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Sarah J. DiBoise, Esquire.
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P.O. Box 513
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Dear Ms. DiBoise:

This letter responds to your request on behalf of Marin General Hospital ("Marin") and Ross Hospital ("Ross") for a statement, pursuant to the Department of Justice Business Review Procedure, 28 C.F.R. § 50.6, of the Department's present enforcement intentions regarding their proposal to consolidate their separate facilities offering certain mental health services into a jointly operated facility. Based on the information you have provided, as supplemented by your revised proposal of February 16, 1996, the Department has no present intention to challenge the proposed joint facility if it is formed and operated as described below.

Marin is a not-for-profit hospital that owns and operates a general acute care hospital in Marin County, California. Marin offers various mental health services at a stand-alone facility near its main hospital. It has 17 licensed, staffed beds for adult inpatient psychiatric care at that facility. It also delivers adult psychiatric partial hospitalization services, adult psychiatric outpatient services, psychiatric emergency triage programs, and electroconvulsive therapy at that facility.

Ross is a for-profit corporation that owns and operates an acute care psychiatric hospital in Marin County. Ross has 18 licensed, staffed beds for adult inpatient psychiatric care. It offers all the adult psychiatric services that Marin offers. Ross offers two types of mental health services at its facilities that Marin does not, namely, inpatient psychiatric services to children and adolescents and chemical dependency programs.

As we understand your proposal, Marin and Ross desire to consolidate the facilities and personnel each uses to provide adult inpatient psychiatric services, adult psychiatric partial hospitalization services, adult psychiatric outpatient treatment programs, psychiatric

emergency triage programs, and electroconvulsive therapy services (collectively "the consolidated services"). They propose to coordinate their delivery of these services but to market and sell these services independently. Each will remain a separate and independent corporate entity, with separate boards of directors and executive management, and each will remain a competitor of the other in the sale of adult mental health services. Each will continue independently to deliver, market and sell health care services that the other does not. Marin will continue to provide general inpatient acute care and other services independently of Ross. Ross will continue to provide chemical dependency programs and inpatient psychiatric care to children and adolescents independently of Marin. Nothing in the proposed consolidation limits or affects the hospitals' ability to provide these services.

Marin and Ross propose to use Marin's stand-alone facility to deliver the consolidated services. In order to do so, they will increase the number of licensed, staffed beds at that facility from 17 to 34. Each will provide various input services necessary to produce the consolidated services. For example, Marin will provide the space at its stand-alone facility, and Ross will provide management services. They will jointly process the billing and collection for, and assure the quality of, the consolidated services under conditions designed to prevent unnecessary exchange of competitively sensitive information. They contend that this consolidation will substantially reduce the cost of delivering services by eliminating duplicative costs and spreading fixed costs over a larger population. They claim that this is particularly true for Ross, which had a 20% occupancy rate in 1993.

Marin has asserted that its primary reasons for pursuing this venture include a desire to respond competitively to lower rates offered by hospitals outside of the county for the business of individuals covered by certain programs of the County of Marin or by California's Medi-Cal program ("County patients"). Marin is eligible to care for County patients because of its license to provide general acute, inpatient care. Ross, however, does not provide general acute, inpatient care and is thus not eligible to provide the consolidated services to County patients under age 65 because of Medicaid program rules. For the period from September 1, 1993 through August 31, 1994, the County was the second largest source of revenue for Marin's adult acute inpatient psychiatric services, providing approximately 28% of Marin's net revenue from these services.[1] In 1995, the County and Marin failed to reach agreement for the treatment of County patients, and the County began sending patients outside of Marin County. You have represented that the County's rates do not cover Marin's costs of providing the consolidated services and that one goal of the proposed consolidation is to bring Marin's costs of treating County patients more in line with the County's rates so that Marin may once again treat these patients. The County has submitted a letter stating its belief that the consolidation will probably lower the cost structure of the combined programs and urging issuance of a positive business review. The payers with whom we spoke did not oppose the consolidation.

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[1] The Medicare program was the largest payer, providing over 45% of Marin's revenue.

Under the proposal, Marin and Ross will determine jointly the price for the consolidated services provided to County patients. They plan to pool the revenues attributable to treatment of County patients with revenues received for care of Medicare patients and to share any

surplus or to fund jointly any deficit from the services provided to patients covered by these programs.

Marin and Ross will not jointly determine the price for other payers. Rather, under the proposal, each will independently decide its rates for the consolidated services and other services that each offers, and whether to contract with any payer desiring those services. Each will remain free to offer the consolidated services and any other services at independent facilities although neither currently contemplates a need for doing so.

Under the proposal, managed care plans and all other payers may seek contracts with either or both Marin and Ross for the consolidated services. In the event a payer contracts with one, and not the other, the contracting hospital will receive the payments from that payer. In the event a payer contracts with both and the contracts do not address allocation of payments between the hospitals, then Ross and Marin will allocate patients covered by such a payer evenly between themselves.

Marin and Ross will honor the preferences of individuals insured by indemnity plans and of uninsured individuals for allocation of their payments to Marin or Ross. In the absence of such a preference, however, patients will be allocated to the hospital with the lower standard rates for the consolidated services, as determined by an independent agent that the hospitals will retain to compare their standard rates. The agent will be subject to a confidentiality agreement prohibiting the agent from disclosing to one hospital the rates charged by the other hospital. The hospitals either will contract with the agent, under the same confidentiality to handle their billing, or will handle their own billing in their separate and independent billing offices.

Marin and Ross will determine the cost per patient for each patient treated at the consolidated facility. Those costs will include compensation of the hospitals for the input services they contribute to the consolidated facility. The hospitals' compensation for the input services will not exceed the cost of the input services, including allocated costs not directly attributable to patient care (i.e., overhead costs), with the exception that Ross's compensation for the management services it provides will not exceed the fair market value of the management services. The parties will allocate costs across all patients receiving the consolidated services (including related support services) regardless of payer, in a manner consistent with the cost allocation system used elsewhere by Marin.

As mentioned above, the parties will share the costs of treatment of County and Medicare patients. For all other patients, the hospital receiving payments for the services provided to the patient will bear the costs for that treatment.

Analysis of the Competitive Effects of the Consolidation

Relying substantially upon your presentation of the pertinent facts, we do not have a present intention to challenge the consolidation if it is formed and operated as described above. In reaching this conclusion, we first analyzed the proposed consolidation and concluded that no aspect of it was per se illegal. We then evaluated the proposal under the rule of reason.

1. Is the proposed consolidation per se illegal?

The consolidation is not per se illegal because the proposal does not involve an agreement on the price to be charged for any services in which the hospitals compete or any other agreement that inherently appears to reduce price competition or output. The joint setting of the rate for services provided to the County is not per se illegal because Marin and Ross are neither actual nor potential competitors for that business since Ross is not an eligible provider under the Medicaid program. Similarly, the pooling of revenues from County patients with those received under the Medicare program, and the sharing of profit and loss on these pooled revenues is not per se illegal. The Medicare program reimburses the parties for the consolidated services on a cost-plus basis.[2] Accordingly, this aspect of the proposal does not eliminate price competition. Beyond the rates charged to the County, the proposal does not contemplate joint pricing. Indeed, the proposal embodies the belief of the parties that they are reasonably able to pursue the procompetitive goals of the proposal, discussed below, while continuing to compete on price for the consolidated services.

The parties have structured other aspects of the proposal in order not to eliminate price competition or reduce output. The use of cost-based charges by the parties for input services and a fair market value payment for Ross's management services precludes the parties from exercising indirectly market power through the device of inflated charges for their individual services to the joint facility. The allocation of both indemnity and uninsured patients without a hospital preference to the hospital with the lower rates does not involve an agreement on price and does not appear to reduce competition inherently but rather preserves the potential for competition by allowing either party to lower its standard rates in order to capture the revenues from these patients. Similarly, the allocation of insured patients, whose insurance contracts make no provision for steering of patients to preferred providers, does not appear inherently to reduce competition because the proposal preserves payers' ability to exploit competition between the hospitals by selectively contracting with one or the other. The consolidation will not reduce the capacity of the parties to provide adult mental health services.

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[2] To the extent Medicare employs selective contracting, for example by providing benefits through contracts with health maintenance organizations, the parties would not pool those revenues with the revenues from County patients. Instead, the parties would treat contracting with, and revenues from, Medicare HMOs in the same manner they contract with and treat revenues from all other HMOs.

Moreover, the plausible efficiencies that this proposal could achieve warrant rule of reason analysis. While, as discussed below, the consolidation could have an impact on some aspects of competition between the parties, the parties appear to have limited their agreements to matters reasonably necessary to achieve the procompetitive ends of reducing the cost of delivering the consolidated services and permitting Marin to compete for the business of the County patients. Accordingly, we proceed to a rule of reason analysis of the anticompetitive potential of the consolidation in light of those procompetitive ends.

2. Is the consolidation unlawful under a rule of reason analysis?

Under the rule of reason, we evaluate whether the consolidation will have a net anticompetitive effect. We weigh the potential anticompetitive consequences of the consolidation in light of its procompetitive potential. In undertaking this analysis, we examine the nature and purpose of the proposal, the markets in which the parties compete, and any collateral agreements.

We are assuming that each of the consolidated services constitutes a relevant product market and that Marin County is a relevant geographic market for each product.[3] It is our understanding that Marin and Ross operate the only adult inpatient mental health facilities in that market and are competitors in these assumed markets.

The participation of the only two competitors in a market in the joint production of their competing product clearly creates the opportunity to collude explicitly or tacitly on prices. In addition, while, as discussed above, the pooling of revenues from County-run programs and the Medicare program, the sharing of profit and loss on patients covered by these programs, and the joint determination of the rates for the County-run programs are not per se illegal, this activity increases both the opportunity and the incentive for the parties to agree explicitly or tacitly on the rates to other customers. One safeguard against such collusion will be the protections against the unnecessary sharing of confidential business information that the parties have

[3] You contend that the geographic market for adult inpatient mental health services is substantially broader than Marin County, that entry is easy into markets for such services, and that Marin and Ross combined would not have market power in the relevant market for each of the services. We have not conducted the comprehensive investigation necessary to determine the relevant geographic market. If your representations in this regard are accurate, the competitive concerns from the proposed consolidation would be reduced. However, because we have a significant concern that Marin County is the relevant geographic market for non-County patients, we have made that conservative assumption for the purposes of this letter.

Our analysis focuses on non-County patients. The fact that County patients are receiving treatment outside of the County does not necessarily conflict with our assumption that the County is a relevant geographic market for non-County patients.

proposed. The parties, among other things, will be prohibited from discussing, communicating or exchanging information with each other relating to the pricing of any patient care service provided by either hospital other than consolidated services provided to County patients. Protections against the unnecessary sharing of confidential business information, if substantial and rigorously followed, should further mitigate, but will not eliminate, the increased potential for collusion.

The consolidation will also eliminate the potential for competition between Marin and Ross through differentiation of their services based on the efficiency and quality of their independent facilities. The absence of indications that the relative efficiency and quality of the hospitals have been significant aspects of competition between them somewhat mitigates our concern. Moreover, the elimination of competition as a spur to efficient operation will not eliminate all incentive to control costs. The profits of Marin and of Ross will depend on the efficiency with which care is delivered by the two hospitals working together. Thus, each hospital will have an incentive to monitor the shared costs that the other controls directly. Finally, the County is the second largest payer and the threat of the loss of its business provides a substantial incentive for the hospitals to control costs and provide quality care.

Our concerns over collusion and the reduction of competition on the basis of efficiency and quality are significant in light of our assumptions regarding relevant markets. Nonetheless, we are not prepared to say that the mere consolidation is likely to have a net anticompetitive effect. The consolidation also has the potential to reduce substantially the parties' costs. While we have not attempted to quantify the proposal's potential savings and have not verified or relied on your figures, you have described cost savings that the consolidation may plausibly achieve.

The savings from the consolidation may be passed on to various consumers of the consolidated services. Managed care plans and other payers in the County retain the opportunity to contract selectively with the parties and thus to benefit from competition between them on the rates each will offer for the consolidated services. Similarly, the parties may compete for the revenues from indemnity patients and uninsured individuals by offering lower standard rates. Finally, as a result of these savings, the parties will be able to compete more effectively with providers outside of the County for the County patients. The potential for increased output from contracting for the County patients appears significant, since County patients accounted for 22% of the hospitals' combined cases from September 1, 1993 through August 31, 1994.

On the basis of the information you have provided, the Department has no present intention to challenge the proposed venture. However, in accordance with our normal practice, the Department remains free to bring whatever action or proceeding it subsequently comes to believe is required by the public interest, if the proposed consolidation proves to be anticompetitive in purpose or effect. Such an effect might occur, for example, if the parties collect more for their input services than the costs of those services, or if their cooperation facilitates collusion

on the pricing of the consolidated services, or if the ultimate price (including utilization) paid by managed care plans and other consumers for the consolidated services is above competitive levels as a result of the consolidation.

This statement is made in accordance with the Department of Justice's Business Review Procedure, 28 C.F.R. § 50.6, a copy of which is enclosed. Pursuant to its terms, your business review request and this letter will be placed in a file that will be available to the public immediately. In addition, any supporting data that you do not identify as confidential business information under paragraph 10(c) of the Business Review Procedure also will be made publicly available in 30 days.

Sincerely,

Joel I. Klein