DECLARATION OF JOHN E. KWOKA, JR.

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1. I am the Neal F. Finnegan Distinguished Professor of Economics at Northeastern University, a position I have held since 2001. I received my PhD in Economics from the University of Pennsylvania. I have previously taught economics at the George Washington University and the University of North Carolina at Chapel Hill, and held visiting positions at Northwestern University and Harvard University. I have also served in various capacities at the Federal Trade Commission, the Antitrust Division of the Justice Department, and the Federal Communications Commission. I serve or have served in senior positions in professional societies, as editor or on the editorial boards of several academic journals, and as a Senior Fellow of the American Antitrust Institute ("AAI"), an organization that advocates for competition policy.

2. I teach, conduct research, consult, and lecture widely on the economics of competition policy. I have published more than 75 articles in academic journals and authored or edited three books, including an antitrust casebook now in its sixth edition. My book on mergers, merger policy, and remedies in the U.S. will be published by MIT Press this December. My consulting experience includes work on many mergers, a number of which were resolved with various types of remedies. I have been qualified as an expert and have testified a number of times, most recently on behalf of the FTC in a non-merger matter (FTC v. North Carolina Board of Dental Examiners). My work at the FCC involved, among other things, the development of price cap plans as applied to the telecommunications sector. My full CV is attached to this declaration.

3. I am prompted to offer this declaration pro bono in support of AAI's comments since, as an economist, a student of merger policy and remedies, and a citizen of the Commonwealth of Massachusetts, I have been concerned with the consolidation of our hospital sector in general, with the planned merger of Partners Healthcare Inc. ("Partners") and South Shore Health Corp. ("South Shore") and Hallmark Hospital (collectively, "the transaction") in particular, and most especially with the remedies that are being proposed to settle the antitrust

complaint against this merger. My declaration focuses on this last issue—the effectiveness of the proposed remedy. I conclude that the proposed remedy is seriously flawed and will not likely resolve the generally acknowledged competitive problems with this transaction. In preparing this declaration, I have reviewed the complaint, the proposed consent, and the relevant reports of the Massachusetts Health Policy Commission.

The Harmful Effects of the Proposed Merger

4. To begin, it is important to recognize that the transaction if consummated, would result in harm to consumers and the competitive process. The Massachusetts Health Policy Commission conducted an analysis of these mergers and concluded that prices would rise and consumers would be harmed. The Attorney General of Massachusetts acknowledges this fact in the complaint, and indeed, the very existence of the consent order is a recognition of the underlying competitive problems with the merger. This much is not in dispute and no further analysis of this question is necessary.

5. It is noteworthy, however, that in this respect this transaction would resemble other carefully studied hospital mergers. My recently published research has compiled all published studies of the effects of consummated horizontal mergers in the economics literature that meet certain methodological standards. Most importantly, these studies—which focus on mergers that are "close calls"—carefully control for other possible influences so as to isolate the effects of the mergers on price and, in some cases, on nonprice outcomes. Among dozens of mergers in some sixteen different industries, the studied mergers on average are found to result in price increases of 7.3 percent. Among all studied industries, the single largest average price increases are in the hospital sector, where the average postmerger price increase is shown to be 20.8 percent.[1]

6. A few of these methodologically careful studies have examined various dimensions of hospital quality resulting from mergers. From that database of studies, there is no evidence of systematic quality improvement. By far the most common finding is the absence of any change whatsoever. In the much smaller number of cases where there is a quality change,

[1] J. Kwoka, "Does Merger Control Work? A Retrospective on U.S. Enforcement Actions and Merger Outcomes," Antitrust Law Journal, 2013, v. 78, no. 3, pp.619-650.

that change splits quite evenly between small improvements and small declines, and rarely is statistically significant. Past experience therefore provides further reason to accept the proposition that this transaction would result in substantial price increases and competitive harm, without any corresponding benefits.

Merger Remedies

7. While acknowledging this competitive problem with this transaction, the Massachusetts Office of the Attorney General ("AG" or "Massachusetts AG") seeks to fashion a solution short of prohibiting the merger altogether. As my research documents, the most effective policy prescription for an anticompetitive merger is to block it. In some cases, the antitrust enforcement agencies have required divestitures as a condition for clearing a merger. Divestitures may be appropriate, for example, when competitive problems arise in only one overlapping portion of large merging companies. Then the sale or spinoff of a plant or product or distribution channel can preserve the same number of independent entities in the competitively affected market. In principle, therefore, divestiture may resolve a localized anticompetitive effect while allowing most of a merger to go forward.

8. The other type of remedy to an otherwise anticompetitive merger is termed a conduct or behavioral remedy. This type of remedy permits the entire merger to go forward, but imposes restrictions on the conduct of the resulting merged company. Certain behavior may be proscribed (information exchanges or retaliation) while other conduct may be prescribed ("must supply" agreements), but in any case these provisions represent rules of operation not unlike traditional economic regulation of a firm. Conduct remedies do not preserve the same number of independent entities; rather, they allow industry consolidation. Conduct remedies do not preserve incentives for independent conduct; rather, they seek to thwart the natural incentives of the merged entity to behave as a single firm. Conduct remedies are not self-enforcing; rather, they require costly monitoring in an effort to secure compliance.

9. For all these reasons, conduct remedies have generally been disfavored by the Justice Department and Federal Trade Commission and the courts. As I discuss further below, conduct provisions are difficult to write, difficult to enforce, and seem on their face unlikely to restrain a firm's natural incentive and ability to exercise the market power secured by merger. And indeed for all these reasons, my research shows that conduct remedies are generally

ineffective at preventing harm to consumers and competition.

10. Within my database on carefully studied mergers are those that were subject only to conduct remedies. If these remedies were fully effective, these mergers should show no postmerger price increase net of other factors such things as general cost changes. But the data in fact show that mergers subject to conduct remedies resulted in price increases that averaged 16.0 percent—far above any benchmark, and indicative of the failure of conduct remedies to prevent harm to consumers and competition.

11. The specific reasons that conduct remedies are ineffective are worth noting, both to better understand their fundamental limitations and also to be sure that the remedy proposed in this transaction is not an exception. From an economic point of view, the dual problems on which conduct remedies founder are (1) incentives and (2) information.[2] The incentive problem arises since conduct remedies are employed essentially to make a merged company act against its own self-interest, that is, in ways that do not fully utilize the market power inherent in its size and structure. The company can therefore be expected constantly to seek methods of crowding the border of stated rules and to identify alternative methods not proscribed by the rules to achieve its objectives. These alternatives will be greater to the extent that (a) the product or transaction is complex, since complexity offers more opportunities to evade the intent of any rule, and (b) the remedy or rule is in existence for a long period of time, since the passage of time changes circumstances and creates new ways to evade the intent of any rule.

12. Both of these features attend the conduct remedy proposed for this transaction. The remedy, like the health care products at issue, involves complex contractual arrangements that have numerous features and trade-offs, altogether unlike, say, the price of a single homogeneous good transacted between buyer and seller. Moreover, the remedy is intended to be in existence over a period of a decade, during which time it is impossible to imagine the changes likely to occur in the health care market and equally impossible now to write down the remedy provisions necessary to effect the same result in those changed circumstances.

13. The other major limitation of conduct remedies from an economic point of view is information. The information necessary to enforce a conduct remedy lies primarily with the

[2] J. Kwoka and D. Moss, "Behavioral Merger Remedies: Evaluation and Implications for Merger Enforcement," Antitrust Bulletin, 2012, v.57, no. 4

merged company and is only imperfectly perceived by the antitrust agency or outside monitor. Moreover, insofar as a conduct remedy relies on customers, suppliers, or rivals of the defendant to provide information about violations of the decree, such information may not be forthcoming because of a fear of retaliation, which itself is difficult to detect. While overt retaliation may be apparent, the relationship between the parties may be multifaceted and ongoing, and can afford ample opportunities for the merged company to exact a penalty against complainants without that being evident and unambiguous. The targeted party, knowing that at the end of the day it will still be locked into a business relationship with the merged company, may understandably and rationally be reluctant to report its concern.

The Proposed Remedy

14. Two key substantive provisions of the proposed remedy deserve closer examination—the component contracting provision and the price growth rule. The component contracting provision does not purport to address the direct loss of competition from the transaction by allowing separate negotiations between payers and various components, and would not work even if it were so designed.[3] Rather, it attempts to prevent the merged entity from tying or leveraging the sale of one component of its health care system to the sale of another component that the buyer ("payer") may not want. The operative question is whether the merged system's natural incentive to link its services can in fact be thwarted by a rule that states that the system must allow payers the option of negotiating for separate and different components. The effectiveness of this rule—its "meaningfulness" in the language of the consent order—depends crucially on the "implementation principles and requirements" stated in paragraph 68.

[3] The well-known case of Evanston illustrates the inherent problems with this approach. The separate-bargaining provision rather implausibly stated that each of the two divisions of the merged hospital system, for purposes of bargaining with insurers, had to act as if it were a free-standing hospital unit, not connected with a second hospital system (which, of course, has the very same instruction). This, it was hoped, would induce competition between the hospitals in setting prices to insurers. But for such an instruction actually to be effective, it would require the operator-manager of each hospital to somehow ignore that hospital's relationship to the other hospital, to ignore the fact that ultimately rewards to each hospital are increased by not bidding against each other, and to ignore the fact that his or her own position as manager is not made more secure by driving down prices and profits. Not surprisingly, the only economic study of separate bidding has concluded that it would not alter the end result. G. Gowrisankaran, A. Nevo, and R. Town, "Mergers When Prices Are Negotiated: Evidence from the Hospital Industry," NBER, 2014.

15. The first of these principles and requirements states that there shall be no contingent offerings of components, that is, no "all-or-nothing" offering. Yet nothing seemingly prevents the merged system from pricing and structuring its component offerings so as to induce the same result. For example, the single desired component can be priced very high when purchased by itself, whereas a bundle of that component with another may be priced so as to make it essentially irrational for the payer not to opt for the bundle. Such bundling strategies are common in many markets and nothing in this rule would seem to prevent it here. Moreover, there is no simple statement of principles that could be introduced to preclude such strategies: the possibilities are extremely difficult to enumerate ex ante and extremely difficult to prevent ex post. It will be nearly impossible for a payer to determine and argue convincingly that this provision has been violated.

16. The second principle and requirement stated in this paragraph of the proposed remedy is an anti-retaliation provision of the sort that was discussed in paragraph 13 above. That discussion cast serious doubt on the likely effectiveness of such provisions in general, and nothing in the proposed consent alters that conclusion. For all these reasons, the serious practical difficulties with component contracting are not likely to be resolved by appeal to these principles.

17. The second major feature of the proposed remedy—the Unit Price Growth Cap—is directed at price changes by Partners. Although limiting price increases below what otherwise would occur is a desirable goal, this rule is an inherently regulatory tool, one that requires careful design, on-going monitoring, mid-course adjustments, attention to adverse side effects, and more. The plan described in Attachment A appears to fall short of this standard in several respects. For one, there is no effort in the plan to determine whether initial prices are set at the correct level. Indeed, since the record indicates that Partners' prices are in fact significantly above the norm, this plan would enshrine that enduring benefit to Partners. Secondly, an economically sound price cap plan should cap prices at the rate of increase of input costs minus the productivity gains likely to be realized by the company.[4] The use of a General Inflation Index (Attachment A, para. III.b) without any offset for productivity gains would, when it is the

[4] J. Kwoka, "Implementing Price Caps in Telecommunications," Journal of Policy Analysis and Management," 1993, v. 12, no. 4.

operative constraint, result in the hospital system being able to raise prices faster than its actual unit costs, and simply pocket the difference.

18. A further problem with this price cap plan is that it creates incentives for the hospital to lower quality of service.[5] The logic is rooted in incentives: if the firm cannot raise price, the sole means of increasing profit is to reduce costs, which may compromise quality. While there are mechanisms in some price cap plans to blunt this effect, this proposed plan does not contain them. Finally, price cap plans must allow for some services in the index to disappear and other new services to be integrated in a fashion that correctly accounts for market adjustments. This is particularly important when plans are expected to last for many years, as is the case here. I do not find attention to these issues in this proposed remedy.

19. In addition to these substantive issues, the proposed remedy involves administrative costs and difficulties, and creates on-going obligations to the Massachusetts AG and the court. Price regulation is an inherently difficult and complicated task, as demonstrated by the need for a 23 page explanatory attachment and 12 additional pages of examples. One single provision in these attachments (para. IV.c.vii, p. 19), for example, lists six different "adjustments" to the TME (Total Medical Expense) calculation, which must be done for each "Risk Arrangement." These include adjustments for "Health Status," as explained in a separate Exhibit F, "Pharmacy Benefit," as explained in Exhibit G, and "Other Benefit Changes," together with adjustments for three other potential discrepancies.

20. There are other illustrations of the administrative issues throughout the proposed remedy, including some of the provisions with respect to affiliate contracting. For example, Paragraph 85 is an effort to permit the creation of certain affiliations under certain circumstances. Outlining the applicable affiliations and circumstances requires a single provision that runs 450 words, which involves the repeated invocation of conditions such as "reasonable period of time" and demonstrations of "integrated clinical relationship," as well as criteria such as "actual or expected membership" on certain committees, "geographic proximity,"

[5] A. Ter-Martirosyan and J. Kwoka, "Incentive Regulation, Service Quality, and Standards in U.S. Electricity Distribution," Journal of Regulatory Economics, 2010, v. 38. Other studies of price caps, in the telecom sector, report examples where service quality may fall, remain unchanged, or even improve. D. Sappington, "The Effects of Incentive Regulation on Retail Telephone Service Quality in the United States," Review of Network Economics, 2003, v. 2, no. 4.

and "participation … in quality improvement and care management programs." It also involves prior notification of the Attorney General, that person's opportunity to object to the proposed arrangement, and a procedure to resolve objections that involves recourse to the court. Such a provision is inherently and intensely regulatory, involving both the Attorney General's Office and the court in a process for which neither institution is designed.

21. These specific aspects of the proposed remedy for the transaction lend further weight to concerns that its anticompetitive effects will go unchecked.

My Conclusion

Based on my research into mergers, merger remedies, and price caps, as well as my experience in actual policy matters, I conclude that the proposed conduct remedy for the Partners-South Shore-Hallmark merger of hospital systems is seriously flawed and unlikely to prevent the merger's harm to consumers and competition in the Commonwealth of Massachusetts.

Respectfully Submitted,

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