



Federal Communications Commission
Office of Plans and Policy
191 M Street, N.W.
Washington, DC 20554

OPP Working Paper Series

25 What Makes The Dominant Firm Dominant?

April 1989

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WHAT MAKES THE DOMINANT FIRM DOMINANT?*

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* The views expressed in this paper are those of the authors and are not meant, nor should they be construed, to reflect those of the Federal Communications Commission, any individual Commissioner, or any other member of the Commission's staff.

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If the commission looks hard at the marketplace realities, there would be very little basis for a conclusion that AT&T is a nondominant carrier.*/

Gerry Kovach, MCI Senior Vice President for
Regulatory and Public Policy

We beat AT&T on this one. This contract is just the beginning. MCI will announce five or six other large network coups--particularly for large data applications--over the next 90 days.*/

Ronald E. Spears, President, MCI Midwestern
Division

*/These quotations appear in two different stories on the same page (41) of the 1/9/89 Communications Week.

Introduction

It has been remarked that regulation is largely a matter of definitions. Perhaps the most important definitional distinction currently drawn in telecommunications regulation is that involving the economic concept of market dominance. A firm's status as either dominant or nondominant makes a huge difference in both the number and difficulty of the regulatory hurdles it must overcome.¹

This paper first identifies the confluence of circumstances that determine whether the dominant-firm model supplies an accurate description of marketplace reality and, hence, a reliable basis for policymaking. It then examines whether these conditions currently prevail in the markets for long-distance telecommunications services in the United States. Our conclusion is that they do not and, thus, that the dominant/nondominant dichotomy provides a questionable basis for assessing regulatory burdens.

These conclusions are, of course, ones that AT&T's rivals in the long-distance business are not likely to share. But their opposition is a prediction of our analysis, and thus serves to confirm its validity. Maintenance of an outmoded system of asymmetric regulation stifles

¹ The difference in regulatory treatment afforded dominant and nondominant carriers is described in an appendix.

competition and harms consumers. The government should replace its asymmetric rules with symmetric ones, and adopt regulatory procedures that foster price competition rather than facilitate recognition of mutual interdependence among oligopolists.

The Dominant-Firm Model

Consider an oligopolistic market in which there is one large firm (the "dominant firm") and several smaller firms (the "competitive fringe").² This kind of market structure can be analyzed using a model, which, in contrast to many other oligopoly models, yields determinate solutions for prices and outputs. It does this by melding elements of monopoly and competition in a way that limits the need for analysis of strategic interdependence, the differentiating characteristic of oligopoly which typically leads determinate solutions to "fade into a mist of interacting uncertainties."³

The trick is accomplished by assuming that one firm behaves as a price-searcher and the others as price-takers. The price-searcher finds a

2 Oligopoly is "competition among the few." See William Fellner (1949). The dominant-firm model was originally postulated by Karl Forchheimer (1908). Our exposition follows the treatment in James Quirk (1976, pp. 274-75).

3 See Jack Hirshleifer (1976, pp. 323-325).

price he likes; the others take that price as a given in deciding how much to supply, expanding their supply the higher the given price. The price-searcher takes these supply decisions into account (i.e., he anticipates the reactions of the fringe to the price he chooses) in deciding what price he likes. He, of course, prefers a high price, but the higher the price, the less he sells as consumers substitute other goods and the competing products of fringe suppliers. So he must balance the gains and losses of a higher price in deciding what price maximizes his profit.

The dominant-firm model predicts an equilibrium price that is lower than the case of pure monopoly and higher than would obtain if there were perfect competition. On the one hand, it shows how a price-searcher is influenced not only by conditions affecting market demand and his own supply capabilities, but also by the supply capabilities of competing firms. The latter reduce and make more elastic (i.e., more responsive to price changes) the demand the price-searcher confronts. He is thus compelled to charge a lower price than he would if effective competitive alternatives did not exist or were only a possibility.⁴

⁴ Ineffective competitors obviously do little to constrain the dominant firm's pricing behavior. The effect of potential competition depends on the susceptibility of a market to "hit-and-run" entry. See William Baumol, John Panzar and Robert Willig (1982).

On the other hand, the price under this type of industry organization is higher than would prevail under conditions of perfect competition. Thus the possibility exists that regulation might improve the efficiency with which resources are allocated. In particular, a regime of asymmetric regulation that effectively (and economically) constrained the dominant firm's price to the competitive level would expand consumer welfare. It is in this sense that the economic model of dominant-firm behavior can be used to justify differences in the regulatory treatment of dominant and nondominant firms.

Note that such regulation would harm (and, therefore, presumably be opposed by) the competitive fringe. The lower the prices the dominant firm is compelled to charge, the smaller the sales of the fringe firms. The interest of the fringe firms is to keep the dominant firm's prices high to provide an "umbrella" under which the fringe can expand its sales. In the dominant-firm model the fringe's interest is clearly in regulation that prevents prices from falling rather than in regulation that compels (or permits) reductions in the dominant firm's prices. In terms of pricing regulations, the interests of the fringe firms and of consumers thus diverge.

What Makes the Dominant Firm Dominant?

The crucial factor that drives outcomes in the dominant-firm model is the size of the fringe's supply capability relative to the size of the market compared to the size of the dominant firm's supply capability

relative to the size of the market. The dominant-firm model assumes that the former is so small relative to the latter that, on the one hand, fringe firms ignore the effects of their actions on the dominant firm's prices and, on the other hand, the dominant firm allows fringe firms to sell all that they wish.

The dominant firm's willingness to forbear is the critical conjecture about the strategic interaction among firms under oligopoly that enables the dominant-firm model to produce determinate outcomes. As long as what the fringe does does not matter much, the dominant firm can afford to leave well enough alone and simply compensate for the fringe's activities in its own pricing decisions.⁵ How much the fringe's activities matter depends on the size of its supply capability relative to the size of the market.

The dominant-firm model provides a description of short-run pricing behavior under oligopoly. That is because, in the short run, both the number of firms and their productive assets are fixed. The dominant firm can sustain a price above cost in the short run because, by assumption, the fringe cannot expand its plant capacity, improve its reputation for competence and fair dealing, or increase its numbers through the entry of new firms. In the long run all of these things can happen in the absence of

5 Over time the dominant firm's market share will decline assuming it bears the brunt of the burden of restricting output for the industry. Assuming capital is sunk and long-lived, the dominant firm will thus tend to earn a lower rate of profit than its rivals. See D. A. Worcester (1957).

artificial entry barriers.⁶

Recall that the dominant firm optimizes over a residual demand schedule given by the difference between market demand and anticipated fringe supply. As fringe supply capabilities expand, that residual demand declines and becomes more elastic, leading the dominant firm to reduce the price of its services. This, of course, assumes that regulation has not already reduced prices and that the firm is permitted to reduce its prices under regulation. Just as the fringe can be expected to oppose regulation-induced price reductions, it can be expected to resist competition-induced price reductions as well. The higher the dominant-firm pricing umbrella, the greater the opportunities for expansion of fringe sales.

As the supply capability of the fringe rises relative to the size of the market, the assumptions underlying the dominant-firm model are violated. At some point, fringe firms can no longer ignore the effects of their actions on market prices or on the decisions taken by the (formerly) dominant firm or by other firms. Similarly, as the supply capability of the fringe rises relative to the size of the market, the dominant firm eventually can no longer afford simply to allow fringe firms to sell all they wish at the price it selects.

⁶ A barrier to entry exists when a firm is barred from competing even though it can meet all cost and production requirements. Requirements for effective performance do not constitute economic barriers.

Ultimately, if the only thing that prevents firm B (or C or D) from taking business from firm A is its (or their) willingness to quote a sufficiently low price, there is no economically relevant sense in which firm A can be said to be "dominant." At that point we pass from the deterministic world of the dominant-firm model into the realm of oligopolistic interdependence and genuinely strategic interaction. As that boundary is crossed, it is important to recognize that the regulatory rules that formerly made sense may no longer be justified. In particular, when no firm can be uniquely categorized as dominant, no asymmetric assignment of regulatory liabilities can be legitimately defended. A new market environment calls for new rules.

Is AT&T Dominant?

The question of dominance turns on a comparison of supply capabilities relative to the size of the market. While supply capabilities may vary over different market segments, a firm's total capitalization provides a reasonable approximation of its overall supply capabilities and a rough gauge of its competitive prowess.

Table I presents estimates of each of the major long-distance competitor's capital assets. In addition, we have calculated two measures

of relative supply capability from these data: the percentage of total industry capital each firm's capital assets represent and the percentage of AT&T's long-distance capital each firm's capital assets represent.

On the assumption that AT&T is itself capable of supplying the entire market, the percentage of AT&T's long-distance assets a firm's assets represent gives an estimate of that firm's supply capability relative to the size of the market. The percentage of total industry capital a firm's own assets represent is likely to understate its true relative supply capability because the long-distance business is currently characterized by significant excess capacity.⁷

7 Robert Crandall (1988, p. 31) has observed that "Given the history of transportation regulation, we know that continued rate regulation and liberalized entry are a potentially lethal combination. Regulators inevitably find themselves hostage to inefficient competitors. It now appears that investment in interstate telephone transmission has been excessive. The frantic investment in fiber-optic networks reminds one of the rush to build railroad lines in the last century. It would be propitious for the regulators to find a way to exit before they are either pressured to keep long-distance rates artificially high or are engulfed in a series of politically embarrassing bankruptcies."

Table I

Long Distance Capital Assets */

	<u>1988 \$Billions</u>	<u>% Total</u>	<u>% AT&T</u>
AT&T	\$ 8.0 E	40%	100%
MCI	\$ 5.8 A	29%	71%
U.S. Sprint	\$ 3.5 A	18%	44%
Other <u>**/</u>	\$ 2.5 E	13%	31%
Total	\$19.8 E	100%	246%

*/ Source: Lap Lee, Salomon Brothers.

**/ Does not include the value of private networks.

It matters little, however, upon which measure of relative supply capability one focuses. By either measure the assumptions of the dominant-firm model are clearly violated. The "fringe" supply capability is very large relative to both the size of the market and the industry's total capitalization. MCI and U.S. Sprint account for 115 percent of AT&T's capitalization and 47 percent of the industry's total assets (compared to AT&T's 40 percent).

The idea that a fringe accounting for 60 percent of total capital and capable of supplying 146 percent of the market can ignore its effect on AT&T's pricing decisions strains credulity. Only the government's willingness to afford the fringe some semblance of a pricing umbrella lends it any plausibility. The idea that AT&T would voluntarily allow fringe competitors to sell all that they wish given their ability to serve (more than) the whole market is, of course, totally ludicrous on its face.⁸

The evidence adduced here thus suggests that AT&T is no longer a dominant firm. Claims that it is for the most part merely represent

⁸ The existence of large amounts of private capacity and the readily apparent potential for construction of additional private networks further constrain AT&T's pricing flexibility vis à vis large corporate customers.

self-serving attempts to sustain an outmoded regime of asymmetric regulation that supplies competitors with protection from competition.

Oligopoly and Regulation

The market equilibrium under oligopolistic industry organization is uncertain. It depends on how firms interact and, thus, different assumptions about the strategic interaction among competitors yield different conclusions. Competitive outcomes are a possibility under oligopoly. So are monopolistic ones. What results actually obtain will depend on a variety of factors, not least important the regulations that govern the behavior of market participants.

Following Bertrand (1883), suppose price is the focal point of competitive rivalry among oligopolists and that each firm takes the price chosen by its rivals as a given. For each firm the optimal strategy is to set a price just infinitesimally lower than its rivals' because the firm quoting a lower price attracts all the business. But if all firms behave that way, the equilibrium price is established at the competitive level as firms continually undercut one another until price cutting is no longer viable.

Alternatively, following Cournot (1897), suppose output decisions are the focus of competitive rivalry and that each firm takes the output chosen by its rivals as a given. Equilibrium in this kind of model occurs when the profit-maximizing outputs firms select coincide with those their rivals expect them to select (i.e., their expectations are consistent and mutually reinforcing). This is an equilibrium in the sense that no firm has an incentive to change its output so long as its rivals maintain theirs. When firms are symmetrically situated, the Cournot equilibrium involves a price-output combination that is, from consumers' standpoint, superior to monopoly but inferior to perfect competition.

There is considerable dissatisfaction among economists with most models of oligopoly. That is, in part, because competitors are (or should be) smarter than oligopoly models generally give them credit for being. Instead of undercutting one another, Bertrand's competitors should be able to see that cooperation (i.e., collusion) to maintain a high price will maximize joint profits. Instead of taking rivals' outputs as fixed (in the face of repeated evidence to the contrary in disequilibrium), Cournot's competitors should learn from experience and comprehend the payoffs to be reaped by cooperation and coordination of supply (i.e., collusion).⁹

⁹ One of the leading modern exponents of Cournot's ideas observes that "Cournot's players persist in behavior which reveals the untruth of the assumptions which prompted the behavior in the first place. Rational players, by comparison, would come quickly to anticipate each other's reactions and would alter their behavior until events confirm (rather than deny) their expectations." See James Case (1979, p. 31).

The modern theory of oligopoly (see George Stigler 1964 and Gary Becker 1968 and 1971) focuses directly on the benefits and costs of collusive behavior among competitors. The gains from collusion (tacit or explicit) are negatively related to elasticities of demand and supply. The costs of colluding (i.e. of taking effective recognition of mutual interdependence) are lower the smaller the number of firms and customers, the less erratic the shifts by customers from one firm to another, and the less hostile government legislation and regulation are to collusive behavior. The theory predicts that noncompetitive outcomes are more likely to occur the greater the net gains from cooperative behavior among competitors.

A regulatory agency whose tariffing procedures and requirements are easily subverted to inhibit competitive responses and could, in principle, supply a clearing house for competitively sensitive information that would facilitate oligopolistic coordination can hardly be characterized as hostile to anticompetitive behavior. The fact that such misuse would constitute a perversion of governmental process does not render the process itself any less noxious. Fundamental reforms, including abolition of the tariffing process for some services, unfortunately require legislative changes that are likely to be a long time coming if they ever come at all. There are, however, less radical reforms that can help prevent the Federal Communications Commission from being transformed into a Federal Communications Cartel.

Thinking the Thinkable

From AT&T's lack of dominance, the effectiveness of competition in the long-distance business does not necessarily follow. First, under a continuing regime of asymmetric regulation, AT&T's effectiveness as a competitor may be significantly constrained. That may reduce the market's ability to police itself through the operation of a competitive process.¹⁰ Second, even in the absence of regulatory asymmetries, effective recognition of mutual interdependence and coordination of supply decisions among (nominally) competing firms may lead to noncompetitive results.

The effectiveness of competition rests, in part, on the intensity of the fear of failure that motivates competitors' efforts to discover and satisfy consumer preferences. The greater the fear of business loss, the greater the degree of consumer sovereignty. Regulations that insulate competitors from competitive pressure by delaying or preventing the introduction of new services or the discounting of existing ones thus reduce consumer sovereignty. Just as consumers are harmed by artificial restraints

¹⁰ If one of the runners in a race is artificially handicapped, that may make the rivalry less intense and the contest less capable of producing a superior performance.

on their ability to utilize different carriers' services, they are harmed by artificial restraints on carriers' ability to offer them services that satisfy their requirements. "Equal access" is a two-way street. In a market environment in which no firm is dominant, no asymmetries in the regulatory treatment of supplier access to customers can be justified.

Considerations related to the possibility of oligopolistic coordination yield similar conclusions for policy. The economic structure of the long-distance business in many respects resembles that of the automobile industry. The structure is oligopolistic with a relatively small number of (facilities-based) suppliers competing for consumers' favor. Substantial investments in sunk capital assets are required for effective participation. On the one hand, this implies a limited role for potential competition to influence market performance.¹¹ On the other hand, it suggests little possibility for effective predation as exit from the market is unlikely once capital has been sunk.

¹¹ Note, however, that the fungibility of productive capacity across market segments does imply that potential competition can play a significant role once capital has been deployed. Potential redeployment of sunk assets acts to constrain pricing in any market segment where the threat of asset redeployment is credible.

The small number of competitors implies comparatively low costs of collusion, but there are strong incentives to cut prices (i.e., to cheat on any collusive understanding) to increase network utilization and thus to spread the high fixed costs. Of course, incentives to cut prices will be mitigated to the extent that asymmetric government tariffing regulations supply a price umbrella. And effective recognition of mutual interdependence will be easier to the extent that tariffing and other regulations make it easier for competitors to signal their own intentions or to fathom the intentions of their rivals.

On the theory that structure determines performance (i.e., the theory of industrial organization economics),¹² a comparably unregulated long-distance business might thus be expected to perform about as well as the automobile industry in terms of satisfying consumers' desires. Unfortunately, the Communications Act of 1934, as amended, would appear to preclude a market test of the validity of that prediction. It is also perhaps worth noting in passing that, in contrast to long-distance, not only is the automobile industry not subject to price regulation, but it is also, as a consequence of government import restrictions, actually afforded significant protection from competition.

12 See F. M. Scherer (1980).

The conclusion that regulation should be symmetric (i.e., should attempt to treat likes alike) leaves unresolved the kind of regulation that should be uniformly imposed upon all regulatees. In our view, the least desirable regulatory model would be one that imposes upon all interexchange carriers the regulatory burdens under which AT&T now labors. Few would dispute that the costs such a regime would impose upon regulators, regulatees, and subscribers would vastly outweigh any benefits that might flow from its imposition. In fact, any form of symmetric regulation short of forbearance will impose new administrative costs on AT&T's competitors without any apparent benefits to the public they serve.¹³ Indeed, the public might well be harmed if new regulation actually facilitated collusion.

From a policy perspective, the most attractive form of symmetric regulation would be to extend to AT&T the forbearance approach now applied to its rivals. But a crucial element of the legal argument supporting the Commission's decision to forbear from regulating AT&T's nondominant competitors was that AT&T's rates remained subject to direct Commission

13 The FCC has already recognized that "[t]he presence of traditional regulation itself may be a significant entry barrier to a market that otherwise could operate efficiently on a highly competitive basis." Decreased Regulation of Certain Basic Telecommunications Services, 2 FCC Rcd 645, 646 (1987) (hereinafter "Basic Services Deregulation Notice").

regulation.¹⁴ For this reason, a decision to forbear from regulating the rates for all of AT&T's services would not only appear to carry substantial risk of being overturned on appeal, but might also jeopardize the Commission's continued ability to forbear from regulating other interexchange carriers.

Thus it appears that, to be legally sustainable, symmetric regulation must impose unnecessary costs on some or all regulatees, not to mention consumers. That raises the question of whether some other regulatory reform could relieve AT&T of the disparate burden it shoulders and yet survive judicial scrutiny? We believe that the answer is "yes." The Commission has, in fact, already developed, albeit on a piecemeal basis, all the policy and legal tools needed to create such reform. The essential components of successful reform lie within two open dockets, the Price Caps proceeding¹⁵

¹⁴ In *FPC v. Texaco*, 390 U.S. 747 (1968) the Supreme Court held that while the Federal Power Commission could not rely exclusively upon market forces to achieve just and reasonable rates for small natural gas producers, it did not have to fix these rates through orders directly addressed to these producers, but could instead rely upon indirect regulation of their rates through orders setting the rates of the large producers. The FCC has repeatedly recognized a need to show that its decisions first to streamline regulation of and then to forbear from regulating nondominant carriers were consistent with the holding of *Texaco*. An essential component of its argument that nondominant carriers' rates would be just and reasonable was that the Commission-regulated rates of AT&T acted as a cap on the rates that these carriers could effectively charge for their services.

¹⁵ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Notice of Proposed Rulemaking, 2 FCC Rcd 5208 (1987), Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 (1988), Report and Order and Second Notice of Proposed Rulemaking, FCC 89-91 (Released: April 17, 1989).

and the Basic Services Deregulation docket.

In the Basic Services Deregulation docket, the Commission proposed to refine the market analysis presented in its Competitive Carrier docket to recognize that a carrier could be dominant in some basic service markets and still be nondominant in others.¹⁶ For those service markets in which an otherwise dominant carrier was found to be nondominant, the Commission tentatively concluded that the carrier's tariff filings should be eligible for streamlined tariff review.¹⁷ Packet services and contract services offered after competitive bidding were explicitly singled out as potentially qualifying for such treatment.¹⁸

16 Op. cit. at 646-647.

17 Id. at 647. Under streamlining, the Commission would presume the carrier's tariff filings to be lawful. A petitioner seeking suspension of such a filing would have to demonstrate that; (a) there existed a high probability that the tariff would be found unlawful after investigation; (b) the harm alleged to competition would be more substantial than the injury to the public arising from the unavailability of the service under the rates and conditions proposed in the challenged tariff filing; (c) irreparable injury would result if the tariff filing were not suspended; and (d) the suspension would not otherwise be contrary to the public interest. Tariffs subject to streamlined review could take effect on 14 days notice (rather than the 45 or 90 days notice required of dominant carriers under Commission rules) and need not be accompanied by the economic support data specified in Section 61.38 of the Commission's rules. See id. at n. 8.

18 Id. at 645.

Fearing that a rate-of-return regulated carrier might try to leverage its its dominant position in other markets to compete unfairly in markets for which it lacked market power, the Commission tentatively concluded that cost allocation and nondiscrimination safeguards were essential to its "piecemeal deregulation" proposal.¹⁹ Note, however, that the absence of rate-of-return regulation and a lack of market dominance would clearly mitigate the need for such safeguards.

In the Price Caps docket, the Commission has replaced rate-of-return regulation with rules that effectively define ceilings or caps on the rates that AT&T may charge for its regulated services. Under the Commission's price cap rules, an AT&T filing that proposed to alter rates of an existing service would be eligible for streamlined tariff review as long as the new rates did not exceed the applicable rate ceilings.

Under this regulatory regime, the prime focus is on rate levels rather than profit levels. The ceiling on rate levels and the spread of effective competition virtually eliminate AT&T's ability to subsidize more competitive services with revenue from less competitive services. Thus under a price cap approach, it should be possible to proceed with the sort of regulatory reform proposed in the Basic Services Deregulation docket without cumbersome

19 Id. at 650.

and inefficacious cost allocation rules.

As price cap rules permit simplification of the piecemeal deregulation docket proposal, the latter's reasoning permits simplification of the price cap rules for AT&T without a concomitant risk of harm to the public. Because it assumes that the carriers subject to price cap regulation are dominant in each telecommunications submarket in which they participate, the Price Cap docket has erected machinery far more cumbersome than appears necessary to assure that AT&T's service rates are just and reasonable.

Applied in the traditional tariff regulation setting, the piecemeal deregulation proposal of the Basic Services Deregulation docket would have divided AT&T's basic services into two categories: those for which the carrier was dominant and those for which it was not. Traditional tariff review rules would govern the former; the latter would be eligible for streamlined review.²⁰ When the reasoning of the Basic Services Deregulation docket is applied in the price caps setting, it logically leads

20 This separation of services into disjoint classes to which different regulatory rules would apply is similar to the core/noncore distinction drawn in OPP Working Paper # 22, in which Commission staff for the first time explored the possibility of applying price cap regulation to AT&T. That paper presented a simple proposal for reforming the FCC's regulation of AT&T "[t]he essence of [which] is to replace rate-of-return regulation with a price cap on a limited set of 'core' services that must be offered in all markets." See John Haring and Evan Kwerel (1987, p. 27). OPP Working Paper # 23 examined the legal issues raised by the Haring-Kwerel proposal and concluded that the proposal would withstand judicial scrutiny. See Kathleen Levitz (1987).

to the separation of AT&T's services into two slightly different disjoint categories, which we shall refer to as core and noncore respectively.

Noncore services would still include those services for which "the competitive process assures that customers will receive the types of services they require at reasonable prices."²¹ They would be afforded streamlined treatment while core services would remain subject to price cap regulation.²² Under price cap regulation, however, it should be possible to expand the set of noncore services eligible for streamlined regulation.

If each AT&T service is grouped with all of its close AT&T substitutes, and if the Commission's price cap rules are applied to even one member of each such class, the price cap has the same effect on all other members of that class that market forces exert upon fully competitive noncore services, i.e., reasonable rate levels. This ability of price cap regulation to act as a (perhaps largely redundant) surrogate for market forces permits the inclusion of all but one member of each class of "close" AT&T service substitutes in the noncore category.²³

21 Id. at 650. Thus, for example, service offerings now included within AT&T's Tariff No. 12 would be categorized as noncore.

22 Applying the regulatory scheme adopted in the price cap docket to our proposal would require each "core" service to be in its own basket, that is, each core service would be individually capped.

23 Thus, if MTS were designated a "core service," optional calling plans like "Reach-Out America" and "Pro-America" would qualify for streamlined tariff review.

The Commission's Basic Services Deregulation docket has already laid a sound policy and legal foundation for adoption of the core/noncore concept. Grafting this concept onto the price caps structure already in place for AT&T would produce regulatory reform simpler and still more effective than would be possible under either docket alone. The synergy between the two concepts, price caps and core/noncore, could create a regulatory scheme in which all but a relatively few AT&T services could be automatically eligible for streamlined tariff review. The tariff filings associated with the remainder of AT&T's regulated services, the core services, would remain eligible for such treatment as long as they comply with individual price ceilings. The end result would be regulation that enhances both the ability and the incentives of all carriers to respond to consumer demand, an outcome clearly in the public interest.

Conclusion

Is regulation part of the solution or part of the problem? The regulatory apparatus that currently governs long-distance telecommunications is a vestige of historical monopoly and was specifically designed to control a dominant firm that is, in fact, no longer dominant. Maintenance of that regime in today's changed circumstances is increasingly likely to produce noncompetitive results and, thus, to harm consumers rather than to protect them.

In this paper we have described how the FCC, having adopted a system of price caps to regulate AT&T, is now well positioned to proceed with additional reform that can help to promote a more competitive marketplace for long-distance services and thus expand consumer welfare. The key to such reform lies in the creation of core and noncore service categories within the Commission's price caps regime for AT&T, with streamlined regulatory treatment afforded an expansive class of noncore services.

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Appendix: Differences in Regulatory Treatment Afforded Dominant and
Nondominant Carriers

In the course of its Competitive Carrier Rulemaking Docket the Commission imposed an increasingly asymmetric regulatory regime upon the common carriers subject to its regulation. See Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252, First Report and Order, 85 FCC 2d 1 (1980)(specialized common carriers and resellers of terrestrial common carrier services operating in the contiguous 48 states designated nondominant henceforth subject to streamlined regulation); Second Report and Order, 91 FCC 2d 59 (1982) (forbearance from even streamlined regulation appropriate for terrestrial resellers whenever it furthers the purposes of the Communications Act), recon. denied, 93 FCC 2d 54 (1983); Third Report and Order, 48 Fed. Reg. 46971 (Oct. 14, 1983) (specialized common carriers and resellers of terrestrial common carrier services operating between any U.S. offshore points or Alaska and the contiguous states now covered by same regulatory policies as those operating within the contiguous states); Fourth Report and Order, 95 FCC 2d 554 (1983) (forbearance applicable to all resellers of domestic common carrier services and specialized common carriers; domestic satellite carriers, miscellaneous common carriers and facilities-owning interexchange carriers affiliated with certain of the independent telephone companies classified as nondominant carriers eligible for streamlined regulation); Fifth Report and Order, 98 FCC 2d 1191 (1984)

(forbearance extended to domestic satellite carriers, miscellaneous common carriers, interexchange carriers affiliated with certain independent telephone companies and certain carriers providing DEMS).

Under the regulatory scheme created by Competitive Carrier many of the rules with which dominant carriers must comply do not apply to nondominant carriers. For example, a dominant carrier must continue to make a tariff filing each time it proposes to offer a new service or to change the terms and conditions under which it offers any service already tariffed. Before that tariff filing becomes effective, both Commission staff and interested members of the public (including, notably, nondominant competitors) review the filing, as well as the often voluminous economic support required under Commission rules. These parties often submit petitions to reject the filing as unlawful or to suspend it while the Commission conducts a more extensive investigation into its lawfulness. The Commission may exercise its authority under Section 204 of the Communications Act to investigate further the tariff's lawfulness and may delay the effective date of the tariff for up to five months while it conducts such an inquiry.

The Commission's recent decision to adopt price cap regulation for dominant carriers changes the filing and review requirements for only those AT&T tariff filings that are not associated with service contracts following competitive bid and that propose only rate level adjustments that comply with the applicable rate caps. See 47 C.F.R. §§ 61.41 - 61.

Tariff filings meeting these two conditions would be eligible for streamlined treatment. Nondominant carriers, however, are subject to no tariff review. Prior to its price caps decision, the Commission also prescribed the rate of return which dominant carriers were to target their interstate services to earn and had asserted its authority to require the carriers to refund overearnings.

The Commission also requires dominant carriers to receive authorization to construct, acquire or operate new interstate transmission facilities, a requirement that it does not impose on nondominant carriers. The Commission also prescribes the rate at which dominant carriers may recover their capital investment. Its Separations Manual, codified as Part 36 of the Commission's Rules, 47 C.F.R. Part 36, prescribes the rules these carriers must use to apportion investment and expenses between their interstate and intrastate operations, rules that often require the performance of expensive cost studies. Even under price caps regulation, AT&T's earnings on interstate services remain the subject of periodic review and a potential basis for adjustments to the rate ceilings. None of these rules apply to nondominant carriers.

AT&T and the former BOC's are also required to comply with the nonstructural safeguards of Computer Three¹ as a condition precedent to

their offering regulated and unregulated telecommunications services on an integrated basis. Among these nonstructural safeguards are requirements: that a dominant carrier use a Commission approved cost allocation manual for apportioning costs between regulated and unregulated services; that it disclose changes to its network that will affect the ability of competitors in the market for unregulated communications services, called enhanced services, to interconnect with that network several months before the changes will become effective; and that it develop an open network architecture through which such competitors can have access to the same facilities and functionalities that the dominant carrier uses to provide these enhanced services. Again none of these rules apply to nondominant carriers that choose also to offer enhanced services, of which electronic mail is but one example.

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