

EX PARTE OR LATE FILED

ORIGINAL

**SWIDLER & BERLIN**

CHARTERED

3000 K STREET, N.W.

SUITE 300

WASHINGTON, D.C. 20007-3851

JONATHAN E. CANIS  
ATTORNEY-AT-LAW

DIRECT DIAL

(202) 944-4173

TELEX: 701131

TELECOPIER: (202) 944-4296

December 10, 1992

**VIA MESSENGER**

Donna R. Searcy, Secretary  
Federal Communications Commission  
1919 M Street, N.W.  
Room 222  
Washington, D.C. 20554

RECEIVED  
DEC 10 1992  
FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

**Re: Association for Local Telecommunications Services  
Notice of Oral Ex Parte Presentation; CC Docket No. 92-141**

Dear Ms. Searcy:

Pursuant to Section 1.1206(a)(2) of the Commission's Rules, and by its undersigned counsel, the Association for Local Telecommunications Services ("ALTS") hereby files an original and two copies of this letter concerning a presentation made by Jonathan Canis on December 10, 1992 to Charla M. Rath, Special Assistant to Chairman Sikes.

The subject of the ALTS presentation was the Commission's pending investigation of the GTE Telephone Operating Companies' proposed below-band rate revisions, which were filed in Transmittal No. 711 in the 1992 annual access filing, and currently are being investigated in CC Docket No. 92-141. During that presentation, ALTS discussed the exclusion of relevant cost data from the GTE support materials and the costing standards to be used in defining the Commission's Average Variable Cost test.

In addition, materials attached to this filing as Appendix A were distributed. As indicated on the handouts, they are excerpts from the ALTS filings on record in this proceeding, or are excerpts from treatises cited by ALTS.

No. of Copies rec'd \_\_\_\_\_  
LIST A B C D E \_\_\_\_\_  
212

Donna R. Searcy  
December 10, 1992  
Page 2

To the extent that further information concerning MFS' ex parte presentation is required, please direct all inquiries to the undersigned.

Respectfully submitted,

ASSOCIATION FOR LOCAL TELECOMMUNICATIONS  
SERVICES

By: \_\_\_\_\_

A handwritten signature in cursive script, appearing to read "Jonathan E. Lewis", is written over a horizontal line.

58578/

cc: Charla M. Rath  
Cheryl A. Tritt  
Gregory J. Vogt  
Christopher J. Frentrop  
Roxanne McElvane  
Downtown Copy Center  
John C. Shapleigh

S.B. & S. LIBRARY AUG 9 1982

**Phillip Areeda**  
*Professor of Law*  
Harvard University

15  
17  
18  
13

**Donald F. Turner**  
*Professor of Law*  
Harvard University

**Volume III**

---

# **Antitrust Law**

---

An Analysis of Antitrust Principles  
and Their Application

**Little, Brown and Company**  
Boston Toronto

**¶719. Multiple Products; Differential Returns**

When a firm earns a different return on its investment in different product lines there may be some concern that the lower rate of return reflects predatory pricing in that product line. Two separate situations are relevant here: (1) different rates of return in the short run, that is, where investment in plant and facilities has already been made, and (2) so-called predatory investment, namely, new investment that produces or is expected to produce a rate of return lower than the firm is earning from its existing plants and facilities.

**719a. Different rates of return in the short run.** The easi-

est short-run case is that of differential returns on unrelated products. This might occur in the conglomerate firm situation, in which the subsidiaries or divisions of a single firm produce a number of unrelated products. One would not expect all divisions of a firm to be earning the same return at any particular time; temporary variations in demand and costs in different industries will most likely result in some differences in returns. Moreover, when the firm has a monopoly in one of the products, it is not unusual for it to earn substantially more on that product than on those it sells in competitive markets. Thus, the mere fact of differential returns proves nothing of any antitrust significance regarding the firm's pricing policy.

It is commonly said that a firm is "subsidizing" low returns in a competitive market with higher returns on a monopolized product. But as long as a firm is turning a profit or breaking even on each additional sale, no subsidy is involved. Thus, just as in the case of the single-product monopolist, illicit pricing can be established only by showing that in the competitive market the firm is pricing below marginal cost or the "surrogate" average variable cost.<sup>1</sup>

Even when it appears that the monopolist has priced below marginal or average variable cost in the competitive market for an unrelated product, he should be entitled to any defenses—such as "promotional" pricing—to which a non-monopolist would be entitled. The monopolist, using revenues from the monopolized product, might be thought more likely to indulge in "excessive" promotional pricing than a single-product producer. But revenues from monopoly are no different from superior resources derived from any other source and their existence should not affect the determination of whether the below-marginal-cost price is indeed promotional.

The more difficult case of short-run differential returns arises when the product earning a lower return is related to a product on which the firm has a monopoly. The products may be related in that they are produced with some common facilities, are sold to and used together by the same consumers, or both. In this situation marginal-cost pricing on the competitive product may adversely affect firms that are the most likely potential rivals in the monopolized-product market. By applying pressure through marginal-cost pricing on the firms in the com-

¶719. n.1. Marginal cost is defined in ¶715d.

petitive market, entry into the monopoly market may be deferred or completely discouraged.

Yet this raises no issues that we have not already covered. If the related-product market is competitive, marginal-cost pricing is the norm and should not be discouraged. If the firm has monopoly power in the related-product market, the question is the same as that raised by marginal-cost pricing by any monopolist—whether possible gains from an umbrella price are worth the short-run economic costs of under-utilization of resources and the severe administrative difficulties of applying a test other than marginal (or average variable) cost.

Production of multiple products necessarily raises one further problem in determining marginal costs and may raise two others. *First*, “overhead” cost items that are not uniquely attributable to one product must be allocated among them. Thus, salaries of a particular operating division’s managerial and research personnel are readily attributable to the products of that division, but must be allocated in some way among those products; and the expenses of a firm’s “top” management must be allocated among all the firm’s products. Allocation in proportion to readily assignable direct costs of the various products may be a presumptively reasonable solution, but will be arbitrary to varying degrees.

*Second*, there may be “joint costs” in the production of two or more products. Where two products can only be produced in fixed proportions, such as cotton fiber and cotton seeds, it is not even theoretically possible to derive a separate marginal cost for each. And even where the proportions are to some degree variable, it may not be practically feasible to determine the respective marginal costs. Where virtually all costs are joint, predation can be tested only by comparing the combined prices of the several products with their aggregate marginal costs. And this may be a satisfactory solution, because products that are joint for the monopolist will be joint for rivals. Where joint costs are relatively minor, they could be allocated in the same manner as “overhead” costs.

*Third*, two products A and B may be complementary in the sense that a lower price for A increases the sale of related product B. In such cases, it is theoretically correct to say either (i) that some revenues from selling B are properly attributable to A, or (ii) that part of the costs of producing A are properly attributable to B. But we reject such a claim by a monopolist seeking to

justify a product's apparently predatory price, at least where rivals selling that product are actual or potential rivals in the sale of the monopolized product. There are three reasons. (1) "Re-allocating" revenues or costs presents severe administrative difficulties. (2) If A is complementary with B, B is complementary with A. Hence, some A revenues really belong to B, or some B costs really belong to A. In short, there are always offsets, and it is not unreasonable, in light of the administrative difficulties, to assume a "wash." (3) To some extent, perhaps to a large extent, the monopolist can achieve the desired increase in revenues by lowering the price of "B" rather than by reducing the price of "A" below marginal costs as normally defined. The options are entirely comparable where the two products are bought in fixed proportions, and in other situations, limiting one option simply reduces the opportunities for price discrimination.<sup>2</sup>

2. We note that our position in this respect is comparable to that on "exclusionary" tying arrangements. See ¶733. We also stress that it is confined to pricing of complementary products by a monopolist. We are not, for example, talking about such promotional devices as "loss leader" selling by grocery or department stores.

For a discussion of the problems encountered in common cost, joint cost, and joint product cases, see A. Kahn, *The Economics of Regulation I*, 77-83 (1970), and references there cited.

3. See ¶718.

**The Economics of Regulation**  
*Principles and Institutions*

Volume I Economic Principles  
Volume II Institutional Issues

**Alfred E. Kahn**

The MIT Press  
Cambridge, Massachusetts  
London, England

### TEMPERING PRINCIPLE WITH PRACTICALITY— OR ONE PRINCIPLE WITH ANOTHER

The outcome of this entire discussion about the problems of defining (as contrasted with actually measuring and applying) marginal cost is that neither the choice between short and long-run, nor the problem of defining the incremental unit of sale, nor the prevalence of common and joint costs raises any difficulties in principle about the economically efficient price. It is set at the short-run marginal cost of the smallest possible additional unit of sale. Common costs do not preclude separable marginal production costs, and joint products have separate marginal opportunity costs.

But, as we have already suggested, short-run marginal costs (SRMC) are the place to begin. There are situations in which it is both efficient and practical to base rates on them, as we shall see. Typically, this is not the case; principle must be compromised in various ways in the interest of practicality, for a number of interrelated reasons:

1. It is often infeasible, or prohibitively expensive, for businesses to make the

---

<sup>42</sup> If either demand shifted far enough relative to the other to restore a Figure 2 situation, we would once again have separate production costs. This would be so in Figure 3 if, for example,  $D_{cso}$  shifted sufficiently to the left to intersect  $S_{cso}$  short of point  $E$ .

<sup>43</sup> A change of this type is depicted in Figure 3, in dashed lines.  $D_c$  declines to  $D'_c$ . This means that the combined demand ( $D_{c-cso}$ ) falls by the same amount, to  $D'_j$ . (It is unnecessary, but perhaps helpful, to draw in the new supply curve for oil,  $S'_{cso}$ , reflecting the diminished contributions fiber purchasers are now prepared to make toward joint costs at various levels of output.) Joint output falls to  $OJ'$ . Society's resource savings are not measured by the area between  $J$  and  $J'$  under the cotton fiber supply curve,  $S_c$ , as they would be if this were a true marginal production cost curve; instead they are measured by the entire area between  $J$  and  $J'$  under the

combined cost curve ( $MC_{c+cso} + MC_{cso}$ ).

<sup>44</sup> See Jack Hirshleifer, "Peak Loads and Efficient Pricing: Comment," *Q. Jour. Econ.* (August 1958), LXXII: 458-459. On the application of this reasoning to public utility pricing, see pp. 87-88 and pp. 91-93, Chapter 4.

On the general theory of joint products, their costing and pricing under competitive and monopolistic conditions, see the very lucid discussion in Mary Jean Bowman and George Leland Bach, *Economic Analysis and Public Policy: An Introduction* (New York: Prentice-Hall, 1943), Chapter 18. Also see Kenneth E. Boulding, *Economic Analysis, Microeconomics* (New York: Harper & Row, 1966), I: 579-584; Joel Dean, *Managerial Economics* (New York: Prentice-Hall, 1951), 317-319; T. J. Kreps, "Joint Costs in the Chemical Industry," *Q. Jour. Econ.* (May 1930), XLIV: 416-461.

necessary fine calculations of marginal cost for each of their numerous categories of service.

2. Marginal costs will vary from one moment to the next, in a world of perpetually changing demand, as firms operate at perpetually changing points on their SRMC functions (unless marginal costs happen to be constant, that is, horizontal), and between far wider extremes than either average variable or average total costs (see Figure 1). It will vary also because cost functions themselves are constantly shifting. Thus, it would be prohibitively costly to the seller to put into effect the highly refined and constantly changing pricing schedules, reflecting in minute detail the different short-run marginal costs of different sales. It would also be highly vexatious to buyers, who would be quick to find discrimination in departures from uniform prices, who would be put to great expense to be informed about prices that were constantly changing, and whose ability to make rational choices and plan intelligently for the future would be seriously impaired.
3. For these reasons the practically-achievable version of SRMC pricing is often likely to be pricing at *average* variable costs (AVC), themselves averaged over some period of time in the past and assumed to remain constant over some period in the future—until there occurs some clear, discrete shift caused by an event such as a change in wage rates. But since short-term AVC (in contrast with SRMC) are never as large as average total costs (see Figure 1), universal adoption of this type of pricing is infeasible if sellers are to cover total costs, including (as always) a minimum required return on investment. This in turn produces a strong tendency in industry to price on a “full cost” basis—usually computed at AVC (really *average* AVC over some period of time) plus some percentage mark-up judged sufficient to cover total costs on the average over some time period<sup>45</sup>—a far cry, indeed, from marginal cost pricing.<sup>46</sup>
4. SRMC can be above or below ATC, as we have seen; but whether it is above often enough for businesses pricing on that basis to cover total costs on the average depends on the average relationship over time between demand and production capacity. As J. M. Clark has often pointed out, excess capacity is the typical condition of modern industry;<sup>47</sup> and we would probably want this to be the case in public utilities, which we tend to insist be perpetually in a position to supply whatever demands are placed on them. In these circumstances, firms could far more often be operating at the point where SRMC is less than ATC than the reverse,<sup>48</sup> and if they based their prices exclusively on the former they would have to find some other means of making up the difference. Partly for this reason, and partly because of the infeasibility of

<sup>45</sup> See the survey article by Richard B. Heflebower, “Full Costs, Cost Changes, and Prices,” in National Bureau of Economic Research, *Business Concentration and Price Policy* (Princeton: Princeton Univ. Press, 1955), 361–392.

<sup>46</sup> Recall that to the extent that depreciation, taxes, and return on capital are a function not of use but of time—as is preponderantly the case—they do not belong in SRMC, hence in price, at all.

<sup>47</sup> *Overhead Costs*, 437–439, 448–449; *Competition as a Dynamic Process* (Washington: Brookings Institution, 1961), 59, 81, 120–121, 133, 140.

<sup>48</sup> This does not follow inevitably from the perpetual presence of surplus capacity. Most of the standby capacity probably has high variable costs—that, indeed, is why it is selected for the standby function. In consequence, even if an industry operates on the average at, for example, 80% of physical capacity, it might find its

permitting prices to fluctuate widely along the SRMC function, depending on the immediate relation of demand to capacity,<sup>49</sup> the practically achievable benchmark for efficient pricing is more likely to be a type of average long-run incremental cost, computed for a large, expected incremental block of sales, instead of SRMC, estimated for a single additional sale. This long-run incremental cost (which we shall loosely refer to as long-run marginal cost as well) would be based on (1) the average incremental variable costs of those added sales and (2) estimated additional capital costs per unit, for the additional capacity that will have to be constructed if sales at that price are expected to continue over time or to grow.<sup>50</sup> Both of these components would be estimated as averages over some period of years extending into the future.

5. The prevalence of common costs has similar implications. Service A bears a causal responsibility for a share of common costs only if there is an economically realistic alternative use of the capacity now used to provide it, or if production of A requires the building of additional capacity. The marginal opportunity cost of serving A depends on how much the alternative users would be willing to pay for devoting the capacity to serving them instead. The sum of the separable marginal costs will therefore cover the common costs only if at separate prices less than this the claims on the capacity exceed the available supply.<sup>51</sup>
6. Long-run marginal costs are likely to be the preferred criterion also in competitive situations. Permitting rate reductions to a lower level of SRMC, which would prove to be unremunerative if the business thus attracted were to continue over time, might constitute predatory competition—driving out of business rivals whose *long-run* costs of production might well be lower than those of the price-cutter.

---

SRMC on the average equal to its composite ATC—running far above ATC when operations exceeded the 80% level and correspondingly below at other times. See pp. 94–97, Chapter 4, below.

<sup>49</sup> If SRMC pricing did not cover ATC over time, capital would eventually be withdrawn and new capital, needed to meet the rising demand, repelled, until a recovering demand, moving up along a steeply rising MC curve, pushed prices up high enough and held them there long enough to attract new capital into the industry—with the possibility of a return of depressed prices with any temporary reemergence of excess capacity. In the case of the partly-empty airplane (see pp. 75–76), the “efficient price” would be zero as long as the response of travelers remained insufficient to fill the plane; then it would have to jump the moment the empty spaces fell one short of demand, possibly to the full cost of an added flight but in any case to whatever level necessary to equate the number of available seats with the number of would-be passengers. On each flight, the available seats would have to be auctioned, with the uniform price settling at the point required to clear the market.

<sup>50</sup> See W. Arthur Lewis, *Overhead Costs* (New

York: Rinehart, 1949), 15–20; Marcel Boiteux, “Peak-Load Pricing” in James R. Nelson, *Marginal Cost Pricing in Practice* (Englewood Cliffs: Prentice-Hall, 1964), 70–72.

<sup>51</sup> As we have just seen in another connection (pp. 82–83), the marginal opportunity cost of providing a cubic foot of warehouse space to any particular user, A, is the most valuable alternative use of that space excluded by serving A—what the most insistent excluded customer would have been willing to pay for it. If at any price per foot less than the proportionate share of the common costs (that is, less than ATC) of the warehouse, there are or would be unsatisfied customers—that is, more cubic feet demanded than were available—then clearly the marginal opportunity cost of each cubic foot would be at least equal to average total costs, and prices correctly set at SRMC would cover total costs. If, instead, at a price equal to ATC there is excess capacity, this demonstrates that price exceeds marginal opportunity costs: serving A is not preventing anyone else willing to pay that much from getting all the space he wants. In this circumstance, prices set lower, at true SRMC, would not provide enough revenue to cover total costs.

It is important to recognize that all these reasons for compromising principle with practicality make sense even in purely economic terms—hence the equivocal subtitle of this section. Consider the fact, for example, that it is costly—that is, it uses resources—to measure and base prices on SRMC. (This will be easier to see at a later point: see pp. 182–187.) If these costs exceed the efficiency advantages of moving to such a pricing system, clearly considerations of economic efficiency alone would dictate refraining from doing so. Therefore, it is not a matter merely of compromising an economic principle; it is a question of correctly applying the relevant principle or of balancing one principle with another.

The limitations of trying to base prices solely on SRMC may be stated more generally. The theory of efficient pricing that we sketched earlier in this chapter is a static theory. It describes the conditions for optimum choosing, given some preexisting technology and pattern of consumer desires. It describes the optimum, equilibrium outcome that will prevail after all adjustments have been made to those two fundamental determinants of supply and demand functions. It makes no calculation of the costs or likelihood of achieving that result in a dynamic economy, in which demand and costs are constantly changing. Or, alternatively, it may be said to describe how that result will be achieved effortlessly, costlessly, and instantaneously under perfect competition—where buyers and sellers of every good and service are infinitely numerous, have perfect knowledge and foresight and act rationally on it, and where resources are perfectly mobile and fully employed. But obviously these conditions do not and cannot prevail in the real world. Only, then, if we can compare the efficiency gains of each proposed movement toward SRMC pricing, on the one hand, with its possible costs and drawbacks in a world of imperfect competition, knowledge, rationality, and resource mobility can we decide whether that move is indeed optimal even in purely economic terms. We have just suggested several reasons why it might not always be optimal.

This list of considerations is by no means exhaustive. Since the best probable compromise of offsetting considerations will clearly vary from one pricing context to another, it is impossible to set forth an integrated, general set of conclusions. Instead what we have is really a set of hypotheses, of relevant considerations. We proceed now to apply them to the most important public utility pricing problems: to the proper distribution of capacity costs; to the optimum pattern of rates over time (these two in Chapter 4); to decreasing cost situations, where MC is less than ATC, and the proper design of a rate structure in these circumstances (Chapter 5); and to situations in which competition is involved—competition involving public utility companies themselves and competition among their customers (Chapter 6).

COMPARISON OF GTE'S PROPOSED TRANSPORT TERMINATION  
CHARGES WITH THOSE OF OTHER LECS

PREMIUM TRANSPORT TERMINATION			
		California	Florida
		0.0019035	0.0019862
Ameritech	0.009885	5.2	5.0
Bell Atlantic	-N/A-	---	---
BellSouth	-N/A-	---	---
New England Tel	0.014191	7.5	7.1
New York Tel	0.016593	8.7	8.4
Pacific Bell	0.007108	3.7	3.6
Southwestern Bell	-N/A-	---	---
U S West	0.009341	4.9	4.7

Source: ALTS petition to reject or suspend Transmittal No. 711, dated April 29, 1992, at 7.

COMPARISON OF GTE'S PROPOSED TRANSPORT TERMINATION RATES  
IN CALIFORNIA AND FLORIDA WITH THOSE IN ITS OTHER SERVICE AREAS

PREMIUM TRANSPORT TERMINATION			
		California 0.0019035	Florida 0.0019862
Alaska	0.0009260	0.5	0.5
Hawaii	0.0060910	3.2	3.1
GTE NORTH			
Illinois	0.0068796	3.6	3.5
Indiana	0.0048652	2.6	2.4
Iowa, Minnesota	0.0059931	3.1	3.0
Michigan	0.0080400	4.2	4.0
Missouri	0.0030875	1.6	1.6
Nebraska	0.0047900	2.5	2.4
Ohio	0.0065460	3.4	3.3
Pennsylvania	0.0042477	2.2	2.1
Wisconsin	0.0061445	3.2	3.1
GTE NORTHWEST			
Idaho, Montana	0.0117708	6.2	5.9
OREGON, WASHINGTON			
California W.C.	0.0068496	3.6	3.4
GTE South	0.0060507	3.2	3.0
GTE Southwest	0.0046215	2.4	2.3

Source: ALTS petition to reject or suspend Transmittal No. 711,  
dated April 29, 1992, at 8.