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REFORMING FCC REGULATION OF DOMINANT TELEPHONE CARRIERS: PUTTING SOME TEETH INTO THE TEST FOR PREDATION

Thomas K. Gump*

After nearly six decades of heavily regulating America's telephone industry, the Federal Communications Commission (FCC) started firmly down the path of deregulation during the 1980s. This deregulatory trend in telecommunications paralleled similar developments in the motor carrier, natural gas, and financial services industries. Deregulation in the telephone industry has taken the form of the price cap regulatory scheme for the American Telephone and Telegraph Company (AT&T) and other dominant telephone carriers. Price cap regulation marks a dramatic step away from the older approach to telephone regulation, rate-of-return regulation, which limited a telecommunications carrier's profits to

* B.A. 1989, Georgetown University; J.D. 1992, University of Michigan Law School. I would like to extend warm thanks to Howard E. Shapiro, Nina Rivera, Irene Lakes, Olivia Veeks-Egoavil, Rebecca Lynn Margulies, and G. James Frick for the patient and thoughtful research and editorial assistance provided during the production of this Note.

5. The FCC deems a telephone company to be dominant if it can exercise market power sufficient to exploit consumers. Thus far, only AT&T and local exchange carriers (LECs) have been found to be dominant telephone carriers. See Policy and Rules Concerning Rates for Dominant Carriers, 3 F.C.C.R. 3195, 3202-03 (1988) (further notice of proposed rule making) [hereinafter Further Notice]. Further Notice was summarized in the Federal Register. See Policy and Rules Concerning Rates for Dominant Carriers, 53 Fed. Reg. 22, 356 (1988) (to be codified at 47 C.F.R. 001, 61, 65, 69). Although the basic criticism of the price cap scheme contained in this Note applies to all telephone companies subject to this form of regulation, this Note will focus on price cap regulation as applied to AT&T.
6. An excellent summary of rate-of-return regulation and its inherent problems appeared in a recent opinion by Judge Stephen F. Williams of the Court of Appeals for the District of Columbia:
a certain percentage return on total investment. Such a compensation structure led to a highly inefficient use of resources as regulated entities raised their level of investment to increase their level of profits, often without regard to whether the new investment was efficient economically or actually needed.  

In contrast, price cap regulation attempts to use market mechanisms and economic incentives to achieve regulatory goals in a less wasteful manner. Price cap regulation allows AT&T to set its own rates for telephone services as long as those rates fall between floor and ceiling prices established by

Rate-of-return regulation is based directly on cost. Firms so regulated can charge rates no higher than necessary to obtain "sufficient revenue to cover their costs and achieve a fair return on equity." As one virtue of perfect competition is that it drives prices down to cost, rate-of-return regulation seems on its face a promising way to regulate natural monopolies, in principle roughly duplicating the benefits of competition.

By the late 1980s, however, the FCC began to take serious note of some of the inefficiencies inherent in rate-of-return regulation. First, the resulting cost incentives are perverse. Because a firm can pass any cost along to ratepayers (unless it is identified as imprudent), its incentive to innovate is less sharp than if it were unregulated.

Second, rate-of-return regulation creates incentives for cost shifting that may defeat the regulatory purpose and have other ill effects. Firms can gain by shifting costs away from unregulated activities (where consumers would react to higher prices by reducing their purchases) into the regulated ones (where the price increase will cause little or no drop in sales because under regulation the prices are in a range where demand is relatively unresponsive to price changes).

Third, rate-of-return regulation is costly to administer, as it requires the agency endlessly to calculate and allocate the firm's costs.


7. For example, regulators might allow a regulated company a 12% return on investment. Thus, a telephone company which had $50 million invested would earn a guaranteed annual profit of $6 million. Although the rate-of-return regulatory scheme was conceived as an attempt to lessen government oversight, it has proven immensely complicated in practice. Sutapa Ghosh, The Future of FCC Dominant Carrier Rate Regulation: The Price Caps Scheme, 41 FED. COMM. L.J. 401, 405–06 (1989).

8. Judge Breyer uses an extreme example to illustrate this phenomena, known as the Averch-Johnson effect. Breyer writes: "Michigan Electric Company would be delighted to borrow $10 million at 7 percent to build Egyptian pyramids if the fair rate of return is 8 percent. If the regulator approves [the expenditure], it will collect an additional $800,000 from its Michigan customers, pay $700,000 to its bondholders, and keep the difference." STEPHEN BREYER, REGULATION AND ITS REFORM 49 (1982).

the FCC. These new regulations give AT&T an economic incentive to increase efficiency because lower costs will raise profits. Thus, AT&T will enjoy great freedom and flexibility in pricing its services for the first time in decades.

Interestingly, it was precisely this freedom and flexibility to price its services that allowed AT&T to engage in anticompetitive practices prior to regulation. In an article commemorating the fifty-year anniversary of the FCC's existence, former FCC Chairman Dean Burch recounted some of the anticompetitive practices from AT&T's history. For example, during the 1890s, AT&T embarked upon an "aggressive program of intimidation and acquisition" in order to monopolize its position in the telephone market. AT&T often refused to sell equipment or to provide interconnection to independent telephone companies as part of its plan to acquire its competitors or to drive them out of business. Although this initial program of monopolization ostensibly was terminated with the Kingsbury Commitment of 1917, AT&T continued to battle the Department of Justice in the courts for most of the next fifty years.

The threat of predatory pricing by AT&T is foremost among

11. Id. Under price cap regulation, AT&T, like firms in competitive markets, can earn extra profits by cutting costs.
13. Id.
14. Id.
15. The Kingsbury Commitment was based upon a letter by Mr. M.C. Kingsbury, then vice-president of an AT&T predecessor company. Kingsbury wrote his letter to the Attorney General in response to a threatened antitrust suit by the federal government. In the Kingsbury Commitment, the vice-president stated that his company agreed to cease acquiring, directly or indirectly, control over any competing company. In addition, Kingsbury stated that his company agreed to connect its system with other telephone systems, so long as the companies which were to be connected assisted with the technical details. FED. COMMUNICATIONS COMM’N, INVESTIGATION OF THE TELEPHONE INDUSTRY IN THE UNITED STATES, H.R. DOC. NO. 340, 76th Cong., 1st Sess. 139–40 (1939) [hereinafter INVESTIGATION]. Thus, the Kingsbury Commitment is one of the earliest examples of the federal government's concern and preoccupation with AT&T's anticompetitive practices.
the antitrust dangers. Under a regime of predatory pricing, a firm reduces prices in the short run "so as to drive competing firms out of the market or to discourage entry by new firms in an effort to gain larger profits via higher prices in the long run."\(^{17}\) This Note examines the ineffective protections against predatory pricing by AT&T contained in the price cap scheme. Part I outlines price cap regulation and explains how the FCC hopes that a test based on the average variable cost standard\(^{18}\) will detect predatory pricing. Part II argues that the FCC erred in adopting an average variable cost standard as the test for telecommunications predation because that standard ignores the high fixed costs\(^{19}\) common to all firms in the industry. Part II demonstrates that AT&T could engage in predatory pricing despite the protections contained in the regulatory scheme. Part II then examines the rationale given by the FCC for adopting a test based on the average variable cost standard and demonstrates its inadequacy. Finally, Part III examines two tests for predation that consider fixed costs, and suggests that replacing the average variable cost standard with a test based on long-run marginal cost\(^{20}\) would provide more effective protection against predatory activity by AT&T in the telecommunications industry.

I. OVERVIEW OF THE FCC PRICE CAP SCHEME

Price cap regulation by the FCC represents an entirely new approach to a century-old problem: ensuring that America's telephone companies serve the public interest. The price cap

\(^{17}\) Paul L. Joskow & Alvin K. Klevorick, A Framework for Analyzing Predatory Pricing Policy, 89 YALE L.J. 213, 219-20 (1979). Alternatively, predatory pricing has been defined as "pricing at a level calculated to exclude from the market an equally or more efficient competitor." RICHARD A. POSNER, ANTITRUST LAW 188 (1976).

\(^{18}\) Variable costs are "costs that vary with changes in output." 3 PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW § 712 (1978). They typically include such items as labor used in production, repair and maintenance costs, and costs of custodial help. \textit{Id.}

\(^{19}\) Fixed costs do not vary with changes in output. They typically include such items as irreducible overhead, some management expenses, and property taxes. \textit{Id.}

\(^{20}\) Long-run marginal cost is the anticipated average total cost per output unit. \textit{Id.} Because total cost includes both fixed and variable costs, a long-run marginal cost test will consider, by definition, fixed costs. A firm seeking to stay in business for the indefinite future must recover its long-run marginal costs. POSNER, supra note 17, at 189.
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orders\textsuperscript{21} indicate that the FCC expects that the new price cap scheme will reduce administrative paperwork, substitute market dynamics for regulatory second guessing of a carrier's business judgment, and deter anticompetitive behavior.\textsuperscript{22} The following subparts demonstrate that the price cap scheme attempts to make wide use of the invisible hand of the free market in order to achieve regulatory goals.

\textbf{A. Price Cap Regulation and the System of Baskets and Bands}

In the past, telephone carriers regulated by the FCC have been required to file extensive documentation with the Commission outlining their tariffs\textsuperscript{23} and demonstrating that the new prices are both just and reasonable.\textsuperscript{24} These documents were reviewed in lengthy administrative proceedings.\textsuperscript{25} Because of the time and expense involved in changing a tariff, this procedure proved to be highly burdensome for the regulated entity.\textsuperscript{26} Essentially, price cap regulation creates a range of tariffs that a carrier may file which will be presumed lawful, thus relieving the carrier of the burden of gaining regulatory approval.\textsuperscript{27} This procedure is commonly known as "streamlined review."\textsuperscript{28}

\begin{itemize}
  \item See Reconsideration Order, supra note 21, at 665–68.
  \item One court has defined a "tariff" as "a public document setting forth the services of the carrier being offered, the rates and charges with respect to the services and the governing rules, regulations and practices relating to those services." IT&T Corp. v. United Tel. Co., 433 F. Supp. 352, 357 n.4 (M.D. Fla. 1975).
  \item Reconsideration Order, supra note 21, at 666. Carriers also have been required to provide 90 days' notice with new filings. \textit{Id}.
  \item Notice, supra note 9, at 5209–10.
  \item Id. at 5210–11.
  \item Under a presumption of lawfulness, a party seeking suspension of the tariff must make a substantial showing that such suspension is warranted. Ghosh, supra note 7, at 414 n.60. Under streamlined review, filed tariffs are presumed lawful and become effective after only 14 days, rather than 90 days under the normally applicable procedures. Reconsideration Order, supra note 21, at 666.
  \item See Reconsideration Order, supra note 21. The FCC sometimes uses the term "streamlined treatment." \textit{Id} at 665. For a full discussion of streamlined review see
\end{itemize}
Under the price cap approach, AT&T’s services are grouped together in accordance with common characteristics. These groups are known as baskets, or baskets of services. In initially crafting the price cap scheme, the FCC created three baskets of services for AT&T. Basket One includes residential and small business services. The remaining two baskets consist of one basket for 800 services and another basket for the remaining business services that AT&T provides. Each basket has an aggregate price cap, which limits the weighted average of the individual service rates contained within the basket. AT&T may not charge more than the aggregate cap placed on the basket for the services contained therein. A recent opinion by Judge Stephen F. Williams explained weighted averages, aggregate prices, and profit caps in the new scheme as follows:

A price cap enables a firm to raise the price of a product or service, so long as the firm offsets any increase for one service with decreases for others within the comparison group selected by the regulator. Thus, if the firm in the benchmark period provided 100 units of service A for $1 each and 100 units of service B for $2 each, for a total of $300, it could thereafter choose any A-B price combination that, at the benchmark volume of sales, would yield no more than $300.

To benefit from streamlined review, the regulated entity must charge for each individual service rates that fall within a

\[\text{supra text accompanying notes 36–38.}\]

29. Ghosh, supra note 7, at 416.
30. The services contained in Basket One include: (1) daytime Message Telephone Service (MTS), (2) evening MTS, (3) weekend and night MTS, (4) international MTS, (5) Reach Out calling plan, and (6) operator assistance and credit card calling. Reconsideration Order, supra note 21, at 666.
31. Under an 800 calling plan, charges and tolls are billed automatically to the party called, not to the calling party. Services in this basket include: (1) Readyline 800, (2) AT&T 800, (3) Megacom 800, and (4) All Other 800. Id.
32. The third and final basket includes: (1) ProAmerica calling plans, (2) WATs calling, (3) Megacom, (4) SDN, (5) other switched services, (6) voice-grade private lines services and below, and (7) private line services larger than voice-grade. Id.
33. Further Notice, supra note 5, at 3352.
34. Id.
35. National Rural Telecom Ass’n v. FCC, 988 F.2d 174, 181 (D.C. Cir. 1993) (footnote omitted). Judge Williams offers a further example: “[The firm] could sell the A services at $.75 each and the B services at $2.25 each. 100 x $.75 = $75; 100 x $2.25 = $225; $75 + $225 = $300.” Id. at 181–82.
range referred to as a "band." A band is "the range within which a carrier may raise or lower any individual rate element in any year and still be entitled to streamlined review." As long as the carrier does not raise or lower rates beyond the limits of the bands, the carrier's tariff will be presumed lawful. In this way, AT&T will be able to avoid the exhaustive procedures normally accompanying a new tariff filing.

B. Price Cap Regulation and Anticompetitive Behavior

The fact that the price cap scheme allows AT&T greater flexibility to price individual services within a given basket without the antitrust protection of comprehensive tariff review suggests that it will be easier for that company to engage in anticompetitive conduct. Specifically, the carrier may choose to engage in predatory pricing by cross-subsidizing its services. Under a scheme of cross-subsidization, AT&T would attempt to charge higher rates to captive customers whose only option is to purchase telecommunications service from AT&T, while simultaneously dropping its prices in competitive markets in order to destroy its rivals. In fact, the company in the past has lowered "monthly charges to residential users—a politically popular thing to do—while subsidizing the resulting revenue shortfalls with excessive long distance fees." Similarly, AT&T could engage in cross-subsidization of other services, not to gain political benefits, but to monopolize the telecommunications market and to increase the company's profits in the long run. Under the price cap scheme, the FCC believes it has crafted a scheme that will deter AT&T from engaging in such predatory pricing.

1. FCC Expectations for the Baskets and Bands—The FCC hopes that the basket and band systems will work together to check predatory pricing. By dividing services that have competitive and noncompetitive markets into different baskets, the FCC hopes to limit strictly AT&T's ability to

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36. Reconsideration Order, supra note 21, at 666.
37. Further Notice, supra note 5, at 3355.
38. Reconsideration Order, supra note 21, at 666.
39. See supra notes 12–17 and accompanying text.
41. Ghosh, supra note 7, at 417.
cross-subsidize rates. Within a given basket, the onerous requirements placed on above-band filings are thought to make it difficult for AT&T to raise its rates for one service so that it may predate in another. Thus, the cap on aggregate profits should help to decrease the desirability of predatory pricing because profits foregone cannot be recouped by raising rates for other services.

The FCC also believes that the band system alone discourages predatory pricing. Under the band system, AT&T will be entitled to streamlined review for all new tariffs that do not increase or decrease prices more than five percent annually. Price changes greater than five percent will be subject to more exhaustive regulatory review. Thus, if AT&T desired to predatorily price a service, it either would have to move prices incrementally downwards over several successive years at a rate of less than five percent annually or justify a single price decrease of more than five percent. The FCC believes that the stringent review accompanying such larger price changes provides an incentive for AT&T to maintain stable price levels, thereby deterring predatory pricing.

2. Average Variable Cost as the Front Line Defense Against Predation—The quality of the more stringent review depends on the effectiveness of the standard chosen as the front-line defense against predation. The FCC believes that judging below-band rates against an average variable cost standard will protect effectively against anticompetitive

42. Id.
43. Above-band filings require the fullest possible consideration by interested parties and by the FCC. Such rates must be filed on 90 days' notice, with a likelihood of suspension. In addition, the justness and reasonableness of above-band rates must be assessed in light of the overall price cap scheme and the "substantial cause" test. Policy and Rules Concerning Rates for Dominant Carriers, 4 F.C.C.R. 2873, 3100-03 (1989) (second further notice of rulemaking) [hereinafter Second Further Notice]; see also, Reconsideration Order, supra note 21, at 666. Second Further Notice was summarized in the Federal Register. See Policy and Rules Concerning Rates for Dominant Carriers, 54 Fed. Reg. 19, 836 (1989) (to be codified at 47 C.F.R. 001, 61, 65). Thus, above-band filings for proposed increases involve detailed and specific cost justifications which will prove both burdensome and difficult to meet. Second Further Notice, supra, at 3100-03.

44. Reconsideration Order, supra note 21, at 666-67; Second Further Notice, supra note 43, at 3103. Interestingly, by establishing a ceiling on rates, the FCC expects to create a competitive floor as well. Id. at 3114.
45. See Reconsideration Order, supra note 21, at 667.
46. Id.
47. Id.
behavior. Under this standard, below-band filings must be accompanied by a showing that the new rates cover the costs of providing the service, otherwise known as average variable costs. For purposes of an initial tariff review, only filed tariffs lower than the average variable cost of providing the service will be suspended.

The most recent price cap order specifically rejects the adoption of a long-run marginal cost test as the test for predation. Instead, the FCC adopted the average variable cost test, despite comments made by those companies that have the most to fear from future predatory activity by AT&T—its competitors. These companies, including MCI Communications (MCI) and Sprint Corporation (Sprint), argued that average variable cost is not the most effective standard to guard against predation. They urged that a long-run marginal cost test would provide more effective protection against predation because it would consider, by definition, fixed cost. By rejecting these arguments, the Commission specifically refused to view the adoption of an average variable cost

48. Id. at 668.
49. The full text of the regulation reads as follows:

Each price cap filing that proposes service category rates below applicable band limits established in § 61.47(e) of this part, must be accompanied by supporting materials establishing that the rates cover the service category's average variable cost, or equivalently, that the service category's net additional revenue resulting from the price change exceeds additional costs.

50. Reconsideration Order, supra note 21, at 667-68.
51. The FCC order states that long-run incremental cost or other standards proposed by the parties filing briefs in the proceeding are not as widely used as average variable cost in testing for predation. Id. at 682 n.39. The order cites the following cases that examined the average variable cost test: Southern Pac. Communication Co. v. AT&T, 740 F.2d 980, 1003-05 (D.C. Cir. 1984) (discussing various tests of predation based on average variable cost); Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 235-36 (1st Cir. 1983) (finding that prices above incremental and average total cost are lawful); Superturf Inc. v. Monsanto Co., 660 F.2d 1275, 1281 (8th Cir. 1981) (holding that prices below fully allocated cost but above average variable cost are not per se predatory absent predatory intent or other unreasonable conduct); Pacific Eng'r & Prod. Co. v. Kerr-McGee Corp., 551 F.2d 790, 797 (10th Cir. 1977) (finding that prices above average variable cost but below average total cost are not predatory where subjective intent and long run variables do not establish predation).
52. Reconsideration Order, supra note 21, at 668.
53. Id. at 682 n.33.
54. Id.
55. See supra note 20.
standard as a "loophole" that would allow AT&T to predate under price cap regulation.\textsuperscript{56}

II. THE AVERAGE VARIABLE COST LOOPHOLE

Throughout the price cap orders, the FCC demonstrates its concern about crafting a price cap scheme that prevents predatory pricing by AT&T.\textsuperscript{57} Thus, despite the existence of a body of economics literature which regards the phenomena of predatory pricing as either entirely mythical or no cause for concern,\textsuperscript{58} one must conclude that the FCC regards predatory pricing by AT&T as a real threat. Otherwise, there would be no reason for imposing on AT&T the administrative burden of complying with regulations designed to guard against predatory tactics. Nonetheless, in adopting an average variable cost test, the FCC has established a regulatory scheme that provides mere phantom protection against anticompetitive behavior which the Commission repeatedly has asserted is a real threat.

A. Services Priced by AT&T Above Average Variable Cost Still May Have Predatory Effects

FCC regulations allow below-band filings if supporting materials establish that the rates cover the service category's average variable costs.\textsuperscript{59} Given the unique nature of the telecommunications industry, however, such pricing still may be predatory with regard to presently existing and potential competition.

1. Prices Above Average Variable Cost May Destroy Present Competition—In contrast to more typical industries, the telecommunications industry is extremely capital intensive.

\textsuperscript{56} Reconsideration Order, \textit{supra} note 21, at 668.
\textsuperscript{57} \textit{See}, e.g., Reconsideration Order, \textit{supra} note 21, at 668; Second Further Notice, \textit{supra} note 43, at 3114.
\textsuperscript{58} \textit{See}, e.g., D.T. Armentano, \textit{The Myths of Antitrust} 73–74, 243 (1972); Roland H. Koller II, \textit{The Myth of Predatory Pricing: An Empirical Study}, \textit{Antitrust L. & Econ. Rev.}, Summer 1971, at 105.
\textsuperscript{59} 47 C.F.R. § 61.49(d) (1992).
Before a company can transmit its first call, a vast telephone network must be in place. Thus, fixed costs constitute a major part of the cost of providing telecommunications service. An examination of the financial statements of two of AT&T's biggest competitors in the long distance market, MCI and Sprint, supports this conclusion. For example, MCI, which controlled about sixteen percent of the long distance market in 1991,\textsuperscript{60} listed the total value of its communications network in service for that year at nearly nine billion dollars.\textsuperscript{61} Sprint, a recent entrant in the long distance market, owned over thirteen billion dollars worth of property, plant and equipment in 1991.\textsuperscript{62} For these companies to survive and earn profits in the long run, they must recover the fixed network costs as part of the charges assessed to consumers for telephone service.

Yet under the current price cap scheme, AT&T may price services that compete with MCI and Sprint at a level that merely covers or marginally exceeds average variable cost.\textsuperscript{63} In a competitive market, such a low price would limit the parties' ability to recover their fixed costs.\textsuperscript{64} As the prominent industrial economist Alfred Kahn has argued, regulated entities should not be allowed to price at a level that covers only short-run costs because such low rates are unremitting if continued over time, and might constitute predatory behavior.\textsuperscript{65} Given the tremendous advantages AT&T enjoys over its competitors in market share, cash flows, and resources, it could defer recouping its fixed costs much longer than its smaller competitors.\textsuperscript{66} Thus, predatory tactics by AT&T could drive its competitors out of business, allowing

\begin{itemize}
  \item \textsuperscript{60} MCI COMMUNICATIONS CORP., 1991 ANNUAL REPORT 3 (1992).
  \item \textsuperscript{61} Id. at 31.
  \item \textsuperscript{62} SPRINT CORP., 1991 ANNUAL REPORT 28 (1992).
  \item \textsuperscript{63} See Reconsideration Order, supra note 21, at 668.
  \item \textsuperscript{64} By definition, a measure of average variable costs does not consider fixed costs. \textit{See supra} notes 18–19. Thus, if AT&T priced a service at average variable cost, it would not recover any of the fixed costs associated with providing the service. Competitors of AT&T would have to price at similarly low levels in order to not lose market share. In doing so, they never would recover their fixed costs and therefore could not operate at a profit in the long run.
  \item \textsuperscript{65} 1 ALFRED E. KAHN, THE ECONOMICS OF REGULATION 85 (1970). Kahn has been described as a "Prophet of Regulation." For an in-depth treatment of Alfred Kahn's life and economic thinking, see McCraw, \textit{supra} note 40, at 222–99.
  \item \textsuperscript{66} In 1991, AT&T enjoyed a 65% share of the long distance market, $63 billion in annual revenue, and $16 billion in net worth. \textit{VALUE LINE INVESTMENT SURVEY}, Oct. 16, 1992, at 751, 763. These figures are especially large when compared with MCI, AT&T's largest competitor, which had only a 16% market share, $8.4 billion in annual revenue, and $2.9 billion in net worth. \textit{Id.} at 763.
\end{itemize}
AT&T to earn greater profits in the future when it regains monopoly status.

2. Prices Above Average Variable Cost May Deter Potential Competition—Furthermore, a regulatory test based on the average variable cost standard could deter potential providers of telecommunications services from entering the market. Potential entrants face exorbitant network construction costs similar to those encountered by MCI and Sprint. Facing such a formidable barrier to entry and the concomitant risk of being unable to recover those tremendous costs, a potential entrant may decide not to enter the market after assessing the possibility of AT&T pricing at a level just above average variable cost. The recently issued U.S. Department of Justice merger guidelines echo precisely such concerns when they state that "[f]irms considering entry [into an industry] that requires significant sunk costs must evaluate the profitability of the entry on the basis of long-term participation in the market, because the underlying assets will be committed to the market until they are economically depreciated." Allowing AT&T to threaten a potential competitor with the possibility of pricing slightly above average variable cost may create risk to potential competitors sufficient to deter entry. Furthermore, if AT&T should develop "a reputation ... for [a] willingness to use predatory pricing," AT&T may be able "to exclude other potential competitors without any additional below-cost selling," as potential competitors perceive the risk of entry as being prohibitively high.

B. The FCC's Rationales for an Average Variable Cost Test are Uncompelling

The FCC defends the average variable cost standard on several grounds. First, the FCC argues that antitrust law provides remedies for antitrust violations by AT&T. Such reasoning fails to recognize that the dominance and influence

68. POSNER, supra note 17, at 186.
69. Second Further Notice, supra note 43, at 3115. The FCC stresses that, despite the existence of the price cap regulatory scheme, injured plaintiffs may still pursue an antitrust claim. Id.
of AT&T in the telephone market has been an enduring concern of FCC regulation for decades. Furthermore, the history of antitrust litigation in this country demonstrates that a deep-pocketed defendant with a team of artful lawyers can stall antitrust litigation long enough to allow only Pyrrhic victories. Thus, antitrust plaintiffs challenging AT&T predation may find their recoveries deferred for a long period of time. Further, remedies occurring after the fact can provide only imperfect compensation to a company that has lost both its market share and its ability to compete. This conclusion holds especially true in the telecommunications industry, which is driven by technological advances.

Second, the FCC points to the general acceptance of the average variable cost standard in other settings as part of its rationale for adopting the standard in the telecommunications context. The FCC cites as evidence several federal antitrust cases to demonstrate the allegedly widespread use of an average variable cost standard as the test for predation. Interestingly, only one of the cases cited involves the telecommunications industry. The force of such an analogy to other industries wanes quickly when one considers the unique nature of the telecommunications industry. In most industries, variable costs greatly exceed fixed costs. An examination of the financial statements of leading firms in such diverse fields as energy production, automobile manufacturing, and surface transportation indicates that variable costs can exceed fixed costs by anywhere from 39% to

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71. Take, for example, the celebrated antitrust litigation against Standard Oil. State and Federal efforts to use antitrust law to control the Standard Oil combination spanned a period of over two decades at the turn of the century. Some regard these efforts as unsuccessful despite their length and the amount of resources expended. See BRUCE BRINGHURST, ANTITRUST AND THE OIL MONOPOLY: THE STANDARD OIL CASES, 1890–1911 (1979). Other examples of lengthy antitrust litigation involving America's leading companies, including AT&T, abound. See generally TALBOT S. LINDSTROM & KEVIN P. TIGHE, ANTITRUST CONSENT DECREES (1974).

72. In fact, AT&T's competitors made precisely this argument in the regulatory process preceding the issuance of the most recent price cap order. See Reconsideration Order, supra note 21, at 692 n.35.

73. For a discussion of the interaction between technology and competition in the telecommunications industry, see MANLEY R. IRWIN, TELECOMMUNICATIONS AMERICA 72–76 (1984).

74. See supra note 51.

75. See Southern Pac. Communications Co. v. AT&T, 740 F.2d 980 (D.C. Cir. 1984).
Such figures suggest that an average variable cost standard indeed might be appropriate in these industries. Companies in these industries must focus primarily on recouping the variable costs in order to remain solvent, as variable costs are much greater than fixed costs. Thus, a test for predation in these industries can ignore fixed costs more easily because of their secondary importance.

In the telecommunications industry, however, the primacy of fixed costs reverses this situation. For example, MCI’s variable costs are only eighty-one percent of their fixed costs. Sprint’s variable costs are even lower, constituting a mere fifty-seven percent of fixed costs. In contrast to firms in other industries, telecommunications firms face a great risk when entering the market and must recoup fixed costs to survive. Yet the FCC ignores this fact by allowing AT&T to price at a level that covers only variable costs and that would deny its competitors the opportunity to recoup their fixed costs. Despite the widespread acceptance of the average variable cost test in other contexts, such pricing still could be predatory in the telecommunications industry.

Third, the FCC relies on the protections that it views as inherent in the system of baskets and bands to deter renewed anticompetitive behavior by AT&T. These devices, however, provide only imperfect protection against AT&T predation. Because AT&T enjoys resources vastly superior to those of any competitor, it would not need to cross-subsidize in order to predatorily lower prices for one service. Instead, AT&T could decide strategically to maintain losses for that service, knowing that its greater resource base would allow it to

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76. Variable costs are reflected in a firm’s financial statements under the category of operating expenses. Relevant 1991 figures for operating costs and fixed costs in property and equipment are as follow: H. Phillips Petroleum Co., $11.6 million operating costs, $8.3 million fixed costs, PHILLIPS PETROLEUM CO., 1991 ANNUAL REPORT 40–41 (1992); Consolidated Freightways, Inc., $3.3 billion operating costs, $1.8 billion fixed costs, CONSOLIDATED FREIGHTWAYS, INC., 1991 ANNUAL REPORT 24–26 (1992); General Motors Corp., $129 billion operating costs (including depreciation), $68 billion fixed costs, GENERAL MOTORS CORP., 1991 ANNUAL REPORT 23–24 (1992); Chrysler Corp., $29 billion operating costs, $10.5 billion fixed costs, CHRYSLER CORP., 1991 ANNUAL REPORT 24–26 (1992).

77. MCI lists almost $9 billion in fixed costs in property and equipment and only $7 billion in operating costs in its financial statements. MCI COMMUNICATIONS CORP., supra note 60, at 30–31.

78. Similarly, Sprint lists $13 billion in fixed costs and only $8 billion in operating costs. SPRINT CORP., supra note 62, at 27–28.

79. See supra notes 42–50 and accompanying text.

80. See supra note 66 and accompanying text.
undercut the prices of its competitors until they are driven out of business. Then, having re-established its monopoly position, AT&T could charge supercompetitive rates to earn long-term profits. Potential entrants, aware of AT&T's demonstrated ability to engage in destructive competition, would be deterred from entering the lucrative market by the threat of renewed price cuts.

Finally, the five percent cap on annual rate reductions provides little protection against predation given the highly competitive nature of the telecommunications market. AT&T presently must compete vigorously for market share with MCI, Sprint, and other telecommunications carriers. For example, AT&T, MCI, and Sprint spent a combined $150 million in advertising during the first quarter of 1992 alone. In such a competitive market, a relatively small price decrease could drive other market players out of the industry. Yet under the current price cap scheme, AT&T could lower its prices by a full ten percent in slightly more than one year and face no administrative obstacles except for the average variable cost test used under streamlined review. Because the highly competitive nature of the telecommunications industry, a price reduction of ten percent may prove sufficient to destroy AT&T's competition. Such a price cut also could limit its competitors' expenditures on research and development, thereby crippling their ability to compete in the technology-intensive industry. In any case, the five percent limit on

81. See IRWIN, supra note 73, at 69–72. Irwin describes this competition as intensive and frantic. Id. at 72. The intense nature of competition in the telecommunications industry perhaps can be explained by the essentially fungible nature of telephone and other telecommunications services. If consumers do not perceive any difference between telephone services, they are not likely to be loyal to a specific company. Instead, consumers generally will switch to the carrier offering the most cost-effective service. This is reflected in the high elasticity of demand in the telephone service market. See Comments of AT&T at 12, In re Price Cap Performance Review for AT&T, No. 92-134 (F.C.C. filed Sept. 4, 1992) (on file with the University of Michigan Journal of Law Reform) [hereinafter Comments of AT&T].

82. Comments of AT&T, supra note 81, at 13. In fact, the telecommunications market may be one of the most competitive in America. By 1992, there were 482 long distance carriers providing service in the United States, representing a 13% increase since 1989. The number of customers switching from or to AT&T has increased by 60% since 1989. Id. at 10–13.

83. For a discussion of streamlined review under the FCC's price cap scheme, see supra notes 27–28, 36–38 and accompanying text.

84. Telecommunications companies must remain on the cutting edge of technological developments in order to be successful in the competitive telecommunications market. If a telecommunications company falls behind in the technological race, it will
annual reductions places only a minimal restraint on AT&T's ability to predate and engage in destructive competition.

III. TWO TESTS INCLUDING FIXED COSTS WOULD GUARD BETTER AGAINST PREDATION

As the previous discussion has demonstrated, an effective test for telecommunications predation must consider fixed costs. By adopting the average variable cost test prevalent in other industries, however, the FCC adopted a test which ignores fixed costs. Fortunately, the average variable cost test is not the only available standard against which to measure a company's allegedly predatory pricing. In fact, a popular handbook on industrial organization identifies seven separate tests for predatory pricing.\textsuperscript{85} Two of these tests, one offered by Judge Richard Posner and the other by Professors Paul Joskow and Alvin Klevorick, include an examination of long-run costs in determining predation. Either of these tests would alleviate the grave problem inherent in present FCC practice. The following discussion reviews and compares these two tests for predatory pricing and suggests that the FCC could improve its present regulatory scheme by replacing the average variable cost test with the test prescribed by Professors Joskow and Klevorick.

A. The Posner Test

Judge Richard Posner presents a two-pronged test to identify predatory pricing.\textsuperscript{86} Posner recognizes that predation is a strategic phenomena that provides benefits to a firm only in the long run.\textsuperscript{87} For this reason, the first prong of the Posner test evaluates a challenged price or tariff by determining whether

\textsuperscript{85} See IRWIN, supra note 73, at 72–76.
\textsuperscript{86} Janusz A. Ordover & Garth Saloner, Predation, Monopolization, and Antitrust, in 1 HANDBOOK OF INDUSTRIAL ORGANIZATION 537, 579–90 (Richard Schmalensee & Robert D. Willig eds., 1989).
\textsuperscript{87} POSNER, supra note 17, at 189; see also Ordover & Saloner, supra note 85, at 584.
it exceeds the long-run cost of providing the service. The long-run cost standard, which by definition includes fixed costs, would alleviate a defect of current FCC practice.

The second prong of the Posner test examines the competitor's intent in pricing the service. Posner would find prices below long-run marginal cost presumptively predatory if accompanied by an intent to exclude an equally or more efficient competitor. This requirement of the Posner test is weak because Posner fails to explain how to determine whether the potential predator has the requisite intent. Thus, the Posner test would prove particularly difficult to implement because it would be difficult to determine AT&T's intent in establishing a pricing schedule and Posner's prescription fails to provide a methodology.

For example, a competitor of AT&T could charge that a new AT&T tariff constitutes predatory pricing. This competitor could present financial analyses demonstrating that AT&T's prices do not exceed long-run marginal cost, thus satisfying the first prong of the Posner inquiry. Demonstrating AT&T's predatory intent, however, would prove to be a thornier problem. Of course, predatory intent could be shown upon an express admission by a responsible AT&T officer that the price was intended to be an instrument of predation. Because predatory pricing is illegal under federal law, however, AT&T's officers are unlikely ever to admit that one of their tariff schedules was intended to be predatory. Further, there are difficult questions regarding whose intent matters for a determination of predatory intent. It is unclear whether Posner would require predatory intent of one, a majority, or all of the officers of the company in order to condemn the rate. In addition, Posner fails to state whether an express intent must be required under his test for predation, or whether a constructive or implied intent would suffice.

Posner himself admits that the "availability of evidence of improper intent is often a function of luck and of the defendant's legal sophistication, not of the underlying reality. A firm with executives sensitized to antitrust problems will not

88. *Id.*
89. *Id.* at 189.
90. *Id.*
91. Ordover & Saloner, *supra* note 85, at 584.
leave any documentary trail of improper intent."93 Thus, it is uncertain whether adopting the Posner test would constitute an improvement over the currently used average variable cost test. It is true that the Posner test would consider whether AT&T's prices recoup fixed costs, thereby eliminating the major shortcoming of present FCC practice. The difficulties of the second prong of the Posner test regarding predatory intent, however, could render the test as ineffective as the average variable cost test in guarding against predation.

B. The Joskow-Klevorick Test

The Joskow-Klevorick (J-K) test similarly establishes a two-tiered approach to identify predation.94 The first tier examines the structural preconditions for successful and rational predation.95 "These structural preconditions include (a) the dominant firm's market share; (b) the size of other firms in the market; (c) the stability of market shares over time; (d) the dominant firm's profit history; (e) residual elasticities of demand; and (f) the conditions" bearing on ease of entry into the market.96 The first tier operates "to filter out allegations of predatory conduct which are likely to prove baseless."97

Under the J-K test, an industry does not have to exhibit all of the preconditions for successful predation in order to pass to the second tier analysis.98 Instead, the first tier analysis is used to obtain an overall picture of the market in question to determine whether, on balance, the structure of the market makes it likely that a dominant firm could engage in predatory pricing.99 J-K's structural analysis suggests that the current telecommunications market is amenable to predation. First, AT&T controls the lion's share of the market; AT&T's closest competitor for long distance services controls merely

94. Joskow & Klevorick, supra note 17, at 242.
95. Id. at 244.
96. Ordover & Saloner, supra note 85, at 583; see also Joskow & Klevorick, supra note 17, at 224–34.
97. Ordover & Saloner, supra note 85, at 583.
98. Joskow & Klevorick, supra note 17, at 245.
99. Id. at 246.
sixteen percent of the market. Second, because competition in the telecommunications market is a relatively new phenomenon, market shares have been relatively unstable. AT&T’s long distance market share has declined steadily since the 1982 consent decree that divested AT&T of its local operating companies. Nonetheless, AT&T’s renewed ability to engage in predatory pricing resulting from the freedom and flexibility of the price cap scheme makes it difficult to predict the future market shares of telecommunications carriers. In fact, one could conclude from the potential of AT&T to price predatory that the market shares of AT&T’s competitors are inherently unstable. Third, AT&T has a long history of strong profitability, although this history stems largely from its past role as a government-sanctioned monopoly. Finally, the barriers to market entry associated with the tremendous network construction costs make it very difficult for potential competitors to enter the field. These factors suggest that the structural preconditions for successful predation in the telecommunications industry have been met.

If industry conditions meet the first tier of the J-K approach, the pricing policies of companies in that industry then would be evaluated under the second tier. Under the second tier, pricing below average total cost will be presumptively

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100. See supra notes 60, 66, and accompanying text.
102. Comments of AT&T, supra note 81, at 13. For example, AT&T’s overall share of minutes of use of residential domestic service declined from 83% to 64% in the first quarter of 1992. Id.
103. For a review of AT&T’s successful history, see SONNY KLEINFIELD, THE BIGGEST COMPANY ON EARTH (1981).
104. See supra Part II.A.2.
105. For a full description of their second tier tests, see Joskow & Klevorick, supra note 17, at 249–58.
106. Id. at 253. Average total cost is calculated by dividing the sum of the fixed and variable costs by the number of units produced or supplied. AREEDA & TURNER, supra note 18. In essence, average total cost measures the total incremental cost of producing an average unit. Joskow & Klevorick, supra note 17, at 252 n.79.
illegal. The party seeking to establish the legality of its filed tariff would need to provide cost studies and economic analyses to show that the challenged pricing exceeds average total cost.

This second tier test is preferable to the second prong of Posner's test because it provides a clear methodology with which to establish presumptively illegal pricing. Furthermore, this second tier test alleviates the problems inherent in the current regulatory scheme, as discussed previously. Thus, the average total cost test as applied by Joskow and Klevorick should be incorporated into the price cap regulations by substituting for the current variable cost test as follows:

Each price cap filing by a dominant carrier in the telephone industry that proposes service category rates below applicable bond limits established in Section 61.47(e) of this part, must be accompanied by supporting materials establishing that the rates cover the service category's average total costs.

This test would condemn pricing below average variable cost as well as pricing levels that would prevent AT&T's competitors from recouping their fixed costs. In addition to providing improved protection against AT&T predation, using an average total cost test comports with the sound economic theory that equilibrium prices in competitive markets will equal average total cost.

**CONCLUSION**

During a recent session of the United States Congress, the House Committee on the Judiciary indicated its interest in

107. Joskow & Klevorick, supra note 17, at 253. The J-K test would allow the dominant firm to assert an affirmative defense if it shows that pricing below average total cost maximizes profits in the short run. This defense is likely to succeed only "when substantial excess production capacity exists in the industry." Id.

108. Id. at 261. If a plaintiff shows under the first tier of the test that predatory preconditions exist, the defendant then carries the burden of production with respect to the second tier. Id.

109. This amendment would be to 47 C.F.R. 61.49(d). Compare this with the existing regulation, supra note 49.

110. Ordover & Saloner, supra note 85, at 583.
examining the need to clarify the legal standard for determining predatory pricing activities.111 The language of the report suggests that the Committee will search for a single standard against which to measure the predatory nature of a company's pricing policies. This Note demonstrates that a single test for predatory pricing may not be equally effective across different industries. Although the average variable cost test has received general acceptance as a test for predatory pricing, such a test does not provide effective protection in the telecommunications context because of the capital-intensive nature of that industry. As a replacement for the average variable cost test, this Note suggests that the FCC adopt the two-tiered approach offered by Professors Joskow and Klevorick as a better method by which to determine whether a new tariff filing by AT&T constitutes predatory pricing.

Perhaps the FCC's concern for predation is less than genuine, despite the language of its own orders and opinions. In fact, some of the arguably cryptic language in the AT&T price cap orders suggests precisely such a conclusion.112 If this is the case, then the FCC should relieve AT&T of the senseless regulatory burden of demonstrating that below-band filings cover average variable cost. On the other hand, if the FCC's concern for predation proves genuine, the FCC should put some real teeth into the test for predation.


112. See, for example, Second Further Notice, supra note 43, at 3114, which states that the FCC has, "through the structure of AT&T's service baskets, created conditions under which predation should be as unlikely in the interexchange telecommunications market as it is in the economy generally." This may be doublespeak, as an administration dominated by Republican appointees intent on deregulation and perhaps steeped in Chicago School economic analysis of the law may actually believe that predatory pricing never exists. See Paul S. Dempsey, The Interstate Commission—Disintegration of an American Legal Institution, 34 AM. U. L. REV. 1, 3–4 (1984) (commenting on the deregulation agenda of Reagan's appointees); Teresa Moran Schwartz, Punitive Damages and Regulated Products, 42 AM. U. L. REV. 1335, 1345 (1993) (commenting on the Reagan Administration's deregulation policy); see also Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 588–90 (1986) (using an economic rationality theory to conclude that predatory pricing is unlikely). It currently is unclear what impact the change of administration which accompanied the 1992 election will have on telecommunications policy as the Clinton FCC Chairman and much of the staff have yet to be appointed.