvania because their employees commute from central Pennsylvania.

The parties attempt to justify their merger based on two arguments: first, they argue that since there is no direct geographic overlap there is no loss in competition. Second, the parties suggest that there will be very substantial cost savings from the merger, which the parties have committed to pass on in the form of benefits for the community.

The Significant Loss of Potential Competition will harm Consumers

It is a settled principle of antitrust law and economics that potential entrants can constrain the ability of actual competitors to exercise market power. Consequently, mergers and other consolidations of current competitors and potential entrants that eliminate the procompetitive effects of potential competition can harm competition — particularly if the potential entrant is one of a relatively small number of firms with the capacity and incentive to enter the market, the market is concentrated, and high barriers to entry are likely to deter other new entrants. In appropriate circumstances, the courts have enjoined such consolidations to preserve the procompetitive benefits of potential competition.[2]

As Justice Potter Stewart observed over a quarter of a century ago:

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[1] Statement Regarding Compliance with the Competitive Standard of 40 P.S. Section 991.1403(d).

[2] *Yamaha Motor Co., Ltd. v. Federal Trade Commission*, 657 F.2d 971 (1981), *cert. den'd* 452 U.S. 915 (1982); *see also United States v. Marine Bancorporation*, 418 U.S. 602 (1974), *Engine Specialties, Inc. v. Bombardier Ltd,* 605 F.2d 1 (1979).

> The central message of the Sherman Act is that a business entity must find new customers and higher profits through internal expansion—that is, by competing successfully rather than by arranging treaties with its competitors.[3]

As the Supreme Court observed in *United States v. Penn-Olin* "[t]he existence of an aggressive, well equipped and well financed corporation engaged in the same or related lines of commerce waiting anxiously to enter an oligopolistic market would be a substantial incentive to competition which cannot be underestimated.[4]

One example where a merger was challenged, in part, because of potential competition concerns was Staples proposed acquisition of Office Depot that was successfully challenged by the FTC in 1996.[5] The merger focused on the thirty or so markets where the firms competed head to head. But both firms were successful and expanding and based on their past history it was reasonable for them to invade each other's territories. The court enjoined the merger both because of the potential loss of actual and potential competition. As to potential competition it observed:

> Since prices are significantly lower in markets where Staples and Office Depot compete, eliminating this competition with one another would free the parties to charge higher prices in those markets, especially those in which the combined entity would be the sole office superstore. In addition, allowing the defendants to merge would eliminate significant future competition. Absent the merger, firms are likely, and in fact have planned, to enter more of each other's markets, leading to a deconcentration of the market and, therefore, increased competition between the superstores.[6]

The *Staples* decision offers an important lesson for this hearing. Within a few years both firms grew sufficiently through internal expansion to achieve most, it not all of the efficiencies sought by proposed merger.

Under the law there are two separate theories of potential competition: "perceived potential competition" theory and the "actual potential competition" theory. When the law speaks of "perceived potential competition" the concern is that competition will be harmed by the elimination of a firm which currently constrains anticompetitive conduct because it is a potential entrant in the market. Elimination of the potential entrant through merger may eliminate that threat, enabling the remaining firms to raise prices, reduce output or lower service. When the law speaks of "actual potential competition" the concern is that competition will be harmed by eliminating a firm through merger that but for the merger would independently enter the market. The injury to competition stems

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[3] *United States v. Citizens & S. Nat'l Bank*, 422 U.S. 86, 116 (1975).
[4] *United States v. Penn-Olin Chem. Co.*, 378 U.S. 158, 174 (1964).
[5] *FTC v. Staples, Inc.*, 970 F. Supp. 1066 (D.D.C. 1997).
[6] *Id*. at 1082.

from this preemption of actual entry that would lead to a more competitive market. Today I will focus on the actual potential competition theory.

There are several reasons why there are significant concerns over the loss of potential competition from the proposed merger. First. IBC and Highmark's predecessors used to compete in Southeastern Pennsylvania prior to a 1996 acquisition. As part of that acquisition IBC and Highmark entered into a ten-year "truce" not to invade each other's territories. Not surprisingly this transaction was announced soon after the ten-year truce expired.

As Anita Smith, the President and CEO of Capital Blue Cross testified before the Pennsylvania Senate Banking and Insurance Committee:

> Highmark and IBC do not compete because they agreed not to compete in 1996. And now that agreement is expired. If they wanted, they could compete right now. Today. We could have vibrant competition between these companies in southeastern Pennsylvania this very minute. Their merger is their effort to make permanent their agreement not to compete. And they want you to help them do it.[7]

Often making a prediction about likely entry and the impact of that entry can be a difficult process. This may not be such a case. Highmark's CEO has been explicit that his goal is to create a single firm to provide services statewide and become the sole Blue Cross firm in the state.[8]

Here history provides a powerful example of both the likelihood and impact of Highmark's entry into southeastern Pennsylvania. In 2002, Highmark severed a joint operating agreement with Capitol Blue Cross and invaded its territory of Central Pennsylvania and the Lehigh Valley. Highmark's expansion resulted in greater competition, lower premiums and improved service and CBC and Highmark battled head-to-head for subscribers, employers, and providers.

The DOJ/FTC *Merger Guidelines*, identify three threshold tests in deciding whether to challenge a transaction based on injury to potential competition. The agencies are "unlikely to challenge a potential competition merger" unless (1) the acquired firm's market is highly concentrated (HHI above 1,800); (2) entry barriers in that market are high, so that firms without specific entry advantages cannot be expected to enter; and (3) the acquiring firm's entry advantage is possessed by fewer than three firms. The *Guidelines* describe the

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[7] *See* January 20, 2008 Testimony of Anita M. Smith at 1.

[8] "We wanted to have a statewide capability because of movement from local purchasing decisions [by customers] to decisions made more on a statewide and multistate basis.' ("Talking With Ken Melani," *Harrisburg Patriot News*, July 22, 2007, C08). "I personally believe it makes sense to have one statewide Blue Cross-Blue Shield organization. We'll work very hard to prove [our merger with IBC] works. Hopefully, it will further demonstrate to Capital and Northeastern that [merging the Blue Plans is] the right thing to do." ("Talking With Ken Melani," *Harrisburg Patriot News*, July 22, 2007, C08.).

effects of actual potential competition as ones where "the merger could result in a lost opportunity for improvement in market performance resulting from the addition of a significant competitor.[9] [fix cite; end quote] Each of these factors seem clearly present in this merger.

- The Southeastern Pennsylvania health insurance market is clearly highly concentrated. IBC dominates the market with a market share of over 71 percent. There are only 4 other competitors in the market and the positions and market shares of those firms have been relatively stable for several years. This is clearly the type of oligopolistic market in which potential competition concerns are particularly important.

- The market has substantial entry barriers. As detailed in the expert testimony of Dr. Monica Noether, numerous firms have attempted to enter into the area and have failed—including, Health Plans of Pennsylvania; Horizon Healthcare of Pennsylvania; and Health Systems International.[10] What is striking about each of these failed entries is that each of these firms adopted different approaches to entry. Moreover, most national health insurers have been unable to establish even a minimal presence in the market. This is striking considering that Philadelphia and the Southeastern Pennsylvania area, is one of the most economically sound and fastest growing markets in the state.

- Finally, the history of Highmark's successful entry into Central Pennsylvania and the failed entry of several firms in Southeastern Pennsylvania demonstrates that Highmark is one of a very small set of firms capable of entering into the market.

- Highmark already has a network of healthcare providers in the market that provides Highmark a substantial advantage over other potential entrants. Highmark has an active statewide network of professional medical providers, including in the Southeast, because it has the statewide Blue Shield license. Traditionally, Blue Shield was the physician insurance and Blue Cross was the hospital insurance. Now, an insurer can offer full-line insurance with either a Blue Shield or Blue Cross license. Because Highmark has a statewide Blue Shield license, they can offer full-line health

[9] 1984 GUIDELINES, at §4.112.
[10] Testimony of Dr. Monica Noether, Competitive Analysis of the Proposed Consolidation between Highmark, Inc. and Independence Blue Cross (July 2, 2008).

> insurance in any part of the state. When Highmark entered Central Pennsylvania to compete with Capital Blue Cross, Highmark already had a network of physicians. Thus, Highmark only had to contract with hospitals to set up a hospital network in that region in order to independently offer full-line health insurance. Similarly, in order to offer full-line health insurance in the Southeastern Pennsylvania, Highmark needs only to contract with a relatively smaller number of hospitals for hospital services.

Let me close this discussion with an observation about the types of evidence in a potential competition case. The Clayton Act is an incipiency statute and as such it deals with "probabilities and not certainties." In a potential competition case there can be "subjective evidence" of the parties' intent on entry and "objective evidence" focusing on more objective factors about the parties' incentives and abilities.[11]

Highmark has argued that subjective evidence is critical, suggesting that it is unlikely Highmark would enter the Southeastern Pennsylvania market since it lacks the intent to enter. But years of antitrust jurisprudence has been justifiably skeptical of such subjective evidence, especially in potential competition cases. In this case, one should be particularly skeptical of such an assertion since it is contrary to Highmark's intent of becoming a statewide provider.

Objective evidence is typically given far greater weight. Thus, courts look for "objective evidence" such as the parties' expertise, financial wherewithal, previous attempts at entry, plans, and market conditions. Many of these facts are not public, but should be scrutinized through a thorough review by antitrust officials.[12] But Highmark's financial status, recent actions in entering into central Pennsylvania, entering into other markets, and unique ability to enter the market present strong objective evidence that it is a significant potential entrant.

<u>The Proposed Efficiencies do not Outweigh the Competitive Harm</u>

Highmark's and IBC's contend that the consolidated company will save about $1.1 billion over the next six years. Of this total, they attribute $820 million to increased economies of scale, while $285 million stems from reducing the cost of pharmaceuticals.

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[11] Darren Bush and Salvatore Massa, "Rethinking the Potential Competition Doctrine, " 2004 Wis. L. Rev. 1035 (2004).

[12] Claims that a firm is unlikely to enter a market but be evaluated carefully, including securing documents and testimony of company officials through compulsory process. A firm's claim that it has no intent to enter a market may be self-serving. We are concerned that level of scrutiny may not have occurred. It appears that the DOJ closed both of its investigations of the merger within 60 days after the Hart-Scott-Rodino filings were made, providing insufficient time for the agency to issue a Second Request for additional information.

Moreover, the parties commit to direct $650 million of those savings to expand health insurance coverage for the uninsured in the Commonwealth.

At the outset we should recognize the importance of the commitment the parties have made to improve healthcare insurance coverage for the uninsured. As far as I know no other health insurers have made as substantial a commitment to the uninsured in any prior health insurance merger. With the chronic and increasing number of uninsured, the parties should be commended for this commitment. Hopefully it will serve as a model for future mergers. Nevertheless, these efficiencies fall short.

The legal standard for the efficiencies defense is straightforward. Highmark must demonstrate that efficiencies are: (1) merger-specific; (2) cognizable and verifiable; and (3) sufficient in magnitude to reverse the anticompetitive effects of the merger.[13] Merger-specific means they must be "likely to be accomplished with the proposed merger and unlikely to be accomplished in absence of either the proposed merger or another means having comparable anticompetitive effect." *Merger Guidelines § 4.* The claimed efficiencies cannot be efficiencies that could "be achieved by either company alone." *FTC v. Heinz*, 246 F.3d at 722. Moreover, because "information relating to the efficiencies is uniquely in the possession of the merging firms, the merging firms carry the burden of proof on efficiencies. *Merger Guidelines* § 4. The alleged efficiencies cannot meet this standard.

Here there are significant reasons to be skeptical of the parties' efficiency arguments. First, as to the pharmaceutical costs, there is no reason to believe that combining Highmark and IBC will lead to savings of that magnitude. Pharmaceutical manufacturers give discounts based on the significance of a payor in a given geographic market. Simply combining the purchases of two geographic disperse payors will not necessarily lead to greater discounts. Moreover, even if it was the case that combining purchasing would lead to greater discounts such savings are not merger-specific. IBC, Highmark and even other insurers could achieve similar cost savings through a group purchasing arrangement.

The vast majority of the savings are from reductions in administrative costs. But the evidence from past health insurance mergers is that these savings rarely occur. As Professor Lawton Burns observed in testimony about this merger:

> [T]he recent historical experience with mergers of managed care plans and other types of enterprises does not reveal any long-term efficiencies.
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> [E]ven in the presence of [efforts to achieve cost-savings] and defined post-integration strategies, scale economies and merger efficiencies are difficult to

[13] *Merger Guidelines § 4; see also FTC v. H.J. Heinz,* 246 F.3d at 720- 21 (D.C. Cir. 2001)("a rigorous analysis" is required to ensure that the claims "represent more than mere speculation and promises"); FTC v. *Swedish Match,* 131 F. Supp.2d 151, 172 (D.D.C. 2000) (rejecting efficiencies claims that were "at best speculative"); *Staples,* 970 F. Supp. at 1089 (rejecting efficiencies claims that were not verifiable, credible or reliable).

> achieve. The econometric literature shows that scale economies in HMO health plans are reached at roughly 100,000 enrollees…. Moreover, the provision of health insurance (e.g., front-office and back-office functions) is a labor-intensive rather than capital-intensive industry. As a result, there are minimal economies to reap as scale increases…. Finally, there is little econometric evidence for economies of scope in these health plans –e.g., serving both the commercial and Medicare populations. Serving these different patient populations require different types of infrastructure. Hence, few efficiencies may be reaped from serving large and diverse client populations. Indeed, really large firms may suffer from diseconomies of scale.[14]

In fact, a recent analysis of mergers of Blue Cross plans over the past several years found little evidence that these mergers resulted in significant administrative savings.[15]

<u>Conclusion</u>

The Pennsylvania health insurance market is dominated by Highmark and IBC. Even though they currently are based in two different ends of the state, permitting their merger would permanently extinguish the opportunity for competition which has brought substantial benefits to Central Pennsylvania. Based on the dominant position of Highmark and IBC and the history of failed entry, it is highly unlikely any other firm could successfully enter these markets and improve competition. The right prescription for health insurance competition in Pennsylvania is to prohibit this merger.

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[14] Testimony of Professor Lawton R. Burns regarding the Highmark/Independence Blue Cross Merger, before the Senate Judiciary Committee (April 7, 2007).

[15] Testimony of Diane Holder, President and CEO of the University of Pittsburgh Medical Center at 6-7 ("The health insurance market is no different than any other market in the U.S. An examination of data from 31 states across the country shows the average cost of health insurance premiums in states with higher than average levels of competition are 12 percent lower than premiums in states with lower than average competitive levels.")