NOTES

Economic Goals and Remedies of the AT&T Modified Final Judgment

WARREN G. LAVEY*
DENNIS W. CARLTON**

The consent decree leading to the forthcoming divestiture of AT&T has set the stage for the future development of the telecommunications industry in the United States. Yet, the full impact of the settlement between the Department of Justice and AT&T upon consumers and the telecommunications-services and telecommunications-equipment industries remains uncertain. In their article, Mr. Lavey and Professor Carlton analyze the antitrust policies upon which the agreement is based and conclude that there are some anomalies in the application of these policies in the agreement. The authors then discuss the settlement agreement as a response to imperfect regulation of cross-subsidies. Finally, the authors discuss the problem of raising sufficient revenue to cover the costs of telephone companies after the divestiture.

An antitrust consent decree, commonly referred to as the Modified Final Judgment (MFJ), was entered into by the American Telephone & Telegraph Company1 and the United States Department of Justice and approved by District of Columbia District Court Judge Harold Greene in 1982.2 The judgment has become a landmark in the development of the telecommunications industry in the United States and its effects on the structure and operation of the telecommunications industry will be extensive. For example, the Bell Operating Companies (BOCs) will be divested from AT&T, new exchange areas,
known as "LATAs," have been approved,\(^3\) property is being valued and transferred between the BOCs and AT&T, new channels for marketing Western Electric's equipment are being opened, and access charges are being developed. The number of technical details involved in these changes is monumental, as are the range and complexity of the legal issues.

In assessing the impact of these changes, it is important to remember that the MFJ is the settlement of an antitrust case. The assumption underlying the MFJ from the Department of Justice's (DOJ's) perspective is that the infusion of competition will enhance consumers' welfare, and thereby realize a fundamental goal of the antitrust laws.\(^4\) Simply stated, the DOJ's theory was that ineffective regulation allowed AT&T to abuse its monopoly power in telecommunications services and equipment, and resulted in certain products and services being offered at prices that were above competitive levels.\(^5\) Pricing a product above the competitive level is inefficient because it causes consumers to purchase less of the product than they would at the competitive price.

This article has two principal objectives. First, it evaluates the goals and remedies of the MFJ through application of the economic criteria of efficiency and consumers' welfare. In addition, the article seeks to establish an economic framework that will be useful to courts and regulators in interpreting and applying the MFJ, to business and government in pursuing legal remedies related to the MFJ, and to legislators and regulators in developing new regulatory regimes.

Sections I and II of this article examine two concerns of the MFJ: (1) abuse of monopoly power, and (2) cross-subsidization from an imperfectly regulated monopoly market to a competitive market. Each section initially addresses the relevant economic and legal theories underlying antitrust enforcement and then analyzes the application of these theories in the MFJ. Section III considers an important economic problem that is affected by, but largely beyond the scope of, the MFJ: Raising sufficient revenue to cover the costs of a regulated firm.

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3. United States v. Western Elec. Co., No. 82-0192, slip op. at 104-116 (D.D.C. July 8, 1983); United States v. Western Elec. Co., 1983-1 Trade Cas. (CCH) ¶ 65,333 (D.D.C. 1983). Under the MFJ, the BOCs cannot provide inter-LATA services. Among the relevant factors in establishing LATAs are "the minimization of service disruption to telephone subscribers; the avoidance of costly network management; and the establishment of LATAs of sufficient size to attract several interexchange carriers." Id. at 69,972 n.27.


5. The Department of Justice reasoned that AT&T, as a rate base/rate of return regulated monopolist, had "both the incentive and the ability, through cross-subsidization and discriminatory actions, to leverage the power it enjoys in its regulated monopoly market to foreclose or impede the development of competition in related, potentially competitive markets." Department of Justice, Competitive Impact Statement, DAILY Exec. Rep. (BNA) B-1, B-2 (Feb. 11, 1982).
I. ABUSE OF MONOPOLY POWER

A. ECONOMIC FRAMEWORK

Monopoly power is defined as the ability of a firm (or group of firms acting jointly) to raise its price above the competitive level without driving away so many customers as to make the price increase unprofitable. The price a firm may charge for its product is constrained by the availability of close substitutes for the product and, provided that there are sufficient close substitutes, its price remains no higher than that which will give it a competitive rate of return. If a firm attempts to charge a higher price—a supracompetitive price—customers will turn to other firms able to supply substitute products at competitive prices. These firms in turn will expand their production to meet the increased demand for their products. If a firm provides a large percentage of the substitutable products actually or potentially available, however, customers may find it more difficult to buy from alternative suppliers when the firm increases its price. Consequently, a firm with a large share of the relevant market of substitutable products may be able to raise its price without losing many customers. For this reason, courts often use market share as a rough indicator of monopoly power.

Supracompetitive prices are associated with a loss of consumers’ welfare because such prices force buyers to consume a mix of products that is different from, and less attractive to them than, what their choices would have been if firms supplied all goods and services at competitive prices. Antitrust laws, however, do not attempt to counter the mere existence of monopoly power, or even the use of monopoly power to extract supracompetitive profits. Some firms, by virtue of their superior skill, foresight, efficiency, or luck, can offer better products and lower prices than their rivals and still earn supracompetitive profits. If the antitrust laws posed disincentives to the existence and


7. Technically stated, the elasticity of demand facing a firm increases with the availability of close demand and supply substitutes. See Landes & Posner, supra note 6, at 945. A relevant market is defined as an “area of effective competition,” has product and geographic dimensions, and includes close demand and supply substitutes. See United States v. E.L. du Pont de Nemours & Co., 351 U.S. 377, 395 (1956); Standard Oil Co. v. United States, 337 U.S. 293, 299-300 n.5 (1949).

8. See Grinnell, 384 U.S. at 571; Broadway Delivery Corp. v. United Parcel Serv. of Am., 651 F.2d 122, 129 (2d Cir.) (market share below 50% rarely evidence of monopoly power; share between 50% and 70% usually strong evidence of monopoly power), cert. denied, 455 U.S. 943 (1981); Landes & Posner, supra note 6, at 938 (market share common indicium of market power). Recent research, however, indicates that the links between concentration and market power may be quite weak. See, e.g., Ravenscraft, Structure-Profit Relationships at the Line of Business and Industry Level, 65 Rev. Econ. & Stat. 22, 29 (1983); Peltzman, The Gains and Losses from Industrial Concentration, 20 J.L. & Econ. 229 (1977). The DOJ, in the 1982 Merger Guidelines of the Department of Justice, 2 Trade Reg. Repr. (CCH) ¶ 4500, 6881-1 (June 4, 1982), uses the Herfindahl-Hirschman Index to measure the competitiveness of a market. This index is calculated by adding the squared shares of the firms in the market. Id. ¶ 4503 at 6881-11-6881-12.


10. See United States v. Aluminum Co. of Am., 148 F.2d 416, 430 (2d Cir. 1945) (L. Hand, J.).
growth of such firms, the laws could impair consumers' welfare.\textsuperscript{11} For example, a firm enjoying economies of scale—as AT&T alleges that it does in interchange telecommunications services—\textsuperscript{12}—does not violate the antitrust laws when it obtains a large market share by charging prices that are profitable to it but so low that its smaller rivals cannot survive.

Some antitrust prohibitions focus on abuses of monopoly power that exclude competition in the monopolized market or involve leverage—the use of power in one market to restrain competition in another market.\textsuperscript{13} An illustration of such a forbidden practice is a tying arrangement, whereby a monopolist conditions the sale of a product in one market on the buyer's purchase of another product in a different market.\textsuperscript{14} A firm may also attempt vertical foreclosure, another prohibited practice, by monopolizing a key stage of an industry's operations.\textsuperscript{15} A vertically-integrated firm may discriminate against competitors by denying access to a facility that is essential to the sale of a product that cannot be duplicated by competitors readily or at a similar cost, and thereby

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  \item \textsuperscript{11} See, e.g., 2 P. Areeda & D. Turner, supra note 4, at 331-41 (excess profits may be result of lower production costs or innovation in product design); Schmalensee, Another Look at Market Power, 95 Harv. L. Rev. 1789, 1805 (1982) (excess profits may provide signals to guide flow of investment funds).
  \item \textsuperscript{12} THE DESIGN AND COST CHARACTERISTICS OF TELECOMMUNICATIONS NETWORKS 1-4 (R. Skoog ed. 1980). See also J. Meyer, THE ECONOMICS OF COMPETITION IN THE TELECOMMUNICATIONS INDUSTRY 181-213, Appendix D (1979)).
  \item \textsuperscript{14} See, e.g., United States Steel v. Fortner Enterps., 429 U.S. 610, 620 (1977); Times-Picayune Publishing Co. v. United States, 345 U.S. 594, 611 (1953). Some economists and lawyers have questioned the rationale for antitrust liability for tie-in arrangements made by unregulated firms. See R. Posner & F. Easterbrook, supra note 4, at 802-10. A firm that is capable of earning monopoly profits on one product often can gain no additional profits by tying a second, related product. Even when tying increases a monopolist's profits, consumers are not necessarily harmed. A firm subject to regulatory restraint on profits from its monopolized product, however, may seek to leverage or engage in tying to earn supracompetitive profits on a related product. See 1 A. Kahn, Economics of Regulation 28 (1970). The DOJ recognized that AT&T's incentive for leverage grew out of its status as a rate base/rate of return regulated monopolist. See supra note 5 (quoting DOJ). See generally Bowman, Tying Arrangements and the Leverage Problem, 67 Yale L.J. 19, 20 (1957); Burstein, A Theory of Full-Line Forcing, 55 Nw. U.L. Rev. 62 (1960); Markovitz, Tie-ins, Reciprocity, and the Leverage Theory, 76 Yale L.J. 1397, 1398 (1967).
  \item \textsuperscript{15} Many economists and lawyers have criticized the proposition that an unregulated monopolist would find it profitable to abuse its monopoly power by curtailing competition in related markets through vertical foreclosure. These authorities argue that it is often unlikely that a monopolist will obtain a second source of monopoly profits from such arrangements, though there are cases in which monopoly profits can rise as a result of vertical integration. See, e.g., 3 P. Areeda & D. Turner, supra note 4, at 199; R. Bork, THE ANTITRUST PARADOX 225-45, 365-81 (1978); E. Singer, ANTITRUST ECONOMICS: SELECTED LEGAL CASES AND ECONOMIC MODELS 206-23 (1968); Bork, Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception, 22 U. Chi. L. Rev. 157 (1954); McGee & Bassett, Vertical Integration Revisited, 19 J.L. & Econ. 17 (1976); Posner, THE CHICAGO SCHOOL OF ANTITRUST ANALYSIS, 127 U. Pa. L. Rev. 925, 926 (1979). Tying sometimes can increase a monopolist's profits, but may or may not harm consumers. Carlton, Notes on Tie-In Sales, Vertical Foreclosure (unpublished paper 1982) (copy on file at Georgetown Law Journal). The DOJ noted that the fact that some of AT&T's services and equipment offerings were regulated could give it the economic incentive to engage in vertical foreclosure (or refusal to purchase from outside suppliers). See supra note 5. The 1982 Merger Guidelines of the Department of Justice, 2 TRADE Ross RPTR. (CCH) ¶ 4500 (June 4, 1982), recognized certain competitive problems possibly arising from vertical mergers, including evasion of rate regulation. Id. ¶ 4504, at 6881-17 - 6881-19.
may exclude more efficient rivals.\textsuperscript{16}

To summarize, two elements of certain antitrust violations are relevant to an analysis of the MFJ.\textsuperscript{17} First, a firm must be shown to possess monopoly power. Second, that power must have been used to exclude competition in the monopolized market or related markets. The possible effects of regulation on the existence and abuses of monopoly power will be discussed in the next section.

\section*{B. ANALYSIS OF THE MODIFIED FINAL JUDGMENT}

The MFJ reflects concerns about four types of abuses of monopoly power. This section discusses these abuses and examines the MFJ’s response to them.

\subsection*{1. Interexchange services}

The MFJ clearly regards the BOCs as present monopolists in local telecommunications, even though there is currently some bypass of the BOCs’ exchange facilities and bypass technologies are becoming increasingly attractive.\textsuperscript{18} The MFJ further assumes that the use of the BOCs’ exchange facilities is essential to competitors providing interexchange (toll) services,\textsuperscript{19} raising a concern that the BOCs could confer a competitive advantage on AT&T’s interexchange services over the services of its competitors by denying exchange access\textsuperscript{20} to other common carriers, providing them with inferior exchange access, or charging them a higher price than what AT&T pays for equal exchange access.

The MFJ is not directed at eliminating the BOCs’ monopoly control of local facilities. Rather, it seeks to prevent the abuse of this power to impair interexchange services. Thus, the MFJ does not prevent the BOCs from providing exchange services and exchange access by cable, optical fiber, cellular radio, or other new technologies,\textsuperscript{21} all of which could compete with their present exchange facilities. Instead, the MFJ attempts to constrain the BOCs’ ability to use their monopoly position to engage in leverage.


\textsuperscript{17} See supra note 13 and cases cited therein.


\textsuperscript{19} American Tel. & Tel. Co., 552 F. Supp. at 188. The Department of Justice noted that

\begin{quote}
AT&T’s control over the local exchange monopolies . . . has given it the power—and its concomitant control of Long Lines has given it the economic incentive—to impede competition in intercity services. The United States alleged that AT&T, after having failed to persuade regulators and courts to prevent new entry, attempted to exercise this power.
\end{quote}


\textsuperscript{20} The MFJ defines “exchange access” as, \textit{inter alia}, “the provision of exchange services for the purpose of originating or terminating interexchange telecommunications.” American Tel. & Tel. Co., 552 F. Supp. at 228. The MFJ sets forth criteria for the establishment of exchange areas by the BOCs. \textit{Id.} See also United States v. Western Elec. Co., 1983-1 Trade Cas. (CCH) ¶ 65,333, at 69,980 (D.D.C. 1983) (requiring BOCs to provide equal access to all interexchange carriers on nondiscriminatory basis for intra-LATA as well as inter-LATA traffic); United States v. Western Elec. Co., No. 82-0192, slip op. at 116-24 (D.D.C. July 8, 1983).

\textsuperscript{21} American Tel. & Tel. Co., 552 F. Supp. at 228.
The MFJ tries to achieve this objective by requiring that the BOCs not discriminate in providing current and future facilities to other interexchange carriers. Under the MFJ, the BOCs must provide to all interexchange carriers exchange access on an unbundled, tariffed basis that is equal in type, quality, and price to that provided to AT&T. The BOCs also may not discriminate in establishing and disseminating interconnection standards and in planning for new exchange-access facilities. These requirements of nondiscrimination are fortified by the ordered divestiture of the BOCs from AT&T and the elimination of joint ownership of facilities. Such actions are intended to decrease the likelihood that the BOCs will have an incentive to favor AT&T. In addition, the BOCs cannot provide interexchange telecommunications services on their own.

By fostering interexchange competition, these provisions aim at decreasing the prices and increasing the quantity, quality, and diversity of services available to consumers making interexchange calls. Unfortunately, it is possible that the combination of nondiscrimination requirements and divestiture will go beyond preventing abuses of monopoly power, to the detriment of competition and consumers' welfare. Divestiture alone would eliminate any incentive for the BOCs to favor one provider of interexchange services. The BOCs will have the incentive to make utilization of their facilities attractive to interexchange carriers and to potential users of interexchange services.

The BOCs may require flexibility in developing interconnection arrangements and prices. The MFJ’s restrictions on the BOCs' prices, terms of offer-

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22. Id. at 227. Provision of equal exchange access by BOCs will be phased-in. Id. at 232-34.
23. Id. at 227.
26. Competition in interexchange services can prevent “supracompetitive price pressures that the [Federal Communications] Commission might not be able to perceive or control” and spur “greater technological advances and more efficient operations.” United States v. FCC, 652 F.2d 72, 104 (D.C. Cir. 1980).
27. Of course, it is possible that the injunctive provisions will be beneficial even after divestiture if, in light of the history of close ties between AT&T and the BOCs, the BOCs would have chosen to favor AT&T.
28. Interexchange carriers can bypass the BOCs' exchange facilities for originating and terminating traffic. See infra footnotes 96-99 and accompanying text. Some interexchange carriers will bypass even if treated nondiscriminatorily and others will not bypass even if subject to substantial discriminatory disadvantages. Still, the threat of greater bypass by any interexchange carrier gives the BOCs an incentive to provide low-cost, high-quality interconnections.
29. If an interexchange carrier can provide a service at a price and with qualities that will increase demand for interexchange services and, thereby, exchange access, the BOCs have no incentive to disadvantage that carrier in interconnection arrangements and prices.
30. The MFJ recognizes that in some exchange areas with small, mechanical switches, nondiscriminatory access arrangements would not promote consumers' welfare because the cost of the necessary
ing services, and planning activities for interconnections may force the BOCs to justify differences in arrangements and prices as nondiscriminatory. The costs of proving nondiscrimination may be substantial, possibly increasing exchange access charges. In addition, fear of possible liability for discrimination may lead the BOCs to offer only a few interconnection arrangements and prices. Such a limited range of options may be suboptimal in terms of innovation, competition among interexchange carriers, and consumers' welfare.31

2. Information services

The MFJ treats the use of the BOCs' exchange facilities as essential to providers of information services.32 The concern arises as to the treatment of rival information-service providers by the BOCs in terms of design of, access to, and charges for use of the BOCs' facilities. That is, how can the BOCs be prevented from abusing their monopoly power in exchange telecommunications to exclude competition in information services?

Under the MFJ, the BOCs can expand the quantity, quality, and range of exchange facilities that they offer to providers of information services, but cannot discriminate among such providers or provide information services to exclude competition in information services.

The BOCs must charge equal access fees to all providers of equipment changes would raise access fees and cause a decline in interexchange traffic, and allows an exception for these from the nondiscrimination requirement. American Tel. & Tel. Co., 552 F. Supp. at 233. The MFJ's requirement that exchange access be provided on an unbundled basis, id. at 227, recognizes that interexchange carriers differ in their demands for interconnections and willingness to pay for certain arrangements, reflecting differences in their customers, services, and facilities. An optimal price/quality combination for one carrier's customers may be suboptimal for those of another carrier.

31. The Robinson-Patman Act, 15 U.S.C. §§ 13-13b, 21a (1976), prohibits charging different prices to different buyers for products of like grade and quality where the price difference may lessen competition. A number of scholars have criticized the Act as inducing price uniformity, discouraging efficient distribution schemes, and, thereby, lessening competition and damaging consumers' welfare. See R. Bork, supra note 15, at 384-91, 398-401; R. Posner, The Robinson-Patman Act: Federal Regulation of Price Differences 49-53 (1976); R. Posner & F. Easterbrook, supra note 4, at 951-54, 988-89; 1 American Bar Association Section of Antitrust Law, The Robinson-Patman Act: Policy and Law 27-37 (1980); Cooper, Price Discrimination Law and Economic Efficiency, 75 Mich. L. Rev. 962 (1977). While the Robinson-Patman Act is limited to price differences for products "of like grade and quality," the MFJ's prohibitions are broader. Though "discrimination" is not defined in the MFJ, it may be that the "term 'price discrimination' describes a pattern of pricing that yields different net returns from the sale or lease of the same or different products to different customers." 2 P. Areeda & D. Turner, supra note 4, at 341-42. Prohibition of price discrimination in this broad sense creates enormous uncertainties and costs of compliance. In addition, it is not clear whether a meeting-competition defense, explicit in the Robinson-Patman Act, will be implied for the MFJ.


32. American Tel. & Tel. Co., 552 F. Supp. at 227. The court expressed this view by compelling the BOCs to provide all interexchange carriers and information service providers exchange access, information access, and exchange services on an equal basis. Id. The MFJ defined "information services" as (with some exceptions) "the offering of a capability for generating, acquiring, storing, transforming, processing, retrieving, utilizing, or making available information which may be conveyed via telecommunications." Id. at 229. See also id. at 189-90 (free access to BOC exchange facilities will encourage competition in information services).

33. Id. at 227. The limitation on the BOCs' provision of information services and divestiture seems to make the nondiscrimination restrictions unnecessary to prevent abuses of monopoly power. Conse-
information services making equal use of the BOCs' facilities. Before the MFJ, the vertical integration of the BOCs with AT&T could have provided the incentive for the BOCs to favor AT&T if AT&T competed against other suppliers of information services. The divestiture of the BOCs from AT&T and the requirement that the BOCs provide equal access to exchange facilities to all information services are aimed at eliminating the BOCs' ability and incentives to impair development of the information-services industry as a competitive, efficient market.  

A related question addressed by the MFJ deals with the ability of AT&T itself to provide information services. The MFJ, as modified by Judge Greene, prohibits AT&T from engaging in electronic publishing over its own transmission facilities. This prohibition reflects concerns that these facilities are essential to providers of information services, that AT&T is a monopolist in interexchange services and that, if AT&T entered into electronic publishing, it would abuse its power to exclude competition. Judge Greene viewed electronic publishing as an infant industry populated by a small number of firms unable to fend for themselves in competition with AT&T if confronted by discriminatory actions undertaken by AT&T. The prohibition on AT&T providing electronic publishing removes the economic incentives for AT&T to discriminate against providers of these services.

In contrast, AT&T is not prohibited from engaging in remote-access data processing services, based on the view that other large corporations are already established in this field, making it unlikely that AT&T would or could exclude competition through discrimination. Judge Greene treated AT&T's entry into this field as likely to stimulate competition. He viewed the facilities of AT&T as less essential than those of the BOCs to providers of data processing services. Supposedly, if AT&T tried to cripple well-established competitors in remote-access data processing by discriminating against them in the price and

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34. See id. at 189-90 (revenues from access fees will encourage BOCs to design network to accommodate information-service providers).
35. Id. at 225. The court defined electronic publishing as the provision of any information that AT&T or one of its affiliates "has, or has caused to be, originated, authored, compiled, corrected, or edited, or in which it has a direct or indirect financial or proprietary interest, and which is disseminated to an unaffiliated person through some electronic means." Id.
36. An implicit assumption here is that divestiture and nondiscriminatory exchange access will not result in a competitive market structure in interexchange services for at least a few years. See id. at 171 (AT&T conceded that as late as 1981 its share of interexchange revenue was about 77%). But see id. at 172 (after divestiture, competitive entry in interexchange telecommunications is likely to increase and AT&T should be unable to engage in monopoly pricing in any market). If providers of information services have competitive alternatives for interexchange services, this prohibition on AT&T is unnecessary for competition in information services and may cause a loss of consumers' welfare by eliminating an efficient supplier.
37. Judge Greene recognized that AT&T could discriminate against competing electronic publishers by giving priority to traffic from its own publishing operations, gaining proprietary information about its competitors' publishing services, developing technology, facilities, and services that favor its own publishing operations and areas served, or providing competitors with inferior or more costly interconnections and maintenance. Id. at 181.
38. Id. at 182.
39. Id. at 179-80.
40. See id. at 180 (inclusion of AT&T will result in further technological advances, new products, and better services).
quality of interexchange services, these competitors would have sufficient alternative transmission facilities available, such as microwave and satellite common carriers or private networks, to survive. Yet, anomalously, these alternatives are basically the same as those available to providers of information services, which are assumed in the MFJ to be subject to AT&T’s monopoly power.

Under the 1980 decision of the Federal Communications Commission (FCC) in *Second Computer Inquiry*, AT&T, through a separate subsidiary, is not prohibited from providing any “enhanced service,” including both electronic publishing and remote-access data processing, on an unregulated basis. The FCC found that the market for enhanced services is “truly competitive” and believed that market forces would protect the public interest in reasonable rates and availability of efficient enhanced services. Judge Greene, and to a lesser extent the DOJ, showed more concern than did the FCC about abuses of monopoly power by the BOCs and AT&T affecting competition in enhanced services and about the inability of regulators to prevent discrimination. The MFJ’s more restrictive requirements on AT&T will limit the range of its activities that are not prohibited under the FCC’s order in *Second Computer Inquiry*.

3. Terminal equipment

Competition in the manufacturing and distribution of terminal equipment is a third concern of the MFJ. Before the MFJ, the BOCs distributed and installed terminal equipment manufactured largely by its corporate affiliate, Western Electric. A BOC also could exclude competing manufacturers or distributors of terminal equipment from selling in its franchise area if it denied, delayed, or charged a higher price for interconnection of terminal equipment made or distributed by its rivals. The vertical integration of the BOCs with Western Electric could have provided the BOCs with the incentive to favor Western Electric in their purchases and installation practices.

Three provisions of the MFJ affect this possible abuse of the BOCs’ monopoly power. First, the MFJ prohibits discrimination by the BOCs among suppliers and products in interconnection with, use of, and charges for the BOCs’

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42. The FCC defined basic service as “a pure transmission capability over a communications path that is virtually transparent in terms of its interaction with customer supplied information.” *Second Computer Inquiry*, 77 F.C.C.2d at 420. Enhanced service “combines basic service with computer processing applications that act on the format, content, code, protocol or similar aspects of the subscriber’s transmitted information, or provide the subscriber additional, different, or restructure information, or involve subscriber interaction with stored information.” *Id.* at 387.
43. *Id.* at 433.
44. *American Tel. & Tel. Co.*, 552 F. Supp. at 190. Western Electric was unregulated, though its dealings with AT&T Long Lines and the BOCs were subject to regulatory scrutiny.
45. The DOJ alleged that the “protective connecting arrangement” required by AT&T for interconnection of customer-provided terminal equipment “erected an unreasonably restrictive barrier to use of competitive terminal equipment.” Competitive Impact Statement, supra note 5, at B-7. *See also Litton Systems, Inc. v. American Tel. & Tel. Co.*, 700 F.2d 785, 794-802 (2d Cir. 1983), petition for cert. filed, 52 U.S.L.W. 3001 (U.S. July 5, 1983).
services and facilities. The obligation of nondiscrimination extends to the establishment and dissemination of interconnection standards. Next, the corporate affiliation between the BOCs and Western Electric is severed. Finally, the BOCs may not engage in the manufacture of telecommunications equipment. These provisions are aimed at lowering the prices and raising the quality of terminal equipment available to consumers.

The MFJ, however, was revised by Judge Greene to allow the BOCs to distribute new terminal equipment. This revision supposedly would aid manufacturers of terminal equipment by expanding sales if the BOCs become efficient distribution channels. Moreover, the end of the BOCs' affiliation with Western Electric suggests that the BOCs would lose the incentive to discriminate in their choices of which manufacturers' equipment to distribute. Yet, allowing the BOCs to distribute terminal equipment may give them the incentive to discriminate against rival distributors. This revision means that the MFJ's prohibition of discrimination by the BOCs will be relied upon to prevent the BOCs from abusing their market power to exclude competition in the distribution of terminal equipment.

Under this revision, BOCs are allowed to distribute, but not manufacture, terminal equipment. The explanation for this treatment does not lie in a difference in the possibility of anticompetitive discrimination. It does not seem that rival distributors could fend for themselves against discriminatory interconnecting by BOCs much better than rival manufacturers could, that consumers would be harmed less by discrimination against distributors, or that the rewards to the BOCs would be less when such conduct is directed against distributors. Instead, the court's reasoning is that distribution is an existing business of the BOCs, and continued participation by the BOCs may promote competition in distribution. Conversely, manufacturing is not an existing business of the BOCs and, supposedly, participation by the BOCs in manufacturing would create a greater risk of loss to consumers via anticompetitive leveraging than the likelihood that consumers would benefit from the BOCs as the most efficient suppliers.

47. Id.
48. Id.
49. Id. at 226-27. The MFJ also requires termination of the standard supply contract between Western Electric and the BOCs and other subsidiaries. Id. at 227.
50. Id.
51. Again, the nondiscrimination restrictions may be unnecessary or even counterproductive in light of the divestiture. See supra text accompanying notes 28-31 and note 33.
52. American Tel. & Tel. Co., 552 F. Supp. at 231. The DOJ opposed this revision. See infra note 82 (DOJ reasoning that distribution of terminal equipment by BOCs would pose competitive dangers). Under the decree, AT&T will retain both the embedded terminal equipment and the existing network of retail outlets. 552 F. Supp. at 192.
53. Id. at 191-92.
54. Id. at 191.
55. "The [BOCs], with their existing relationship to telephone users, are more likely than any other competitive entity to provide an effective counterbalance to AT&T's market strength [in distributing terminal equipment]." Id. at 192. Moreover, Judge Greene observed that the BOCs are likely to serve as outlets for many small equipment manufacturers, stimulating both price competition and innovative design and manufacturing. Id. at 192 n.249.
4. Switching and transmission equipment

Procurements by the BOCs represent a large portion of total sales of switching and transmission equipment in the United States. Assuming that the corporate affiliation between Western Electric and the BOCs lessened the degree to which price and quality considerations formed the basis for the BOCs' procurement practices or the ability of other manufacturers to make equipment satisfying the BOCs' needs, the BOCs' procurement practices would have foreclosed competition in manufacturing switching and transmission equipment.56

The MFJ provides that the BOCs must make nondiscriminatory procurements, nondiscriminatorily establish and disseminate technical information, sever their affiliation with Western Electric, and neither manufacture nor provide any switching or transmission equipment.57 These provisions seek to promote consumers' welfare by increasing competition in manufacturing such equipment and lessening incentives for inefficient purchases.58

5. Summary

The preceding discussion of the goals and remedies of the MFJ indicates the skepticism of the DOJ and the court about the effectiveness of state and federal regulators in limiting the ability of the BOCs and AT&T to abuse their market power. The MFJ assumes that the procompetitive policies set forth in the antitrust laws have not been and, without the MFJ's remedies, would not be implemented effectively by regulators.59 Underlying the MFJ is the supposition that AT&T is not immune from the antitrust laws by reason of pervasive regulation.60 According to the MFJ, drastic structural remedies, limitations on the


58. The nondiscrimination provisions may be unnecessary to prevent abuses of market power and may actually be detrimental to consumers' welfare. See supra notes 28-31 and accompanying text. The requirement under the Communications Act of 1934 that the FCC approve investments in transmission lines was designed to prevent carriers from inflating their rate bases, such as by inefficient purchases. See 47 U.S.C. § 214(a) (1976); 78 CONG. REC. 10,314 (1934); AT&T: Construction and Operation of Carrier Systems, 10 F.C.C. 315, 321 (1944). The FCC found that competition in supplying equipment to the BOCs benefits consumers, AT&T: Charges for Interstate Telephone Service, 64 F.C.C.2d 1, 26 (1977), and that there was some inefficiency in the BOCs' equipment procurements because of the close relationship between Western Electric and the BOCs. Id. at 41. At times, the FCC has monitored closely AT&T's equipment procurement practices. See, e.g., AT&T: Northeast Corridor Lightguide Cable, 84 F.C.C.2d 303, 316 (1981). See also AT&T: Charges for Interstate Telephone Service, 64 F.C.C.2d 1, 51-52 (1977) (chronic forecasting errors by AT&T and ineffective regulatory review led to overbuilding and network underutilization); Competitive Carrier Rulemaking, 77 F.C.C.2d 308, 344-47 (1979) (FCC's frustration in reviewing AT&T's construction and purchase plans too late in planning cycle reasonably to require major changes).

59. The FCC is not limited in its pursuit of the public interest to the policies of the antitrust laws. United States v. FCC, 652 F.2d 72, 88 (D.C. Cir. 1980).

60. The court in American Tel. & Tel. Co. noted that "the Bell System has been neither effectively regulated nor fully subjected to true competition." 552 F. Supp. at 170. See also MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) ¶ 65,137, at 71,363-72 (7th Cir. 1983) (denying AT&T antitrust immunity for involuntarily initiated interconnection practices neither controlled nor supervised by FCC), petitions for cert. filed, 52 U.S.L.W. 3011 (U.S. July 11, 1983); Phonetele Inc. v. American Tel. & Tel. Co., 664 F.2d 716, 727-38 (9th Cir. 1981) (AT&T claim of implied antitrust immunity due to pervasive regulation denied; noting limited authority of FCC to approve proposed tariffs before they go into effect), cert. denied, 103 S. Ct. 785 (1983); Northeastern Tel.
scope of firms' activities, and clear prohibitions against discrimination are necessary to prevent future exclusionary conduct by these regulated firms.

II. CROSS-SUBSIDIZATION

A. ECONOMIC FRAMEWORK

This section discusses economic harms that can arise from a firm's use of profits earned in a regulated monopoly market to help cover its costs in a competitive market. Cross-subsidization enables a firm to price one of its products below its directly-attributable costs and still survive. It thereby may be able to drive out efficient rivals in supplying the subsidized product. It then could use actual or potential cross-subsidization to prevent potential competitors from entering to meet the market for the subsidized product, leaving the firm with the ability to extract monopoly profits for that product and impair consumers' welfare. In addition, cross-subsidization will increase the price charged for the regulated, subsidizing product.

An integrated firm that has a regulated monopoly in one market and faces competition in another is difficult to regulate because regulators cannot possibly detect all instances of cross-subsidization. One form of regulation involves limiting the rates charged by a firm so that it covers its costs in providing a regulated product and earns no more than a competitive rate of return on its investment for that product.  


61. The courts in MCI Communications Corp. v. American Tel. & Tel. Co., 1982-83 Trade Cas. (CCH) at 65,137 (7th Cir. 1983), petitions for cert. filed, 52 U.S.L.W. 3011 (U.S. July 11, 1983), and Northeastern Tel. Co. v. American Tel. & Tel. Co., 651 F.2d 76 (2d Cir. 1981), cert. denied, 455 U.S. 943 (1982), rejected the claim that pricing below fully-distributed costs but above directly-attributable (long-run incremental or average marginal) costs constitutes predatory pricing. MCI, 1982-83 Trade Cas. (CCH) at 71,383-84; Northeastern Tel. Co., 651 F.2d at 89-90. The courts held that pricing above directly-attributable costs does not involve cross-subsidies. MCI, 1982-83 Trade Cas. (CCH) at 71,383-84; Northeastern Tel. Co., 651 F.2d at 88. See W. SHARKEY, THE THEORY OF NATURAL MONOPOLY 40-42 (1982) (cross-subsidization is the failure of the price charged for a service or product to cover the cost of producing it).

62. Perfect competition and perfect regulation in the competitive and regulated markets, respectively, would protect consumers from the harms of cross-subsidization. The danger of harmful cross-subsidization arises only when regulation is imperfect.

63. The FCC has at times attempted to improve its ability to detect and thereby to limit cross-subsidies by requiring the formation of separate subsidiaries for certain activities. See infra note 73.

64. See, e.g., S. BREYER, REGULATION AND ITS REFORM 36-59 (1982); G. GARFIELD & W. LOVEJOY, PUBLIC UTILITY ECONOMICS 44-45 (1964); I. A. KAHN, THE ECONOMICS OF REGULATION 25-54 (1970); F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 481-86 (2d ed. 1980); Averch & Johnson, Behavior of the Firm Under Regulatory Constraint, 52 AM. ECON. REV. 1053 (1962);
Problems exist with cost-based regulation because cost accounting for a multi-product firm is often inadequate. Under the basic principles of cost accounting, firms should assign costs and investment to the specific activities that caused them. It may be difficult, if not impossible, to allocate some categories of costs and investment, such as executives' salaries, research and development expenditures, and the expenses of production facilities used to manufacture several products, to particular products on the basis of cost causation. Even if it is possible to arrive at a sound cost-causation-based allocation of a firm's costs and investment by product, it may be hard for regulators to detect instances of cross-subsidization in which the firm misallocated its costs and investment across its products. The FCC's failure to develop effective cost-accounting procedures for AT&T's interstate services is a classic example of these difficulties.

The main issue is why a firm would have an incentive to cross-subsidize. One concern is that cross-subsidization may foster predatory pricing. Predatory pricing is the temporary reduction of price by one firm in an attempt to drive out rivals or to discourage new competitors from entering the market. Once the rival firms are eliminated, the predator may raise its prices above the competitive level in order to recoup its short-term losses and realize supracompetitive profits. Successful predatory pricing thus decreases consumers' welfare in the long run, although there is a short-run benefit from the temporarily lower prices.

Courts view predatory pricing as an attempt to monopolize in violation of the antitrust laws. Many legal and economic scholars believe that unregulated firms have no incentive to engage in predatory pricing and rarely do so. A predator's success depends upon both the successful and permanent elimination of competitors.


tion of rivals and the ability to charge supracompetitive prices in the rivals’ absence to regain lost profits. In reality, however, fulfillment of such conditions is unlikely. Evidence of successful predators is scarce because predation is often more costly to the predatory firm than it is to its rivals.69

The incentives for predatory pricing may be the same for a multi-product firm possessing a regulated monopoly in some products and facing competition in others as for unregulated firms. Under the assumptions of profit maximization and poor regulatory scrutiny of cost allocations, such a firm could shift some of its costs and investment attributable to the competitive product into the rate base for a regulated product to maximize its overall profits on the regulated and competitive products. Thus the firm may earn apparently supracompetitive profits on the unregulated product even though it charges a competitive price. If the firm attempts predation by pricing below the competitive level in the unregulated market, it will incur lost profits in the short run. It will sacrifice these profits only on the hope of excluding competition and recouping its losses. The regulated firm may differ from an unregulated firm in that, during predation, the former might appear to earn competitive or supracompetitive profits on the product subject to predation through cost shifting. Yet under these assumptions, regulated and unregulated firms actually would face similar incentives regarding the decision whether to engage in predation. Any theory that predicts why predatory pricing is not attractive to unregulated firms would apply equally to regulated firms.70

A second concern about cross-subsidization involves economic efficiency. Rate-base regulation seeks to limit rates such that a firm’s total revenues from a service cover the costs and yield a fair (i.e., competitive) rate of return on the investment allocated to the service. If rate-base regulation permits improper shifting of costs toward the regulated service, the price of the regulated service will be higher than is justified under efficient pricing principles. This result may increase the firm’s profits but will generally be detrimental to consumers’ welfare.

B. ANALYSIS OF THE MFJ

The DOJ recognized the potential for AT&T to engage in cross-subsidization.71 Likewise, the court acknowledged the possibility for cross-subsidization


70. See R. POSNER & F. EASTERBROOK, supra note 4, at 994-95 (discussing Otter Tail Power Co. v. United States, 410 U.S. 366 (1973)). If managers in regulated firms do not profit maximize, but instead pursue other goals such as maximizing their job security, while managers in unregulated firms do profit maximize, it is possible to conceive of cases in which predation is more likely to occur in the multi-product regulated firm than in the multi-product unregulated firm.

71. The Department of Justice reasoned that because AT&T’s aggregate earnings may not exceed a specified rate of return, when it faces competition for some but not all of its services AT&T has an incentive to reduce prices for its competitive services and raise prices for its monopoly services. Competitive Impact Statement, supra note 5, at B-7. The DOJ reasoned that consequently, when faced with competitive entry in certain intercity services, AT&T lowered its prices on those services, without regard to the costs of providing them and with the effect of impeding new intercity competition. Id.
if the divested BOCs were permitted to engage in particular activities. The MFJ manifests this awareness in two ways.

1. Divestiture

On several occasions the FCC has required that the competitive activities of a regulated monopolist be carried out through a separate subsidiary. This structural separation reduces the monopoly's ability to cross-subsidize by promoting detection and prevention of cross-subsidization attempts. The MFJ achieves structural separation of the BOCs from AT&T and Western Electric through total divestiture, a more drastic remedy than separate subsidiaries. Two reasons underly the MFJ's approach.

First, the court reasoned that neither the FCC nor a "judicially-created bureaucracy" to oversee an injunction decree possesses the ability to police effectively AT&T's cost accounting and conduct, perhaps even with separate subsidiaries. The court viewed divestiture as a more effective enforcement mechanism than structural separation. Although the separate subsidiary approach provides a means for revealing intra-company transactions so that regulators may better detect and prevent cross-subsidization, it does not eliminate the economic incentives, to the extent they exist, for anticompetitive conduct. The parent company still has the same incentive to use a regulated-monopoly subsidiary to provide a competitive advantage to another of its subsidiaries through cross-subsidization or discrimination. In contrast, a monopolist has no incentive to favor a separately-owned company over its rivals.

Second, the court viewed separate subsidiaries essentially as a regulatory device and therefore not an appropriate antitrust remedy. The nature of the action against AT&T, and not just the goal of economic efficiency, thus dictated certain aspects of the final order.

72. American Tel & Tel. Co., 552 F. Supp. at 188-94 (restrictions imposed on divested BOCs prohibiting them from manufacturing terminal equipment and providing interexchange or information services; no restrictions placed on marketing terminal equipment or on directory advertising because no danger of cross-subsidization from regulated to unregulated products in these areas).

73. See Application of Gen. Tel. and Elecs. to Acquire Control of Telenet Corp., 72 F.C.C.2d 111, 137 (1979) (in approving acquisition FCC required that Telenet operate as separate subsidiary; structural separation necessary to avoid cross-subsidization), mod., 84 F.C.C.2d 18, 32-37 (1979); Second Computer Inquiry, 77 F.C.C.2d at 457-87, reconsidered, 84 F.C.C.2d at 71-75 (amendment of § 64.702 of FCC's Rules and Regulations to require AT&T to offer customer-premises equipment and enhanced services through separate subsidiary); Land Mobile Services, 51 F.C.C.2d 945, 951 (1975) (wireline telephone companies must establish separate corporations for the operation of cellular mobile radio communication systems), aff'd sub nom. National Ass'n of Regulatory Util. Comm'rs v. FCC, 525 F.2d 630, 637 (D.C. Cir. 1976), cert. denied, 425 U.S. 992 (1976).

74. See Second Computer Inquiry, 77 F.C.C.2d at 462 (principal mechanisms employed include reduction in extent of joint and common costs between affiliated firms, requirement that transactions move from one set of corporate books to another, and publication of rates, terms, and conditions on which services will be available to all potential purchasers).

75. American Tel & Tel. Co., 552 F. Supp. at 168. See also Byars v. Bluff City News Co., 609 F.2d 843, 863-64 (6th Cir. 1979) (courts should consider feasibility of forming final decrees; injunction ordering monopolist to deal might enmesh court in difficult problems of price regulation).


78. Id.
2. Opportunities for cross-subsidization

Under the MFJ, the BOCs will be allowed to continue engaging in certain unregulated activities, specifically the sale of directory advertising (Yellow Pages) and the distribution of terminal equipment. The court did not require separate subsidiaries for these activities, but recognized that regulators may want to impose this requirement to help detect cross-subsidies. Cross-subsidization considerations entered into the court’s treatment of these activities in two ways.

First, the court reasoned that cross-subsidization affecting the distribution of terminal equipment was unlikely since the risks of detection were high and the possibility of successful predation low. Nevertheless, the DOJ viewed a ban on the BOCs engaging in the distribution of terminal equipment as necessary for efficient competition in that market because the BOCs might have the incentive to cross-subsidize or leverage through discriminatory interconnections.

On the other hand, cross-subsidization from directory advertising to regulated services was both expected and encouraged. The court treated directory advertising as a source of profits that could be used to subsidize local telephone rates. The court believed that having the BOCs provide directory advertising instead of AT&T would have no anticompetitive effect on the market for advertising. Rather, the court saw the cross-subsidies to local telephone service as promoting the federal policy of making telephone service available at reasonable rates.

In the absence of structural separation of directory advertising from the BOCs’ exchange and exchange access services, the court expected cross-subsidization. It is not clear, however, whether the court expected the revenues or, possibly, losses from the BOCs’ distribution of terminal equipment to affect the amount of revenue required to provide services.

III. RAISING SUFFICIENT REVENUE

A. ECONOMIC FRAMEWORK

The historical rationale for telephone regulation was that because the provision of local telephone service was a natural monopoly, output could be provided most efficiently by one firm. The provision of telephone service is

79. Id. at 231.
80. Id. at 193 n.251.
81. Id. at 191-92.
82. District Court Accepts Government’s, AT&T’s Assent to Changes in Settlement, 43 ANTITRUST & TRADE REG. REP. (BNA) No. 1079, at 380-381 (Aug. 26, 1982) (DOJ reasoning that “provision by the BOCs of more complex customer premises equipment, which necessarily involves a high degree of coordination between the equipment provider or customer and the local exchange carrier with respect to such matters as installation, maintenance, testing and restoration, would pose substantial competitive dangers”). See supra notes 14 and 15 (discussing tie-in and foreclosure arrangements).
84. Id. See also United States v. Western Elec. Co., No. 82-0192, slip op. at 150-54 (D.D.C. July 8, 1982); United States v. Western Elec. Co., 1983-1 Trade Cas. (CCH) ¶ 65,533, at 69,973 (D.D.C. 1983) (continued viability of BOCs in public interest in light of goal of universal telephone service); infra note 113.
85. See, e.g., 1 A. KAHN, supra note 64, at 125-26; W. LAVEY, FACTORS INFLUENCING INVESTMENTS,
characterized by high fixed costs, and the incremental (marginal) cost of serving an additional subscriber is less than the average cost (the total cost of providing telephone service in the specified area divided by the total number of subscribers). Charging a price per subscriber equal to the marginal cost of serving him would not produce sufficient revenues to cover a telephone company's total costs. Consequently, the prices for some products or services must be set above their marginal costs. The difficulty facing regulators is how to set the price of each service so as to cover total costs.

There are well-established economic pricing principles for raising the necessary revenue in such circumstances, assuming that the goal is to minimize the unavoidable economic inefficiency that results from charging prices in excess of marginal cost. The extent of the economic inefficiency or distortion will depend on the degree to which the demand for a product is reduced by an increase in its price and to what extent the price of a product exceeds its marginal cost. The greater the disparity between product demand at the elevated price level and product demand at marginal cost, the greater tends to be the economic distortion. The distortion is minimized if (1) products whose demand is less price sensitive bear the brunt of the financing burden, and (2) there are many products whose prices can be raised above marginal cost. If there are many products, the amount by which any one product's price exceeds its marginal cost can be less while raising the same amount of revenue.

Consider the situation in which regulators have the option of raising the prices of many products above their marginal costs in order to cover the costs of providing telephone exchange services. This occurs when the regulated monopolist is permitted to sell multiple products and is protected from competitive entry. Suppose that the BOCs were allowed to sell salt and tried to do so at a price above its marginal cost in order to contribute to the revenue requirement of their telephone exchange facilities. They would be unable to sell salt at a supracompetitive price because salt buyers would turn to rival sellers of salt. Only if the BOCs were granted a monopoly in salt and the entry of rivals was forbidden would it be possible for them to earn revenue in the salt market to help pay for the costs of the telephone facilities. The benefit to consumers from granting the BOCs a monopoly in salt is the resulting drop in the distortionary effects of raising sufficient revenue to cover costs. Consumers, however, would not be protected from resulting inefficiencies in salt production.

Costs, and Revenues of REA Telephone Companies (Harvard Program on Information Resources Policy 1982).


87. If demands for products are interrelated, the principles for optimal pricing must be modified somewhat. See Baumol & Bradford, supra note 86, at 266-67.

88. The principles described in this section apply as well to exchange facilities owned by independent telephone companies and to interexchange plant owned by AT&T.

89. For a discussion of instances in which a natural monopolist of several products must be protected from entry for efficiency reasons, see Panzar & Willig, Free Entry and the Sustainability of Natural Monopoly, 8 Bell J. Econ. 1 (1977).
That task would fall on regulators as ancillary to the regulation of exchange telephone service.\footnote{United States v. Southwestern Cable Co., 392 U.S. 157, 167-68 (1968) (broad construction of agency power to enable it to exercise comprehensive regulatory authority); National Broadcasting Co. v. United States, 319 U.S. 190, 219 (1943) (regulatory powers of FCC include oversight of affiliations between broadcast stations and networks); General Tel. Co. of Southwest v. United States, 449 F.2d 846, 853 (5th Cir. 1971) (FCC endowed with broad authority to accommodate new developments in field of communications such as CATV systems). But cf. Home Box Office, Inc. v. FCC, 567 F.2d 9, 13-14 (D.C. Cir.) (ancillary jurisdiction of FCC over CATV more limited than jurisdiction over broadcast services), \textit{cert. denied}, 434 U.S. 829 (1977). Of course, we are not suggesting that the FCC's jurisdiction under the Communications Act of 1934 extends to the production and sale of salt.\footnote{American Tel. & Tel. Co., 552 F. Supp. at 169, 187-88.}} The restraint on competition in the production and sale of salt involved in this situation is antithetical to the antitrust laws.

An alternative method for efficiently raising revenue is to allow free entry into a market but subject sales to a government charge or "tax" used to help finance the costs of providing telephone service. For example, there may be free entry into the salt market but all sales of salt would bear a charge to help offset the costs of providing telephone service. This would raise revenue that could be used to help cover costs regardless of whether the BOCs could compete in selling salt. The effect on salt buyers would be similar to the existence of a monopolist in salt in that the price would be above the competitive level, causing some decline in salt demand. Consumers, however, would be protected from inefficiencies in the production of salt because the pre-tax price would still reflect a competitive market, the disparity between the regulated market price and a purely competitive price being the result of the government-imposed tax. If the level of the tax on salt is determined according to economic principles, there would be a net gain in social welfare over the alternative proposal of covering all telephone exchange costs through telephone rates alone. In short, a general tax to raise revenue is superior to licensing monopolies in otherwise competitive industries; the former forces firms to produce efficiently while the latter does not.

**B. ANALYSIS OF THE MFJ**

The MFJ recognized the need for the BOCs to raise sufficient revenue to cover their costs.\footnote{The court noted that Many persons . . . claim that [the MFJ's] restrictions [on the BOCs] would have adverse consequences in that they would either undermine the financial viability of the divested [BOCs], or produce substantial increases in the rates for local telephone service, thus eroding the statutory goal of universal telephone service for all Americans. . . . This factor, to be sure, cannot preclude the imposition of a restriction necessary to preclude the anticompetitive activity; but to the extent that a restriction does not have a procompetitive effect, it may not be imposed if it infringes upon other important public policies. \textit{Id.} at 187-88 (footnotes omitted). However, in a later opinion, Judge Greene noted that "[o]ne of the Court's principal aims throughout the public interest process has been to ensure that divestiture would not bring about or contribute to local telephone rate increases." United States v. Western Elec. Co., No. 82-0192, slip op. at 153 (D.D.C. July 8, 1983).} The MFJ's primary concern, however, is with remediying restraints on competition that might violate the antitrust laws.\footnote{The court noted that} The MFJ is not a blueprint for raising revenue for the BOCs and AT&T, despite the relationship of this problem to economic efficiency and competition in the telecommunications industry and other industries. Rather, the MFJ left to the
federal and state regulators and legislatures the problem of raising revenue to recover the costs of providing telephone service.\textsuperscript{93}

1. Free entry

The MFJ firmly rejected the proposition that economic efficiency justifies a lack of competition within the telecommunications industry. The additional efficiency in raising revenue from protected markets was judged to be small relative to the potential inefficiency that may result from insulating potentially competitive markets from competition. The court saw no reason to exempt this industry from the antitrust laws\textsuperscript{94} and did not believe that the antitrust remedies of the MFJ—divestiture and prohibitions on the BOCs' entry into certain activities—endangered the BOCs' viability.\textsuperscript{95}

The court considered the proposal that AT&T should be prevented from using new local distribution technologies that would allow it to originate and terminate interexchange traffic by bypassing the BOCs' exchange plant.\textsuperscript{96} Entry by AT&T into exchange access service would deprive the BOCs of revenue that otherwise would be used to help cover the BOCs' costs. The court rejected this proposal, reasoning that other interexchange carriers have the ability to bypass the BOCs and that to prohibit AT&T from bypassing would restrict competition and thus be antithetical to the antitrust laws.

In addition, development of competitive bypass facilities would further the purpose of the antitrust laws by increasing the quantity and quality of exchange access services and decreasing their price and the potential for their use in exclusionary conduct.\textsuperscript{97} According to the court, a legislative program of subsidies, special charges, or other regulatory means ultimately may have to be developed in order to maintain affordable local rates as the growth of bypass services decrease the number of customers upon which the BOCs must depend to recover their costs.\textsuperscript{98} The potential for such problems did not warrant preventing bypass by AT&T in this antitrust consent decree.\textsuperscript{99}

The court removed two of the restrictions on the BOCs' activities that were previously agreed to by the DOJ and AT&T. The MFJ permitted the BOCs to continue to publish local Yellow Pages advertising and to distribute customer-premises equipment.\textsuperscript{100} The court noted that there were profits derived from local directory advertising,\textsuperscript{101} making these activities an attractive source of revenue to help cover the BOCs' costs. This factor played a large role in the court's decision to remove these restrictions. Raising revenue to cover the BOCs' exchange plant, however, was not a major consideration in the court's decision to allow them to distribute terminal equipment. According to the

\textsuperscript{93} American Tel. & Tel. Co., 552 F. Supp. at 169 n.161.
\textsuperscript{94} Id. at 170 (history teaches that fair competition is more likely to benefit consumers than monopoly; telecommunications industry is no exception). See also supra note 60 and cases cited therein.
\textsuperscript{95} American Tel. & Tel. Co., 552 F. Supp. at 189-91.
\textsuperscript{96} Id. at 175-76.
\textsuperscript{97} Id. at 175. See also STAFF REPORT, FCC POLICY ON CABLE OWNERSHIP 141, 159-60 (1981).
\textsuperscript{98} American Tel. & Tel. Co., 552 F. Supp. at 175-76.
\textsuperscript{99} Id. at 176.
\textsuperscript{100} Id. at 186-91. If there is no realistic possibility of abuse of monopoly power, the court would grant a BOC's petition to engage in an unrelated industry. Id. at 195 n.267.
\textsuperscript{101} Id. at 193-94.
court, competition in this activity makes it unlikely that the BOCs will be able to extract much revenue from it for that purpose. Rather, the decision seems to have been made in the hope of promoting efficient distribution.102 In addition, the court allowed the BOCs to raise revenues by sublicensing AT&T’s patents on customer-premises equipment to manufacturers.103

The DOJ and the court rejected arguments that the BOCs should be allowed to enter into interexchange and information services because of potential abuses of monopoly power. Those who favored allowing the BOCs to provide interexchange services argued that the operating companies would provide additional competition in the interexchange market and that the resulting revenues to the BOCs would increase their viability and reduce the need for local rate increases to cover their costs.104

2. Access charges

The MFJ requires the BOCs to establish charges for exchange access provided to interexchange carriers and information-service suppliers.105 While access charges are to be “cost justified,” the MFJ leaves to regulators the decision as to what costs should be included in this calculation and what costs should be covered by exchange service.106 Regulators could retain the cost allocation presently used in telephone separations and settlements procedures, providing a large allocation of plant costs to interexchange services. In addition, regulators could choose to make access charges for carriers and subscribers usage sensitive or flat fees per line.107 Finally, Judge Greene referred to the possibility of using state or federal tax revenues to subsidize exchange and exchange access services.108

Though the MFJ is silent on the optimal methodology for covering the cost of providing telephone service, economic theory is not. The cost should be covered by pricing services above their marginal costs according to the inverse of the elasticities of demand for the services.109 Studies have shown that the demand for interexchange service is more elastic (price sensitive) than the demand for connection to exchange facilities.110 A five-percent increase in a

102. Id. at 192 n.249. See also supra note 55 (discussing competition between AT&T and BOCs in terminal equipment distribution).


105. Id. at 232-34.


107. The court criticized the FCC’s decision to adopt flat fees per line as running “directly counter to one of the decree’s principal assumptions and purposes—that the fostering of competition in the telecommunications field need not and should not be the cause of increases in local telephone rates.” United States v. Western Elec. Co, 1983-1 Trade Cas. (CCH) ¶ 65,335 at 69,973. The court seemed to be more concerned about “the protection of rates which will permit all segments of the population to enjoy telephone service” than about economically-efficient pricing. Id. at 69,975. See also United States v. Western Elec. Co., No. 82-0192, slip op. at 74-76 (D.D.C. July 8, 1983).


109. See supra notes 86-87 and accompanying text (discussing effect of elasticities of demand on optimal pricing structure).

BOC's price for using each unit of exchange access for interexchange service will cause a decline in demand for such exchange access because of a drop in interexchange traffic or possibly-inefficient bypass of the BOC's exchange facilities. This percentage decline is larger than the percentage decline in subscribers resulting from a five-percent increase in the flat cost of connection to the BOC's exchange facilities. A similar result may be expected for usage-sensitive charges on exchange access for information services. It therefore would be more efficient to cover costs primarily through flat fees or surcharges on subscriber connections than through usage-sensitive charges that greatly exceed marginal cost.111

3. Achieving social goals

The reason economists use prices to allocate goods and require firms to be self-financing is to make sure that those who consume the firm's product benefit enough to justify the cost of providing the product.112 In a competitive market, consumers of a good must be willing to pay for the cost of its production. Attempts to cross-subsidize by charging a supracompetitive price to one group in order to enable another group to pay less than the competitive price would not succeed in a competitive environment because the first group would turn to alternative suppliers ready to supply them profitably at the competitive price.

The MFJ encourages competition in interexchange services and terminal equipment. These developments make it more difficult for AT&T and the BOCs to charge rates exceeding the costs of supplying some users. For example, under current nationwide toll rate averaging, supracompetitive toll rates charged by AT&T for traffic between some low-cost (typically densely-populated) areas generate revenues (cross-subsidies) that make it possible to charge subcompetitive rates on traffic between some high-cost (typically rural) areas. Competition in interexchange service between densely-populated areas undercuts the ability of AT&T to continue such pricing.

If the United States continues to pursue public policy goals like universal service113 and toll-rate averaging, someone must ultimately bear the costs of providing these services. When a public policy decision is made to provide a service to those who are unable or unwilling to pay its cost, the economic rationale that the telecommunications industry must be self-financing and competitive can no longer apply. The MFJ promotes competition within the industry and restricts the products and services that the BOCs and AT&T can provide. Therefore, requiring the BOCs and AT&T to set prices to achieve


certain social goals and yet be self-financing could seriously distort the pricing of the products and services that are monopolized. Such distortions would cause inefficiencies, such as the suppression of usage of certain services, construction of inefficient bypass facilities, and development of arrangements to take advantage of underpriced services (e.g., arbitrage).\footnote{114} As a matter of economic theory, general tax revenues are the most appropriate source of revenue to achieve certain social goals in telephone service pricing.\footnote{115}

**CONCLUSION**

The primary economic goals of the MFJ involve promotion of competition in interexchange services, information services, manufacture and distribution of terminal equipment, and manufacture of switching and transmission equipment. The MFJ attempts to prevent abuses of monopoly power by the BOCs and AT&T as well as anticompetitive cross-subsidization by the BOCs. The corresponding remedies aimed at eliminating incentives for anticompetitive conduct require divestiture of the BOCs from AT&T and restrictions on the activities of the BOCs and AT&T. Any remaining incentive to discriminate or cross-subsidize is discouraged by equal-access requirements on the BOCs. Certain anomalies appear in these restrictions.

The competitive structure of the telecommunications industry is only one aspect of its economic efficiency. Another aspect is how revenue is raised to cover the costs of providing telephone service and achieve certain social policy goals in pricing telephone services. The MFJ affects this issue by promoting competition, making it more difficult to raise revenues for these purposes. The MFJ leaves for regulatory and legislative action the development of cost allocations, surcharges, taxes, and subsidies. The resolution of these issues will have a major impact on the efficiency of the post-MFJ telecommunications industry.

\footnote{114} See, e.g., Resale and Shared Use, 60 F.C.C.2d 261 (1976), aff'd sub nom. AT&T v. FCC, 572 F.2d 17 (2d Cir.), cert. denied, 439 U.S. 875 (1978); Resale and Shared Use (MTS/WATS), 83 F.C.C.2d 167 (1980).

\footnote{115} Political realities may prevent the use of the most economically-efficient methods of raising revenue.