Reexamining DOJ's Predation Analysis in *United Regional*

By David A. Argue, Ph.D.[1] and John M. Gale, Ph.D.[2]
Economists Incorporated, Washington, DC

In February 2011, the U.S. Department of Justice (DOJ) published a complaint and settlement after conducting a Section 2 monopolization investigation of United Regional Hospital in Wichita Falls, Texas.[3] The 369-bed hospital was accused by DOJ of engaging in exclusionary practices with managed care plans that prevented the 41-bed, physician-owned Kell West Hospital from becoming a full-service hospital in competition with United Regional. The unusually detailed Competitive Impact Statement (CIS) issued by DOJ described various aspects of the contracts between United Regional and several small commercial payors that ostensibly harmed competition. The largest commercial payor, Blue Cross of Texas (Blue Cross) was not bound by any allegedly harmful exclusionary provisions in its contract with United Regional.

The DOJ's complaint alleged that the bundled discounts in United Regional's contracts with the non-Blue Cross plans constituted harmful predatory pricing. This conclusion relied on a novel variation of the discount attribution approach used in other managed care plan cases, *Ortho*[4] and *PeaceHealth.*[5] Ultimately, however, that variation is not compatible with DOJ's theory of competitive dynamics in the alleged *United Regional* market. Moreover, DOJ presented no analysis of recoupment of forgone profits or how a below-cost strategy might otherwise be profitable. These shortcomings render the predatory pricing analyses in *United Regional* insufficient to support the conclusion of antitrust injury.

DOJ's Theory of Competitive Harm

As articulated in the complaint and CIS, DOJ believed that United Regional harmed competition by preventing Kell West from having access to the business of the non-Blue Cross insurers.[6] United Regional allegedly denied Kell West's access to the non-Blue Cross

---

[1] David A. Argue is a Principal at Economists Incorporated in Washington, D.C.

[2] John M. Gale is a Vice President at Economists Incorporated in Washington, D.C.

[3] Complaint, U.S. and State of Texas v. United Reg. Health Care Sys., No. 07:11-CV-00030 (N.D. Tex. Feb. 25, 2011), *available at* http://www.justice.gov/atr/cases/f267600/267651.pdf.

[4] Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455 (S.D.N.Y. 1996).

[5] Cascade Health Solutions v. PeaceHealth, 515 F.3d 883 (9th Cir. 2008).

[6] Competitive Impact Statement, U.S. and State of Texas v. United Reg. Health Care Sys., No. 7:11-CV-00030 (N.D. Tex. Feb. 25, 2011), *available at* http://www.justice.gov/atr/cases/f267600/267653.pdf [hereinafter "CIS"].

commercial plans by entering into contracts with those plans that excluded Kell West from their networks in exchange for increased discounts from United Regional. The discounts covered all services purchased from United Regional, not just those services that were also available at Kell West. Had these insurers included Kell West in their networks, DOJ argued, the profits Kell West would have earned from its subscribers would have enabled Kell West to expand the services it offers to include those for which United Regional is the sole community provider ("monopoly services").[7] Kell West ostensibly would have added "more beds and additional services, such as additional intensive-care capabilities, cardiology services, and obstetrics services."[8] DOJ alleged that United Regional began its predation strategy in 1999 when it entered into bundled discount contracts with five payors, subsequently followed by contracts with three more payors.[9] Since DOJ did not allege that United Regional would have forced Kell West out of the market, its theory implies that United Regional must maintain this scheme of exclusive contracting in exchange for greater discounts for an extended period to protect its monopoly services and to keep Kell West from becoming a full-service hospital.

Among other things, DOJ accused United Regional of using these contracts to effectuate a competitively harmful strategy of below-cost predatory pricing. To test whether United Regional engaged in predatory pricing, DOJ applied a modified form of the "discount attribution" approach articulated by the district court in *Ortho* and used by the Ninth Circuit in *PeaceHealth*.[10] In general, the discount attribution approach assigns the entire amount of the discount for the bundle of services to the sales of the competitive service alone. DOJ's modification arises in how it determined which services constituted the competitive services. DOJ identified the competitive services by dividing United Regional's patients insured by payors with exclusive contracts into three groups: (1) those receiving services not available at Kell West (e.g., patients receiving cardiac surgery or obstetrics care), denoted here as "monopoly services," (2) those receiving services available at Kell West but who prefer United Regional and would not switch to Kell West,[11] denoted here as "preferred services," and (3) those receiving services available at Kell West who would switch to Kell West if the payor did not have an exclusive contract with United Regional. The third group of patients constitute what DOJ believed are the competitive sales, and it denotes these patients as "contestable." DOJ estimated that only 10% of non-Blue Cross commercially insured patients were contestable.[12] After attributing the discount on the whole bundle of services entirely to the 10% of non-Blue Cross commercial patients, DOJ concluded that United Regional's prices for the competitive services

[7] DOJ does not describe why this strategy is a credible entry deterrent or why Kell West could not finance through other means the expansion that DOJ evidently believes would be profitable.

[8] CIS, *supra* note 6, at 12.

[9] CIS, *supra* note 6, at 3.

[10] CIS, *supra* note 6, at 14; Ortho Diagnostic Sys., Inc. v. Abbott Labs., Inc., 920 F. Supp. 455, 467 (S.D.N.Y. 1996); Cascade Health Solutions v. PeaceHealth, 515 F.3d 883 (9th Cir. 2008).

[11] CIS, *supra* note 6, at 16. "[M]any patients are likely to choose care at United Regional even for services that competing providers offer."

[12] CIS, *supra* note 6, at 15-16. This estimate is based on usage patterns of Blue Cross and Medicare patients. One concern with using Medicare patients is that they are not representative of commercially insured patients. Medicare patients are likely to be systematically older and with no demand for obstetrics or pediatrics services.

supplied to the contestable patients were well below its costs, so United Regional must have engaged in competitively harmful predatory pricing.[13]

Faulty Logic of DOJ's 10% Solution

A closer examination of the allegations in *United Regional* shows that DOJ failed to incorporate some important aspects of the competitive dynamics of its own theory. As a consequence, it reaches a mistaken conclusion about the discount attribution. The core of the alleged harm in DOJ's theory in *United Regional* is not that the 10% of non-Blue Cross patients could not use Kell West. Those patients are simply the mechanism by which harm is allegedly inflicted. The alleged harm is that Kell West is prevented from expanding into a full-service competitor of United Regional. By not incorporating this concept properly into its discount attribution analysis, DOJ mistakenly focused on the 10% of patients it believed to be contestable.

To better understand the implications of DOJ's theory in *United Regional*, it is helpful to consider a stylized example of discount attribution. The district court in *Ortho* used an example of bundled discounting of shampoo and conditioner to illustrate the concept of discount attribution.[14] This example was also cited by the Ninth Circuit in *PeaceHealth* to explain its decision about discount attribution.[15] In the *Ortho* example, a conditioner monopolist who also produces shampoo attempts to eliminate a shampoo rival by using below-cost bundled discounts. That example can be altered slightly without changing its substance to align it more closely to the *United Regional* allegations in which the defendant is accused of preventing entry of a competitor rather than inducing a competitor's exit. The logic of the example is easy to discern. Suppose that one firm produces both shampoo and conditioner and a second firm wants to enter the shampoo market. The incumbent hair-products monopolist offers the two-product bundle at a discount below the products' combined stand-alone prices. The discount attribution approach weighs the entire bundled discount against the stand-alone price of the shampoo, the product area in which entry is threatened. The discount is attributed entirely to the shampoo because the discount is designed to affect competition in the shampoo market. The discount has no effect on the monopoly conditioner market. Moreover, since consumers must purchase conditioner from the monopolist in any event, there would be no reason to discount its prices.

In *United Regional*, United Regional's alleged attempt to thwart Kell West's entry into the monopoly services market is analogous to the hair products monopolist's attempts to prevent entry into the shampoo market, though there are some important differences. In the *Ortho* example, the discount is intended to affect competition in the market for the competitive product (shampoo), leaving the monopoly product (conditioner) untouched. United Regional, however, has no service line that is a secure monopoly, free from threatened entry. Rather, United Regional's monopoly services markets are threatened by Kell West's expansion. Protecting against that threat, according to DOJ, was the basis for United Regional's bundled discount. The impact of the bundled discount (and the related exclusivity) was felt directly by the contestable patients who would otherwise have chosen Kell West, but the discount's ultimate aim was to thwart Kell West's service line expansion. Thus, DOJ's contestable patients were not the target of the

[13] CIS, *supra* note 6, at 16.

[14] *Ortho*, 920 F. Supp. at 455, 467.

[15] *Cascade Health Solutions*, 515 F.3d at 896-97.

alleged anticompetitive conduct but rather the means to accomplish it.

Once the markets ultimately affected by the alleged anticompetitive conduct are identified, it becomes clear how to attribute the bundled discount. In the hair products example, the entire discount is attributed to shampoo because that is the market with the competitive impact. In *United Regional*, DOJ theorized that the bundled discount prevented the entry of Kell West into monopoly services and thus prevented its expansion into a full-service hospital. Were Kell West to become a full-service hospital, all of the business that it could not otherwise attract (i.e., users of the monopoly services and the preferred services)[16] would become competitive. The effect of the alleged anticompetitive conduct thus was not on the 10% of patients DOJ denoted as contestable, but on all of the other patients. Rather, in DOJ's theory, the bundled discount affected United Regional's competition for all patients, and it should be attributed to all of them. As DOJ stated, "the entire discount should be attributed [ ] to the patients that United Regional would actually be at risk of losing," and it risks losing all patients to an expanded Kell West.[17] Whether United Regional would actually lose all of those patients depends on many factors like the relative efficiency of the two hospitals, but that does not change the analysis of attributing the bundled discount.

Another way to view this concept is to consider how large a discount United Regional would be willing to offer to non-Blue Cross commercial payors in exchange for exclusivity. Once again, the *Ortho* example of shampoo and conditioner shows how this line of reasoning leads to the proper discount attribution. In that example, the hair-products monopolist would be willing to offer a discount up to the present value of the incremental profit gained by maintaining market power in shampoo sales. The amount of this profit is unaffected by the conditioner market, which is not threatened by entry. Logically, the entire discount should be attributed to shampoo with none being attributed to the monopoly conditioner product. In *United Regional*, if United Regional were attempting to protect its monopoly services (and those patients who prefer United Regional) from Kell West's entry, as DOJ's theory stated, then United Regional should be willing to offer payors a discount up to the present value of the profits that United Regional derives from those payors' use of the monopoly and preferred services. By this reasoning, the discount United Regional offered payors for exclusivity is tied to and defined by the combined monopoly and preferred services markets rather than by the contestable patients, and it should be attributed to the combined monopoly and preferred services rather than only to the contestable 10%. Since Kell West's transformation into a full-service hospital also means that United Regional would risk losing the contestable patients as well, United Regional would be willing to offer a discount up to the amount of profits received from those patients also. Again, in that manner, the discount should be attributed to all patients.

---

[16] Although the CIS does not explain why some patients supposedly prefer United Regional for services available at Kell West, it is reasonable to assume that product differentiation is the reason. United Regional attracts patients that could go to Kell West because it is an established, large, full-service hospital whereas Kell West is a newer, smaller, limited-service hospital. DOJ's theory depends on Kell West becoming a binding competitive constraint on United Regional when it expands into a full-service alternative by adding the monopoly services. Product differentiation is the only explanation for these patients choosing United Regional over Kell West that is consistent with DOJ's theory.

[17] CIS, *supra* note 6, at 15.

Before concluding this discussion, it is helpful to consider bundled discounting in the context of a capacity constraint, especially since the CIS references an article about capacity constraints in its discussion of DOJ's version of contestable patients.[18] With a capacity constraint at Kell West, the contestable sales might more reasonably be considered to be less than the full volume of competitive sales. The standard discount attribution approach assumes that the rival supplier can take all of the sales of the competitive product from the bundled discounter if the products were unbundled. If the rival has limited capacity, however, then only a portion of the competitive sales could switch. In essence, the bundled discounter could price the competitive product on a stand-alone basis above the competitive level and risk losing sales only up to the rival's capacity level. While that reasoning may provide a justification for attributing the bundled discount entirely to the competitive product, DOJ does not make the argument in *United Regional* that Kell West's capacity is constrained. Quite the contrary, DOJ's arguments imply that Kell West could rapidly expand to rival United Regional.

In sum, it is apparent that the bundled discount in *United Regional* should be attributed to the monopoly and preferred services or, more appropriately, to all services. It is an empirical matter whether the fully allocated discount results in below-cost prices, but the implications of attributing the increased discount offered for exclusivity to a much larger portion of United Regional's patients than just the 10% is obvious: the likelihood of United Regional's discounted prices being below cost is much smaller or even non-existent.

[18] CIS, *supra* note 6, at 15 (referencing Mark S. Popofsky, *Section 2, Safe Harbors, and the Rule of Reason,* 15 GEO. MASON L. REV. 1265, 1294 (2008)).

Investment in Predation

Setting aside the appropriateness of attributing the entire discount to the small set of so-called contestable patients, the questions remain of whether investment in a below-cost pricing strategy is economically rational and how to recoup forgone profits. Recoupment has long been a central feature of any analysis of alleged predatory pricing.[19] The reason for its pre-eminence is that no economically rational firm should be expected to invest in a strategy of below-cost pricing that offers no prospect of generating a return that will compensate for the investment. As Justice Kennedy wrote in *Brooke Group*, "[r]ecoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation."[20]

A straightforward way to consider this issue for *United Regional* is to assess United Regional's options in choosing a pricing strategy. The first option would be to enter into exclusive contracts with the non-Blue Cross health plans in which those plans forgo a broad hospital network in exchange for a greater discount from United Regional. This, of course, is the option that United Regional chose from 1999 until its settlement with DOJ in 2011. This option can be divided into two separate possibilities that are relevant to the issue of predation. On the one hand, United Regional might offer the health plans a discount that results in United Regional's price being below cost, as DOJ alleged. Alternatively, United Regional might offer discounts to the health plans that are sufficient to compensate the plans for accepting

[19] *See, e.g.,* Brooke Group Ltd. v. Brown & Williamson Tobacco Co., 509 U.S. 222 (1993); Herbert Hovenkamp, *Discounts and Exclusion*, 2006 UTAH L. REV. 841, 844-45.

[20] *Brooke Group Ltd*., 509 U.S. at 224.

a narrow hospital network, but nevertheless result in prices above cost. Since prices remain above cost in this latter scenario (ignoring how the discount is attributed), it cannot be the basis for allegations of predatory pricing.

A third option for United Regional would be to jettison altogether the exclusive contracts and the discounts that go with them. According to DOJ, if United Regional chose this option, Kell West's access to the non-Blue Cross patients would allow it to expand into a full-service hospital. In this no-exclusives, no-discounts scenario, United Regional would price its monopoly services at the monopoly level to maximize profits over the time period it takes Kell West to effectuate its expansion.[21] Once Kell West became a sufficient competitor to discipline United Regional's prices, United Regional would be forced to lower the prices of its formerly monopoly services to competitive levels.[22] Obviously, no basis exists in that situation for allegations of predatory pricing.

Thus, only one scenario exists in which United Regional could be engaged in the predatory strategy that DOJ alleged: pricing below costs.[23] As noted above, a logical question to ask in the context of an alleged below-cost pricing strategy is whether the strategy is economically rational, either through recoupment of lost profits or through other means. Yet despite all of the detail in the CIS, DOJ included no discussion or analysis of the economic rationality of this strategy.

It is possible that DOJ has made the same mistake as the Ninth Circuit in *PeaceHealth* and some of the Antitrust Modernization Commission members regarding recoupment. The Ninth Circuit stated that a seller of bundled products need not meet the recoupment standard as long as it makes positive profits on bundled sales.[24] In fact, any price below the single-period profit maximizing level involves an investment in the form of forgone profits that must generate an adequate financial return.[25] It is also possible that DOJ did not address this issue because it foresaw no future period in which United Regional could actually recover its investment. The perpetual discounting that is necessary in DOJ's theory to keep Kell West from entering the monopoly services market makes recoupment through a price increase impossible. DOJ does not explain how United Regional ever arrives at a point at which it can both meet the below-cost requirement of predatory pricing and still recover the forgone profits attributable to this alleged predation strategy. Absent an alternative explanation, this

[21] A complication in this scenario concerns pricing of the "preferred services." In reality, the preferred services are a set of patients who consume the same services as the contestable patients but who prefer to receive them at United Regional. United Regional cannot distinguish among those patients, so it cannot raise the price on the preferred patients alone. For this reason, United Regional would raise price in this scenario for just the monopoly services.

[22] This assumes no oligopoly interaction in a two-firm market that would yield above-competitive prices.

[23] A scenario might be conjured in which United Regional lowers its price to small plans sufficiently to entice them to sign exclusive contracts, but it still sets prices above its costs. This assumes that the health plans would be better off to accept a price that is between the single-period monopoly price and the competitive price hereafter rather than to accept the monopoly price in the first period (i.e., until Kell West expands into a to full-service hospital) followed by the competitive price thereafter. This type of above-cost limit pricing was not alleged by DOJ.

[24] Cascade Health Solutions v. PeaceHealth, 515 F.3d 883, 910 n.21 (9th Cir. 2008). *See also* Jonathan Jacobson, *Exploring the Antitrust Modernization Commission's Proposed Test for Bundled Pricing,* 21 ANTITRUST A.B.A. 23, 25-26 (Summer 2007).

[25] *See* David A. Argue, *Predatory Bundling and Recoupment in the Ninth Circuit's PeaceHealth Decision*, ANTITRUST HEALTH CARE CHRONICLE, Oct. 2007, at 5.

is not an economically rational pricing strategy and therefore should be rejected as a possible explanation of United Regional's actions.

Payors' Incentives and Abilities to Affect Market Structure

An additional issue in *United Regional* is the implication of DOJ's assertion that if Kell West attracted just 10% of the non-Blue Cross commercial patients, it could expand into a full-service hospital. While DOJ argued that the non-Blue Cross health plans were more profitable to the hospitals than Blue Cross, 10% of non-Blue Cross patients represented only 2.5% of United Regional's entire commercial patient population.[26] If Kell West needed so little incremental business to launch itself into full competition with United Regional, it must already have been a close competitor of United Regional. This possibility is consistent with DOJ's statement that Kell West provides a "wide range of inpatient and outpatient procedures."[27] Moreover, any other scenario would represent an extraordinary turnaround of the usual DOJ/FTC position of dismissing the competitive significance of smaller hospitals. The agencies often refuse to credit a small hospital with the potential ability to discipline a large competitor.[28]

An additional important implication of Kell West being so nearly a full competitive rival to United Regional concerns the incentives of Blue Cross. If Kell West were on the cusp of becoming a full-fledged rival of United Regional, then it should not be difficult for Blue Cross to modify its rates to Kell West to facilitate Kell West breaking United Regional's hold on the monopoly services. Regardless of Blue Cross's size, it does best by purchasing hospital services sold in a competitive market. No indication exists, however, that Blue Cross has given Kell West more favorable rates to sponsor Kell West's expansion into those services or that United Regional increased its discount to Blue Cross to prevent it from helping Kell West. Not only is there no discussion of Blue Cross's incentives vis-à-vis Kell West's expansion, but the CIS is silent about Blue Cross's demonstrated ability to resist United Regional's alleged demands for exclusivity provisions. DOJ's theory of United Regional being a "must-have" hospital implies that Blue Cross has no bargaining leverage to thwart United Regional's demands, but DOJ ignored information that is inconsistent with that theory.[29]

Similarly, the incentives of the non-Blue Cross plans must also be taken into account. Like Blue Cross, these plans have an economic incentive to foster competition among the providers from which they purchase services.[30]

---

[26] CIS, *supra* note 6, at 10-11. This estimate is based on Blue Cross accounting for 75% of commercial enrollment in the area, as reported by the American Medical Association, Competition in Health Insurance: A Comprehensive Study of U.S. Markets, 2007 Update, *available at* http://www.ama-assn.org/ama1/pub/upload/mm/368/compstudy_52006.pdf.

[27] CIS, *supra* note 6, at 3.

[28] FTC v. Tenet Health Care, 186 F.3d 1045, 1052 (8th Cir. 1999); U.S. v. Mercy Health Servs., 902 F. Supp. 968, 977 (N.D. Iowa 1995).

[29] DOJ may believe that Blue Cross and United Regional are bi-lateral monopolists and thus reach an indeterminate outcome on price. If DOJ thinks that Blue Cross has market power, it should not act in a manner that harms Blue Cross's competitors, yet that is a likely outcome of the settlement. United Regional's but-for price absent the exclusive should be expected to increase. If so, the commercial plans' costs for the 90% of patients who stay at United Regional would increase, causing premiums to rise, and inducing enrollees to switch to Blue Cross, thereby strengthening Blue Cross's purchasing power.

[30] The impact of this incentive may be offset by each individual plan's incentive to free ride on the others in promoting Kell West's expansion.

In principle, United Regional could overcome this economic incentive with a large enough discount. If, however, the plans thought that Kell West could readily expand to discipline United Regional's pricing, as DOJ's theory suggests, that would increase the likelihood that they would reject United Regional's bundled-price exclusivity and instead support Kell West's expansion. If, in contrast, they doubted DOJ's estimate of Kell West's potential, the plans would be more likely to accept United Regional's offer of discounted pricing, which, of course, is what they did.

Conclusion

DOJ's investigation of United Regional's pricing strategies focused on several themes related to alleged anticompetitive exclusionary conduct. Central to those allegations is DOJ's assertion that United Regional used bundled discounts to implement a predatory pricing strategy. That assertion depends in turn on DOJ's novel approach of attributing the full bundled discount to United Regional's so-called "contestable" patients. Importantly, DOJ's theory that United Regional was attempting to protect is "monopoly services" from Kell West's entry, however, more logically points to a fully allocated discount, thereby undermining claims of below-cost pricing. Further, DOJ's silence on recoupment of forgone profits leaves a gap in its overall analysis of predation. The failure of United Regional's alleged below-cost predatory pricing to eliminate Kell West's threat of entry in DOJ's theory requires perpetual predation. Absent a return on the investment in lost profits, the strategy cannot be economically rational and thus cannot be accepted as the explanation for United Regional's conduct.