

GAZETTE NOTICE NO. DGTP-007-05
PETITIONS TO THE GOVERNOR IN COUNCIL
TELECOM DECISION CRTC 2005-28
REGULATORY FRAMEWORK FOR VOICE COMMUNICATION
SERVICES USING INTERNET PROTOCOL

**PREDATORY PRICING AND PUBLIC POLICY IN
CANADIAN TELECOMMUNICATIONS**

**A REPLY TO THE CANADIAN CABLE
TELECOMMUNICATIONS ASSOCIATION (CCTA)**

By

Dennis L. Weisman
Professor of Economics
Kansas State University

April 12, 2006

TABLE OF CONTENTS

EXECUTIVE SUMMARY 3

1. Introduction..... 4

1.1 Professional Qualifications..... 4

1.2 Objectives and Overview..... 5

1.3 The CCTA’s Predation Claims..... 6

1.4 Outline and Preliminary Notes..... 7

2. Implications of Market and Technological Convergence..... 8

2.1 Overview 8

2.2 The Evolving Product Market..... 8

2.3 The VoIP Paradigm Shift..... 10

3. The Law and Economics of Predation 13

3.1 Traditional Theories 13

3.2 Modern Theories 14

3.3 Public Policy and the Law 17

4. Evaluating the Credibility of the CCTA’s Claims 20

4.1 Overview 20

4.2 The Basic Arguments..... 20

4.3 Why The Modern Theories of Predation Break Down 24

4.4 The Issue of Targeting..... 26

4.5 Assessment..... 32

5. The Social Cost of Misdirected Protections..... 33

5.1 Competitor Protections and Consumer Welfare 33

5.2 Type I and Type II Errors..... 34

6. Summary and Conclusions..... 35

EXECUTIVE SUMMARY

The purpose of this statement is to respond to the various claims put forth by the Canadian Cable Telecommunications Association (CCTA) concerning the incentive and ability of Canada's incumbent local exchange carriers (ILECs) to engage in predatory pricing of local telephone services. These claims, made on the record of two separate policy and regulatory proceedings and in the CCTA's 7 November comments on the Petitions, are without merit. In particular, they are unsupported by the expert evidence filed by the CCTA in these and other proceedings.

This statement is framed around six primary arguments. First, in evaluating the incentives for predation, it is necessary to understand the implications of technological/market convergence for the evolving nature of Canada's local telephone service markets. Second, while claims of predation are common in regulated industries, actual cases of successful predation are, in fact, so rare as to prompt reference to predatory pricing as the "Loch Ness Monster" of competition and antitrust law. Third, policymakers must clearly distinguish between legitimate concerns about predatory pricing and what are merely attempts on the part of rivals to peg ILEC prices at *supra-competitive* levels. Fourth, merely recounting various theories of predation, as the CCTA's experts do, is not a substitute for actual evidence of predation in the marketplace. On this score, the CCTA continues to fail to establish the credibility of its claims. Fifth, contrary to the CCTA's claim that "targeted" price reductions are anti-competitive, cutting prices in order to respond to competition and increase business is often the very essence of competition. Finally, sound competition policy should place the burden of proof in making predation allegations on those market participants alleging predation—a burden that, by a consensus of expert opinion in recent regulatory proceedings, the CCTA has not met.

1. Introduction

1.1 Professional Qualifications

1. My name is Dennis L. Weisman. I am employed by Kansas State University as a Professor of Economics. My business address is Department of Economics, Waters Hall, Kansas State University, Manhattan, Kansas 66506-4001.
2. I received a B.A. in economics and mathematics from the University of Colorado; an M.A. in economics from the University of Colorado; and a Ph.D. in economics from the University of Florida with a specialization in industrial organization and regulation. I have testified in numerous regulatory proceedings to the economic and social impacts of regulatory policies and have served as an advisor to telecommunications firms, electric power companies and regulatory commissions on economic pricing principles, the design of incentive regulation plans, and competition policies.
3. My primary research interests are in strategic behavior and government regulation. I have authored or co-authored more than 70 articles, books and book chapters. My research has appeared in the *Antitrust Bulletin*, *Economics Letters*, the *Journal of Regulatory Economics*, the *Yale Journal on Regulation*, *The Journal of Policy Analysis and Management*, and the *Federal Communications Law Journal*. My research has also been cited by the U.S. Supreme Court in *Verizon v. FCC*, both majority and dissenting opinions. I am the co-author of *DESIGNING INCENTIVE REGULATION FOR THE TELECOMMUNICATIONS INDUSTRY*, published by the MIT Press and the AEI Press in 1996, and *THE TELECOMMUNICATIONS ACT OF 1996: THE "COSTS" OF MANAGED COMPETITION*, published by Kluwer in 2000.
4. I currently serve on the editorial boards of the *Journal of Regulatory Economics*, *Information Economics and Policy* and *The Review of Network Economics*. I was most recently a guest editor for a special issue of *The Review of Network Economics* on incentive regulation. I am also a member of the academic advisory board for the Institute for Regulatory Law and Economics, which is housed at the

Progress and Freedom Foundation. For the past year, I have served as a member of the regulatory framework group for the Digital Age Communications Act (DACA) project. This project, which is sponsored by the Progress and Freedom Foundation, has as its primary objective to draft model telecommunications reform legislation for the United States.

1.2 Objectives and Overview

5. The purpose of this statement is to respond to the various claims put forth by the Canadian Cable Telecommunications Association (CCTA) concerning the incentive and ability of Canada's incumbent local exchange carriers (ILECs) to engage in predatory pricing of local telephone services. These claims, made on the record of two separate policy and regulatory proceedings and in the CCTA's 7 November comments on the Petitions, are without merit. In particular, they are unsupported by the expert evidence filed by the CCTA in these and other proceedings.
6. This statement is framed around six primary arguments. First, in evaluating the incentives for predation, it is necessary to understand the implications of technological/market convergence for the evolving nature of Canada's local telephone service markets. Second, while claims of predation are common in regulated industries, actual cases of successful predation are, in fact, so rare as to prompt reference to predatory pricing as the "Loch Ness Monster" of competition and antitrust law.¹ Third, policymakers must clearly distinguish between legitimate concerns about predatory pricing and what are merely attempts on the part of rivals to peg ILEC prices at *supra-competitive* levels. Fourth, merely recounting various theories of predation, as the CCTA's experts do, is not a substitute for actual evidence of predation in the marketplace. On this score, the CCTA continues to fail to establish the credibility of its claims. Fifth, contrary to the CCTA's claim that "targeted" price reductions are anti-competitive, cutting prices in order to respond to competition and increase business is often the very

¹ Donald J. Boudreaux and Andrew N. Kleit, "How the Market Self-Policies Against Predatory Pricing," Antitrust Reform Project, Competitive Enterprise Institute Monograph, ISSN#1085-9047, June 1, 1996.

essence of competition. Finally, sound competition policy places the burden of proof in making predation allegations on those market participants alleging predation—a burden that, by a consensus of expert opinion in recent regulatory proceedings, the CCTA has not met.

1.3 The CCTA's Predation Claims

7. The CCTA has made claims in three recent Canadian regulatory and policy proceedings regarding the alleged incentive and ability of Canada's incumbent telephone companies to attempt to eliminate competition by means of anti-competitive strategies of predation. Before analyzing these claims and the expert evidence that the CCTA has purported to rely upon in making them, they are briefly reviewed below for the sake of convenience. The information in this section has been provided to me by TELUS Communications Inc.
8. In the proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* (the "local forbearance proceeding") the CCTA claimed that if granted forbearance, the ILECs would have the incentive and ability to "target" customers of their competitors with special low-price offers, the implication being that such conduct constitutes anti-competitive behaviour (in fact there could be no other characterization, since low-price offers that are not anti-competitive are inherently consumer welfare enhancing, as explained elsewhere in this statement).
9. Over the course of 2005, a number of petitions were filed with the Governor in Council seeking, on numerous grounds, a review of Telecom Decision CRTC 2005-28, *Regulatory framework for voice communication services using Internet Protocol* (12 May 2005). By means of Gazette Notice No. DGTP-007-05 - *Petitions to the Governor in Council* (Canada Gazette Part 1, 3 September 2005), the Minister of Industry solicited comment on those petitions (the "VoIP petition proceeding"). On 7 November 2005, the CCTA filed a reply submission addressing those petitions (the "Reply Submission"). Attached to that submission, among other documents, was a statement by Dr. Gerald W. Brock

dated 10 October 2005 and titled “The Economic Theory of Predatory Pricing.” This statement and the CCTA’s purported reliance on it in its Reply Submission are reviewed in Section 4 below.

10. In this statement, I have been asked to comment on the validity of the CCTA’s claims that the ILECs have both the ability and the incentives to engage in predation in the Canadian telecommunications marketplace.

1.4 Outline and Preliminary Notes

11. The outline for the remainder of this statement is as follows. Section 2 discusses the market and technological convergence currently taking place in the telecommunications industry. Section 3 reviews the various theories of predation, including recent court decisions examining this issue. Section 4 examines the CCTA’s claims regarding predation and juxtaposes these claims against marketplace facts. Section 5 discusses the social harm that results from misdirected protections wherein public policy seeks to protect individual competitors rather than the integrity of the competitive process. Section 6 presents a brief summary and conclusion.
12. At the outset, a word or two about terminology and jurisprudence is in order. This statement is written from the perspective of an American economist, and as such focuses on American antitrust literature and jurisprudence. However, to my knowledge there is nothing that limits the applicability of this literature and jurisprudence to the Canadian telecommunications industry and Canadian competition policy. In addition, just as there are important lessons that U.S. policymakers can learn from the Canadian telecommunications industry, developments in the U.S. telecommunications industry may likewise serve to inform the design of Canadian telecommunications policy.

2. Implications of Market and Technological Convergence

2.1 Overview

13. In order to understand why the CCTA’s predation claims are without merit, it is important to place them in the context of the market and technological forces that are currently reshaping local telecommunications markets in North America. The key points developed in this section are summarized briefly here. First, the telecommunications marketplace is increasingly characterized by competition for the customer’s entire portfolio of telecommunications services—one-stop shopping. Second, the “rents from incumbency” in telecommunications markets,² if they exist at all, are considerably diminished as a result of technological and market convergence. Third, VoIP represents a fundamental paradigm shift in the technology of providing local telephony—one that represents a significantly lower-cost technological platform in comparison with traditional circuit-switched telephony. Fourth, the cable companies see strategic importance—serving as one-stop providers—in entering the telephony markets and, if the experience from the U.S. serves as a guide, would presumably not be deterred from entering even if market forces required them to charge markedly low prices.

2.2 The Evolving Product Market

14. The telecommunications industry today is in the midst of a sea change of seemingly unprecedented proportion in which markets are being redefined as a result of shifting technological and market forces. This is perhaps best characterized as a process of technological and market convergence in which the unit of sale increasingly encompasses bundled arrays of services and options provided over different technological platforms. These include the proverbial triple-play, which consists of telephony, video and broadband. Increasingly, the triple-play is morphing into the “quadruple-play” with the addition of wireless to the product mix.

² “Rents from incumbency” may be defined as the propensity for consumers to remain with the incumbent provider in the face of comparable (price/quality) service offerings from rivals.

15. In the telecommunications industry today, the nature of competition is not for individual services *per se*, such as local or long-distance telephone service, but rather for the right to serve as the customer's one-stop provider of the entire array of communications services, including local/long distance telephone service, broadband, video entertainment and wireless. This represents a fundamental change in the nature of telecommunications product markets and carries important implications for the incentive, or lack thereof, to predate, as explored in subsequent sections.
16. One important implication of this process of "convergence" is that differential customer acquisition costs, by which is meant customer acquisition costs less customer retention costs,³ were probably more important in the past than they are in the current telecommunications marketplace. This is the case because "incumbency" is no longer well-defined.
17. In this era of market and technological convergence, in which customers are increasingly purchasing an entire array of telecommunications and video entertainment services—frequently as packages—from a variety of competing suppliers using different technological platforms, it is unclear whether the "incumbent" is the local exchange carrier, the cable company, the wireless provider or some other entity.
18. Whereas the cable companies are new entrants into telephony, the ILECs are new entrants into video entertainment. Similarly, while the cable companies incur customer acquisition costs to attract their customers' telephony business, the

³ Differential customer acquisition costs may constitute a barrier to entry, but it is unclear that it is a barrier to entry that regulators should necessarily do anything about. For example, suppose a firm engenders high customer loyalty because it provides stellar customer service and otherwise provides consumers with a high-value product. Consumers of this firm's products and services may well exhibit high degrees of inertia. If other firms want to wrest these customers away, they too must offer a high-value product. If the regulator intervenes in this process to somehow reduce this inertia, it will likely serve only to undermine the competitive process. The incumbent firm may have weaker incentives to cultivate customer loyalty because it knows the regulator will intervene if it does "too good of a job." Similarly, competing firms will have to work less hard to wrest customers away, recognizing that the regulator will, in part, do the job for them. In the end, the regulator's intervention into the competitive process has served only to hurt consumers by weakening the incentives firms have to compete in a manner that can be expected to engender customer loyalty.

ILECs likewise incur customer acquisition costs to attract their customers' video entertainment business. Both the cable companies and the ILECs are starting from a position of incumbency with respect to one service in a bundle of services that customers are increasingly interested in purchasing from a single provider. Hence, there is a certain symmetry between the ILECs and the cable companies in terms of market positioning, and yet fundamental, government-imposed, asymmetries in the form of winback and promotion restrictions limit the ILECs' ability to compete on the merits.

2.3 The VoIP Paradigm Shift

19. Nowhere is this fundamental change in the telecommunications marketplace more apparent than in provision of Voice over Internet Protocol ("VoIP"). VoIP represents a technological paradigm shift in the provision of telephony—one that promises to irrevocably change the economics of the telecommunications industry.

VoIP Technology enables end users to treat voice telephone calls and their accompanying features as just another set of applications they can run over any broadband connection . . . VoIP thus frees such applications from the control of telephone company software locked in centralized circuit switches. In this respect, VoIP invites end-user innovation for voice services in the same way that the Internet facilitates such innovation for communications in general: it turns the circuit-switched telephone network "inside out."⁴

20. The following quotations describe the extent to which VoIP is transforming the telecommunications marketplace.

It is now no longer a question of whether VOIP will wipe out traditional telephony, but a question of how quickly it will do so. People in the industry are already talking about the day, perhaps only five years away, when telephony will be a free service offered as part of a bundle of services as an incentive to

⁴ Jonathan E. Neuchterlein and Philip J. Weiser, *Digital Crossroads, American Telecommunications Policy in the Internet Age*. Cambridge MA: The MIT Press, 2005, p. 192.

buy other things such as broadband access or pay-TV services. VOIP, in short, is completely reshaping the telecoms landscape.⁵

Voice Over Internet Protocol,” known increasingly by its monosyllabic acronym VoIP (“voyp”), is a textbook model of such creative destruction. And, in a few short years, this technology may well uproot the foundation of traditional telephone regulation.⁶

In the early years of the 21st century, as a critical mass of American consumers ordered broadband connections, new service providers and software developers began specializing in VoIP products that rivaled conventional circuit-switched telephone service in call quality. The result is a tremendous boon for consumers—and a potential catastrophe for the traditional telephone industry.⁷

Because VoIP runs as an application over any broadband platform, a residential consumer who already has a broadband connection can purchase VoIP services at an incremental cost far below what conventional telephone companies charge for voice service on a stand-alone circuit-switched platform. Indeed, vertically-integrated broadband access providers will increasingly include VoIP service “for free” with the sale of their other services, as Cablevision has already done.⁸

21. VoIP technology is facilitating the entry of a seemingly endless array of competitive local telephone service providers, including access-independent applications provided by Vonage and Primus, as well as access-dependent services provided by major cable companies. This observation harbors two important implications for the likelihood of predation on the part of the ILECs. First, these new entrants are likely to have lower costs than the ILECs. In general, a high-cost provider cannot successfully predate against a low-cost provider because it inflicts more financial damage on itself than it does on its rival. Second, some VoIP providers do not require their own network, which means that entry barriers are extremely low. With low entry barriers, it is difficult or

⁵ “How the Internet Killed the Phone Business.” *The Economist*, September 17, 2005, p. 11.

⁶ Jonathan E. Neuchterlein and Philip J. Weiser, *Digital Crossroads, American Telecommunications Policy in the Internet Age*. Cambridge MA: The MIT Press, 2005, pp. 191.

⁷ *Id.*, p. 192.

⁸ *Id.*, p. 193.

- impossible for the predator to recoup its losses from predation.
22. Indeed, to implement their strategy of serving as the one-stop provider of telecommunications services, cable companies *must* enter the market for voice telephony. Moreover, according to Nuechterlein and Weiser, “vertically-integrated broadband access providers will increasingly include VoIP services ‘for free’ with the sale of other services, as Cablevision has already done.”⁹ Moreover, a recent *Wall Street Journal* article discusses the packages of services that Cablevision sells and notes that “Cablevision is effectively giving away phone service.”¹⁰
23. The above observations beg the question as to why the cable companies in the U.S. are entering telephony markets with extremely low and perhaps below-cost prices, while the margins for Canadian cable companies are seemingly quite robust. In other words, what are the key differences North and South of the border? In the U.S., the ILECs are not subject to the same type of onerous winback and promotion rules than hamstringing the ILECs in Canada. In addition, the ILECs in the U.S. are able to de-average prices in a manner that their Canadian counterparts cannot. Hence, a plausible hypothesis is that the cable companies in Canada have been able to leverage these constraints on the ILECs to charge prices that their counterparts in the U.S. would not be able to sustain under conditions of less restrained competition. While these differences are indeed noteworthy, the key insight to be gleaned from the U.S. experience is that the cable companies are moving rapidly to enter telephone markets despite the low prices for their telephony product. In other words, their entry would appear to be more strategic or defensive and less financial in nature.

⁹ Jonathan E. Neuchterlein and Philip J. Weiser, *Digital Crossroads, American Telecommunications Policy in the Internet Age*. Cambridge MA: The MIT Press, 2005, p. 193.

¹⁰ Ken Brown, “Cablevision to Offer Internet Phone-Call Bundle.” *The Wall Street Journal*, June 21, 2004, p. B5.

3. The Law and Economics of Predation

24. In order to evaluate the CCTA's and its experts' claims regarding predation, it is useful briefly to review the traditional and modern theories of predation in this section. Recent public policy and legal decisions are also discussed in this section.

3.1 Traditional Theories

25. The traditional theory of predation envisions two stages in carrying out the predation strategy—the predation stage and the post-predation stage.¹¹ In the predation stage, the predator prices its product below some measure of economic cost—typically incremental cost—with the intent of driving its prey from the market. In the post-predation stage, the prey leverages the absence of meaningful competition to price its product at *supra-competitive* levels, thereby recovering the losses incurred during the predation stage and earning monopoly profits thereafter.

26. The consensus view in the literature, and this is a view that has prevailed for several decades now, is that traditional predation is difficult and hence frequently irrational. Because firms will re-enter the market when the predator commences pricing at *supra-competitive* levels, recoupment of the losses incurred in the predation stage is virtually impossible. Hence, in order for the predation strategy to be successful, there must be some type of barrier to entry that precludes entry from occurring when the predator prices at *supra-competitive* levels. In fact, traditional predation is likely to be particularly difficult in regulated network industries due to the high-proportion of sunk costs and the fact that productive capacity typically does not leave the industry even if particular competitors should exit the market.^{12, 13} In other words, productive capacity in the industry serves as a

¹¹ See, for example, John S. McGee, "Predatory Pricing Revisited," *Journal of Law and Economics*, Volume 23, October 1980, pp. 296-297; and Paul Joskow and Alvin Klevorick, "A Framework for Analyzing Predatory Pricing Policy," *Yale Law Journal*, Volume 89, 1979, pp. 213-270.

¹² Dennis L. Weisman, "The Law and Economics of Price Floors in Regulated Industries," *The Antitrust Bulletin*, Vol. XLVII(1), Spring 2002, p. 112.

check on *supra-competitive* pricing. Consequently, even if predation should succeed in driving a particular competitor from the market, the (independent) productive capacity that the competitor leaves behind continues to discipline pricing. And with rate regulation in place, it may be difficult to raise rates after the prey has departed, making recoupment problematic.

3.2 Modern Theories

27. Over the past 25 years, following important developments in game theory, a number of modern, strategic theories of predation have emerged. These models, which include financial market predation, reputation models and cost signaling models,¹⁴ generally require conditions of asymmetric information. In other words, the predator has information that its prey does not, and it leverages this informational asymmetry to drive the prey out of the market or to deter its expansion into new markets. The following quotation captures the essence of these “new” theories.

Thus, for example, a firm in an industry with rapid product change might cut prices sharply in answer to new entry in order to discourage the new entrant from continuing an active product development programme. Whether the entrant attributes its lack of profitability to its high costs, to weak market demand, to over-capacity in the industry, or to aggressive behaviour by its competitor, it will properly reduce its estimate of its own future profits. If its capital has other good uses, this might lead it to withdraw from the industry. If not, it may nevertheless be dissuaded from making new investments in and developing new products for the industry. At the same time, other firms may be deterred from entering the industry. If *any* of these things happen, the predator benefits.¹⁵

¹³ Moreover, as Schmalensee points out, in markets that are “fragile” due to rapid technological advance, it is important to ask whether the alleged predator could expect to have monopoly power long enough to recoup the costs of predation? See Richard Schmalensee, “Antitrust Issues in Schumpeterian Industries,” *American Economic Review*, Vol. 90, No. 2, May 2000, p. 193. In this context, it should be recognized that VoIP and other technological advances tend to augment this fragility.

¹⁴ For a review of this literature, see Jean Tirole, *The Theory of Industrial Organization*, Cambridge MA: The MIT Press, 1988, Chapter 9; and Patrick Bolton, Joseph F. Brodley and Michael H. Riordan. “Predatory Pricing: Strategic Theory and Legal Policy.” *Georgetown Law Journal*, Vol. 88, 2000, pp. 2239 - 2330.

¹⁵ Paul Milgrom, “Predatory Pricing,” in the *New Palgrave Dictionary of Economics*, Vol. 3, ed. by John Eatwell, Murray Milgate and Peter Newman, London: The Macmillan Press Limited., 1987, p. 938.

28. In the case of *Financial Market Predation*, the prey is dependent upon some source of external financing. The focus is on the relationship between the prey and its investors. “The predator seeks to manipulate that relationship and thereby drive the prey out of the market or deter its expansion into new markets.”¹⁶ For example, the predator may reduce prices in order to reduce the profitability of its rivals. The rival’s investors view this decrease in profitability as a signal that prospects in this market are limited and move either to reduce financial support or terminate funding entirely. In this model, investors are unable to differentiate between the predation campaign and managerial incompetence.

Nor can lenders solve the financing problem by excusing default when caused by predatory pricing. The lender may be unable to determine whether the default stems from predatory pricing or from the debtor’s poor performance because the lender lacks both full information and the expertise available to a market insider.¹⁷

29. *Reputation Predation Models* are based on a type of signaling wherein the predator seeks to convey a reputation for “toughness” and a steadfast willingness to defend its market at virtually any cost.

In reputation effect predation the predator reduces prices in one market to induce the prey and potential entrants to believe that the predator will cut price in other markets or in the predatory market at a later time. The predator seeks to establish a reputation as a price cutter, based on some perceived special advantage or characteristic. Thus, a predator trying to establish a reputation for financial predation cuts price when it has superior financial resources (and when the other conditions for financial predation are present).¹⁸

In this model, the predator reduces its prices in order to signal to its rivals that it is a tough competitor and that opportunities for positive returns will be strictly limited either in other markets or in the predatory market in the future. It is important to note, however, that this theory may not be completely robust.

¹⁶ Patrick Bolton, Joseph F. Brodley and Michael H. Riordan. “Predatory Pricing: Strategic Theory and Legal Policy.” *Georgetown Law Journal*, Vol. 88, 2000, p. 54.

¹⁷ *Id.*, p. 57.

¹⁸ *Id.*, p. 74.

Although economic theory views reputation effect predation as a separate and distinct predatory strategy, a reputation effect theory based on irrational toughness may be too easy to assert and too difficult to prove.¹⁹

30. In the *Cost Signaling Model of Predation*, the predator wishes to signal its rivals that it is a low-cost rather than a high-cost provider. Rivals will enter the market if they believe the dominant firm is a high-cost provider, but will not enter the market or will choose to exit the market if they believe the dominant firm is a low-cost provider.

In cost signaling a predator drastically reduces prices to mislead the prey to believe that the predator has lower costs and to exit the market. More specifically, a predator trying to establish a reputation for low cost cuts price below the short run profit-maximizing level. Observing the predator's low price, the prey rationally believes that there is a least some probability that the predator has reduced costs. This lowers the prey's expected returns and causes the prey to exist.²⁰

31. It is important for the discussion that follows in Section 4 to be clear as to the key assumptions on which these modern theories of predation are based. First, these models require some type of asymmetric information—information in the possession of the predator that is not common knowledge. Second, these models typically assume that the predator enjoys some financial or cost advantage over its prey. If the prey is in a superior financial position or if it is known to have lower costs, there is no real prospect for predatory behavior. Third, these models are of limited relevance when the prey's presence in the predatory market is driven primarily by strategic or defensive considerations rather than financial considerations. Finally, as discussed in the following subsection, policymakers should be cognizant of the high social cost of falsely labeling competitive behavior as predatory. When the market conditions requisite to predatory behavior are not present, allegations of predation serve only to reduce consumer welfare.

¹⁹ *Id.*, p. 75.

²⁰ *Id.*, p. 100.

3.3 Public Policy and the Law

32. Claims of predation are common in regulated industries, but in many, if not most, cases likely amount to little more than attempts by competitors to peg their rivals' prices at artificially-high levels. This is the view espoused by Professor William Baumol when he observes that:

Rules that make it excessively easy to secure a conviction on charges of predation invite anticompetitive and rent-seeking litigation. Such rules tempt firms that cannot make it in the marketplace by virtue of superior products or greater efficiency and lower costs, to seek success over their more efficient rivals in the courts instead. There they can hope to constrain the vigor of rivalrous acts by competitors and to transmogrify the character of their rivals from energetic enterprise to timidity and hesitance. ... Long study of the subject has led me to the conclusion that litigation of this sort is a major handicap to the growth and competitiveness of the nation's economy.²¹

33. Professor Baumol further observes that "there seems to be a general consensus among informed observers that genuine cases of predation are very rare birds."²² The courts have decisively arrived at similar conclusions.²³ In *Matsushita v. Zenith*,²⁴ the U.S. Supreme Court has noted that "predatory pricing schemes are rarely tried and even more rarely successful." And in *U.S. v. Eastman Kodak*,²⁵ the Court dismissed concerns raised by the government regarding predatory pricing in part because "the Government could not cite one modern example of successful predatory pricing."

34. And, as Justice Lewis Powell recognized in the context of the *Matsushita case*, the costs of falsely inferring predatory intent can be very high:

[C]utting prices in order to increase business often is the very essence of competition. Thus, mistaken inferences in cases

²¹ William J. Baumol. "Predation and the Logic of the Average Variable Cost Test." *Journal of Law and Economics*, Vol. XXXIX, April 1996, p. 51.

²² *Id.*

²³ See also Robert H. Bork. *The Antitrust Paradox*. New York: The Free Press, 1978, pp. 144-160; and W. Kip Viscusi, John M. Vernon and Joseph E. Harrington, Jr. *Economics of Regulation and Antitrust*. Cambridge MA: MIT Press, 1995, Chapter 9.

²⁴ *Matsushita v. Zenith*, 475 U.S. 574 (1986).

²⁵ *U.S. v. Eastman Kodak*, 853 F. Supp. 1454 (W.D.N.Y. 1994) at 81.

such as this one are especially costly, because they chill the very conduct the antitrust laws are designed to protect.²⁶

35. The courts have also recognized that it may be difficult in practice to differentiate between predatory pricing and a legitimate response to increased competition.

The difficulty, of course, is distinguishing highly competitive pricing from predatory pricing. A firm that cuts its prices or substantially reduces its profit margin is not necessarily engaging in predatory pricing. It may simply be responding to new competition, or to a downturn in market demand. Indeed, there is a real danger in mislabeling such practices as predatory, because consumers generally benefit from the low prices resulting from aggressive price competition.²⁷

36. The courts have also explicitly recognized that pricing individual products or services below cost need not harbor predatory intent. This is particularly likely to be the case for a multi-product firm selling bundles of products and services. For example, in *American Drugs v. Walmart Stores*, the plaintiff argued that Wal-Mart was regularly selling products below cost in violation of the Arkansas Unfair Practices Act. The Arkansas Supreme Court did not concur.

We discern no proof in the record of this case that Wal-Mart specifically intended to destroy competition with regard to any one article like Crest toothpaste or Bayer Aspirin or Dilantin by selling below cost for a sustained period of time. What is evidenced is that Wal-Mart regularly would sell varying items below cost as a loss leader to entice people into its store and increase traffic, . . . That strategy of selling below the competitor's price and even below Wal-Mart's own cost, which Wal-Mart admits to, is markedly different from a sustained effort to destroy competition in one article by selling below cost over a prolonged period of time.²⁸

37. Finally, it should be noted that a recent case alleging predation among commercial airlines in the U.S. was dismissed on summary judgment.^{29, 30}

²⁶ *Matsushita Electric Industrial Co., Ltd. V. Zenith Corp.*, et al. 106 S. Ct. 1348 (1986) at 1360.

²⁷ *Barry Wright Corp. v. ITT Grinnell Corp.*, 724 F.2D 227, 231 (1st Cir. 1983).

²⁸ *Wal-Mart Stores v. American Drugs, Inc.*, No. 94-235, Supreme Court of Arkansas, 319 Ark. 214; 891 S.W.2d 30; 1995 Ark. LEXIS I; 1995-1 Trade Cas. (CCH) P70, 853 January 8, 1995, Opinion Delivered, as Amended.

²⁹ *United States v. AMR Corp.*, 2003 U.S. App. LEXIS 13530 (10th Cir. Kans., July 3, 2003.)

As we have said in the Sherman Act context, predatory pricing schemes are rarely tried, and even more rarely successful, and the costs of an erroneous finding of liability are high. The mechanism by which a firm engages in predatory pricing—lowering prices—is the same mechanism by which a firm stimulates competition It would be ironic, indeed, if the standards for predatory pricing liability were so low that antitrust suits themselves became a tool for keeping prices high.³¹

The “meeting competition” defense is similar to a statutorily recognized defense to a price discrimination charge under the Robinson-Patman Act. See 15 U.S.C. s 13(b). A company should not be guilty of predatory pricing, regardless of its costs, when it reduces prices to meet lower prices already charged by its competitors. To force a company to maintain non-competitive prices would turn the antitrust laws on their head.³²

This court has previously noted that a high market share cannot be inferred as creating actual or potential monopoly power where a given market has low entry barriers and other factors rendering monopoly power unlikely.³³

38. This last quotation has important implications for the Canadian telecommunications industry. To wit, the emergence of VoIP and the market presence of cable companies with parallel facilities-based networks suggests that entry barriers are extremely low. In the CRTC’s recent local forbearance proceeding, Dr. Robert Crandall of the Brookings Institution made the following observations regarding the relatively modest capital requirements needed for the cable companies to enter the market for telephony.³⁴

Second, cable companies do not need to capture a large share of the voice telephone market to succeed because their fixed entry costs are very low. Rogers Communications, for example, has announced that it will enter telephony in its cable territories by

³⁰ It should be noted that Professor William Baumol was the economist for the defendant, American Airlines, in this case and his arguments prevailed.

³¹ *Id.*, at 151.

³² *Id.*, at 178.

³³ *Id.*, at 190.

³⁴ Statement of Dr. Robert Crandall, Appendix 2 to TELUS’ Comments of 22 June 2005 in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* at ¶ 22.

investing only \$200 million in new network assets and \$300 to \$400 per subscriber enrolled.³⁵ Shaw Communications has announced that its “all in” capital costs for the first 100,000 telephone subscribers will be \$50 to \$55 million and for the next 100,000 subscribers only \$35 million.³⁶

39. The capital requirements necessary for an access-independent VoIP provider to enter the market for telephony are lesser still. For example, according to a recent industry report, entry costs for VoIP providers may be less than \$8,000 CDN.³⁷

The phone business used to be a business of giants – only large corporations, with deep pockets of cash, and legions of engineers and technicians – could contemplate offering telephone service. No longer. Barriers to entry in the phone business have collapsed.³⁸

4. Evaluating the Credibility of the CCTA’s Claims

4.1 Overview

40. As explained in Section 1.3 above, the CCTA has made similar claims and filed similar expert evidence regarding the ILECs’ alleged incentive and ability to predate in two ongoing proceedings, the VoIP petition proceeding and the winback constitutionality proceeding. In this section, I make use of the key concepts developed in Sections 2 and 3 to evaluate the CCTA’s claims in its Reply Submission in the VoIP petition proceeding and in its interrogatory response CCTA(CRTC)24Oct05-2 in the winback constitutionality proceeding.

4.2 The Basic Arguments

41. The CCTA Reply Submission in the Governor in Council’s VoIP petition proceeding states at ¶ 3 that “Economic experts appearing on behalf of CCTA before the CRTC in the proceeding on local forbearance explained that the ILECs could effectively engage in anticompetitive behavior and would have the

³⁵ Rogers, 2004 Annual Report, p. 19.

³⁶ Shaw Communications Inc., *Annual Report 2004*, p. 5.

³⁷ The Anarchist’s Cookbook (Addendum) – Start Your Own Telco! A Seaboard How-To Guide. *Research & Trends*, Seaboard Group, May 2005, p. 1.

³⁸ *Id.*, p. 2.

- incentive to do so.” In the course of the public hearings on forbearance, the CRTC’s Vice-Chair of Telecommunications, Richard French, placed the burden of proof squarely on the CCTA economists for demonstrating that the ILECs would engage in predation—a burden that they did not meet, as explained below.³⁹
42. At paragraph 24 of its VoIP petition Reply Submission, the CCTA observes that “The local telephone market has never been characterized by ease of entry.” The validity of this statement must be seriously questioned upon recognizing that the presence of cable companies and access-independent VoIP providers changes everything.⁴⁰ While there may be barriers to entry associated with traditional circuit-switched telephony, these barriers are largely absent when it comes to VoIP. This is significant because a successful predation strategy typically requires barriers to entry that would limit the ability of firms to re-enter the market when the predator begins to price at *supra-competitive* levels in the second stage of the predatory campaign. In the absence of such entry barriers,⁴¹ there would be little if any opportunity for the predator to recoup the losses that it incurred during the first stage of the predation campaign.
43. CRTC Vice-Chair French underscored the point that the Competition Bureau did not find the claims of the CCTA on the issue of predation to be credible. The following excerpts from the transcript of the local forbearance hearing are instructive:

We are hearing two stories about predation and one story, I would venture to say, is the orthodox -- the orthodoxy in telecom economics represented by the ILECs economists who tell us that recoupment will be too difficult, and therefore predation is not a valid strategy.

³⁹ See Excerpts from CCTA Testimony, 5557 - 5567, Public consultation in PN 2005-2, *Forbearance from regulation of local exchange services* 28 September 2005, Gatineau, Quebec.

⁴⁰ “Entry is only effective in constraining the exercise of market power if it is viable. When entry is likely, timely and sufficient in scale and scope, an attempt to increase price is not likely to be sustainable as buyers of the product in question turn to other sources of supply.” Competition Bureau of Canada, *Merger Enforcement Guidelines*, September 2004, § 6.2.

⁴¹ As discussed in sub-section 3.1, the costs of entry into telephony markets for the cable companies and independent VoIP providers are quite modest.

And we've heard another story which, in my opinion, and this doesn't have anything to do with its validity, is a minority opinion in industrial organization and competitive theory, that is the reputational argument, I fight you hard here, you never want to come near me again.

You know, I was taught that that was a minority view, but that didn't mean it wasn't valid. I guess I still want to give Doctors Ross and Gillen a last opportunity to provide me with any other kind of intellectual sustenance to sustain the credibility of a predatory threat. And I'm not saying I don't believe the kind of argument that I've heard from the CCTA and some other parties, only that it doesn't appear to me to be sustained by any sort of rigorous economic theory that I can hold onto and get my teeth into.

So I've heard from the Competition Bureau, who, frankly, went out of their way to tell us and the world that they didn't find the argument that the CCTA presented to meet their standards. And they are, after all, a crown agency and don't have a dog in this fight or at least not a commercial dog in this fight. So I'm asking you or giving you the opportunity please to say whatever else it is you think you want to say about this so we have it on the record and appreciate the illumination that will follow, I hope.⁴²

44. What followed, however, were merely descriptions of the financial market predation and reputation predation models, neither of which apply in the context of large, well-financed cable companies providing telephone service over their existing networks—companies that may in fact be in a financial position superior to that of the ILECs.⁴³
45. After the Commissioner of Competition and Vice-Chair French's expressions of doubt about its predation evidence, the CCTA apparently sought out another expert to try to lend support to its position. However, Dr. Brock's statement,

⁴² Transcript of public consultation in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* (28 September 2005, Gatineau, Quebec) at 5557-5560.

⁴³ See, for example, the statement of Dr. Robert Crandall, Appendix 2 to TELUS' Comments of 22 June 2005 in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* at ¶¶ 46 and 47.

attached to both the CCTA's Reply Submission in the VoIP petition proceeding and to interrogatory response CCTA(CRTC)24Oct05-2 in the winback constitutionality proceeding, is merely a descriptive recounting of the various theories of predation. His analysis does not address the Canadian telecommunications marketplace and thus he falls victim to the very same criticisms that had previously been leveled at the other economic experts representing the CCTA.

46. The CCTA's statement in both proceedings intimate that Dr. Brock says something that he does not. There is nothing in Dr. Brock's statement to suggest that he necessarily believes predation is likely under the market conditions that presently exist in the Canadian telecommunications marketplace. Dr. Brock's statement is simply a recounting of the various strategic theories of predation and as such is unexceptionable. Dr. Brock does not arrive at any firm conclusions other than that there is a theoretical possibility of predation. In other words, the gap between the CCTA's unsubstantiated conclusions that the ILECs will, if given the opportunity, engage in predation and Dr. Brock's theoretical analysis must be filled in with the relevant fact-specific information from the Canadian telecommunications marketplace. Hence, while Dr. Brock recounts a number of theories, he provides no facts to substantiate the CCTA's claims that these theories have any applicability to the Canadian telecommunications marketplace.
47. It is noteworthy that in evidence filed in the CRTC's recent forbearance proceeding, the Competition Bureau engages in what is arguably a sweeping dismissal of the predation arguments espoused by the CCTA. Specifically, at ¶ 266 of its evidence, the Bureau observes that "It is not obvious that the conditions required for ex ante concern sufficient to restrict downward price flexibility by the ILECs are applicable when forbearance is based on entry into a well defined antitrust market by a rival network."

4.3 Why The Modern Theories of Predation Break Down

48. At ¶ 267 of its evidence in the forbearance proceeding, the Competition Bureau specifically dismisses concerns about so-called strategic or modern theories of predation—the focus of Dr. Brock’s statement—when it observes that “Furthermore, it also seems unlikely that the signaling/reputation models provide a basis for which predation is rational when the entrant is a cable company because it generally has a presence in most markets already and VoIP and economies of scope may provide it with a cost advantage.” In addition, given the plethora of evidence on costing in telecommunications networks, particularly those of the ILECs for purposes of pricing unbundled network elements, it would seem difficult to argue that informational asymmetries, the key assumption underlying modern theories of predation, even exist. Finally, these so-called modern theories of predation have been around for almost a quarter of a century. Hence, it is not the case, as the CCTA seemingly intimates, that policymakers are unaware of these theories; it is that to date the courts and policymakers have simply not bought into them.
49. On pages 2-4 of his statement, Dr. Brock discusses the theory underlying *Financial Market Predation*. The basic idea here, as discussed in greater detail in Section 3, is that by cutting prices, the ILECs can essentially “dry up” the flow of capital needed by its rivals to continue or expand operations. As the Competition Bureau has previously indicated, this seems unlikely, particularly for the large well-capitalized cable companies.⁴⁴ First, the cable companies have already incurred the sunk costs necessary to enter these markets and the incremental cost of providing telephony for the cable companies is generally considered very low, as per their own public statements. Second, the cable companies may even enjoy a cost advantage over the ILECs because they are provisioning telephony over VoIP rather than with circuit-switched technology. Finally, the cable companies appear to be entering telephony in order to provide a full complement of

⁴⁴ Commissioner of Competition’s Comments of 22 June 2005 in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* at ¶s 266-267.

telecommunications services—to serve as a one-stop provider. This suggests that their interest in telephony may well be more strategic or defensive than financial in nature—in essence to protect the revenues from other relatively high-margin services that they provide.

50. At page 4 of his statement, Dr. Brock discusses the theory underlying *Reputation Models of Predations*. The basic idea here, as discussed in greater detail in Section 3, is that the incumbent provider will cut its prices in order to facilitate a reputation for being a “tough competitor” that is willing to defend its market at virtually any cost. This reputation as a “tough competitor” discourages other providers from entering the market or expanding their operations, thereby allowing the incumbent to sustain *supra-competitive* prices. These reputation-type models would not seem to apply in the Canadian telecommunications industry. First, the cable companies have already entered the market for the provision of video entertainment and broadband. Second, the incremental cost of providing telephony over a cable network that has already been deployed for other purposes is very low. This suggests that prices that are below costs for the ILECs may still generate positive contribution for the cable companies. Third, if the CCTA is going to pin its predation arguments on such a model, it would seem incumbent upon them to explain to policymakers how the ILEC is supposed to predate against a rival that, if the experience in the U.S. is any guide, appears willing to give away telephony—the ILEC’s core service. Finally, as discussed in Section 3:

Although economic theory views reputation effect predation as a separate and distinct predatory strategy, a reputation effect theory based on irrational toughness may be too easy to assert and too difficult to prove.⁴⁵

51. On pages 4-6 of his statement, Dr. Brock discusses the theory underlying *Cost Signaling Models of Predation*. The basic idea here, as discussed in greater detail in Section 3, is that by cutting prices the ILEC attempts to signal that it is a low-

⁴⁵ Patrick Bolton, Joseph F. Brodley and Michael H. Riordan. “Predatory Pricing: Strategic Theory and Legal Policy.” *Georgetown Law Journal*, Vol. 88, 2000, p. 75.

cost provider. If the signal is perceived as being credible, the rivals will not enter the market because they do not wish to compete against a low cost provider as opportunities to earn positive returns would be limited. Again, the Competition Bureau largely dismissed concerns about such models with its observation that “Furthermore, it also seems unlikely that the signaling/reputation models provide a basis for which predation is rational when the entrant is a cable company because it generally has a presence in most markets already and VoIP and economies of scope may well provide it with a cost advantage.”⁴⁶ In other words, the ILECs cannot signal something contrary to what market participants already know to be true and that is that the ILECs are not the low-cost providers.

4.4 The Issue of Targeting

52. At ¶ 46 of its Reply Submission, the CCTA states that “The reason that the ILECs claim they need more pricing flexibility is not to broadly deliver the benefits of lower prices but to price below cost in a discriminatory manner to just those customers who have or are about to switch to a competitor.” The CCTA message is a simple one—if you allow the ILECs to respond to entry by the cable companies with lower prices, the cable companies will choose not to enter and customers will be forced to pay higher prices. The reality is quite different, however. If the cable companies are able to constrain through regulation the ability of the ILECs to respond where competition is present, they will “get away” with offering their customers lower value, higher prices and/or lower quality, than the market would force them to supply under conditions of less restrained competition. In this regard, it is noteworthy that the cable companies in the U.S., where ILECs are not subject to the same onerous restrictions on winbacks and promotions, are, at least in some cases, apparently selling telephony at considerably lower prices than that which we observe in Canada.

⁴⁶ Commissioner of Competition’s Comments of 22 June 2005 in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* at ¶ 267.

53. Imagine, if you will, a customer who is shopping for a new car. Customer A walks into the car dealer and informs the dealer that he has not visited any other car dealer and intends to visit no other car dealer, but must purchase a car today. Customer B walks into the car dealer carrying a wireless phone with three other car dealers holding on the line—in essence, facilitating real-time bidding for the lowest price at which any dealer will sell the car. Which customer is going to get the better deal? In essence, the CCTA wants the government to preclude customer B from getting the best deal possible by limiting the ability of other suppliers to respond in kind.
54. In interrogatory response CCTA(CRTC)24Oct05-2 in the winback constitutionality proceeding, the CCTA relies on the same statement by Dr. Brock in an attempt to support its theory that removing the local winback restrictions would provide the ILECs with the opportunity to target the customers of their competitors on a “direct and specific basis, and at very little cost to the ILECs.” The CCTA implies that direct marketing, a common practice in any competitive market, including the broadcasting distribution markets in which the CCTA’s members are active, is predatory and therefore anti-competitive. They go on to say that “There is strong evidence as to the ability and incentive of the ILECs to engage in such targeting.”
55. However, Dr. Brock’s statement only discusses targeting in a superficial way in the second to last paragraph of the conclusion. Here, Dr. Brock makes the point that when the incumbent has the ability to engage in targeted pricing, it “increases the rational incentive to engage in predatory pricing.” He does not say the incumbents *will* engage in predation, nor does he present evidence that they *would* do so. If the likelihood of predation is one in ten million and targeting increases the likelihood to two in ten million, the probability of predation has doubled but nonetheless still constitutes a *de minimis* risk from the perspective of designing public policy. The entry barriers associated with VoIP are generally considered very low. Recall that a VoIP provider does not even require its own network. Hence, the recoupment issue looms large—how is the incumbent supposed to

recover the costs associated with the first stage of the predatory campaign when entry barriers are so low?

56. In addition, Dr. Brock makes the following observation at page 8 of his statement:

In a world of easy entry to all segments of the market, targeting is ineffective because the competitor simply shifts to serving the more profitable non-targeted segments of the market. However, in telecommunications and other real-world markets, entrants must incur substantial customer-specific costs (such as marketing, order entry, and costs of service hookup). If the incumbent convinces those customers to switch back to its service, the customer-specific sunk costs cannot be recouped by the entrant and therefore the entrant cannot easily shift from serving the targeted customers to serving the non-targeted customers.

57. The above passage from Dr. Brock's statement raises a number of issues, the validity of which must be carefully examined. First, regulators should not be in the business of guaranteeing any market participant—whether they be new entrants or ILECs—that they will necessarily be able to recover their costs. Indeed, competitive markets are distinguished by the absence of just such guarantees. Second, Dr. Brock's analysis fails to account for the evolving nature of the telecommunications product market. To wit, while the cable companies are new entrants into voice telephony, the ILECs are new entrants into video entertainment, which is likely to be considerably more difficult and expensive in terms of the capital requirements.⁴⁷ In other words, while the cable companies are incurring customer acquisition costs to attract their customers' telephony business, the ILECs are incurring customer acquisition costs to attract their customers' video entertainment business. Hence, there is a certain symmetry between the ILECs and the cable companies in terms of market positioning, but fundamental, government-imposed, asymmetries in the form of winback and promotion restrictions that limit the ILECs' ability to compete on the merits.

⁴⁷ Jonathan E. Neuchterlein and Philip J. Weiser, *Digital Crossroads, American Telecommunications Policy in the Internet Age*. Cambridge MA: The MIT Press, 2005, pp. 194 – 195. See also the Statement of Dr. Robert Crandall, Appendix 2 to TELUS' Comments of 22 June 2005 in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* at ¶s 49 and 50.

- Third, once the customer switches to a rival, the ILEC would then have to incur the customer acquisition costs to attract that customer back. Finally, any attempt on the part of regulators to prevent the ILEC from mounting a competitive response would only serve to allow its rivals to “get away” with offering consumers less value, higher prices and/or lower quality, than would otherwise be available to them.
58. It is noteworthy that the CCTA portrays targeting as something “bad.” And yet, whereas lower prices may be bad for the profit margins of the cable companies, they are obviously good for consumers. Targeting is in reality simply competition by a different name. In fact, it is the CCTA’s members that are the market participants actually engaged in targeting: They can target their services to the most profitable customers, while leaving the less profitable customers for the ILECs to serve. But what the CCTA really wants is not only the ability to target the most profitable customers, but to use the regulatory process to constrain the ILECs from mounting an effective competitive response necessary to retain those customers.
59. This is certainly not the first nor the only time that rivals of the incumbent provider in the telecommunications industry have attempted to use the regulatory process to peg the incumbent’s prices at artificially-high levels. The long distance market in the U.S. is a case in point. For a prolonged period of time, the FCC severely restricted AT&T’s ability to reduce prices in response to competition out of concern that lower prices would place new entrants in financial jeopardy. These policymakers ultimately came to realize that these asymmetric regulatory policies succeeded only in forcing consumers to pay higher prices than would otherwise have been necessary. The following passage is instructive:

It can be argued, for instance, that some of the Commission’s regulatory actions in the interexchange market that were designed to promote competition during transition, such as . . . restrictions on competitive pricing responses by AT&T, will have resulted in substantial, unnecessary costs for society that never would have been incurred in a truly competitive marketplace. Moreover, this approach will have directly

increased consumer costs by requiring regulated firms to charge higher prices to protect competitors during the transition.⁴⁸

60. On pages 6 and 7, Dr. Brock discusses commercial airlines as an example of an industry in which predatory pricing is purportedly a legitimate concern. This example is somewhat curious. As discussed above in sub-section 3.3, a recent predation case in commercial aviation—that involving American Airlines—was dismissed on summary judgment. Furthermore, there is no evidence to suggest that incumbent airlines have used predation to block entry by low-cost carriers, such as Southwest, Airtran, and Jet Blue. Nor could they have succeeded if they had tried because these entrants have demonstrably lower costs. In this respect, there are clear parallels between the incumbent airlines and the incumbent telephone companies; neither have any prospect of successfully predating, so why would they try?
61. In fact, in light of the evolving nature of the competition in local telecommunications markets—increasingly between the ILECs and the cable companies—it is difficult to see how a predation strategy on the part of the ILECs could possibly succeed. The relevant question is not whether cable companies can afford to offer voice telephony, but rather whether they can afford not to.⁴⁹ Indeed, as discussed in Section 2, there is evidence from the U.S. that the cable companies are essentially using voice telephony as a loss leader—increasingly including VoIP services ‘for free’ with the sale of other services.⁵⁰ In fact, a recent *Wall Street Journal* article discusses the packages of services that Cablevision sells and notes that “Cablevision is effectively giving away phone

⁴⁸ Mark S. Fowler, Albert Halprin, and James D. Schlichting. “‘Back To The Future’: A Model For Telecommunications.” *Federal Communications Law Journal*, 38, 2, 1986, pp. 193-194. [At the time this article was written, the authors were, respectively Chairman, Chief, Common Carrier Bureau, and Special Counsel, Common Carrier Bureau, Federal Communications Commission.]

⁴⁹ See Excerpts from Shaw Testimony, 6183 - 6189, Public consultation in PN 2005-2, *Forbearance from regulation of local exchange services* 29 September 2005, Gatineau, Quebec. In particular, at excerpt 6070, Mr Shaw observes that “Telus won’t kill Shaw and Shaw won’t kill Telus. I think there is lots of market for everybody here.”

⁵⁰ In marketing, a loss leader is an item that is sold below cost in an effort to stimulate other profitable sales.

service.”⁵¹ While the cable companies in Canada have to date not adopted this strategy—the regulatory constraints imposed on the ILECs likely serving to soften price competition—it does demonstrate a willingness on the part of the cable companies to enter telephony for strategic reasons that may be largely independent of profitability in the telephony sub-segment of the evolving product market.

62. The above observations beg the question as to precisely how an ILEC can successfully predate against a rival that is “effectively giving away” the product that forms the very core of the ILEC’s product market—telephony? This observation notwithstanding, this discussion should not be construed to suggest that predation is impossible or that it is always irrational. The weight of the evidence suggests, however, that genuine cases of successful predation are extremely rare and that the evolving telecommunications product market is particularly ill-suited for such behavior.
63. Finally, even if the ILEC’s price for voice telephony were to be below forward-looking incremental cost, this would not be presumptively predatory—any more than Cablevision in the U.S. giving away voice telephony is predatory.⁵² The reason being that a price below cost is predatory only if its profitability turns on the rival exiting the market as a result of the below-cost price.⁵³ A price for a service below incremental cost may well be compensatory if it preserves for the ILEC additional revenues from other complementary services.⁵⁴ This was, in essence, the conclusion reached by the court in *American Drugs v. Walmart Stores*.⁵⁵

⁵¹ Brown, Ken. “Cablevision to Offer Internet Phone-Call Bundle.” *The Wall Street Journal*, June 21, 2004, p. B5.

⁵² *Id.*

⁵³ As the Competition Bureau observes in its evidence in the CRTC’s recent forbearance proceeding at ¶ 266, “It seems unlikely that predation is going to induce exit in cases where the rival has invested in a sunk network that is ubiquitous and exists for other reasons, not only to supply telecommunications services.”

⁵⁴ To wit, we would not think to accuse Gillette of predation if it were to give away razors—obviously at a price below cost. The reason is that Gillette would be giving away razors to stimulate demand for relatively high-margin complementary sales of razor blades.

⁵⁵ See note 28 *supra*.

4.5 Assessment

64. By way of summary, it is useful to recap the recent regulatory history of the predation issue in Canadian telecommunications. We began with the report filed by the CCTA's expert economists in the CRTC's forbearance proceeding that advanced theories, but no facts. The Competition Bureau dismissed these theories as essentially having little or no applicability to Canadian telecommunications. In fact, CRTC Vice-Chair French went out of his way to note that the CCTA's economic experts were espousing a "minority view" in which the Competition Bureau did not concur. Next came Dr. Brock, who nicely recounted various theories of predation, but again presented no facts. Nor did Dr. Brock indicate that he necessarily believed predation would occur under the conditions that currently prevail in telecommunications markets in Canada. So twice we have theory and twice we have no facts, which strongly suggests that there is only theory with no supporting facts. What then are we to make of the CCTA's claims regarding predation on the part of the ILECs? What is abundantly clear is that theories of predation alone do not constitute proof of predation. Wishing it could be otherwise does not make it so. The cable companies wish to portray the ILECs as the "Big Bad Wolf" in *The Three Little Pigs* fairy tale who will huff and puff and blow the cable companies' house down. The market reality is that, with the possible exception of the rural areas, any dominance on the part of the ILECs or the cable companies is likely to be transitory in nature; neither is going to blow down the other's house. Perhaps Jim Shaw said it best when he observed during the local forbearance public consultation that "Telus won't kill Shaw and Shaw won't kill Telus. I think there is lots of market for everybody here."⁵⁶ In crafting sound competition policy for the dynamic telecommunications industry, it is thus critical that policymakers clearly differentiate between the facts and the fairytales.

⁵⁶ Transcript of public consultation in proceeding initiated by Telecom Public Notice CRTC 2005-2, *Forbearance from regulation of local exchange services* (29 September 2005, Gatineau, Quebec) at 6070.

5. The Social Cost of Misdirected Protections

5.1 Competitor Protections and Consumer Welfare

65. The targeting issue highlights a fundamental problem with misdirected governmental protections because it speaks directly to whether pricing restrictions imposed on the ILECs serve consumer interests or merely the interests of the ILECs' rivals. To understand the nature of these issues and their implications for consumer welfare, consider the following simple example. The ILEC currently serves two customers—customer A and customer B. One day, the cable company turns up service and offers a competing telephony product to customer B, but not to Customer A. The ILEC would like to make customer B an attractive, competitive offer, but it can do so only if it offers the same proposal to customer A. The ILEC does not find it profitable to offer this proposal across the board to both customers A and B so customer B does not enjoy the benefit of a competitive response from the ILEC. As a result, the price that the cable company offers to customer B is higher than it would be if the ILEC were able to offer a competitive price.
66. It is instructive to examine the effect of this policy on consumer welfare. Customer A continues to pay the same price as s/he did previously, so there is no change in consumer welfare for customer A. Customer B switched to the cable company and may pay a lower price than that which was previously offered, but a higher price than that which would prevail if the ILEC were able to respond on a targeted basis. Hence, consumer welfare for customer B is lower than it would otherwise have been because the ILEC is constrained to reduce prices across the board rather than for individual customers facing competitive alternatives. Hence, the policy of constraining the ILEC to offer the same prices to all customers is actually welfare-diminishing (Customer A's welfare is unchanged and Customer B's welfare is reduced). In other words, policies that strive to protect competitors vis-à-vis the integrity of the competitive process can [actually] harm consumers.

67. The Honorable Stephen Breyer, Associate Justice of the U.S. Supreme Court, has warned of the dangers associated with just such misdirected protections:

A second special policy risk of deregulation is that government policymakers will protect competitors instead of protecting competition. This is a problem familiar to students of antitrust. It arises when regulators or antitrust enforcers confuse means with ends by thinking that the object of the law is to protect individual firms from business risks rather than to bring consumers the price and production benefits that typically arise from the competitive process. Where deregulation is at issue, the consequence of misdirecting protection is to threaten to deprive the consumer of the very benefits deregulation seeks.”⁵⁷

5.2 Type I and Type II Errors

68. In recognition of the fact that the law and economics literature finds that predatory pricing is quite a rare phenomenon,⁵⁸ there should be a presumption that the price of any service offered for sale by the ILECs is compensatory unless there is credible evidence to contrary. That is to say, the dearth of actual cases of successful predation, inclusive of evidence from the experimental economics literature,⁵⁹ suggests that those alleging predation should be required to bear the burden of proof.
69. In terms of evaluating price reductions on the part of the ILECs, there is the possibility of Type I errors (labeling a price cut predatory when it is actually competitive) and Type II errors (labeling a price cut competitive when it is actually predatory).⁶⁰ The optimal public policy should balance the risk of error in a manner that maximizes expected consumer welfare. For example, a public

⁵⁷ Stephen Breyer, *Anticipating Antitrust’s Centennial: Antitrust, Deregulation, and the Newly Liberated Marketplace*. 75 CALIF. L. REV. 1005, 10018, (1987) at 1018.

⁵⁸ See, for example, Dennis L. Weisman, “The Law and Economics of Price Floors In Regulated Industries.” *The Antitrust Bulletin*, Vol. XLVII(1), Spring 2002, pp. 107-131.

⁵⁹ Due to their inability to replicate predation in laboratory experiments considered favorable to its emergence, Professors Isaac and Smith observe that “we feel that they alter the burden of proof for those who would design public policy as though predation were a robust phenomenon.” R. Mark Isaac and Vernon L. Smith, “In Search of Predatory Pricing,” *Journal of Political Economy*, Volume 93, 1985, p. 321, note 1.

⁶⁰ For a discussion of Type I and Type II errors as it applies to predatory pricing, see Paul Joskow and Alvin Klevorick, “A Framework for Analyzing Predatory Pricing Policy,” *Yale Law Journal*, Volume 89, 1979, pp. 213-270.

policy that is more likely to result in a Type I error than a Type II error is likely to entail high social costs because it will give firms pause in lowering prices out of fear that such behavior will be condemned as being predatory. Given the market conditions that currently prevail in the telecommunications industry, it would be irrational for an ILEC to attempt predation given its extremely low probability of success. This strongly suggests that policymakers should be much more concerned about mistakenly classifying competitive behavior as predatory (“Type I errors”) than mistakenly classifying predatory behavior as competitive (“Type II errors”).

6. Summary and Conclusions

70. The CCTA, through its response to the telephone companies’ petition to the Governor in Council, has engaged in fear-mongering with its unsubstantiated claims that the ILECs will engage in predatory pricing. As discussed above, while Professor Brock’s recount of the various theories of predation is for the most part unexceptionable, there has been no evidence put forth to establish that the marketplace facts fit the theories he has advanced. In this sense, Dr. Brock’s views, or at least the CCTA’s reliance upon them, fall victim to the very same criticism that CRTC Vice-Chair, Richard French, leveled against the CCTA’s expert economists in the CRTC’s recent forbearance proceeding—the rough translation of which is “where’s the beef!” The fact that the CCTA has not been forthcoming with data to support its theories strongly suggests that it has no data to support its theories. This should not be surprising in light of the fact that actual cases of successful predation are rare, the courts are highly skeptical of its very existence, and market conditions in the telecommunications industry would seem particularly ill-suited for predatory behavior on the part of the ILECs.
71. Furthermore, CRTC Vice-Chair Richard French took the opportunity to point out in the course of the Commission’s recent public hearings on local forbearance that the Competition Bureau was not swayed by the CCTA’s arguments on the

predation issue. In fact, the Competition Bureau largely dismissed as unfounded claims by the CCTA that the ILECs would engage in predation.

72. In conclusion, sound competition policy in the telecommunications industry should be based on the presumption that any observed price reduction reflects competitive rather than anticompetitive conduct, absent credible evidence to the contrary. Given the dearth of actual, confirmed cases of successful predation along with the market conditions that currently prevail in the Canadian telecommunications industry, policymakers should be much more concerned about mistakenly classifying competitive behavior as predatory (“Type I errors”) than mistakenly classifying predatory behavior as competitive (“Type II errors”). It necessarily follows that the burden of proof should be placed on those market participants alleging predation— a burden that, by a consensus of expert opinion in recent regulatory proceedings, the CCTA has not met.