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Incentives for non-price discrimination

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Abstract

A regulated upstream monopolist supplies an essential input to firms in a downstream market. Non-price discrimination or sabotage becomes a concern when the upstream monopolist vertically integrates downstream. This article develops a simulation algorithm to determine the likelihood that discrimination will arise in equilibrium using data from the US long-distance market. Based on 1000 random draws of own and cross-price elasticities, the simulations reveal that discrimination arises in 934 cases at current access charges. This analysis has implications for regulatory policy, including access charge reform and entry by the Regional Bell Operating Companies into the interLATA long distance market.
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1. Introduction

In network industries such as telecommunications, electric power, and natural gas it is common for an upstream monopolist to supply an input essential to the production of the downstream service. This essential input is commonly referred to as access. For example, in the long-distance market, carriers such as AT&T, MCI and Sprint rely upon the access services supplied by local telephone companies for the origination and termination of long-distance messages.[1] In similar fashion,

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[1] These long-distance carriers along with other prospective entrants in the market for local telephone services also depend on the incumbent local telephone companies for unbundled network elements—the inputs required to assemble competing local telephone service offerings. See Sidak and Spulber (1997).

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stand-alone Internet service providers may be dependent in certain regions on the high-speed access lines of a combined AOL–Time Warner. In the electric power industry, entrants are dependent on the distribution facilities of incumbent providers to serve retail customers. Hence, while the focus of this analysis is on the US telecommunications market, the basic problem we examine is more general.

A commonly voiced concern is that a vertically integrated provider (VIP) will have the incentive to degrade the quality of access provided to independent rivals in order to favor its downstream operations.[2] In fact, allegations that AT&T had engaged in discriminatory practices against its rivals in the long distance market resulted in the Regional Bell Operating Companies (RBOCs) being prohibited from participating in the interLATA long-distance under the terms of the 1984 Bell System Divestiture.[3] Section 271 of the 1996 Telecommunications Act allows the RBOCs to petition for entry into the (in-region) InterLATA long-distance market once they have opened their local telephone markets to competition and have satisfied a 14-point competitive checklist.[4] The purpose of this checklist is, in part, to ensure that the RBOCs do not have the opportunity to discriminate against their rivals in the downstream long-distance market as a result of their control over an essential input to production (access). Discrimination occurs when the RBOC intentionally degrades the quality of the access service provided to downstream competitors with the effect of raising rivals' costs.[5]

The incentives for non-price discrimination in a Cournot framework have been examined in a number of recent studies including Sibley and Weisman (1998), Economides (1998), Mandy (2000), Weisman and Kang (2001) and Weisman and Williams (2001). This research is concerned primarily with identifying the conditions under which the incentive to discriminate arises (respectively, does not arise) in equilibrium. The main finding of this research is that the independent rivals must be significantly more efficient that the VIP in the downstream market in order for the incentive to discriminate not to arise in equilibrium.

The analysis of the incentive to discriminate in a Bertrand framework has been examined in Weisman (1995, 1998), Reiffen (1998) and Beard et al. (2001).

[2] In the electric power industry, concerns along these lines have forced some companies to spin-off their generating assets if they are also involved in local distribution.

[3] In order to facilitate the divestiture and allow for the financial viability of the RBOCs, the country was divided into 161 local access transport areas, or LATAs. The RBOCs are allowed to carry long-distance traffic within LATAs, but not between LATAs in their own territories.

[4] In addition, the RBOCs must have the concurrence of the individual state public service commissions and the Federal Communications Commission, with significant weight given to the views of the Department of Justice, before interLATA entry can be authorized. At the time of this writing, 20 states have been granted interLATA relief.

[5] See Bernheim and Willig (1994), Krattenmaker and Salop (1986) and Salop and Scheffman (1983).

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