Appendix E

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Investigation of Certain Price Cap Local Exchange Carrier Business Data Services Tariff Pricing Plans	)	WC Docket No. 15-247
	)	
	)	

ORDER INITIATING INVESTIGATION AND DESIGNATING ISSUES FOR INVESTIGATION

Declaration of Eric R. Emch, Ph.D.
and
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January 8, 2016

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I. Executive summary

(1) To determine whether the pricing plans designated for investigation are just and reasonable, or alternatively whether they lock-in customers and anticompetitively foreclose the market to CLECs, the Bureau will need to conduct an in-depth and complete market analysis. Commission precedent, antitrust precedent, and the relevant economics literature all view such an analysis as a necessary component of evaluating the potential for anticompetitive outcomes.

- Such an analysis will require the Bureau to evaluate not only the data it requested in its October 16, 2015 *Special Access Tariff Investigation Order*,[1] but also the data it requested in its September 20, 2014 *Special Access Data Collection Reconsideration Order*.[2]

- In addition, the Bureau is likely to need to request additional data that it has not collected in the general rulemaking proceeding or requested in this proceeding, including time-series data to evaluate how particular market characteristics have changed over time, as the market rapidly transitions from a TDM-based telecommunications world to a packet-based world.

(2) The Commission historically has recognized that it is necessary to consider market conditions and the level of competition in evaluating the reasonableness of rates, terms, and conditions. It has long acknowledged that it is unnecessary and counterproductive to regulate the rates, terms and conditions of carriers that lack market power. And it has further recognized that it is necessary to grant pricing flexibility to "dominant" carriers as competition develops, so that they can respond to increasing competition.

(3) In the *Special Access Tariff Investigation Order*, the Bureau analogized the terms and conditions under investigation to exclusive contracts, contracts that reference rivals, and loyalty discount agreements.[3] For ease of reference, we will adopt the Bureau's phrase "conditional pricing" or "conditional pricing provisions," to refer collectively to exclusive contracts, contracts referencing rivals, and loyalty discounts. We note, however, that the discounts contained in the four Verizon special access pricing plans under investigation are neither exclusive contracts nor contracts directly referencing rivals, like market-share discounts.[4] The economics literature and antitrust precedent

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[1] *Investigation of Certain Price Cap Local Exchange Carrier Business Data Services Tariff Pricing Plans*, Order Initiating Investigation and Designating Issues for Investigation, WC Docket No. 15-247 (rel. Oct. 16, 2015) ("*Special Access Tariff Investigation Order*")

[2] *Special Access for Price Cap Local Exchange Carriers,* Order on Reconsideration, 29 FCC Rcd 10899 (Wireline Comp. Bur. 2014) ("*Special Access Data Collection Reconsideration Order*").

[3] *Special Access Tariff Investigation Order* at n.54

[4] *Id.* As discussed below, the terms and conditions in Verizon's pricing plans, unlike exclusive dealing arrangements, do not commit the buyer to purchasing only from Verizon. Rather, they only require purchases at least equal to some percentage of the initial contract demand. Thus, these contract terms could represent only a small percentage of a

agree that contracts with conditional pricing provisions, such as exclusive contracts and loyalty discounts, can have anticompetitive effects only under certain narrow circumstances. These necessary, but not sufficient, conditions include: that the seller has substantial market power in the relevant markets; that there exist significant economies of scale in the production of the relevant product or service; that the effect of the conditional pricing provision is to foreclose a sufficient amount of total demand such that the entrant cannot achieve minimum efficient scale; and that firms can either discriminate among customers or negotiate with them sequentially.

(4) The Bureau designated four optional Verizon special access pricing plans for investigation: the Commitment Discount Plan ("CDP"), the National Discount Plan ("NDP"), the DS1 and DS3 Term Volume Plans (collectively, "TVP") and the Eight- and Ten-Year DS1 Term Volume Plans ("ETTVP"). The CDP and NDP are *term* plans with portability.[5] The TVP and ETTVP, in contrast, are *term and volume* plans, though they also allow customers to port circuits.

(5) It is important to note that the Verizon pricing plans under investigation are optional. Customers, including CLECs, are not required to choose any of these particular Verizon pricing plans, and other options are available. Nor are customers required to renew any pricing plans they may have chosen. For example, <<

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(6) In addition, none of the plans precludes customers from buying service from other providers. The Verizon pricing plans under investigation instead contain term or term and volume discounts, which may give customers incentives to commit to longer terms or to buy larger volumes from Verizon but do not reference purchases from rivals. Volume and term discounts are common in many ind ustries, including many competitive industries and in many telecommunications markets. They generally are offered by sellers that lack market power.

(7) The Commission has long recognized the potential benefits of pricing plans with term and/or volume commitments. For example, in 1992, it observed that "volume and term discounts can be a useful and

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customer's demand for special access service, and if the customer's demand is increasing over time, the commitment will represent a decreasing percentage of the customer's purchases. Similarly, the Verizon terms and conditions do not constitute contracts that reference rivals. Professor Fiona Scott-Morton defines contracts that reference rivals ("CRRs") as "contracts containing material terms that are contingent not only on the prices, quantities transacted between the parties to the contract, but also on the prices, quantities, or other terms of the relationship between one of the parties and product market rivals of the other." Fiona Scott-Morton, *Contracts that Reference Rivals*, ANTITRUST MAGAZINE 72 (Summer 2013). Unlike CRRs, the terms and conditions under investigation are not contingent on the prices, quantities or other terms of transactions between the customer and other providers of special access services. A volume discount, like those under investigation, does not directly increase a buyer's cost of increasing purchases from a rival, while an exclusive dealing contract or a market share contract does. Because of this, the exclusionary effects, if any, of the terms and conditions under investigation are likely to be less severe than those of either exclusive contracts or CRRs. This is particularly true if total market demand is growing, as it appears to be in the markets for dedicated transmission services.

[5] By "circuit portability," we mean that, during the term of the discount plan, a customer can change the location of circuits it purchases, without incurring early termination charges as long as the circuit is in place for at least one year.

legitimate means of pricing special access services to recognize the efficiencies associated with larger volumes of traffic and the certainty of longer term deals."[6] Moreover, in the one case in recent decades where the Commission found a volume and term discount to violate Section 201, the court of appeals reversed, holding, among other things, that the Commission "failed to show that the large, established companies were at all harmed by the 90% commitment requirement, much less that the relative harm to them exceeded the relative benefits."[7]

(8) Economists also generally view volume and term discounts as beneficial to both the buyer and seller. They allow for more certainty on both sides of the transaction, bring a closer alignment of costs and prices, and/or provide a way to prevent opportunistic behavior by one or both parties. Commitment devices, such as early termination fees, shortfall payments, and overage provisions are generally necessary to support the efficiencies of volume and term discounts by providing incentives for parties to comply with the terms of the agreement, thereby increasing certainty, reducing potential costs to Verizon resulting from opportunistic behavior, and preventing contractual hold-ups. Provisions specifying penalties for breach of contractual commitments are nearly universal in commercial contracts, and generally are regarded as enhancing efficiency.

(9) The Bureau suggests that the terms and conditions under investigation may have an exclusionary impact akin to exclusive contracts or other contracts that reference rivals. Economists have developed a number of models that identify specific cases where exclusivity, or other contractual provisions referencing rivals, forms part of a profitable exclusionary strategy. These "exclusion" models depend on certain assumptions, such as the form of competition upstream and downstream, or the existence of economies of scale, which depend on the particular characteristics of the markets and industries involved. Given the stylized facts and assumptions of the models, a number of the economists who have authored these models have urged caution in using them to condemn exclusive dealing arrangements, tying arrangements, and other potentially exclusionary practices under the antitrust laws. In addition, these models generally ignore any possible efficiencies associated with the practices. The empirical economic literature, however, has found that efficiencies from such practices seem to be more common than anticompetitive effects.

(10) Existing antitrust precedent also finds conditional pricing provisions problematic only under certain limited conditions, and thus applies a "Rule-of-Reason" analysis.

(11) With respect to exclusive contracts and exclusive dealing arrangements, courts in antitrust cases generally require plaintiffs to: (1) define both the relevant product and geographic markets; (2)

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6 *Expanded Interconnection with Local Telephone Company Facilities,* Report and Order and Notice of Proposed Rulemaking, 7 FCC Rcd 7369, at para. 199 (1992) ("*Special Access Expanded Interconnection Order*"), *vacated in part and remanded,* Bell Atl. Tel. Cos. v. FCC, 24 F.3d 1441 (D.C. Cir. 1994).

7 BellSouth Telecomms. v. FCC, 469 F.3d 1052, 1060 (D.C. Cir. 2006).

demonstrate that a significant percentage of the relevant market has been foreclosed, and (3) prove that the provision at issue has resulted, or will result, in anticompetitive harms.

(12) With respect to loyalty discounts, the courts are split as to whether they should apply an exclusive dealing framework or a predatory pricing framework. To the extent that loyalty discounts are viewed as a form of predatory behavior, plaintiffs must satisfy the two-part test from *Brooke Group* in order to prevail: that prices are below a relevant measure of cost and that such losses can realistically be recouped in the future.

(13) Existing FCC and antitrust precedent and the relevant economic literature agree that term and/or volume discounts and the associated terms that help enforce these contractual commitments are not inherently anticompetitive or anticonsumer. Thus, before condemning what typically are mutually beneficial and efficiency enhancing contract terms, the Bureau should take care to identify the exact conditions under which such generally beneficial terms and conditions might prove anticompetitive.

(14) In light of the relevant FCC precedent, antitrust precedent, and economics literature, we offer the following recommendations for how the Bureau might most efficiently analyze the reasonableness of the pricing plans designated for investigation.

- First, the Bureau needs to define the relevant product and geographic markets that include the TDM special access services covered by the pricing plans under investigation.
    - With respect to the relevant product market, it is important that the Bureau not limit the relevant market necessarily to the TDM services covered by the tariffed pricing plans, but instead it must include all the services that customers treat as reasonably close substitutes.
    - With respect to the geographic market, the fact that the parties subscribing to such pricing plans likely are multi-location customers suggests that the Commission should define the relevant area as "encompass[ing] all the geographic locations where these multi-location business customers may have a presence."[8]
- Second, the Bureau should assess the competitive conditions within those relevant markets and determine whether Verizon and the other incumbent LECs possess substantial market power. This will require an analysis of all of the data collected pursuant to the Bureau's 2014 order,[9] and it most likely will require the collection of additional data. If the Bureau concludes that the incumbent price-cap carriers no longer possess substantial market power,

8 *See, e.g., SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18290, para.63 (2005).

9 *Special Access Data Collection Reconsideration Order*, 29 FCC Rcd 10899.

then the inquiry should end, and the Bureau should find that the terms and conditions comply with Section 201.

- Third, if the Bureau determines that the incumbent price-cap carriers possess substantial market power, it then must determine whether there is any evidence of adverse competitive effects from the pricing plans.

    - To the extent that the terms and conditions under investigation have foreclosed such a significant percentage of total market demand that competitors cannot achieve minimum efficient scale, this might provide indirect evidence of adverse competitive effects

    - Given the fact that these pricing plans have been offered for over a decade, however, if the plans were anticompetitive, there should be significant evidence of *actual* adverse competitive effects during this period, including significant numbers of competitive LECs that have been forced from the market or deterred from entering or significant increases in prices charged to end-users.

    - If the Bureau cannot find substantial evidence of adverse competitive effects, then it should find the plans consistent with Section 201.

- Finally, even if the Bureau finds that the carriers whose plans are being investigated have substantial market power and that the terms and conditions under investigation have caused significant adverse competitive effects, it also must examine the potential efficiencies and other benefits arising from the use of these terms and conditions.

II. Charge and Qualifications

A. Charge

(15) Verizon has asked us to offer our opinion and views with respect to certain economic issues raised by the Wireline Competition Bureau's recently released *Special Access Tariff Investigation Order*. In developing our opinions, we have reviewed the Bureau's order and various other Commission orders, the four Verizon special access pricing plans that were designated for investigation, and selected comments and declarations that were filed in WCB Docket No. 05-25. We have not had access to the

confidential data or information that was submitted in Docket No. 05-25, nor to the data that was submitted in response to the Bureau's September 15, 2014 order.[10]

(16) We discuss below the potential efficiencies and benefits associated with the volume and term discounts and accompanying commitment provisions that were designated for investigation, as well as the potential anticompetitive effects that might be caused by these terms and conditions. We also suggest how, consistent with FCC and antitrust precedent and the relevant economic literature, the Bureau should weigh the potential benefits and costs of these terms and conditions and make a determination as to whether those terms are "just and reasonable," as required by Section 201 of the Communications Act.

B. Qualifications

(17) **Eric R. Emch**: I am a partner at Bates White Economic Consulting, where I consult on antitrust and regulatory issues. I have a PhD in Economics from the University of California at Berkeley, and a BA from Brown University.

(18) Prior to joining Bates White, I served as Staff Economist and Assistant Section Chief in the US Department of Justice's (DOJ) Antitrust Division. As Assistant Section Chief, I led teams of economists in theoretical and empirical analyses of merger, monopolization, and collusion cases. As a staff economist, I conducted theoretical and empirical analysis in support of investigations in a wide variety of industries.

(19) From 2007–2008, I led the OECD's Regional Competition Center in Seoul, Korea, where I designed, organized, and conducted competition policy workshops for staffers of national competition authorities across Asia. I have published in journals such as the Journal of Industrial Economics, Review of Industrial Organization, Review of Network Economics, and Antitrust Law Journal on a number of antitrust-related topics.

(20) **Donald K. Stockdale, Jr.:** I am a partner at Bates White Economic Consulting, where I consult on antitrust and telecom regulatory issues. I have a BA, JD and PhD in Economics, all from Yale University, and a BA and MA from King's College, Cambridge University.

(21) Prior to joining Bates White, I was a partner at a major U.S. law firm, where I represented clients in antitrust and telecommunications regulatory matters. Before that, I held various leadership positions at the Federal Communications Commission (FCC), including, most recently, Deputy Chief and Chief Economist of the Wireline Competition Bureau. While at the FCC, I supervised the review of major wireline mergers and had leadership roles in the review of significant wireless, media, and

[10] *Special Access Data Collection Reconsideration Order*, 29 FCC Rcd 10899.

satellite mergers. I also supervised the Bureau's Pricing Policy Division and led numerous FCC rulemaking proceedings involving wireline telecommunications, including the Commission's 2008 effort to reform intercarrier compensation and universal service. During my time at the FCC, I played significant roles in the development of much of the Commission's current approach to market definition, merger analysis, and analysis of competition and market power.

(22) I have been active in the ABA's Antitrust Section, where I currently am co-chair of the Economics Committee, and in the Federal Communications Bar Association, where I am co-chair of the International Telecommunications Committee. For the past several years, I have been an instructor at the Public Utility Research Center/World Bank International Training Program on Utility Regulation and Strategy.

III. Introduction and Background

A. Introduction

(23) On October 16, 2015, the Wireline Competition Bureau released an order initiating an investigation of certain terms and condition of special access tariff pricing plans of four price-cap ILECs and designating certain issues for investigation. The Bureau order stated that the investigation was motivated by complaints from competitive local exchange carriers ("competitive LECs" or "CLECs") that certain terms and conditions contained in those pricing plans were "unreasonable, anticompetitive, and lock up the vast majority of demand for TDM-based business data services."[11]

(24) Based on the Bureau's summary of the allegations, the CLECs appear to assert two main claims. First, they complain "that incumbent LEC business data services tariff pricing plans incorporate a complicated web of all-or-nothing bundling, loyalty and term commitments, complex enforcing penalties, circuit migration rules and other provisions," which have the effect of locking up "substantial portions of . . . end-user demand."[12] In essence, they appear to argue that these pricing plans represent an exclusionary strategy under which Verizon and the three other carriers under investigation lock-in a substantial percentage of total demand for dedicated transmission services (including both end-user demand and demand for wholesale services), thereby foreclosing competitors from competing for a major percentage of the market. Second, the CLECs complain that they themselves are subject to lock-in because they "must purchase . . . significant amounts of business data services from the local incumbent LEC," and that "in practice their only option in

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[11] *Special Access Tariff Investigation Order* at para. 1.
[12] *Id.* at para. 6.

making such purchases is to be entangled in a web of terms and conditions that limit significantly their ability to respond to marketplace opportunities to deploy their own infrastructure."[13]

(25) The Bureau order states that, if these allegations prove true, "the consequences could well be that, despite competitive entry for a segment of the demand for business data services, incumbent LEC *dominance* over facility-based provision of such services is preserved in many areas and costs for entry or expansion for competitive LECs is increased with the direct result of that dominance being that end-users are deprived of the benefits of both competition and innovation."[14]

(26) In the order, the Bureau states that, despite substantial advocacy in the record on both sides of the issues," the Bureau "believe[s] that a more systematic inquiry into the tariff pricing plans in question is needed before any determination on the merits can be made."[15]

(27) As discussed below, we agree with the Bureau that, in order to determine whether the terms and conditions identified by the Bureau for investigation are anticompetitive, and thus violate Section 201, it is necessary to conduct a systematic inquiry. We disagree with the Bureau, however, to the extent that it believes it can make such a determination based on the information it has requested in the *Special Access Tariff Investigation Order* or without fully analyzing competitive conditions in the markets for business data services.[16] Rather, as we explain below, we believe that the Bureau will not be able to determine whether the terms and conditions under investigation violate Section 201 until after it has completed a full market analysis that is sufficient to answer the following questions, among others:

- What are the relevant product and geographic markets that include the TDM special access services covered by the tariff pricing plans under investigation?
- Do the incumbent LECs whose tariffs are subject to the investigation have substantial market power in the relevant markets?

[13] *Id.*

[14] *Id.* (emphasis added).

[15] *Id.* at para. 1.

[16] We recognize that the Bureau, on December 4, 2015, released an Order and Protective Order, which permitted participants in the tariff investigation proceeding to use data from the business data services rulemaking proceeding. *Investigation of Certain Price Cap Local Exchange Carrier Business Data Services Tariff Pricing Plans*, Order and Protective Order, WC Docket No. 15-247 (rel. Dec. 4, 2015) ("*Special Access Tariff Investigation Protective Order*"). In that order, the Bureau acknowledged that "there are data submitted in the rulemaking proceeding that are relevant to the question of the reasonableness of the incumbent LEC pricing plan terms and conditions," but it did not go into detail as to which data it thought relevant, except to note that "both incumbent LECs and competitive LECs submitted data related to the terms and conditions of their tariffs or sales agreements." *Id.* at para. 9. Moreover, the Bureau order did not discuss the relevance of these data to assessing market conditions or the extent of competition in the relevant markets. Thus, it is not clear what data from the rulemaking proceeding the Bureau currently believes relevant to assessing the reasonableness of the pricing plans under investigation.

- Do the terms and conditions under investigation have the effect of foreclosing a significant portion of the demand for the relevant services, and if so, what percentage of the total demand for the relevant services is foreclosed?

- What is the minimum efficient scale ("MES") for CLEC entry into the relevant market and how does this MES compare with the total uncommitted demand for the relevant business services both today and going forward?

- Is there evidence that the provisions under investigation have actually resulted in anticompetitive effects, such as forcing the exit, or deterring the entry, of CLECs, or raising significantly the price of the relevant services to consumers?

- How should efficiencies resulting from the terms and conditions under investigation be weighed against any anticompetitive effects?

(28) In order to answer the above questions, the Bureau, at a minimum, needs to complete its market analysis in the special access rulemaking proceeding, which requires completing its analysis of all the data it requested in that proceeding.[17] In addition, it likely will require asking for and analyzing additional data. For example, the data the Bureau collected in the rulemaking proceeding contains information about competitors' facilities, revenues, and customers, which may be relevant to assessing whether the carriers under investigation possess substantial market power in specific relevant product and geographic markets.[18] These data also may help the Bureau assess the extent of potential competition. For example, carriers' responses concerning business rules for build-out may shed some light on when, and under what conditions, it is feasible for carriers to build out their infrastructure.

(29) We note, however, that the decision by the Office of Management and Budget ("OMB") to limit the data request to one year for most categories of data severely limits the usefulness of the data collected, even assuming that it is accurate.[19] Time-series data would be extremely useful in assessing whether the incumbent LECs, whose tariffs are the subject of this investigation, have

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[17] *See Special Access for Price Cap Local Exchange Carriers*, Order and Further Notice of Proposed Rulemaking, 27 FCC Rcd 16318 (2012) ("*Special Access Data Collection Order*"); Report and Order, 28 FCC Rcd 13189 (Wireline Comp. Bur. 2013) ("*Special Access Data Collection Implementation Order*"); Order on Reconsideration, 29 FCC Rcd 10899 (Wireline Comp. Bur. 2014) ("*Special Access Data Collection Reconsideration Order*"); Order, 29 FCC Rcd 14346 (Wireline Comp. Bur. 2014) ("*Special Access Data Collection Extension Order*").

[18] As discussed below, market share is one factor that is generally considered in assessing whether a particular carrier has substantial market power, but it is not the only factor. In dynamic markets, like those for dedicated transmission services, it is also important to obtain trend data over multiple periods to assess how markets are evolving, and also to consider other data (such as demand trends) to evaluate how the marketplace is evolving.

[19] A further significant limitation of the data that OMB permitted the Commission to collect is that it is now two years old. Given the rapid changes in this marketplace, this could mean that the data are relatively obsolete. Moreover, as noted in the text, even if the data were current, they would still be of limited usefulness absent time-series data that could show trends over time.

substantial market power in the relevant markets.[20] Without such data, the Bureau may find it difficult to calculate trends in market shares, which can provide useful information on whether carriers possess substantial market power. This is particularly true where the markets at issue are subject to rapid change,[21] which, as the Bureau has acknowledged, is the case for dedicated transmission services.[22] Similarly, it would be extremely useful to have time series data showing how CLEC and cable infrastructure has changed over time, as well as how end-user demands have changed over time (both in terms of whether it is an ILEC or CLEC that is providing the dedicated service and the kind of service (TDM or packet-based) that is being provided). In addition, time series data could provide critical information on the percentage of total demand that is subject to the pricing plans under investigation and the percentage of demand that has been, and remains, uncommitted, or will soon become uncommitted, and how those percentages have changed over time.[23]

(30) Time-series data may also shed light on broader changes in the markets and products involved that point to new areas of actual or potential competition. For instance, time series data may prove valuable in evaluating whether substitution between TDM and packetized dedicated transmission services has changed over time and the implications of any such change for market definition. To take one example, time series data may indicate how the demand by mobile wireless carriers for backhaul service has evolved as carriers have upgraded their networks to LTE, which may inform the

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[20] Without data from multiple periods that would allow calculation of trends, it will be difficult to determine whether the data collected provide a relatively realistic, if static, snapshot of the market. For example, in 1995, the Commission found that AT&T lacked individual market power in the market for interstate, domestic, interexchange telecommunications services, despite the fact that AT&T had market shares of 55.2 percent and 58.6 percent of revenues and minutes respectively. *Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier*, Order, 11 FCC Rcd 3271, at para. 67 (1995) ("*AT&T Reclassification Order*"). In addition, although the Commission did not report that figure in the order, AT&T also had a 74.6 percent market share in terms of residential subscribers in 1995. INDUSTRY ANALYSIS DIVISION, COMMON CARRIER BUR., FEDERAL COMMUNICATIONS COMM., TRENDS IN TELEPHONE SERVICE, Table 10.10 at 10-15 (2000). Despite these relatively high market shares, the Commission nevertheless found that AT&T lacked individual market power, based in part on the fact that AT&T's market share had fallen steadily from 90 percent, and on the fact that AT&T faced two full facilities-based competitors and at least one potential facilities-based competitor. *AT&T Reclassification Order* at paras. 67 & 70.

[21] *See, e.g.* ABA SECTION OF ANTITRUST LAW, MARKET POWER HANDBOOK: COMPETITION LAW AND ECONOMIC FOUNDATIONS 112 (2d ed. 2012) ("Trends in shares may indicate a market or competitor in flux. A declining share may indicate that a firm has less competitive significance than its current share would otherwise suggest.").

[22] *See, e.g., Special Access Tariff Investigation Order,* at para. 11 ("[S]pecial access services are undergoing a fundamental transformation as providers transition from TDM-based special access infrastructure and services to packet-based special access infrastructure and services.").

[23] In order to assess whether particular contracts or pricing plans are likely to have an exclusionary effect, one must consider not only the percentage of total demand that is committed under those pricing plans in the current period; but also the percentage of those contracts or pricing plans that will expire during the current period, and the growth in total demand during this period. We note that not only does the Bureau lack time series data that would allow it to estimate uncommitted demand over time so that it can more realistically estimate the extent of foreclosure, but it also appears to lack the data to calculate uncommitted demand for a particular period in time — 2013. Specifically, the Bureau, in its *Special Access Tariff Investigation Order*, asked incumbent LECs for total sales data, broken down by pricing plan, for the years 2012-2014, but it does not appear to have requested data from customers, including CLECs, that would allow it to estimate currently uncommitted demand.

issue of market definition. Similarly, data on changes in CLEC footprints may provide insights on potential competition.

(31) For the remainder of the declaration, we proceed as follows. In the next subsection we review relevant Commission precedent, which shows that the Commission repeatedly has recognized that: (1) for carriers lacking market power, it can rely on the market and competition to ensure that rates, terms and conditions are just and reasonable; and (2) it should allow even dominant carriers some flexibility in setting terms and conditions. In Section IV, we briefly discuss the terms of the Verizon pricing plans that the Bureau has designated for investigation, and explain that those terms and conditions are similar to volume and term discounts that are commonplace in competitive markets, including telecommunications markets. We also explain why volume and term discounts generally are viewed as beneficial to both buyer and seller. Section V discusses the economic literature and antitrust precedent concerning exclusive contracts and loyalty discounts, which the Bureau has analogized to the terms and conditions under investigation. We explain the relatively narrow conditions under which such conditional pricing provisions may have anticompetitive effects and identify a number of necessary, but not sufficient, conditions for such anticompetitive effects to occur. Finally, in Section VI we offer some recommendations as to how the Bureau should proceed in evaluating the terms and conditions it designated for investigation.

B. The FCC repeatedly has found that competition can ensure that rates, terms and conditions are just and reasonable

(32) Since the Commission first began introducing competition into previously monopoly telephone markets, it has recognized that it is necessary to consider market conditions and the level of actual and potential competition in evaluating the reasonableness of rates, terms, and conditions. It also has long acknowledged that it is unnecessary and counterproductive to regulate the rates, terms and conditions of carriers that lack market power. Finally, it has recognized that, as competition is introduced, it should grant increasing pricing flexibility to dominant carriers so that they can respond to increasing competition.

(33) In 1980, for example, the Commission, in the first of a series of orders in the *Competitive Carrier* proceeding, distinguished between carriers that possessed market power ("dominant carriers") and those that lacked it ("nondominant carriers"), and it found that "firms lacking market power simply cannot rationally price their services in ways which, or impose terms and conditions which, would contravene Sections 201(b) and 202(a) of the Act."[24] Accordingly, the Commission streamlined the regulation of nondominant carriers, including by eliminating rate regulation and streamlining tariff

[24] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor*, First Report and Order, 85 FCC 2d 1, 31 (1980) ("*Competitive Carrier First Report and Order*").

filing requirements.[25] In that order and subsequent orders in the *Competitive Carrier* proceeding, the Commission effectively found that competition would prevent nondominant carriers from offering terms or conditions that could violate Section 201.

(34) In 1991, the Commission, recognizing the need to allow AT&T to respond to increasing competition in the long-distance business market, streamlined the regulation of AT&T's interstate long-distance services for business customers.[26] Notably, although the Commission, in that order, did not find that AT&T lacked individual market power and did find that the long-distance market was "not perfectly competitive,"[27] it nevertheless concluded that competition for long-distance business services had developed to a sufficient extent that it made sense to streamline the regulation of certain of AT&T's business services.[28] Among other things, the Commission permitted AT&T and other interstate long-distance carriers to offer services pursuant to individually negotiated contracts (*i.e.*, to offer contract tariffs), which could include volume and term discounts like those under investigation here.[29] In 1995, the Commission reclassified AT&T as nondominant with respect to all domestic, interstate, interexchange, long-distance services.[30]

(35) In 1990, the Commission adopted price cap regulation for the largest incumbent local exchange carriers ("ILECs").[31] Because price-cap LECs were required to "offer all interstate special and switched access services at geographically averaged rates for each study area,"[32] the Commission, in the *Special Access Expanded Interconnection Order*[33] and the *Switched Transport Expanded Interconnection Order*,[34] allowed ILECs "to introduce density-zone pricing for high-capacity special

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[25] *Id.* at 31-37. Subsequently, the Commission announced a policy of permissive "forbearance," under which it would forbear from applying the tariff filing requirements of Section 203 to nondominant carriers. *See Competitive Carrier Second Report and Order*, 91 FCC 2d 59, 73 (1982); *Competitive Carrier Fourth Report and Order*, 95 FCC 2d 554, 557 (1983); *Competitive Carrier Fifth Report and Order*, 98 FCC 2d 1191, 1193, 1209 (1984). In 1985, the Commission decided to shift from "permissive" to "mandatory" forbearance, thus requiring detariffing by all nondominant carriers. *Competitive Carrier Sixth Report and Order*, 99 FCC 2d 1020, 1030-32 (1985). A federal court of appeals reversed this decision, holding that the Commission lacked statutory authority to prohibit the filing of tariffs, and in a subsequent appeal, the appellate court further found that the Commission lacked the authority at that time to allow permissive detariffing. *See MCI v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985); *AT&T v. FCC*, 1993 WL 260778 (D.C. Cir. 1993), *aff'd MCI v. AT&T*, 512 U.S. 218 (1994).

[26] *Competition in the Interstate Interexchange Marketplace*, Report and Order, 6 FCC Rcd 5880 (1991) ("*First Interstate Interexchange Competition Report*").

[27] *Id.* at 5881.

[28] *Id.* at 5882.

[29] *Id.* at 5897, 5899-5901. In addition, the Commission removed services that it found to be subject to substantial competition from price cap regulation (*i.e.*, eliminated rate regulation), reduced the notice period for tariff filings relating to those services; and eliminated the cost-support requirement for those tariffed services. *Id.* at 5894.

[30] *AT&T Reclassification Order*, 11 FCC Rcd 3271.

[31] *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786 (1990) ("*LEC Price Cap Order*").

[32] *Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221, 14229 (1999) ("*Special Access Pricing Flexibility Order*").

[33] *Special Access Expanded Interconnection Order*, 7 FCC Rcd 7369.

[34] *Switched Transport Expanded Interconnection with Local Telephone Company Facilities*, Second Report and Order, 8 FCC Rcd 7374 (1993) ("*Switched Transport Expanded Interconnection Order*").

access and switched transport services" in a study area under certain conditions, and "to offer volume and term discounts for special access and switched transport services upon specific competitive showings."[35] Thus, as with AT&T in the long-distance market, the Commission here recognized the need to allow price-cap incumbent LECs some flexibility to respond to increasing competition.

(36) In its 1999 *Pricing Flexibility Order*, the Commission gave price-cap LECs additional pricing flexibility with respect to special access services. With respect to the pricing flexibility that required a competitive showing, the Commission concluded that, upon satisfaction of the Phase I triggers, price-cap LECs should be permitted to offer "volume and term discounts to enable them to respond to competition."[36] The Commission further concluded that "the benefits of permitting volume and term discounts without requiring a cost-showing outweigh any possible costs," and accordingly, it did "not require that LECs demonstrate that the volume and term discounts they may offer at Phase I are cost-based."[37]

(37) In the *Pricing Flexibility Order*, the Commission thus recognized that: (1) incumbent LECs needed to be granted greater pricing flexibility to enable them to respond to competition (particularly where they were forced to price on a geographically averaged basis while competitors were likely to target low-cost areas);[38] and (2) while incumbents theoretically might try to use volume and term discounts to "lock in" customers, the presence of competition and sunk investment by competitors would reduce the likelihood of that occurring.[39]

(38) In August 2012, the Commission issued an order suspending its special access pricing flexibility rules on the basis that the rules were "not working as predicted," and that they "fail[ed] to reflect competition in today's special access markets."[40] Although the Commission found that the geographic area it had chosen as the basis for relief (the MSA) and the proxies it had chosen for competitive investment (fiber collocations) might not perfectly reflect actual market conditions, it notably did not find that incumbent LECs still possessed monopoly power in all the relevant markets that included special access services. Rather, it called for "a robust market analysis to assist us in determining how best to assess the presence of actual and potential competition for special access services that is sufficient to discipline prices."[41] Moreover, the Commission reaffirmed that it "continue[s] to strongly believe, consistent with the goals set forth in the *Pricing Flexibility Order*, that regulation should be reduced wherever evidence demonstrates that actual or potential competition

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[35] *Special Access Pricing Flexibility Order*, 14 FCC Rcd at para. 14.

[36] *Id.* at para. 124.

[37] *Id.* at para. 127.

[38] *See, e.g.*, *Access Charge Reform*, Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry, 11 FCC Rcd 21354, para. 182 (1996) ("*Access Charge NPRM and Third R&O*").

[39] *Special Access Pricing Flexibility Order*, 14 FCC Rcd at para. 125.

[40] *Special Access for Price Cap Local Exchange Carriers*, 27 FCC Rcd 10557, 10558 (2012) ("*Pricing Flexibility Suspension Order*").

[41] *Id.* at 10604.

is acting as a constraint to ensure just and reasonable rates, terms and conditions for special access services."[42]

IV. Term and volume discounts are commonly found in competitive markets and are generally viewed as mutually beneficial

A. The Verizon tariff plans designated for investigation

(39) Customers, including CLECs, that seek to purchase dedicated transmission services from Verizon have numerous choices. They can negotiate a commercial agreement for packet-based transmission services, like Ethernet. In many areas, they can negotiate a contract for the provision of dedicated TDM services, which Verizon would then file with the Commission as a contract tariff. Alternatively, they can take TDM special access services according to the terms of Verizon's generally applicable FCC tariff. If they choose the last option, they again have a number of choices. If they want to maintain maximum flexibility to add or remove circuits, they can pay the standard, undiscounted rate. Purchasing at standard, undiscounted rates does not require the buyer to make any volume or term commitment.[43] Or customers can take advantage of any of a variety of generally available, optional discount plans, including the four plans that have been designated for investigation. These optional discount plans offer purchasers a discount off the standard, undiscounted rates, but require them to make some sort of commitment in return (for example, in relation to the term of the contract or the term and volume). As is typical with contractual commitments, these plans generally impose various penalties if the buyer fails to live up to its term or volume requirement.

(40) In the *Special Access Tariff Investigation Order*, the Bureau designated four Verizon optional special access pricing plans for investigation – the Commitment Discount Plan ("CDP"), the National Discount Plan ("NDP"), the DS1 and DS3 Term Volume Plans ("TVP") and the Eight- and Ten-Year DS1 Term Volume Plans ("ETTVP"). All four optional pricing plans offer term or term and volume discounts with circuit portability. They all resemble a long-term contract for a particular volume, in that the buyer commits to maintain a certain level of demand for the period of the contract. They differ from traditional long-term contracts, however, in that they give the buyer some flexibility to vary demand or change (or port) circuits within its commitment level.

[42] *Id.* at 10559

[43] We understand that customers purchasing at Verizon's standard rates can disconnect a circuit after as little as one to three months without incurring early-termination fees. *See* Verizon FCC Tariff No. 14, § 3.2.4 (DS1, one month); Verizon FCC Tariff No. 1, § 7.4.4 (DS1, two months); Verizon FCC Tariff No. 11, § 7.4.4 (DS1 and DS3, three months).

(41) The CDP is a term plan with portability. The CDP has only one minimum commitment *level* (*e.g.*, 90% of the total number of channel terminations for DS1 and DS3 services purchased from Verizon at the time of subscription),[44] but it allows the customer to choose different commitment terms for different types of services.[45] For example, for DS1s, it allows the customer to choose among four different term commitments – two, three, five, or seven years.[46] Unlike a traditional term plan, it does not commit the customer to keep every circuit for the entire term of the agreement; rather, the customer commits only to keep the circuit for one year, and to maintain its commitment level for the term of the agreement. Thus, customers have significantly greater flexibility under the CDP than under traditional term agreements. The CDP also allows customers to vary their demand for circuits over the term of the agreement, from as little as 90% of initial period demand for DS1s and/or DS3s to 30% above the minimum commitment level, without incurring a shortfall or overage payment.

(42) The NDP is also a term plan with portability, but it differs in a number of respects from the CDP. First, unlike the CDP, the NDP offers only a single *term* option – a five-year term commitment.[47] On the other hand, the NDP, unlike the CDP, offers customers three options for commitment *levels* – 85%, 90% or 92% of initial period demand.[48] Moreover, the NDP allows customers to aggregate circuits and change the location and type of circuits throughout Verizon's footprint.[49] The exact level of the discount will depend on the customer's quantities of qualifying services, the commitment level (or commitment matrix) it chose, and the plan year. Finally, like the CDP, the NDP not only allows customers to change circuits (including changing the types of circuits it orders), but also to vary their demands over times. For example, if a customer chose an 85% commitment level, it could vary its demand from as little as 85% of initial period DS1 equivalent demand to up to 160% of initial period demand without incurring either a shortfall payment or having an upward adjustment in its minimum commitment level.

(43) The TVP offers discounts based on the customer's commitment to maintain certain terms *and* volumes. For example, in the case of the DS1 TVP, a customer can choose a term commitment ranging from one year to five years.[50] It can also choose from among nine different volume threshold levels.[51] The discounts will increase with the length of the commitment term and the volume

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[44] FCC No. 1, Section 25.1.3(C)(4)

[45] *Id.* at Section 25.1.4(D). As with the other plans, there is also a minimum commitment period for each circuit of 1 year. *Id.* at Section 25.1.12.

[46] *Id.* at Section 25.1.4(B).

[47] FCC No. 1, Section 25.3.1(B)(23)

[48] *Id.* at Section 25.3.1(C). The NDP also contains a 1 year commitment period for each specific circuit ordered. FCC No. 1, Section 25.2.8.

[49] FCC No. 1, Section 25.3.1

[50] FCC No. 14, Section 5.6.14(A).

[51] *Id.* at Section 5.6.14(D). The plans require a minimum commitment term for each circuit ordered – 1 year for the DS3 TVP and 1 month for the DS1 TVP. FCC No. 14, Sections 3.2.4 & 5.6.19(M)

commitment. A shortfall payment will apply if the customer's demands fall below 97% of the initial period demand.

(44) The ETTVP offers discounts on the customer's commitment to maintain certain terms and volumes.[52] Customers can choose one of five volume threshold levels and a term commitment of 8 or 10 years.[53] The discounts increase with the length of term commitment and the volume threshold. A shortfall payment will apply if the customer's demand falls below 90% of the initial period demand,

(45) None of the four pricing plans under investigation requires the customer to purchase exclusively from Verizon. Nor do the plans require customers to purchase a particular percentage of their total demand from Verizon, as market share discounts do. Rather, the plans are optional, and the commitment levels are based on a percentage of the initial Verizon purchases when the customer subscribed to the plan, and that is completely within the choice of the customer. In addition, customers are not required to renew the plans or to renew them at the same levels. For example, we were informed that, <<

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B. Term and volume discounts are commonplace and generally viewed as mutually beneficial

(46) Term and/or volume discounts are common in many industries, including many competitive industries. For example, real estate owners frequently offer a discount if a tenant agrees to a longer term lease; car rental companies offer lower rates for week- or month-long rentals; parking garages offer cheaper rates for monthly contracts compared to hourly rates; home security services offer discounts for multi-year commitments; and magazines offer significant discounts for multi-year subscriptions. Volume discounts are similarly pervasive. In consumer goods, buyers frequently can obtain a discount if they are willing to buy a case of beer, rather than a six-pack or a bottle, or a multi-pack of paper towels rather than a single roll. Clothing stores offer 2-for-1 sales. Loyalty discounts, such as programs that reward frequent patronage of a store or usage of a good or service, are also commonplace.[54]

(47) Volume and term discounts are also commonplace in telecommunications and media markets. For example, in the mobile wireless industry, customers frequently receive discounts when they purchase larger buckets of data, and, although most plans currently offer unlimited talk, wireless customers can

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52 FCC No. 14, Section 5.6.14(A).

53 FCC No. 14, Section 5.6.14(D).

54 We note that the phrase "loyalty discounts" has been used to refer to different types of discount agreements. *See* note 108 *infra*.

still find less expensive pre-paid plans that offer discounts on larger buckets of limited voice minutes. Wireline broadband providers likewise frequently offer discounted or free equipment and/or discounted monthly charges when customers commit to a multi-year agreement. And Netflix and Apple Music offer family plans that provide an effective discount for families that want to watch or listen to programming on multiple devices at the same time. Furthermore, it is our understanding that competitive LECs, some of whom are complaining in this docket, offer similar volume and term discounts on dedicated transmission services sold to business customers.[55]

(48) Not only are volume and term discounts pervasive, but they also are generally viewed as beneficial to both the buyer and seller.[56] The seller may benefit by aligning prices more closely with costs, or simply by gaining profitable sales from rivals by offering a more attractive package. Buyers gain lower prices in return for providing more certainty to the seller.

(49) With respect to term discounts in particular, term commitments with early termination fees can benefit both the buyer and the seller. The buyer benefits from lower prices associated with a longer term commitment and from an assurance of a continued provision of service for the term of the contract. With a longer contract term, the buyer may also benefit from the seller's being able to spread any upfront, nonrecurring costs (such as the cost of provisioning a circuit) over a longer period, thus allowing it to reduce the monthly rate or initial nonrecurring charge. The seller benefits from a reduced risk of opportunistic behavior. For example, to the extent that the seller has to make sunk investments in provisioning the circuits, the term commitment reduces the likelihood that the buyer subsequently will try to engage in hold-up and demand a lower price once the seller has made its sunk investment.[57] The term commitment also can assist the seller in planning its investment or

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55 *See, e.g.* Letter from David L. Lawson to Marlene H. Dortch, WC Docket No. 05-25 at 2-3 (Mar. 28, 2012) ("[T]he few responses to the Commission's most recent data requests confirm that competitive providers also offer volume and term discounts when they sell DS1, DS3 and Ethernet services."); *see also Special Access Data Collection Reconsideration Order*, 29 FCC Rcd at 10916 (Questions II.A.17-19) (seeking information on CLEC terms and conditions and business justifications therefor)..

56 In its *Special Access Tariff Investigation Order*, the Bureau analogizes the volume and term discounts under investigation to exclusive dealing arrangements, contracts that reference rivals, and loyalty discounts. In the next section, we explain how volume and term discounts differ from these other conditional pricing provisions in certain important respects and why they are likely to be less competitively problematic because of those differences. Nevertheless, to the extent that the Bureau sees similarities between volume and term discounts and these other conditional pricing provisions, it is worth pointing out that economists have identified numerous benefits associated with both exclusive dealing arrangements and loyalty discounts. *See, e.g.*, J. Mark Ramseyer & Eric B. Rasmusen, *Exclusive Dealing: Before, Bork, and Beyond*, 57 J. L. & ECON. S145 (2014); Benjamin Klein, *Exclusive Dealing As Competition for Distribution "On the Merits,"* 12 GEO. MASON L. REV. 119 (2003); Benjamin Klein & Andres V. Lerner, *The Expanded Economics of Free-Riding: How Exclusive Dealing Prevents Free-Riding and Creates Undivided Loyalty,* 74 ANTITRUST L. J. 473 (2007); Howard Marvel, *Exclusive Dealing,* 25 J. L. & ECON. 1 (1982); Francine Lafontaine & Margaret Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy in* HANDBOOK OF ANTITRUST ECONOMICS 391, 408 (Paolo Buccirossi ed., 2008); James C. Cooper, Luke M. Froeb, Dan O'Brien & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference,* 23 INT'L J. INDUS. ORG. 639 (2005).

57 "Hold up" refers to a situation where, after a seller makes a customer-specific sunk investment, the buyer may attempt to "hold up" the seller by threatening to stop purchasing from the seller unless the seller agrees to a lower price. *See* Benjamin Klein, *supra* note 56 at 139-40 (2003). *Cf.* Paul L. Joskow, *Contract Duration and Relationship-Specific Investments: Empirical Evidence from Coal Markets*, 77 AM. ECON. REV. 168, 184 (1987) (finding that, as relationship-specific investments become more important, parties will tend to "rely on longer-term contracts that specify the terms

allocating capacity. These types of contract terms also can intensify competition on price, and the terms of the contracts themselves may be a form of competition.

(50) Similarly, contracts containing volume as well as term commitments are also mutually beneficial. Such contract terms reduce the number of contracts that must be executed and thus reduce transactions costs, permit nonrecurring costs to be recovered over a longer period, reduce uncertainty, (including by limiting the possibility of *ex post* opportunistic behavior), help realize economies of scale, and assist the seller in making appropriate investments in, and allocations of, capacity.

(51) Commitment devices, such as early termination fees, shortfall payments, and overage provisions are generally necessary to support the efficiencies of volume and term discounts by providing incentives for parties to comply with the terms of the agreement, thereby increasing certainty, reducing potential costs to Verizon resulting from opportunistic behavior, and preventing contractual hold-ups. Provisions specifying penalties for breach of contractual commitments are nearly universal in commercial contracts, and generally are regarded as enhancing efficiency.

(52) The volume and term provisions of the four Verizon plans under investigation, which buyers can choose from among a range of purchase options from Verizon, would similarly appear to benefit both Verizon and the customers who subscribe to them in the ways discussed above. They reduce uncertainty as well as transaction costs to both buyer and seller that would result from repeated contracting for shorter terms. They benefit customers through lower rates, but have an advantage over traditional term discounts in that they allow customers the flexibility to move circuits or, in the case of the NDP and CDP, to change the type of circuits over time. They also appear to be similar to volume and term provisions that the FCC has approved in previous decisions.

(53) In its *Special Access Tariff Investigation Order*, the Bureau correctly points out that the Commission previously expressed a concern "about *dominant* carriers offering their services on terms and conditions that weaken or harm the competitive process sufficiently to reduce consumer welfare."[58] However, the Commission also has recognized the potential benefits of volume and term discounts as well as contract tariffs, even when offered by a carrier with substantial market power. For example, in the *Special Access Expanded Interconnection Order*, the Commission found that "reasonable volume and term discounts can be a useful and legitimate means of pricing special access services to recognize the efficiencies associated with larger volumes of traffic and the certainty of longer term

and conditions of repeated transactions *ex ante*, rather than relying on repeated bargaining.").

58 *Special Access Tariff Investigation Order*, at para. 19 (citing *Special Access Rates for Price Cap Local Exchange Carriers*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994, at para. 115 (2005) ("*Special Access NPRM*"))(emphasis added)). As discussed below, although Verizon and the other price-cap carriers are still *classified* as dominant, neither the Commission nor the Bureau has conducted a systematic market analysis to determine whether Verizon and the other carriers subject to investigation possess substantial market power in the relevant markets that include special access services.

deals."[59] And in the *Access Reform* proceeding, the Commission proposed to eliminate "four significant regulatory constraints when an incumbent LEC can demonstrate that it faces *potential* competition for interstate access services in specific geographic areas," including the ban on volume and term discounts.[60] In explaining the reasons for this tentative conclusion, the Commission stated:

> Removing these restraints should permit LECs greater ability to price economically and therefore bring more competitive pressures, including lower prices, in areas and for services where we expect competitive forces initially to be strongest. Such reforms would have the goal of fostering efficient and effective competition, to the benefit of customers, wherever possible. Without such reform, continuing uneconomic regulation may serve primarily to permit inefficient new entrants to gain market share among the most attractive customers rapidly.[61]

(54) Earlier, the Commission had proposed to permit interexchange carriers to "offer large business users the option of obtaining services under contract."[62] Several of the reasons the Commission gave for allowing contract offerings apply equally to term and volume discounts. For example, the Commission explained:

> [C]ontracts could facilitate planning by users and IXCs alike through the greater availability of long-term commitments and price protection. Long-term commitments would benefit carriers in their network planning and their allocation of network resources, and users, who may prefer long-term rate commitments to the uncertainties of the tariff process. . . . [C]ontracts would permit the realization of economic efficiencies. To the extent that carriers are able to share with individual customers efficiencies that accrue from particular customer commitments, carriers can encourage the more efficient use of their facilities. In addition, permitting carriers to offer discounts to win business that they might otherwise lose to a competitor will result in lower prices for consumers.[63]

(55) Following the release of the 1990 NPRM, the Commission issued an order allowing AT&T to "offer contract rates for services subject to further streamlining," despite the fact that AT&T was still classified as a dominant carrier and that the Commission did not find that AT&T lacked market power.[64] The Commission concluded that "allowing AT&T greater freedom to enter into contracts

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59 *Special Access Expanded Interconnection Order*, 7 FCC Rcd at para. 199.

60 *Access Charge NPRM and Third R&O*, 11 FCC Rcd at para. 168 (emphasis added).

61 *Id.*

62 *Competition in the Interstate Interexchange Marketplace*, Notice of Proposed Rulemaking, 5 FCC Rcd 2627, para. 128 (1990).

63 *Id.*

64 *First Interstate Interexchange Competition Report*, 6 FCC Rcd at para. 102.

with customers for these business services will benefit consumers without increasing the risk of anticompetitive or other undesirable behavior by AT&T."[65]

(56) Since adoption of the *Special Access Pricing Flexibility Order*, the Commission has only once found a special access volume or term discount plan to be unlawful, and in that case the D.C. Circuit Court of Appeals reversed the Commission's decision. In *AT&T Corp. v. BellSouth Telecommunications*, the Commission found that a term and volume plan offered by BellSouth, which required buyers to maintain purchases at levels no lower than 90 percent of the base period demand, violated the nondiscrimination requirement of Section 272.[66] In reversing the Commission's determination that the term and volume commitment was unlawful, the court of appeals observed that the tariff plan "is most naturally viewed as a bargain containing terms that both benefit and burden its subscribers," and it found that the Commission "failed to show that the large, established companies were at all harmed by the 90% commitment requirement, much less that the relative harm to them exceeded the relative benefits."[67]

(57) Thus, although the Commission in the past has expressed concern that volume and term discounts, when offered by firms possessing market power, may harm competition under certain conditions, it also has recognized that volume and term discounts frequently benefit consumers and competition, even when offered by dominant carriers. Furthermore, the fact that so many of the firms that offer volume and term discounts operate in competitive markets with no possibility of achieving market power suggests that these terms often promote, rather than undermine, competition.[68] This suggests that volume and term discounts and the associated terms that help enforce these contractual commitments are not inherently anticompetitive or anticonsumer. Thus, before condemning what typically are mutually beneficial and efficiency enhancing contract terms, the Bureau should take care to determine whether Verizon and the other price-cap carriers subject to investigation possess substantial market power in the relevant markets containing special access services, and in addition, to identify any other necessary market conditions which might cause such generally beneficial terms and conditions to prove anticompetitive.

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65 *Id.*

66 *AT&T Corp. v. BellSouth Telecomm.*, 19 FCC Rcd 23898 (2004).

67 BellSouth Telecomm. v. FCC, 469 F.3d at 1060.

68 *Cf.*, Louis Kaplow & Carl Shapiro, *Antitrust* in 2 HANDBOOK OF LAW AND ECONOMICS 1073, 1209 (A. Mitchel Polinsky & Steven Shavell eds., 2007) ("That exclusive arrangements can promote efficiency may be inferred from their use in situations where meaningful market power is clearly absent . . . .").

V. Anticompetitive conditional pricing provisions can only be identified through a complete market analysis

(58) In the *Special Access Tariff Investigation Order,* the Bureau quotes a 1992 Commission order to the effect that "certain long-term access arrangements . . . tend to 'lock up' the access market,"[69] and it claims that this assertion is consistent with the economic literature and antitrust precedent.[70] In this section, we address this claim. We discuss the economics literature cited by the Bureau and suggest what lessons can be learned from it. We also discuss the relevant antitrust precedent and what that suggests for how the Bureau should approach this tariff investigation.

A. The economics literature on conditional pricing suggests that such provisions will have anticompetitive effects only under certain limited circumstances

(59) In its 1949 *Standard Stations* decision,[71] the Supreme Court adopted what has been referred to as the "quantitative substantiality" test.[72] In that decision, the Court, while acknowledging that exclusive dealing contracts "may well be of economic advantage to buyers as well as to sellers, and thus indirectly of advantage to the consuming public,"[73] nevertheless took a hostile approach to evaluating exclusive contracts, and it concluded that Section 3 of the Clayton Act "is satisfied by proof that competition has been foreclosed in a *substantial share* of the line of commerce affected."[74] Under that standard, the Supreme Court went on to find that Standard Oil's exclusive dealing contracts violated Section 3 even though they affected just 6.7 percent of the relevant geographic market. Similar contracts entered into by Standard Oil's competitors covered another 42.4 percent of sales.[75] The *Standard Stations'* quantitative substantiality test subsequently was relied on by lower courts as they routinely condemned exclusive dealing arrangements.[76]

(60) In 1978, Robert Bork presented an influential critique of the *Standard Stations* decision in *The Antitrust Paradox.* There, Bork, in arguing for the efficiency of exclusive dealing arrangements, pointed out that a seller must offer something of value to a buyer (such as a lower price) to induce the buyer to accept the exclusivity commitment, and for the seller to make that offer, it must expect that

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69 *Special Access Tariff Investigation Order*, at para. 19 (quoting *Special Access Expanded Interconnection Order*, 7 FCC Rcd at para. 201).

70 *Id.*

71 Standard Oil Co. (Cal.) v. United States, 337 U.S. 293 (1949).

72 *See* Jonathan Jacobson, *Exclusive Dealing, "Foreclosure," and Consumer Harm*, 70 ANTITRUST L. J. 311, 321 (2002).

73 Standard Oil Co. (Cal.) v. United States, 337 U.S. at 306.

74 *Id.* at 314.

75 *Id.* at 295, 314.

76 Jacobson, *supra* note 72 at 321.

the arrangement will create efficiencies that justify that offer.[77] Others in the "Chicago School" have further argued that buyers would be unwilling to accept an exclusive dealing arrangement if they believed that it would result in anticompetitive exclusion, unless the seller adequately compensated the buyers for the lost consumer surplus from having fewer options.[78] Since the seller's increase in profit from exclusive dealing, absent efficiencies, will be less than the buyer's loss of consumer surplus (due to the deadweight triangle loss of surplus), the seller generally will not be able to adequately compensate the buyer.[79]

(61) Since publication of Bork's *Antitrust Paradox*, economists have developed a number of models that identify specific cases where exclusive contracts, exclusive dealing arrangements, or other contractual provisions referencing rivals become a profitable "exclusionary" strategy. These models, as Professor Whinston points out, generally involve a contract between two parties that imposes some sort of externality on third parties that reduces their competitive vitality.[80] The models depend on certain assumptions – such as the exact form of competition upstream and downstream, asymmetries between incumbents and rivals, or the existence of economies of scale – whose validity depends on the particular characteristics of the markets and industries involved. One therefore must take care in making broad assertions based on any particular model of exclusionary exclusive contracting.[81]

(62) Given the stylized facts and necessary simplifying assumptions contained in these models, economists, including several who authored the models, have urged caution in using them to

77 *See* ROBERT BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 309 (1978).

78 *See* Louis Kaplow & Carl Shapiro, *supra* note 68 at 1203.

79 *See, e.g.,* Ramseyer & Rasmusen, *supra* note 56 at S148 ; MICHAEL D. WHINSTON, LECTURES ON ANTITRUST ECONOMICS 136-39 (2006). Professor Whinston goes on to explain that "as long as B [the buyer] and I [the incumbent seller] bargain under complete information, we expect them to reach an agreement that maximizes their joint payoff, regardless of how their respective bargaining powers and positions affect the split of this joint payoff." *Id.* at 138-39.

80 *Id.* at 140 ("These models [that show that exclusive dealing can be a profitable exclusionary strategy] all have the feature that some form of externality arises from an exclusive contract signed by two parties onto other individuals, and this externality makes the contract jointly optimal for the contracting parties."); *see also* B. Douglas Bernheim & Randal Heeb, *A Framework for the Economic Analysis of Exclusionary Conduct*, in 2 OXFORD HANDBOOK OF INTERNATIONAL ANTITRUST ECONOMICS 8 (2015) (The mechanism of concern is most easily illustrated by a model in which "one customer's decision to enter into an exclusionary arrangement with the market leader reduces the benefits that *other* customers can expect to derive from vendor competition. In the language of economists, this effect is an example of a 'negative contracting externality' . . . -that is, an adverse effect that one party experiences due to the nature of a contract between other parties.").

81 As Fiona Scott-Morton points out, certain contracts that reference rivals ("CRRs"), including exclusive contracts, may cause anticompetitive effects through collusion or softening of competition rather than through exclusion. For example, a pattern of MFN agreements or price-matching polices may increase market prices without causing exclusion. *See, e.g.,* Fiona Scott-Morton, *supra* note 4 at 75; Steven C. Salop, *Practices that (Credibly) Facilitate Oligopoly Co-ordination*, *in* NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE 265 (Joseph E. Stiglitz & G. Frank Mathewson eds., 1986); Aaron S. Edlin & Eric R. Emch, *The Welfare Losses From Price-Matching Policies*, 47 J. INDUS. ECON. 145 (1999); Einer Elhauge, *How Loyalty Discounts Can Perversely Discourage Discounting*, 5 J. OF COMPETITION L. & ECON. 189 (2009). From the summary of the CLEC allegations contained in the Bureau order, it does not appear that the CLECs are suggesting that the terms and conditions under investigation are causing collusion or softening competition. And if they were, the appropriate response would be for the Commission to launch a rulemaking proceeding to consider whether to generally prohibit such terms and conditions by all providers of dedicated transmission services, and not investigate the tariffs of four individual LECs.

condemn exclusive contracts, tying arrangements, and other potentially exclusionary practices under the antitrust laws.[82] Results can change significantly if certain key assumptions are changed.[83] In addition, these exclusionary models generally do not consider efficiency motivations for exclusionary practices.[84] Also, even within the context of the models, they often do not consider the full welfare implications of the practices. For instance, many of these models, while analyzing the likelihood of entry, do not consider the welfare implications of the exclusive contracts.[85]

(63) The above caveats must be considered when interpreting models of exclusionary, conditional pricing arrangements. In addition, when determining the applicability of these models to any particular situation, it is important to keep in mind certain common characteristics of firms and markets in the models that drive the results. First, these models generally assume that the seller offering the conditional pricing provision is an incumbent, monopoly provider. Second, as the Bureau recognized, many of the models assume that there exist economies of scale in the market and that there exists a minimum efficient scale that an entrant must achieve in order to enter and compete profitably in the market. [86] Third, the models generally assume that the rival must be substantially foreclosed for

[82] *See, e.g.,* Michael D. Whinston, *Tying, Foreclosure, and Exclusion*, 80 AMER. ECON. REV. 837, 855-856 (1990) ("While the analysis vindicates the leverage hypothesis on a positive level, the normative implications are less clear. Even in the simple models considered here, which ignore a number of other possible motivations for the practice, the impact of this exclusion on welfare is uncertain. This fact, combined with the difficulty of sorting out the leveraged-based instances of tying with other cases, makes the specification of a practical legal standard extremely difficult."); Dennis Carlton & Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries* at 37 (NBER Working Paper No. 6831, 1998) ("It would be a grievous mistake to condemn such strategic behavior and attempt to use the antitrust laws to condemn it without an analysis of the welfare consequences of such behavior and without an analysis of the likelihood of being able to correctly identify such behavior without simultaneously condemning welfare enhancing behavior. Too often in the past, antitrust advocates have confused the theoretical possibility of harm with an empirical demonstration of such a harm.").

[83] For example, Segal and Whinston develop a model in which an incumbent seller can successfully use exclusive contracts with final customers to deter entry. Ilya R. Segal & Michael D. Whinston, *Naked Exclusion: Comment*, 90 AMER. ECON. REV. 296 (2000). Fumagalli and Motta modify the Segal and Whinston model by treating the buyers as homogeneous Bertrand competitors (rather than final customers) and assuming that these buyers must pay a fixed fee to participate in the downstream market. Chiara Fumagalli & Massimo Motta, *Exclusive Dealing and Entry, when Buyers Compete*, 96 AMER. ECON. REV. 785 (2006. Because under the Fumagalli-Motta model, a single buyer who refuses an exclusive contract could expand sales sufficiently to permit the entrant to reach minimum efficient scale, they suggest exclusive contracts are a more effective exclusionary technique where the buyers are final consumers, rather than distributors. Simpson and Wickelgren, modifying the Fumagalli and Motta model so as to allow buyers to breach their contracts and pay expectation damages, argue that this change in assumptions will generate the opposite results from Fumagalli and Motta. Under this assumption, "[w]hile an incumbent generally cannot use exclusive contracts to monopolize a market when buyers are final consumers, an incumbent monopolist generally can use exclusive contracts to monopolize a market when buyers are intense competitors in that market." John Simpson & Abraham L. Wickelgren, *Naked Exclusion, Efficient Breach, and Downstream Competition*, 97 AMER. ECON. REV. 1305, 1306 (2007).

[84] *See, e.g.,* Derek W. Moore & Joshua D. Wright, *Conditional Discounts and the Law of Exclusive Dealing*, 22 GEO. MASON L. REV. 1205, 1216 (2015) ("A handful of conditions are common to most if not all of these . . . models . . . [including] vertical contracts are generally assumed not to generate efficiencies . . . .")

[85] The welfare analysis of exclusive dealing is complicated because some profitable entry may be inefficient. *See* Kaplow & Shapiro, *supra* note 68 at 1206-07. In addition, in some models where sellers compete for exclusives, this competition can intensify competition, which can lead to lower prices. *See, e.g.*, Cooper *et al.*, *supra* note 56 at 647 & n.24.

[86] We acknowledge that there are some models that do not require the existence of economies of scale, but we think that those models do not focus on *exclusion* as is alleged here. For example, in the Aghion and Bolton model cited by the Bureau, the exclusive contract does not necessarily exclude a potential competitor, but rather provides a mechanism

exclusion to be successful.[87] These assumptions must be compared to the facts on the ground in order to determine the applicability of these models to any particular situation. For instance, if the Bureau concludes that Verizon lacks substantial market power, or that rivals are not substantially foreclosed, then the Bureau should find that the terms and conditions under investigation are unlikely to have adverse competitive effects and thus conclude that they comply with Section 201.

(64) Papers by Rasmusen, Ramseyer and Wiley and by Segal and Whinston,[88] which the Bureau cites,[89] focus on exclusive contracts with final customers that result in potential entrants not being able to achieve minimum efficient scale. This exclusion of potential entrants as a result of customers locking

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whereby the incumbent and buyer can extract any surplus from the more-efficient entrant if the buyer breaches the contract and purchases from the entrant. Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, AMER. ECON. REV. 388 (1987); *see generally* WHINSTON, *supra* note 80 at 143 (The "Aghion and Bolton model . . . is not a good model of complete exclusion that occurs with exclusive contracts. The reason is that the whole point of Aghion and Bolton's stipulated damage contract is to extract some of E's [the entrant's] profit; if E never enters, then there is no profit to extract."). Similarly, in the Elhauge and Wickelgren model, the harm arises not from exclusion primarily, but from softening of competition, which results from the fact that the loyalty discount is calculated in reference to the price charged to free/ non-loyal customers. This makes it more expensive for the incumbent to compete for these free customers, thus softening competition. The special access market does not follow the assumptions of this model, in that incumbents can compete for free customers by offering a wide variety of different pricing plans, and discounts offered to free customers are not necessarily passed through to loyal customers. Einer Elhauge & Abraham L. Wickelgren, *Robust Exclusion and Market Division through Loyalty Discounts* (Harvard Public Law Working paper Apr. 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2419722.

[87] *See, e.g.*, Moore & Wright, *supra* note 84 at 1216 (2015) ("A handful of conditions are common to most if not all of these . . . models: (1) vertical contracts are generally assumed not to generate efficiencies; (2) economies of scale or scope are required; and (3) a rival must be substantially foreclosed. . ."); Ramseyer & Rasmusen, *supra* note56. at S153("[N] naked exclusion works only if supplier 1 can foreclose a large enough fraction of the market to deny competitors the minimum efficient scale. If sufficient suppliers remain to serve those retailers who refuse the contract, naked exclusion fails."); KAPLOW & SHAPIRO, *supra* note 68 at 1203 ("Anticompetitive exclusion most plausibly arises when [a manufacturer] requires its dealers to purchase only from itself, these dealers constitute a large proportion of the market, and profitable entry or continued survival requires the rival to achieve a scale greater than is possible if sales must be limited to dealers not subject to exclusive-dealing contracts."); Hans Zenger, *Loyalty Rebates and the Competitive Process*, 8 J. OF COMPETITION L. & ECON. 717, 749 (2012) ("Exclusionary conduct can sometimes be profitable for a dominant firm, especially in industries where dominance is very pronounced and where scale economies are significant. If a dominant firm is in a position to foreclose such a substantial part of the market that the output of smaller competitors is suppressed below the minimum efficient scale of production, retroactive rebates can cause anticompetitive harm by jeopardizing the viability of the dominant firm's competitors."); Benjamin Klein, *supra* note 57 at 122 ("Anticompetitive exclusive dealing requires foreclosure of a sufficient share of distribution so that a manufacturer's rivals are forced to operate at a significant cost disadvantage for a significant period of time. In particular, if exclusive contracts foreclose a sufficient share of distribution to rivals for a significant time so that what remains to serve competitors cannot support a manufacturer of minimum efficient scale, the exclusive will force existing competitors and potential new entrants to operate at a cost disadvantage. The exclusives then may have the effect of driving out and/or preventing entry of manufacturing competitors until sufficient distribution becomes available."); Joshua Wright, *Moving Beyond Naïve Foreclosure Analysis*, 19 GEO. MASON L. REV. 1163, 1166 (2012) ("The unifying economic logic of these models is that the potential entrant (or current rival) could, absent the exclusionary contracts, attract a sufficient mass of retailers to cover its fixed costs of entry, but that the monopolist's contracts with retailers prevent the potential entrant from doing so. A consensus has emerged that a necessary condition for anticompetitive harm arising from allegedly exclusionary agreements is that the contracts foreclose rivals from a share of distribution sufficient to achieve minimum efficient scale ("MES")").

[88] Eric B. Rasmusen, J. Mark Ramseyer & John S. Wiley, Jr., *Naked Exclusion*, 81 AMER. ECON. REV. 1137 (1991); Segal & Whinston, *supra* note 83; Eric B. Rasmusen, J. Mark Ramseyer, & John S. Wiley, Jr., *Naked Exclusion: Reply*, 90 AMER. ECON. REV. 310 (2000). As noted above, the results of these models may change if one changes some of the assumptions. *See supra* note 83

[89] *Special Access Tariff Investigation Order* at n.54.

themselves into exclusive contracts resembles some of the allegations raised by the CLECs, though those authors model fully exclusive contracts, which are not present in the pricing plans under investigation. The models those authors present show that, under certain circumstances, it is profitable for an incumbent monopolist to employ exclusive contracts to deter entry. The models demonstrate that, where the market exhibits economies of scale of a particular form, and the incumbent seller can either discriminate among buyers or approach them in a sequential order, then the incumbent can profitably employ exclusive contracts to deter entry of a rival.[90] They also show, however, that if the incumbent must negotiate simultaneously with buyers and the buyers can coordinate, then the incumbent may not be able to exclude the entrant.[91] These models overcome the Chicago School critique because the exclusion increases the surplus of both contracting parties, so the seller is able to adequately compensate the buyer for accepting the exclusion. They fit the framework described by Whinston because the contracting parties exert a negative externality on non-contracting firms that increases the joint surplus of the contracting parties.

(65) There are clear limits to the applicability of these models to this case, however. Like many economic models, they describe a particular static framework in which the profits and payoffs from particular actions are predictable and stable. This seems unlikely to accurately describe the dynamics of the telecommunications services at issue, where innovation and rapidly evolving demands are rendering (if they have not already rendered) TDM technology obsolete. Also, the results depend on the existence of economies of scale, which makes the potential entrant's entry decision depend on the availability of other buyers (*i.e.*, the entrant can only achieve minimum efficient scale if more than one buyer refuses the incumbent's exclusive contract). The successful expansion of cable companies into enterprise services markets and the successful *de novo* entry of smaller, full facilities-based CLECs, like LightTower, FPL Fibernet, and others, suggest that the minimum efficient scale in this case is significantly smaller than the uncommitted demand in the market. In addition, in order to ensure an exclusionary equilibrium, Segal and Whinston require that the incumbent be able either to discriminate among buyers or to negotiate sequentially with them. Given the tariffing and nondiscrimination requirements imposed on price-cap LECs, this level of discrimination among buyers does not fit the markets at issue. The models further assume that entry is only a one-time possibility. In the telecommunication markets at issue, however, entry has already occurred and is occurring, and the threat of entry is continuous. Finally, these papers model the effects of pure exclusive contracts, where a buyer agrees to purchase exclusively from the incumbent seller. In contrast, the Verizon terms and conditions under investigation are much less restrictive; they simply commit the customer to purchasing a specified percentage of the customer's base period demand for a specified period. The terms do not prevent the customer from dealing with the seller's rivals, nor do they commit the customer to purchasing a specified percentage of its total needs from the seller

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90 Segal & Whinston, *supra* note 83 at 296-97, 299-302.

91 *Id.* at 298-99.

(66) The second CLEC complaint identified by the Bureau – that CLECs themselves are locked into the pricing plans under investigation – does not find support in the literature cited by the Bureau. In the models cited by the Bureau, an exclusive contract between a buyer and seller leads to foreclosure of a third party such as a potential competing seller in the Segal and Whinston model. The anticompetitive harm results from the fact that the buyer does not consider the contracting externalities before choosing an exclusive contract. The CLECs, however, appear to be complaining that they, as the potential entrants, have been forced to accept the exclusive contract. But they are the parties that would be adversely affected by foreclosure, and they fail to explain, why, when faced with a range of options, including self-supply, purchase from third parties, or a whole range of options from the ILEC, they do not choose the option that is most efficient for them. They further fail to explain why, when presented with the option of purchasing at standard, undiscounted rates, which rates presumptively are just and reasonable, they would choose an anticompetitive, and unjust and unreasonable option.

(67) Empirical studies of exclusive contracts and vertical restraints have found that efficiencies are an important rationale for vertical restraints, and that they seem to be more common than anticompetitive effects. These studies provide little support for the proposition that exclusive contracts and other vertical restraints commonly harm competition or consumers. For example, Cooper, *et al.*, after reviewing empirical studies of the competitive effects of vertical integration and vertical restrictions, find:

> In reviewing this literature, two features immediately stand out: First, there is a paucity of support for the proposition that vertical restraints/vertical integration are likely to harm consumers. Of all the studies [reviewed here], only one . . . , a study of vertical integration between cable television franchises and cable programmers) purports to find unambiguously an instance where vertical integration was harmful to consumers. And in this instance, the losses are minuscule ($0.60 per cable subscriber per year). Second, a far greater number of studies found that the use of vertical restraints in the particular context studied improved welfare unambiguously (i.e., resulted in lower prices and larger quantities).
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> More specifically, the studies [reviewed here] appear to provide strong support for the proposition that vertical integration/vertical restraints often help solve double markup problems, and/or reduce costs in other ways.[92]

They summarize their findings as follows:

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[92] Cooper, *et al.*, *supra* note 56 at 648.

> Overall, we would characterize the empirical literature on vertical restraints/vertical integration as follows:
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> - Most studies find evidence that vertical restraints/vertical integration are procompetitive;
> - This efficiency often is plausibly attributable to the elimination of double-markups or other cost savings;
> - A number of studies also find evidence consistent with "dealer services" efficiencies;
> - Instances where vertical controls were unambiguously anticompetitive are difficult to find.[93]

(68) Similarly, Lafontaine and Slade, after reviewing empirical studies of exclusive dealing and other vertical restrictions, conclude:

> In general, the empirical evidence leads one to conclude that consumer well-being tends to be congruent with manufacturer profits, at least with respect to the voluntary adoption of vertical restraints. When the government intervenes and forces firms to adopt (or discontinue use of) vertical restraints it tends to make consumers worse off.
>
> We conclude that while there are clearly limitations to the set of available studies in terms of techniques used, industry coverage, and ability to interpret findings, the empirical evidence is consistent and convincing. Taken at face value, [the studies reviewed] indicate that vertical restraints in manufacturer/retailer settings are publicly desirable when privately desirable, and thus government intervention is not warranted in those situations. This is not to say that their use should never be questioned, but the presumption should not be that they are detrimental to consumers.[94]

(69) Both the theoretical and empirical literature on conditional pricing provisions thus suggest that one generally should be cautious in condemning vertical restrictions, including conditional pricing provisions. The facts of the markets and pricing provisions at issue seem particularly noncongruent with the assumptions of the cited models. Thus, the Bureau should require a clear and strong showing that competitors have been forced from the market or deterred from entering and that prices to consumers have risen significantly before concluding that the practices at issue violate Section 201. As discussed in the next section, antitrust precedent supports such a cautious approach and provides additional reasons for exercising care and applying a full "Rule of Reason" analysis.

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93 *Id.* at 658.

94 Lafontaine & Slade, *supra* note 56 at 408.

B. Existing antitrust precedent also finds conditional pricing provisions problematic only under certain limited conditions and thus applies a "Rule-of-Reason" analysis

(70) Challenges to exclusivity arrangements and loyalty discounts can be brought under Sections 1 or 2 of the Sherman Act and Section 3 of the Clayton Act.[95] Because these contractual provisions can generate efficiencies, they are reviewed under the Rule of Reason.[96] We do not attempt an in-depth survey of this area of antitrust law here, but rather make just a few points that we believe are relevant to the Commission's review of the tariff provisions under investigation.

(71) First, with respect to exclusive contracts, including exclusive-dealing arrangements, courts require plaintiffs to define the relevant product and geographic markets in order to assess the seller's position in the upstream market, the extent of foreclosure, and possible adverse effects on competition.[97] Such an analysis involves careful consideration of potential substitutes to the product at issue along with the relevant geographic dimensions of competition.

(72) Second, although some early cases found exclusive contracts to violate the antitrust laws even where they resulted in only minimal foreclosure in the downstream market,[98] more recent cases routinely sustain the legality of exclusive arrangements that involve less than 40 percent of the downstream market.[99] And cases involving more than 40 percent of the downstream market are analyzed under the rule of reason, and are not considered presumptively anticompetitive.[100] Moreover, Areeda and

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95 HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 478 (4th ed. 2011); PHILIP AREEDA & HERBERT HOVENKAMP, AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION at ¶1800C (Last update Aug. 2015); *See also* ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 249-51 (7th ed. 2012) ("ANTITRUST LAW DEVELOPMENTS").

96 *See, e.g.,* AREEDA & HOVENKAMP, *supra* note 95 at ¶¶ 1802b & 1821c1.

97 In *Tampa Electric*, the Supreme Court stated that, in evaluating exclusive dealing arrangements under Section 3 of the Clayton Act, a court first must define the relevant product and geographic markets. Specifically, it stated: "*First*, the line of commerce, *i.e*., the type of goods, wares, or merchandise, etc., involved must be determined. . . . *Second*, the area of effective competition in the known line of commerce must be charted by careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies. In short, the threatened foreclosure of competition must be in relation to the market affected." Tampa Electric Co. v. Nashville Coal Co., 365 U.S. 320, 327 (1961). *See also* PepsiCo, Inc. v. Coca-Cola Co., 315 F.3d 101 (2d Cir. 2002) (affirming grant of summary judgment for defendant on ground, *inter alia*, that plaintiff had failed to support its proposed relevant product market). *See generally* AREEDA & HOVENKAMP, *supra* note 95 at ¶ 1821a2.

98 *See, e.g.*, Standard Oil Co. (Cal.) v. United States, 337 U.S. 293 (1949) (finding an exclusive dealing arrangement between a gasoline refiner and service stations to violate Section 3, despite the fact that defendant's contracts affected only 6.7 percent of the relevant geographic market).

99 *See, e.g.*, Jacobson, *supra* note 72 at 324 ("Post-*Beltone* decisions routinely sustained the legality of exclusive dealing arrangements with foreclosure percentages of 40 percent or less."); *see also* AREEDA & HOVENKAMP, *supra* note 95 at ¶ 1821c1 ("Picking the correct number is somewhat arbitrary, but single-firm foreclosure percentages of less than 30 or 40 percent in a properly defined market would seem to be harmless to competition, at least where there is no indication of upstream collusion or oligopoly using exclusive dealing as an entry-deterrence device.").

100 *See, e.g.*, Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 237 (1st Cir. 1983) (even 50 percent acceptable if there were only "limited anticompetitive effects"); CDC Techs., Inc. v. IDEXX Lab., Inc., 186 F.3d 74, 80 (2d Cir. 1999) ("80% share where distributors only provided "qualified leads" was not anticompetitive); s*ee generally* AREEDA &

Hovenkamp, distinguishing between pure exclusive contracts and discounts that may encourage exclusivity (which they refer to as "quasi" exclusive dealing), suggest that higher percentages should be required for discount provisions before they can be condemned under the rule of reason. In relevant part they write:

> When the restraint in question excludes less and rivals are in a stronger position to bid business away from the defendant, then foreclosure percentages must accordingly be higher. . . . [T]he structural requirements for "quasi" exclusive-dealing practices that fall short of actual exclusive dealing, including market-share and similar discounts where price is the engine of exclusion, should be the same as those for monopolization cases generally.[101]

Since the pricing plans under investigation do not constitute exclusive contracts, but rather only term and volume discount plans, this suggests that, before the Bureau can find the terms and conditions to be anticompetitive and thus unreasonable, it must first find that the Verizon and the other price-cap carriers possess monopoly power in the relevant market and that the effect of the terms and conditions is to foreclose a very significant portion of the downstream market.

(73) Third, courts have moved away from a narrow focus on foreclosure percentages and have begun to focus more on whether the exclusive arrangement is likely to: (1) create or enhance market power, and (2) result in anticompetitive harms.[102]

(74) Finally, Areeda and Hovenkamp's *Antitrust Law* treatise discusses the elements that a plaintiff must establish as part of its *prima facie* case to establish that an exclusive dealing arrangement violates the antitrust laws. Several of these elements also appear relevant as the Commission considers whether

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HOVENKAMP, *supra* note 95 at ¶ 1821c1 ("[E]ven relatively high percentages are not necessarily illegal, for there is no 'per se' rule condemning any specific percentage.") & 1821d5 ("[E]ven a high foreclosure percentage does not indicate that exclusive dealing is anticompetitive unless rival suppliers would find difficulty in setting up new firms to compete with those in the downstream market."); Jacobson, *supra* note 72 at 325 ("As the threshold of illegality of foreclosure moved higher and higher, in fact, the focus on foreclosure levels began to be asserted by defendants – not plaintiffs – as a basis for quick dismissal of a claim." (footnote omitted)).

101 AREEDA & HOVENKAMP, *supra* note 95 at ¶ 1807d.

102 *See, e.g.*, Roland Machinery Co. v. Dresser Inds., 749 F. 2d 380, 394 (7th Cir. 1984) (holding that the plaintiff "must prove that the probable (not certain) effect of the exclusion will be to *raise prices above (and therefore reduce ou*tput below) the competitive level, or otherwise injure competition; he must show in other words that the anticompetitive effects (if any) of the exclusion outweigh any benefits to competition from it."); PepsiCo, Inc. v. Coca-Cola Co., 315 F.3d 101, 109 (2d Cir. 2002) (finding that the plaintiff had: (1) failed to support its proposed (but overly narrow) relevant product market, and (2) "failed to adduce direct evidence that Coca-Cola has market power."); ZF Meritor, LLC v. Eaton Corp., 696 F.3d 254, 271 (3d Cir. 2012). (observing that, in evaluating exclusive dealing agreements, "modern antitrust law generally requires a showing of significant market power by the defendant."); *see generally* ANTITRUST LAW DEVELOPMENTS, *supra* note 95 at 215 ("Since *Tampa Electric*, courts have steadily moved away from a strict focus on foreclosure percentage to a more nuanced analysis of whether the arrangement threatens to create or enhance market power and therefore lead to an anticompetitive outcome."); Jacobson, *supra* note 99 at 326 (After *Beltone*, "an increasing number of decisions analyzed whether the exclusive arrangements would likely create or enhance market power – the power to increase market prices or restrict market output – in contrast to bare [foreclosure] percentages.").

the terms and conditions under investigation violate Section 201.[103] They explain that "the plaintiff's logical first step is to establish market structure, market share, and foreclosure percentages."[104] Noting that "[e]ven a high foreclosure percentage creates no injury to competition if no one is being excluded in fact by the challenged arrangement," they suggest that evidence of *actual* exclusion would be relevant and helpful.[105] And, citing *Jefferson Parish*, they suggest that where the plaintiff is an excluded rival of the upstream firm, provable actual exclusion, inability to expand, or higher costs would seem to be a prerequisite for any showing of injury-in-fact."[106]

(75) To the extent that the Bureau is considering applying the analytical framework for exclusive dealing to the terms and conditions under investigation, it is important to recognize that the terms and conditions under investigation differ significantly from the exclusive dealing arrangements and exclusive contracts discussed above. While an exclusive contract prevents a customer from dealing at all with the seller's rivals, the terms and conditions under investigation are much less restrictive; they simply commit the customer to purchasing a specified percentage of the customer's base period demand for a specified period. The terms do not prevent the customer from dealing with the seller's rivals, nor do they commit the customer to purchasing a specified percentage of its total needs from the seller. That the terms and conditions are less restrictive suggest that they generally should be viewed more favorably. Thus, Areeda and Hovenkamp suggest that "discounts attached merely to the quantity of goods purchased, and not to exclusivity itself, be treated as lawful, and not be subjected to the laws of exclusive dealing."[107]

(76) The law concerning the appropriate antitrust treatment of loyalty discounts or conditional discounts is less settled than that concerning exclusive discounts.[108] In particular, cases are divided as to whether

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103 AREEDA & HOVENKAMP, *supra* note 95 at ¶ 1821d1

104 *Id.*

105 *Id.* at 1821d2

106 *Id. Cf.* ANTITRUST LAW DEVELOPMENTS, *supra* note 95 at 216-217 ("Courts evaluate a wide variety of market conditions in assessing whether an exclusive arrangement threatens to harm competition. Initially, courts tend to focus on the ability of competitors (usually sellers) to reach the market in the face of the exclusive deal. Thus, partial requirements contracts, minimum purchase agreements, 'loyalty' discounts that reward buyers for purchasing an increasing proportion of their needs from the seller, and sales quotas have been found permissible when they do not preclude competing sellers from selling to the buyers on whom the agreements have been imposed.").

107 AREEDA & HOVENKAMP, *supra* note 95 at ¶ 1807b2. Their one proposed exception to this proposed rule of per-se legality "is when the discounted price is below cost, in which case it would be subject to the ordinary rules governing predatory pricing." *Id.*

108 There also does not appear to be consensus on how to define the terms "loyalty discounts" and "conditional discounts." Jacobson suggests that a "loyalty or market share discount is a price break given by a supplier in return for the customer's commitment to take a given percentage of its requirements from the supplier in question." Jonathan M. Jacobson, *A Note on Loyalty Discounts*, THE ANTITRUST SOURCE 1 (June 2010). Kobayashi, in contrast, defines loyalty discounts as "a particular form of non-linear pricing in which the unit price of a good declines when the buyer's purchases meet a buyer-specific minimum threshold requirement. Bruce H. Kobayashi, *The Economics of Loyalty Discounts and Antitrust Law in the United States* 1 (Geo. Mason Univ. School of Law Working Paper No. 05-26). Finally, Moore and Wright define "conditional discounts broadly as "a broad category of business practices by which a seller agrees to lower its price if the buyer agrees to certain conditions." Moore & Wright, *supra* note 84 at 1205.

to treat allegedly anticompetitive loyalty discounts as a form of predatory pricing[109] or a form of exclusionary conduct, akin to exclusive dealing.[110] At least one decision has applied both frameworks.[111]

(77) We do not offer an opinion as to whether loyalty discounts should be evaluated solely under a predatory pricing standard, an exclusive dealing standard, or both, but we do offer a few observations. First, under either approach, the Bureau must first define the relevant product and geographic markets. It must then assess whether the carrier offering the terms and conditions has substantial market power in the relevant markets and whether the terms and conditions have resulted in adverse competitive effects. If the Bureau determines that the carrier offering the pricing plan lacks substantial market power, that should be the end of the inquiry, and the Bureau should find the terms and conditions just and reasonable. Similarly, if the Bureau fails to find any anticompetitive effects, such as significant numbers of rivals that have been forced to exit or deterred from entering or expanding, or material increases in price, then it likewise should end the inquiry.

(78) To the extent that the Bureau determines that the carrier possesses substantial market power and there is evidence of anticompetitive effects, then the Bureau's next steps will depend on which theory of harm it is investigating. If it believes that the terms and conditions should be analyzed as an exclusive dealing arrangement, despite their less restrictive nature, then the Bureau must determine the extent of the total market demand that has been committed under the terms and conditions at issue, and then consider how the remaining uncommitted demand compares to the minimum efficient scale of CLECs. In addition, the Bureau will need to examine the potential efficiencies and other benefits resulting from the terms and conditions.

(79) If the Bureau decides to evaluate the terms and conditions under the predatory pricing framework, then it must determine whether the Commission's test for predatory pricing has been violated.

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[109] *See, e.g.*, Barry Wright Corp. v. ITT Grinnell Corp., 724 F.2d 227, 231 (1st Cir. 1983) (rejecting challenge to loyalty discount on ground that "prices, while lower than normal, nonetheless generated revenues more than sufficient to cover the total cost of producing the goods to which they applied."); Virgin Atl. Airways Ltd. v. British Airways PLC, 257 F.3d 256, 259 (2d Cir. 2001) (affirming decision for the defendant on the grounds, *inter alia*, that plaintiff had failed to prove that defendant priced below cost or recouped its losses by bundling ticket sales).

[110] *See, e.g.* ZF Meritor, LLC v. Eaton Corp. 696 F.3d 254, 277-78 (3d Cir. 2012) (while holding that the price-cost test is appropriate "when price is the clearly predominant mechanism of exclusion," majority concluded that price was not the primary mechanism of exclusion in the case before it). *See generally* Moore & Wright, *supra* note 84; Jacobson, *supra* note 108.

[111] Concord Boat Corp. v. Brunswick Corp., 207 F.3d 1039, 1044-45 (8th Cir. 2000) (in case challenging loyalty discounts under Sections 1 and 2 of the Sherman Act, the court of appeals treated the Section 1 claim as an exclusive dealing claim and the Section 2 claim as a predatory pricing claim); *See generally* Moore & Wright, *supra* note 84; Jacobson, *supra* note 108.

VI. Recommendations for evaluating the reasonableness of the terms and conditions under investigation

(80) In light of the relevant FCC precedent, antitrust precedent, and economics literature on exclusive contracts and loyalty discounts, we offer the following recommendations for how the Bureau might most efficiently analyze whether the special access pricing plans it has designated for investigation violate Section 201's "just and reasonable" requirement. We focus primarily on the CLEC's claim that the terms and conditions under investigation "lock-up" potential CLEC customers.

(81) First, the Bureau should define the relevant product and geographic markets that include the TDM special access services covered by the pricing plans under investigation. With respect to the relevant product market, it is important that the Bureau not limit the market necessarily to just the TDM services covered by the tariffed pricing plans under investigation. Rather, it must include within the relevant market all the services that customers treat as reasonably close substitutes. Thus, the Commission needs to consider whether various types of packet-based dedicated services, including both wired and wireless packet-based services, and even best-efforts cable-modem services, are reasonable substitutes for TDM-based services. As the Bureau and Commission have recognized, we are now undergoing a fundamental transition from TDM-based services to packet-based services, and not only are providers transitioning their infrastructure, but customers are transitioning their demands to newer and higher capacity services, including possibly best-efforts cable-supplied services. Defining the appropriate product market will be critical to accurately assessing whether Verizon and the other three price-cap carriers have substantial market power as well as to determining the extent to which the relevant market has been foreclosed by the terms and conditions under investigation.

(82) It is also important that the Bureau properly define the geographic market. In particular, given that the terms and conditions under investigation generally involve volume and term discounts for large numbers of DS1 and/or DS3 circuits, the vast majority of the parties taking such pricing plans are likely to be multi-location customers. Given this, it appears appropriate to depart from the Commission's traditional approach for defining the geographic market for single-location customers and instead follow the approach the Commission adopted in the *SBC/AT&T* and *Verizon/MCI* orders. In those orders, it defined the relevant geographic market for *multi-location* business customers as "encompass[ing] all the geographic locations where these multi-location business customers may have a presence."[112]

[112] *SBC Communications Inc. and AT&T Corp. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18290, para.63 (2005); *Verizon Communications, Inc. and MCI, Inc. Applications for Approval of Transfer of Control*, Memorandum Opinion and Order, 20 FCC Rcd 18433, para.63 (2005); *see also AT&T Inc. and BellSouth Corporation Application for Transfer of Control*, Memorandum Opinion and Order, 22 FCC Rcd 5664, at para. 69 (2007).

(83) Second, once the relevant markets have been defined, the Bureau should assess the competitive conditions within each market and determine whether the carriers whose pricing plans are the subject of the tariff investigation possess substantial market power. In order to make this determination, the Bureau will need to examine a number of market characteristics and market trends, which in turn will require an analysis of all the data collected pursuant to the Bureau's 2014 order,[113] and it most likely will require the collection of additional data in order to assess how this dynamic market has evolved. Thus, for example, to the extent that the Bureau calculates market shares, it should do so not only on the basis of various alternative metrics, (such as revenues and units and capacity), but it should also calculate trends in market shares over time. In addition, while the Bureau should analyze data on the location of existing facilities (and for example compare how ILEC and CLEC infrastructure compare with customer locations), it should also consider how various types of competitors, including cable companies and full-facilities-based fiber providers have expanded their networks over time. In order to assess potential competition, the Bureau should analyze when and under what conditions it is economically feasible for service providers, whether incumbent or competitive, to extend their facilities in response to customer demands, and examine how and why various types of competitors have expanded into new geographic areas. Data on how the infrastructure of various providers, including cable companies, fiber companies, and traditional CLECs, has expanded over time would be extremely useful in assessing supply elasticity and potential competition.

(84) If the Bureau concludes that the incumbent price-cap carriers do not possess substantial market power, then that should end the inquiry, and the Bureau should find that the terms and conditions comply with Section 201. Only if it determines that the four incumbent carriers possess substantial market power would the Bureau need to proceed to the next steps in its analysis.

(85) Third, even if the Bureau determines that the incumbent price-cap carriers possess substantial market power, it then must determine whether there is any evidence of actual adverse competitive effects resulting from the pricing plans. For example, the Bureau should consider whether the terms and conditions at issue have forced the exit of substantial numbers of competitive carriers, deterred the entry of new competitors, or significantly limited the expansion of existing competitors. In making this assessment, historical data over the last fifteen years would be extremely helpful. Similarly, the Bureau should examine whether the pricing plans under investigation have resulted in a significant increase in the price of the relevant services. In examining that issue, it would be helpful to have price data for several years to determine the general trend in prices and their relationship to competitive conditions. We note that evidence of *actual* adverse competitive effects is likely to prove extremely important in this case, given that some of these pricing plans under investigation have been available in the tariffs for over a decade. If the Bureau cannot find substantial evidence of adverse competitive effects during the years that the pricing plans have been available, then this suggests that the plans are not anticompetitive or violative of Section 201.

[113] *Special Access Data Collection Reconsideration Order*, 29 FCC Rcd 10899.

(86) The Bureau also could look for indirect evidence of adverse competitive effects. For example, to the extent that the Bureau views the terms and conditions as a potentially exclusionary device, akin to exclusive dealing, then it should also consider the extent to which the terms and conditions under investigation have in fact foreclosed a substantial portion of total market demand from competitive carriers, such that the competitive carriers have been prevented from achieving minimum efficient scale. In making this assessment, it would again be helpful to have time-series data that could show how the percentage of the market committed under these pricing plans has changed over time. On the other hand, if the Bureau decides to view this as a form of predatory pricing, then it needs to decide what test for anticompetitive and predatory pricing it should apply.

(87) Finally, consistent with the economics literature and antitrust precedent on exclusive dealing and with the court of appeals decision in *BellSouth v. FCC*, the Bureau also should examine the potential efficiencies and other benefits arising from the use of these terms and conditions.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on January 8, 2016

Eric R. Emch

I declare under penalty of perjury that the foregoing is true and correct.

Executed on January 8, 2016

Donald K. Stockdale, Jr.

Donald Stockdale