

ECONOMICS OF ANTITRUST:
COMPLEX ISSUES IN A
DYNAMIC ECONOMY

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OF ANTITRUST:
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IN A DYNAMIC
ECONOMY

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Anticompetitive Price Squeezes in the Telecommunications Industry: A Common Complaint about Common Facilities

ALLEGATIONS of price squeezes have a familiar ring because the underlying theory of competitive harm combines elements of several well-known theories of exclusionary conduct, such as predatory pricing, refusals to deal, vertical foreclosure, and denials of access to essential facilities. In both the United States and Europe, price squeezes are the subject of much controversy in the telecommunications sector and other regulated industries, where access to common facilities is a frequently contested issue.

This chapter discusses the economic and public policy issues that encompass analyses of price squeezes. The authors point out that an assessment of the competitive effects must account for the regulatory rules and competitive dynamics that affect the pricing of the common facility at issue. This is particularly true in the telecommunications industry after the Telecommunications Act of 1996.

Anticompetitive Price Squeezes in the Telecommunications Industry: A Common Complaint about Common Facilities

William Taylor and Timothy Tardiff

Allegations of anticompetitive price squeezes generally have the following storyline. The tale typically begins with a firm that has control over the supply of a key input or production facility that customers must purchase or obtain access to if they are to make a product that is purchased by downstream consumers. The drama is that the firm that has control over the essential input also makes this downstream product, which means that the *vertically integrated* owner of the key input has an opportunity to lower the downstream price or raise the price of the input so that its customers—who are also its downstream competitors—cannot profitably compete and are squeezed out of the market. This is the classic price squeeze, which has raised the ire of many a competitor.

The story is easy to tell, but the underlying theory is complicated in that it has elements of several anticompetitive theories, such as predatory pricing, refusals to deal, vertical foreclosure, and denials of access to essential facilities. Moreover, the alleged competitive effects of price squeezes are often questionable, particularly if downstream customers are benefiting from lower, not higher, prices. The complexity of the analysis is raised one notch if there are regulatory rules that affect pricing and access to the essential input at issue. A number of economic and regulatory factors can enter into such an analysis, and this chapter will discuss them in the context of competition in the telecommunications industry, where allegations of anticompetitive price squeezes are the source of much trial and tribulation.

The Economics of Anticompetitive Price Squeezes

Suppose a vertically integrated firm is both a monopoly supplier of an essential input in an upstream (wholesale) market and one of a number of competing producers of a downstream (retail) product that is made from that key input. Thus, the owner of the essential input has control over the

wholesale price of the input and potentially downstream prices, as well, which creates the conditions for an anticompetitive price squeeze.

Determining when the downstream prices are anticompetitive is very similar to determining when prices are predatory.¹ If the vertically integrated firm can earn greater profit from selling the essential input to competitors than by selling the competitive product in the downstream market, then the difference between the retail and wholesale prices may subject dependent rivals to an anticompetitive price squeeze. Just as below-cost pricing of a product is predatory when the intent is to drive rivals out of the market with the expectation of increasing prices to recoup lost profits later, the firm that forgoes greater profits from sales in the upstream market could harm competition in a similar manner.²

In predatory pricing cases, much attention is paid to the magnitude of the relevant incremental cost. Similarly, in competitive analyses of price squeezes, the focus is on the minimum price that is consistent with a competitive outcome, so that prices below that level could indicate an anticompetitive price squeeze.

The economic price floor that emerges can be described as follows:

$$\text{minimum price} = \text{downstream cost} + \text{forgone profits from upstream sale}$$

A simple example illustrates the rationale for this formula. Suppose the vertically integrated firm uses one unit of the upstream product and one unit of an input that its rivals are capable of producing (or acquiring from other suppliers) and each costs \$1.00 to produce. The cost of its downstream product would be \$2.00. If we also assume a wholesale price of \$1.50 when the upstream product is sold to rival producers,³ the vertically integrated firm realizes a \$0.50 profit from that sale.⁴ Therefore, the minimum downstream price would be \$2.50 (\$2.00 of cost + \$0.50 of forgone profit).⁵ In other words, pricing below this level could allow the owner of the key input to squeeze out its equally efficient rivals.

Of course, even if the vertically integrated firm were to price its downstream product at this minimum price, firms that are *more efficient* at producing the competitively supplied input could profitably enter. For example, if a rival could produce the downstream input for \$0.90, it could purchase the upstream input and offer the downstream product profitably for a price as low as \$2.40 (\$1.50 for the upstream input + the \$0.90 cost of making the downstream product), and therefore compete successfully against the vertically integrated provider.⁶

While this statement of a minimum price is straightforward and its rationale unexceptionable, actually establishing such minimums can be enormously complicated in many industries. One such example is the telecommunications services market that emerged subsequent to the Telecommunications Act of 1996.⁷

The Rules of Competition after the Telecommunications Act of 1996

The Telecommunications Act was an attempt to create a new competitive market for telecommunications services. The legislation was based on the premise that parts of the networks of incumbent providers of telecommunications services are necessary inputs for new entrants.⁸ Indeed, the Telecommunications Act established a process for granting mandatory access to certain of these elements⁹ and developing explicit rules for pricing these elements.¹⁰

The Telecommunications Act also articulated an objective of deregulation, and it envisioned a new world of competition among a variety of rivals, including local and long-distance telephone companies and cable television companies.¹¹ Not surprisingly, the tension in the Act between the desire to reduce costs through widespread mandatory sharing of key facilities and the objective of head-to-head competition among firms who made large investments to create these facilities has produced a great deal of conflict in proceedings before federal and state telecommunications regulators and some initial antitrust claims in the courts.¹²

In the eight years following passage of the Telecommunications Act, the most extensive requirement to share facilities has been the mandatory provision of the so-called *unbundled element platform* (UNE-P), which essentially enables new entrants to simply rebrand the services formerly provided by the *incumbent local exchange carrier* (ILEC).¹³ Such extensive sharing of ILEC facilities might make economic sense if these facilities had the characteristics of essential facilities—monopoly-provided inputs that are uneconomic to duplicate and that other firms require to compete in downstream markets. Indeed, in evaluating the US Federal Communication Commission (FCC) rules for mandatory sharing, both the US Supreme Court and the DC Circuit Court discussed the essential facilities concept as a possible mechanism for setting the mandatory sharing obligations consistent with the statute. The courts concluded, however, that the FCC's public policy mandate to expand the scope of competition could result in more extensive sharing than that dictated by strict adherence to the essential facilities concept.

Despite the arguably more demanding sharing requirements codified in the Telecommunications Act, complaints concerning ILECs' actions that allegedly harm competition have fallen into the familiar antitrust areas of refusals to deal and price squeezes: whether ILECs are unlawfully withholding the inputs rivals need to compete in downstream markets and, if not, whether the prices charged by ILECs in downstream markets are too low to allow entrants to earn an adequate profit.¹⁴ Indeed, ILEC competitors have raised the claim that ILECs are engaging in anticompetitive price squeezes in many different forums.¹⁵

Assessing the Competitive Effects of Price Squeezes:

Public Policy and Other Market Factors

How do we evaluate whether there has, in fact, been an anticompetitive price squeeze? As described above, *if the upstream input has characteristics of an essential facility*, the analysis would involve a study of the key input owner's upstream and downstream prices and costs. If the integrated firm sets its prices such that its upstream profit margin (i.e., price less incremental cost) is higher than its downstream (retail) profit margin, then the firm *loses* money on every retail customer it attracts. That is because the profit earned on each retail sale comes at the expense of a higher profit that could have been earned by selling the input to a rival downstream competitor. Under some circumstances, such pricing could be viewed as predatory in the sense that selling the retail service at those prices would only increase profits in the long run if it induced equally efficient downstream firms to exit the market.

Although at this point the analysis focuses on costs and profit margins, it is important not to neglect the market factors that determine whether the upstream input is necessary for downstream competition. In the case of the telecommunications industry, several features complicate any assessment of whether particular downstream prices are pro- or anti-competitive. As described below, these market factors, some of which are present in many industries, include (a) legislation and regulated prices, (b) complex competitive dynamics, and (c) the premise of mandatory sharing in the first instance.

Legislation and Regulated Prices

The continuing presence of regulation in both upstream and downstream telecommunications markets is perhaps foremost among the market factors that complicate competitive analyses of telecommunications

markets. Indeed, in *Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP (Trinko)*, the Supreme Court explained how the regulation of the availability of shared facilities tips the balance of the cost and benefits against antitrust intervention.

However, the scope of regulation is not limited to the concerns that were at issue in the *Trinko* case. Prices of certain retail services, particularly basic local phone service, are constrained by the Telecommunications Act and public policy as articulated by state regulators. For example, the price of residential local exchange service has been set in many states below any measure of the incremental cost of the service, particularly in rural areas. In addition, even prior to the Telecommunications Act, a number of states had established price floors for retail services such as toll services in markets that they had opened to entrants offering competing services that relied on upstream inputs acquired from the ILECs.¹⁶

The fact that, in certain respects, the scope of regulation goes well beyond the level that tipped the balance against antitrust intervention in the *Trinko* case is interesting for two reasons. First, in those states that have established price floors for retail services, the *Trinko* reasoning would seem to remove price squeeze claims from the purview of antitrust enforcement. Not only are state regulators providing oversight on the availability, quality, and prices of the upstream inputs as mandated by the Telecommunications Act, they are also establishing downstream price floors for regulated services, explicitly designed to prevent anticompetitive price squeezes.

Second, explicit downstream price floors may themselves harm competition in the very same ways that have made courts cautious in ordering antitrust remedies. In particular, establishing price floors forces the regulator to make bright-line distinctions between conduct that is entirely expected and desired in competitive markets (i.e., vigorous rivalry that results in lower prices, higher quality, and new and innovative products and services) and conduct that is anticompetitive.

Preventative *regulatory* measures have the potential to harm competition in additional ways. Not only do regulators provide forums in which rivals can ask for lower prices for the upstream inputs they buy from the ILECs, explicit price floors invite petitions to increase the retail prices against which the rivals must compete. In effect, regulators may now be hosting the “Gary dinners” (of steel price-fixing fame).¹⁷ Consequently, the competitive arena may well shift from the marketplace—where it belongs—to regulatory hearing rooms, where any resulting advantage may well be artificial.¹⁸

For this reason, economists have long observed that claims of prices that are “too low” are typically not made by consumers, but rather by those rivals whose profits would increase if price competition were less vigorous.

While the presence of regulatory oversight may increase the reluctance of courts to impose antitrust remedies, the rationale for that reluctance should make regulators themselves cautious.¹⁹ As we describe in greater detail below, the characteristics of telecommunications competition are complicated and changing in ways that are beyond the vision apparent in the Telecommunications Act. As Supreme Court Justice Stephen Breyer cogently noted in his dissent in the *Verizon* case, which upheld the FCC’s rules for establishing the prices of the network elements ILECs must provide to their rivals, the Telecommunications Act was intended to set in motion a process by which competition, not regulation, established the prices that would prevail in the market.²⁰

In contrast, as Alfred Kahn, a distinguished scholar in the economics of regulation, has observed many times, the FCC’s rules for establishing the regulated rates for upstream elements essentially force state regulators to predict the *outcome* of the competitive process for supplying the network elements.²¹ Determining price floors as a preventative regulatory measure would be considerably more heroic. As we describe in greater detail below, downstream telecommunications markets *are* competitive today, are becoming increasingly so, and the nature of that competition is becoming increasingly complex. A variety of firms, a growing number of which do not rely on upstream inputs obtained from the ILECs, offer full packages of local and long-distance telephone service, Internet access, and even video services. Distinguishing before the fact between ILEC retail prices that are consistent with vigorous competition and those that are attempts to harm competition becomes increasingly problematic under these circumstances.

Complex Competitive Dynamics

The characteristics of telecommunications competition also render the measurement of price floors difficult and prone to error. Unlike our stylized model in which one unit of the upstream input produced one unit of the downstream output, which in turn was sold at a single price, even the simplest telecommunications services have had complicated price structures. For example, in the earlier days of long-distance service competition, the essential facility (access to the local network) was priced at regulated rates that did not vary by time of day. At the same time, the vertically integrated firms priced long-distance service to their retail

customers at rates that were more expensive in peak periods (e.g., week-days) and lower off-peak.

Today, retail pricing is even more complicated. For example, in some states, when a competing carrier purchases UNE-P service from an ILEC, it pays a single flat rate for a telephone line and any usage of the ILEC's network that goes with the line. The carrier then uses that line in combination with its own facilities to offer customers packages containing several services that were typically sold separately in the past. In these circumstances, the ILEC and its rivals are clearly competing to supply such packages (bundles) of services and the competition is taking place in markets that are much broader than any individual service. Accordingly, the question of whether efficient rivals can compete downstream revolves around whether the ILEC's prices for its downstream packages provide at least as much profit as it would realize when it provided the upstream input (UNE-P) to its rivals.

It has been suggested that the prices of the components of a bundled service be subjected to individual price floors. However, this would be wrong. There are no meaningful prices for the components of a bundle, and any price floor must be calculated for the bundle as a whole. Determinations of individual minimum prices for the separate services that may be components of a package (either as part of antitrust enforcement or as part of an explicit price floor regime) would undermine the price competition that is continuing to develop in telecommunications and create an administrative nightmare.

Essentiality: Calling into Question the Premise of Mandatory Sharing

In the telecommunications industry, the very premise as to why mandatory sharing might be necessary in limited circumstances appears to be rapidly eroding. While the profitability of particular firms that use the ILECs' upstream inputs is undoubtedly affected by the profit margins that the ILECs' downstream prices provide, the prominence of firms that compete without the use of ILEC-provided upstream inputs is rapidly increasing. In particular, for several years, certain cable television providers have been enhancing their networks to offer telephone service, and where they have done so, they have captured 20 to 30 percent of the customers.

Potentially of even greater significance is the emergence of firms such as the cable providers themselves and newer competitors, such as Vonage, that offer Voice over Internet Protocol (VoIP) telephone service to customers with high-speed connections to the Internet.²² And since

(a) cable modems have enjoyed a constant lead over ILEC-provided DSL service as the preferred means of high-speed Internet access and (b) cable modems are now available to the large majority of US households, ILECs face the prospect of growing competition from rivals that have chosen *not* to avail themselves of the mandatory sharing that the Telecommunications Act has heretofore provided. Myopic regulation that ignores technology when attempting to level the playing field between vertically integrated and dependent wireline telephone companies may leave all wireline companies disadvantaged on the relevant playing field.²³

The vigor of this new competition is also noteworthy. VoIP providers offer packages that have undercut comparable ILEC offerings by 30-40 percent.²⁴ Under these circumstances, the practical motivation for establishing price floors for ILECs—that their prices may be too low for competition to survive—appears inconsistent with the facts. While a price squeeze between wireline competitors may be possible, it would be something like theft on the *Titanic*. Subjecting ILECs to explicit price floors may be attractive to some of its rivals, but a likely result would be to deprive consumers of the pricing and product innovations that price floor limits would preclude. In other words, as certain upstream inputs become increasingly less necessary for competition to progress in downstream markets, basing assessments of minimum procompetitive prices on the margins of firms that use the upstream inputs to compete could materially harm competition. That is to say, regulatory-determined price floors fail the cost-benefit test from society’s perspective.

Conclusion

As the US Court of Appeals for the Eleventh Circuit directed in its *Covad Communications v. BellSouth Corporation* opinion, price squeezes pose many of the same questions that arise in the context of a predatory pricing claim: (a) Is the vertically integrated owner of the upstream input pricing below its downstream costs? and (b) If so, is it likely to recoup its losses in the future? In the case of telecommunications markets, not only does growing competition from firms in downstream markets that do not rely on inputs from the incumbent call into question the “essentiality” of such inputs, these firms are already offering lower prices, suggesting that future recoupment of any putative losses may be very unlikely.²⁵ All of this suggests that regulatory intervention and litigation on issues related to a price squeeze serve no real purpose other than to fight battles in the hearing room that would better serve consumers if they were fought in the marketplace.

CASE STUDY

An FCC decision in 2004 disposing of a price squeeze allegation cogently illustrates the issues considered above. In early 2001, Verizon's Massachusetts operation requested authority under Section 271 to offer long-distance (i.e., interLATA) service. AT&T and MCI opposed the application, based in part on the claim that the difference between Verizon's retail and wholesale (UNE-P) prices provided an insufficient margin for an entrant to be profitable; therefore, Verizon allegedly had not opened its local market to competition and its entry into long-distance service would not be in the public interest. In performing their price squeeze analysis, AT&T and MCI included as revenues only those that regulators traditionally classify as local, for example, the monthly charge for basic telephone service plus a few features such as call-waiting.

In April 2001, the FCC approved Verizon's request, and in the process dismissed the price squeeze allegations on the grounds that ILECs are not required to guarantee competitors a certain profit margin. However, in ruling on an appeal of the FCC's approval, the DC Circuit instructed the Commission to consider whether the pricing of the upstream inputs "doomed competitors to failure." Armed with these instructions, the FCC reconsidered the price squeeze claim and declined to conclude that AT&T's and MCI's analyses of retail-wholesale margins were indicative of a price squeeze. In assessing the competitive significance of whether particular competitors might face unattractive margins between the wholesale prices charged by the ILECs and the retail prices against which they must compete, the FCC noted that the significance of such situations

[D]epends on the competitive characteristics of the state telecommunications market across all zones and modes of entry. In conducting such an analysis, we must consider evidence of a price squeeze along with evidence of how much the alleged price squeeze affects competition statewide and the state of or potential for competition by other modes of entry, including facilities-based entry and resale. Thus, the competitive significance statewide of any demonstrated price squeeze must be taken into account, along with other factors, in determining whether such price squeeze amounts to a violation of the public interest requirement.*

In other words, the FCC emphasized such facts as (a) certain competitors did not even rely on ILEC inputs, (b) AT&T and MCI themselves were charging retail prices comparable to Verizon's, and (c) their entire revenue stream—and not just the revenues obtained from local services—must be considered in assessing whether competition can occur.

The facts show that competition has flourished. According to a 2006 report by the FCC on the development of local competition, competitors' share of local telephone service subscribers in Massachusetts more than doubled from when AT&T and MCI alleged a price squeeze problem, increasing from 11 percent at the end of 2000 to 25 percent by the end of 2005.†

* See *In the matter of Verizon New England et al. for Authorization to Provide In-Region, InterLATA Services in Massachusetts*, Order on Remand, CC Docket No. 01-9, released February 20, 2004, at paragraph 11 (emphasis added).

† See Federal Communications Commission, *Local Telephone Competition: Status as of December 31, 2005*, Industry Analysis and Technology Division, Wireline Competition Bureau, July 2006, Table 8.

Notes

1. For example, in its opinion in *Covad Communications Co. v. BellSouth Corp.*, the US Court of Appeals for the Eleventh Circuit remanded back to the District Court the issue of whether Covad's price squeeze claim—that BellSouth was charging too much for access to key local telephone exchange elements (e.g., the copper loops that connect customers' homes to the telephone network) while pricing its downstream DSL services too low—was a violation of the antitrust laws. Just as in the case of a predatory pricing claim, it instructed the District Court to determine (a) whether BellSouth's prices for its DSL downstream service were lower than its costs (which would include the cost of the upstream service provided to both itself and rivals) and (b) if so, was there a dangerous probability that BellSouth would recoup its investment in below-cost prices. See *Covad Communications Co. v. BellSouth Corp.*, 374 F.3d 1044, 2004-1 Trade Cases P 74, 466, 32 Communications Reg. (P&F) 1111, 17 Fla. L. Weekly Fed. C 729.

In this case, price squeezes and predatory pricing are identical in that the level at which the downstream price just breaks even is the same. As we describe below, pursuant to the Telecommunications Act of 1996, the prices for elements that are shared with competitors are purportedly set by regulators at cost, suggesting that there are no economic profits from selling them to rivals. However, there are two reasons why the regulated prices could be above or below costs. The prices could be higher than the pure incremental costs of producing the element in question because of economies of scale and scope in producing that element in combination with other products and services. Alternatively, the regulated prices by design are based on a very aggressive interpretation of cost. This raises the possibility that incumbent local exchange carriers (ILECs) are obligated to sell these elements to rivals at prices lower than their own economic costs, that is, they lose profits in the process. In such a case, they could actually mitigate the damage by selling their downstream service at a price lower than its cost, but high enough to produce a lesser loss of money than if it provided the upstream element to its rivals. In such circumstances, below-cost downstream prices would clearly not be predatory, because they would have the same impact on competition as selling the downstream product with a positive profit when the upstream element was priced at cost. These issues are discussed more fully in Dennis L. Weisman, "The (In)Efficiency of the 'Efficient-Firm' Cost Standard," *The Antitrust Bulletin* 45, 1, (Spring, 2000): 195-211.

2. The Supreme Court's *Trinko* decision (*Verizon Communications, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 124 S. C.7.872 (2004)) made essentially the same observation. In explaining its reasoning in the earlier *Aspen Skiing* case (*Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 US 585 (1985)), the Court in *Trinko* observed:

We upheld a jury verdict for the plaintiff, reasoning that "[t]he jury may well have concluded that [the defendant] elected to forgo these short-run benefits because it was more interested in reducing competition...over the long run by harming its smaller competitor"...The unilateral termination of a voluntary (*and thus presumably profitable*) course of dealing suggested a willingness to forsake short-term profits to achieve an anticompetitive end (emphasis original, at 9).

The Court's focus on competitive impact in a downstream market also applies to analyses of alleged price squeezes.

3. In the telecommunications industry, these wholesale prices are typically determined by a regulator.
4. In this example, we assume that the cost of supplying the upstream input to rivals is also \$1.00. We also assume that each unit of downstream sales gained by rivals displaces one unit of sales by the vertically integrated provider. For analyses of more general cases, see Dennis L. Weisman, "The Law and Economics of Price Floors In Regulated Industries," *The Antitrust Bulletin* 47, 1 (Spring 2002): 107-131, and Jerry A. Hausman and Timothy J. Tardiff, "Efficient Local Exchange Competition," *The Antitrust Bulletin* 40, 3 (Fall 1995): 529-556.
5. In telecommunications regulation, the minimum price is often framed in terms of "imputing" the price of the upstream product into the vertically integrated firm's downstream price. This produces the equivalent formula: minimum price = upstream price + cost of competitively supplied input. In our example, the first term is \$1.50 and the second is \$1.00, producing the same minimum price of \$2.50.
6. Conversely, if the rival were less efficient, (e.g., it produced the downstream input at a cost of \$1.10), it would lose money if it tried to enter and compete against the vertically integrated firm pricing at the minimum price. In this case, the rival's cost for the downstream product would be \$2.60. While such a firm may well claim that it is being "squeezed," no anticompetitive price squeeze has occurred because there has been no foreclosure of efficient rivals.
7. Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, codified at 47 U.S.C. 151 *et seq.* (Telecommunications Act).
8. These ILECs were historically regulated monopoly providers of standard phone services, that is, basic local calling and short-haul toll calling.
9. The Federal Communications Commission (FCC) was charged with developing rules consistent with the requirements of the Act. Both state regulators and ILECs almost immediately challenged the initial rules, which called for virtually total access to all parts of the ILECs network. On three occasions, the rules were overturned by federal courts. In February 2005, the FCC released its fourth version of mandatory sharing requirements, (which were finally upheld as consistent with the statute). See *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499, (1996); *Competitive Telecommunications Ass'n v. FCC*, 117 F.3d 1068 (8th Cir. 1997); *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997); *AT&T v. Iowa Utils. Bd.*, 119 S. Ct. 721 (1999); *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, Third Report and Order and Fourth Further Notice of Proposed Rulemaking, 15 FCC Rcd 3696 (1999); *United States Telecom Ass'n v. FCC*, 290 F.3d 415 (D.C. Cir. 2002); *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket Nos. 01-338, 96-98, 98-147, Report and Order on Remand and Further Notice of Proposed Rulemaking, 18 FCC Rcd 16978 (2003); *United States Telecom Ass'n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004); Federal Communications Commission, *In*

the Matter of Unbundled Access to Network Elements (WC Docket No. 04-313) and *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (CC Docket No. 01-338), Order on Remand (“*Triennial Review Remand Order*”), 20 FCC Rcd 2533 (2005); and *Covad Communications Co. v. FCC*, 450 F.3d 528 (2006).

10. These rules require that network elements be provided at cost, based on an aggressive definition of economic costs that was coined “total-element long-run incremental cost (TELRIC).” While also subject to almost immediate challenge and initially overturned by a federal circuit court, the rules were ultimately upheld by the Supreme Court. See Supreme Court of the United States (2002) *Verizon et al. v. FCC et al.*, Case No. 0051, May 13. This decision noted that TELRIC rates are very favorable to entrants in that they are “designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbents’ property.”
11. An example of the sort of competition envisioned in the Telecommunications Act is the rivalry between cable television companies and ILECs in their offer of high-speed services for accessing the Internet: cable modems and digital subscriber lines (DSL).
12. While the FCC is charged with determining which part of the network must be shared with competitors and establishing the broad outlines of the rules for pricing these elements, state regulatory commissions actually apply the FCC’s rules to determine the prices that prevail in their states.
13. In 2005, the FCC ended this obligation by phasing it out over a 12-month transition period. See Federal Communications Commission, *In the Matter of Unbundled Access to Network Elements* (WC Docket No. 04-313) and *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (CC Docket No. 01-338), FCC 04-290, Order on Remand, (“*Triennial Review Remand Order*”).
14. Indeed, in the *Trinko* case, the Supreme Court ruled that the ILEC in question (Verizon) had not violated antitrust laws based on the allegation that the network elements it was required to provide to competitors were of inferior quality. A major component of the Court’s reasoning was distinguishing Verizon’s behavior from the unlawful refusal to share in the *Aspen Skiing* case. The fact that Verizon never provided the shared facilities at issue before being obligated by the Telecommunications Act meant that it had not anticompetitively forgone profits by withholding a facility it had previously provided to a rival. And while the Telecommunications Act expressly states that antitrust laws still apply to the parts of the industry subject to its provisions, the Court ruled that the presence of regulators overseeing the terms of access is an important factor in tipping the cost-benefit balance away from antitrust enforcement. Subsequently, the DC Circuit Court dismissed a price squeeze allegation against an ILEC, noting that “Bell Atlantic’s duty to makes these loops available at all, however, is purely a creature of the 1996 Act.” See *Covad Communications Co. v. Bell Atlantic Corp.*, 398 F.3d 666 (D.C. Cir. 2005).
15. See, for example, *Covad v. BellSouth*, *Sprint Communications v. FCC*, 274 F.3d 549 (D.C. Cir. 2001), *WorldCom, Inc. v. FCC*, 308 F.3d 1 (D.C. Cir. 2002), and Anne Marie Squeo, “Bells Mount Two-Way Assault on Local Market,” *The Wall Street Journal*, August 3, 2004.

16. The FCC has not imposed explicit price floors on long-distance and other downstream services offered by ILECs. Under Sections 271 and 272 of the Telecommunications Act, ILECs were allowed to request authority to provide long-distance services that they were previously barred from providing under the terms of the 1984 divestiture of AT&T upon establishing they had opened their local services to competition. Such authority was eventually granted in every state. The Telecommunications Act imposed a separate subsidiary provision for at least three years, which by design renders the price squeeze issue moot.
17. Elbert H. Gary was the President of United States Steel Corporation in the early 1900s. In 1907, he began hosting a series of dinners with leaders of rival steel producers, which led to agreements on pricing and marketing. The competitive effects of those agreements were the focus of the famous antitrust case, *United States v. United States Steel Corporation* (251 US 417 (1920)).
18. Weisman, “The Law and Economics of Price Floors In Regulated Industries” (as cited in note 4).
19. As noted by antitrust scholar Phillip Areeda and cited in the Supreme Court’s *Trinko* decision, at 15:

No court should impose a duty to deal it cannot explain or adequately or reasonably supervise. The problem should be deemed irremedia[ble] by antitrust law when compulsory access requires the court to assume the day-to-day controls characteristic of a regulatory agency.
20. See *Verizon v. FCC*, Dissent, at 22:

[T]he 1996 Act is not a typical regulatory statute asking regulators simply to seek low prices, perhaps by trying to replicate those of a hypothetical competitive market. Rather, this statute is a deregulatory statute, and it asks regulators to create prices that will induce appropriate new entry.
21. See, for example, Alfred E. Kahn, *Letting Go: Deregulating the Process of Deregulation* (East Lansing, Michigan: Michigan State University, The Institute of Public Utilities and Network Industries, 1998), at 92. Even though the rationale for imposing the sharing obligation on ILECs is that production of the elements at issue has some degree of natural monopoly characteristics, TELRIC pricing rules require the regulator to figure out what prices would look like if there were competition in their provision.
22. The volumes supplied by VoIP providers are growing rapidly. For example, between mid-2005 and mid-2006, US subscribership increased from 2.7 million to 6.9 million, or over 250 percent. See Timothy J. Tardiff, “Changes in Industry Structure and Technological Convergence: Implications for Competition Policy and Regulation in Telecommunications” (paper presented at the 34th Telecommunications Policy Research Conference, Vienna, Virginia, October 1, 2006, and forthcoming in *International Economics and Economic Policy*).
23. Similarly, as suggested in a 2004 *Wall Street Journal* editorial, the presence of such facilities-based competition renders “far-fetched” the second issue raised by the Eleventh Circuit in the *Covad* remand—whether the incumbent can recoup any losses from pricing its retail services too low. See “Dial M for Market,” *The Wall Street Journal*, August 30, 2004.

24. See Declaration of Alfred E. Kahn and Timothy J. Tardiff, on behalf of Verizon, Federal Communications Commission, WC Docket No. 04-313 and CC Docket No. 01-338, October 4, 2004.
25. In addition, in industries with a high proportion of sunk costs, such as telecommunications, artificially low prices may temporarily cause certain firms, but not their assets, to exit the market. This makes recoupment highly improbable, if not impossible. See, for example, Weisman, "The Law and Economics of Price Floors In Regulated Industries" (as cited in note 4).