PRICE DISCRIMINATION: TERRITORIAL PRICING FOR CABLE TELEVISION SERVICES AND THE MEETING COMPETITION DEFENSE UNDER THE CABLE TELEVISION CONSUMER PROTECTION AND COMPETITION ACT OF 1992

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On October 5, 1992 Congress voted to override a Presidential veto and the 1992 Cable Television Consumer Protection And Competition Act[1] became law. Buried in the Act amidst a host of other requirements is a little noticed provision that forbids price differences.[2] On its face, the uniform pricing or "price discrimination" provision would not allow a cable operator to maintain different prices in response to different competitive conditions.

This article explains how a price discrimination provision came to be included in the Act. It then explains in general terms the economic and legal theories of price discrimination. With that background in place, the article discusses how the courts might interpret the new price discrimination provision, with particular attention to the need for a "meeting competition defense." Finally, the article offers some thoughts on the practical implications this provision holds for cable operators, municipal franchising authorities and consumers.

I. HISTORY

Since 1984, when the Cable Communications Policy Act[3] became law, municipal franchising authorities have expressed concern over the absence of competition in the market for cable services.[4] These concerns have been based on the widespread perception that in the absence of either price regulation or direct competition cable operators have been charging monopoly rates for their services.[5]

Because in most cases the '84 Cable Act forbade regulation of rates,[6] municipalities sometimes encouraged entry by a second cable operator in the

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1. The Cable Television Consumer Protection Act of 1992, Pub. L. No. 102-385, 106 Stat. 1460 (1992)(to be codified at scattered sections of 47 U.S.C. §§ 521 et. seq.) (hereinafter '92 Cable Act).

2. Section 3 of the new '92 Act states:

> (d) Uniform Rate Structure Required. — A cable operator shall have a rate structure, for the provision of cable service, that is uniform throughout the geographic area in which cable service is provided over its cable system.

3. The Cable Communications Policy Act, Pub. L. No. 98-549, 98 Stat. 2779 (1984)(codified at 47 U.S.C. §§ 521-611) [hereinafter '84 Cable Act].

4. *See, e.g., The Oversight of The 1984 Cable Telecommunications Act: Hearings Before the Subcommittee on Communications of the Committee on Commerce, Science, and Transportation,* 101st Cong., 1st Sess. 187 (Nov. 16, 1989) [hereinafter Senate Comm. Hearings](statement of James Sharpe, Mayor, City of Newark, N.J., on behalf of the Nat'l League of Cities and the United States Conference of Mayors).

5. *Id.*

6. *See* 47 U.S.C. § 543.

belief that fostering direct competition between cable operators will control cable prices.[7] These efforts to introduce competition have occurred in spite of strong evidence that direct competition between cable operators cannot be sustained.[8]

After exploring alternatives and finding that they cannot directly regulate cable rates,[9] some communities have decided that their only option is to encourage a competitor to enter the market in the hope that competition would force the incumbent cable operator to reduce rates.[10]

Few companies have been willing to respond to these municipal invitations by entering into direct competition against incumbent operators.[11] However, in the belief that they could secure a customer base by charging lower rates than the incumbent operator, some companies have taken on the challenge.[12] Where this has occurred the results have usually been highly unsatisfactory.[13]

One result has been that the newly entering competitors, often referred to as "overbuilders" because they overbuild an existing system,[14] typically, choose not to construct a system that extends over the entire area being served by the

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7. *See, e.g.*, Cable Alabama Corporation v. City of Huntsville, 768 F.Supp. 1484 (N.D. Ala. 1991), discussing the extreme measures taken by the city of Huntsville, Alabama not only to encourage, but to compel, direct competition between cable operators.

8. The most comprehensive report produced to date on the subject of direct competition between cable operators reported that "[n]o long term benefits will occur because competition is not likely to be sustained." Touche Ross, Metro Dade Report on Overlapping Cable Franchises, 1 (Oct. 1987) [hereinafter "Metro Dade Report"]

9. Section 543(a) of the '84 Cable Act prohibited all regulation of rates. 47 U.S.C. § 543. Section 3 of the '92 Cable Act eliminates that prohibition and restores some rate regulating authority. § 3 (amending 47 U.S.C. § 543). It remains to be seen whether or not this change will relieve some of the pressure to introduce competition.

10. While the '92 Cable Act contains provisions that authorize rate regulation by local franchising authorities under certain circumstances and these provisions may diminish the perceived need for competition in some communities, other provisions of the Act are likely to lead to rate increases which may in turn create the perception that rate regulation is a failure. *See e.g.*, § 6, '92 Cable Act (amending 47 U.S.C. § 325 to provide for retransmission consent). This may fuel the demand for direct competition. Similarly, in the hope of gaining a new income stream to replace declining revenues from other sources, some municipalities are electing to build their own systems and go into competition with incumbent cable operators themselves. Thus, there is likely to be an increase in direct competition between cable operators rather than a decrease.

11. Most operators recognize that cable's natural monopoly characteristics preclude direct competition between cable service providers. *See* Alfred Kahn, 2 *The Economics of Regulation: Principles and Institutions* 34 (1971)("[a] CATV system is itself a natural monopolist, within any given geographic region, subject to the familiar increasing returns with increasing intensity of use; it would obviously be inefficient to have more than one antenna and system of cables."); Omega Satellite Products Co. v. City of Indianapolis, 694 F.2d. 119, 126 (7th Cir. 1982)("The cost of the cable grid appears to be the biggest cost of a cable television system and to be largely invariant to the number of subscribers the system has. We said earlier that once the grid is in place—once every major street has a cable running above or below it that can be hooked up to the individual residences along the street—the cost of adding another subscriber probably is small. If so, the average cost of cable television would be minimized by having a single company in any geographic area; for if there is more than one company and therefore more than one grid, the cost of each grid will be spread over a smaller number of subscribers, and the average cost per subscriber, and hence price will be higher").

12. The leading example of such a company is Telesat Cablevision, Inc., which has been described as "the most aggressive overbuilder in the country," Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications For Public Policy*, 7 YALE J. ON REG. 65, 92 (1990), and which has overbuilt a number of Florida cable television markets.

13. The Metro Dade Report found that as of 1987, 80% of the overbuild systems authorized were either not constructed or had been terminated. Metro Dade Report, *supra* note 8 at 45.

14. Donald L. Bell, *Unbundling: An Alternative To the Current System of Cable Television Franchising*, 21 CUMB. L. REV. 43, 58 n.77 (1991).

incumbent operator. Instead, they choose to build only a small system that overlaps some portion of the incumbent operator's territory,[15] where they charge prices lower than the incumbent. As expected, the incumbent operator reduces prices in response to the new competition. However, the incumbent operator usually extends price reductions only to those areas where the new competitor builds a system. The result is that the incumbent maintains a two-tiered territorial pricing policy under which customers in non-competitive areas pay higher prices for cable services than customers in competitive areas.

In most situations, these price differences have resulted in complaints from the overbuilder that the incumbent is engaged in anti-competitive "price discrimination"[16] and complaints from consumers who pay the higher rate that the incumbent is treating them unfairly.[17] Consequently, it is not surprising that cable operators' territorial pricing policies have often fallen into disfavor with municipal officials who may wrongly perceive that these policies inhibit competition.[18] It was in response to these complaints that Congress enacted section 623(d) of the '92 Cable Act.

II. OTHER RELEVANT STATUTES AND ORDINANCES

In the 1930's because it feared that large economically powerful chain stores would use their purchasing power to compel supplier discounts, thereby driving small retailers out of business, Congress passed legislation which under certain circumstances outlaws differences in price.[19] The Clayton Act provides in relevant part that:

> It shall be unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality . . . and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.[20]

Because it was intended to prevent misconduct by retail chains, the Clayton Act extends only to sales of commodities.[21] Early Court decisions addressing the

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15. The overbuilder will typically target high density areas where residents have a relatively high average income that can be spent on cable services. This is often referred to as a "cherry-picking" strategy. *Id.* at 67 n. 110.

16. *See, e.g.*, Susan G. Strother, *County Would Restrict Cable-TV Rates*, ORLANDO SENTINEL, C-1, C-6 (Aug. 22, 1989)(Harry Cushing, President of Telesat Cablevision, Inc., an overbuilder, complains that through a proposed County ordinance "appears to put the County's stamp [of approval] on price discrimination.").

17. *See, e.g.*, *Hearing Set on Cable-TV Rates*, ORLANDO SENTINEL, C-1, C-6 (April 18, 1989) (discussing complaints by local Orange County, Florida cable subscribers that "their rates are nearly twice those of other homeowners who live only a block away").

18. Because of cable's natural monopoly characteristics direct competition between cable operators probably cannot be sustained. *See supra* note 11. Because direct competition cannot exist under natural monopoly conditions, perceptions that price discrimination inhibits competition are misplaced. In fact, when competition does develop, territorial pricing may be the only viable means by which an incumbent cable operator can compete. *See infra* note 83.

19. Clayton Act § 2(b), 38 Stat. 730 (1914), as amended by the Robinson-Patman Act, 49 Stat. 1526 (1936), (Current version at 15 U.S.C. § 13(a)(1973)) [hereinafter "Clayton Act"]

20. *Id.*

21. *See, e.g.*, Export Liquor Sales, Inc. v. Ammex Warehouse Co., 426 F.2d 251 (6th Cir.

issue concluded that cable television involves the sale of a service rather than a commodity. Thus, for reasons unrelated to any determination of whether territorial pricing policies are economically or morally offensive, the Clayton Act does not apply to the delivery of cable television services.[22] However, as will be seen, the Clayton Act is still important to any discussion of price discrimination in cable markets.

The fact that the Clayton Act does not directly apply to cable television has not left pricing for cable services free of all legal scrutiny.[23] There are numerous State statutes modeled after the Clayton Act that do extend to price discrimination in service markets. Thus cable television is within the scope of some of those statutes.[24] Furthermore, in order to eliminate a perceived competitive imbalance between incumbent cable operators and newly entering competitors, municipalities have sometimes passed ordinances that specifically target the territorial pricing policies of incumbent cable operators.[25] However, as previously noted, the '84 Cable Act prohibited rate regulation. The Act also contained a strong preemption provision which made the legitimacy of State and local price discrimination ordinances questionable under Federal law. For these reasons, and perhaps because of some doubts about the economic implications involved, even when they have passed cable pricing ordinances few local officials have actually been willing to apply them to cable operators.

Section 623(d) of the '92 Cable Act, which is very similar to, and was perhaps modeled after, some local ordinances, represents an effort by Congress to prohibit cable operators from using price discrimination as an anti-competitive tool.[26] However, the question remains: How should section 623(d) be applied in particular situations? If the court's apply it only to anti-competitive behavior then it will serve a valuable purpose. If it used to prohibit legitimate competitive behavior then it will have negative consequences for consumers, and cable operators alike.

In order to examine how section 623(d) should be applied in particular instances, it is necessary to examine the economic circumstances under which price discrimination is likely to occur and the reasons for its occurrence.

III. THE ECONOMICS OF PRICE DISCRIMINATION

To establish the existence of economic price discrimination we examine the ratio between the marginal costs of selling to different customers and the prices

1970), *cert. denied*, 400 U.S. 1000 (1971)(real estate transactions not covered); Baum v. Investors Diversified, Inc., 409 F.2d 872 (7th Cir. 1969)(mutual funds not covered); CBS, Inc. v. Amana Refrigeration, Inc., 295 F.2d 375 (7th Cir. 1961), *cert. denied*, 369 U.S. 812 (1962)(television advertising not covered).

22. *See, e.g.*, Telescripps Cable Co. v. City of Glasgow, et al., C-88-0169-BG(M)(W.D. Ky. 1990); Rankin County Cablevision v. Pearl River Valley Water Supply Dist. et al, 692 F.Supp. 691 (S.D. Miss. 1988); H.R.M., Inc. v. Tele-communications, Inc., 653 F.Supp. 645 (D.C. Colo. 1987); Satellite Television & Associated Resources, Inc. v. Continental Cablevision of Virginia, Inc., 586 F.Supp. 973 (E.D. Va. 1982), *aff'd*, 714 F.2d 351 (4th Cir. 1983).

23. Arguably, except where specifically authorized, the Cable Act does in fact free a cable operator's pricing policies from all legal scrutiny by State and local officials. *See* 47 U.S.C. § 543 (1991).

24. *See e.g.*, COLO. REV. STAT. § 6-2-103 (1991); FLA. STAT. ch. 540 (1991); WIS. STAT. § 133.04 (1991).

25. Examples of communities that have passed such ordinances include: Tifton, Georgia; Cape Coral, Florida; Citrus County, Florida; Colorado Springs, Colorado; and Montgomery, Alabama.

26. *See e.g.*, S. 12, 102nd Cong., 1st Sess. (1991); S. 1880, 101st Cong., 2d Sess. (1990).

those customers are charged. If the ratio between marginal cost and price is different for different customers then there is an economic price discrimination.[27] For example, in the heavily regulated business of distributing electricity, economic price discrimination is a standard practice. Regulators normally require that all customers being served by a given electricity distribution system be charged the same uniform "averaged" rate.[28] However, it is almost always true that the marginal cost of serving some consumers of electricity is greater than for others. The electric rates of those who are served at a high marginal cost are subsidized by those who are served at lower cost. It is not practical to entirely avoid economic price discrimination in the distribution of electricity and arguably it may even serve some useful purposes.[29]

In the legal context, the term "price discrimination" normally bears no relationship to the economic concept just described.[30] For legal purposes, price discrimination can be said to exist whenever a firm offers the same product or service at different prices to different customers. Thus, the common legal concept of price discrimination involves only a difference in price without reference to cost.[31] However, the simple existence of price differences has historically not been sufficient to establish misconduct or liability and the question of when, or whether, firms should be allowed to maintain price differences has been the subject of some controversy.

Price discrimination as an economic theory is premised on the belief that each consumer places differing values on the products and services they purchase. Consequently, different buyers would be willing to purchase a given product or service at different pricing levels.[32] Thus, by accurately identifying the pricing points at which different consumers would purchase a product or service, a firm could maximize its profits by selling to each consumer at the maximum price that each consumer is willing to pay.[33]

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27. The economic theory of price discrimination is well accepted. *See e.g*, RICHARD A. POSNER, ANTITRUST LAW, AN ECONOMIC PERSPECTIVE 62 (1976).

28. Rate averaging is common to industries that require an extensive distribution network. For example, garbage collection service is usually provided at a uniform rate even though there is undoubtably a higher marginal cost associated with serving some customers than others. Another example of rate averaging occurs in the business of delivering telephone service. *See* Manley Irwin, *The Communication Industry and The Policy of Competition*, 14 BUFF. L. REV. 256, 261 (1964).

29. For example, in the absence of rate averaging some telephone users would be priced out of the market. Reducing the numbers of persons who have telephone service reduces the utility of having the service for the remaining subscribers. Arguably, all users of telephone service benefit by increased subscribership, and this increase in the utility of the service justifies some rate discrimination. Even if we assume no such benefit exists, in such service industries as telephone and electric service the economic benefit to be gained by eliminating the subsidy paid by some users would be outweighed by the increased administrative and regulatory cost of eliminating the discrimination. For additional discussion of the social pros and cons of rate averaging *see* Bell, *supra* note 14, at 53 n.50.

30. It has been argued that the existence of economic price discrimination is strong evidence of independent monopolization, POSNER, *supra* note 27, or collusion in oligopolistic markets. Richard A. Posner, *Oligopoly and The Antitrust Laws*, 21 STAN. L. REV. 1562, 1578-79 (1969). Thus, while it has no significant role in straight forward price discrimination cases, the concept of economic price discrimination does have some application in cases brought under the Sherman Antitrust Act. 15 U.S.C §§ 1 and 2 (1973).

31. FTC v. Anheuser-Busch, Inc., 363 U.S. 536, 549 (1960).

32. *See* POSNER, *supra* note 27, at 62.

33. [T]he monopolist who is able to move down the demand curve from its highest point to its intersection with the marginal cost curve, charging a different price for each sale according to the strength of the customers desires for it, will obtain greater profits than the monopolist who charges a single price. *Id.*

For the most part, this kind of "customer by customer" price discrimination is confined to the retail sales of such large ticket items as automobiles and appliances where the normal marketing practice is to encourage an intensive one-on-one meeting between salesperson and consumer. For purposes of this discussion I will distinguish these markets by describing them as "individual markets." Even in these individual markets for large ticket items, the resulting discrimination is imperfect because it relies on the seller's ability to accurately gauge the value placed on the product by each individual consumer.[34] The seller can only estimate. Too high an estimate results in a lost sale; too low an estimate results in a failure to maximize profits.[35]

In these "individual markets" the above factors tend to minimize the danger that consumers as a group will suffer any injury from price discrimination. The economic benefit to be gained by establishing a wide price spread between individual consumers is counterbalanced by the risk of lost sales that would accompany doing so.[36] Measured over a period of time, for each instance in which an individual consumer pays a higher price because a salesperson has accurately gauged the maximum price a customer would be willing to pay, we can speculate that there will be other instances in which the same consumer pays a correspondingly lower price because of a salesperson's inaccurate determination. Furthermore, assuming sufficient levels of competition exist, in the individual markets for items such as automobiles and appliances consumers can to some degree avoid the effects of price discrimination through market research and comparison shopping.

Based on the forgoing it seems clear that the greatest danger of price gouging and a resulting injury to consumers exists in what I will describe as "mass markets," including markets for cable television services.

"Mass markets" are those in which the large scale production of a lower priced product or service is followed by mass sales. Not all mass markets are susceptible to effective discrimination. All other factors being equal, consumers in a competitive market will purchase a product from the seller who offers it at the lowest price.[37] This is true whether we are dealing in an individual market or a mass market. Thus, in mass markets, effective direct competition minimizes opportunities for sellers to engage in effective price discrimination.[38]

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34. *Id.* at 64 ("[A]ll price discrimination . . . is imperfect.").

35. *See id.*

36. It has also been noted that in monopoly markets too large a price spread tends to encourage entrepreneurial efforts to supplant the monopolist as well as encouraging legislation intended to curb the monopolists pricing policies. Richard A. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 558 (1969).

37. "Classical economic theory states that perfect competition is the most efficient and socially desirable market result against which all other market results or market structures are measured. Firms produce as much of their product as they are physically capable, and sell the product at their marginal cost of production." Nicholas J. Pappas, Note, *In Defense of Monopoly Cable Television Franchising: Defining the First Amendment Rights of the Public and the Cable Operator Under the Public Forum Doctrine and Natural Monopoly Theory*, 13 RUTGERS COMPUTER & TECH. L. J. 137, 209 (1987).

38. All other factors being equal, where a competing product is offered at a lower price and can be easily substituted for the higher discriminatorily priced product, the potential customer will purchase the substitute product. Anticipating that discrimination will result in lost sales and a diminished ability to compete, the seller in a competitive market will not discriminate.

In single seller mass markets, (non-competitive markets) while there is a danger of supra-competitive pricing, (monopoly rents) the threat of injury to consumers from price discrimination is, again, very limited. Because the mass market seller deals in high volume sales, it is not economically feasible, as it is in individual markets, for the seller to identify each consumer in advance of sale. Nor is it usually possible to identify the maximum price each consumer would be willing to pay. This inability to identify particular customers in advance or to identify the maximum price that each customer would be willing to pay imposes significant practical limitations on a firm's ability to engage in price discrimination in mass markets. Consequently, firms that are in a business that calls for a high sales volume of relatively lower priced products or services have an incentive to engage in price discrimination only where there is a readily identifiable group of people who would be willing to pay a higher price than some other groups.

For example, telephone companies can easily distinguish commercial telephone subscribers from other subscribers based on the obviously enhanced economic benefit they derive from telephone service. Thus, telephone companies have two readily identifiable classes of customers, one of whom would be willing to pay a higher rate for telephone service than the other. The result is that telephone companies can safely enhance profits by charging different (discriminatory) rates to each of these two classes of customers.[39]

To summarize, price discrimination will only occur when there are two readily identifiable groups of customers who would be willing to pay different prices. In mass markets, this is most likely to occur when a firm faces differing levels of competition in different locations. A firm can then be expected to charge a higher price in areas where there is less competition and a lower price where it faces greater competition.

This is precisely what happens in the overbuilt markets for cable television services. When a system belonging to an incumbent operator is overbuilt by a newly entering operator and the newly entering operator does not build out the entire service area, the result is to create two easily distinguishable groups of customers, one group being in the competitive area the other being in the non-competitive area, who would be willing to pay different prices for cable service. It is natural under these circumstances that the incumbent operator (which we can assume hopes to maximize its profits) will charge the highest permissible price in all of the areas where it offers service. The highest permissible price will be higher in non-competitive areas than in areas where the incumbent faces direct competition.[40] Thus, the efficient, profit maximizing incumbent cable operator will establish a territorial pricing policy based on the differing levels of competition it faces in different areas. Absent any other factors that could be considered anti-competitive the incumbent operator is behaving as should be expected in a competitive market. It has lowered prices in response to competition — a desirable

39. The fact that higher rates for commercial users may be lawful, or otherwise justifiable, does not alter the economic analysis of why such rate differences occur or the results that accrue from those differences.

40. *See supra* note 37 and accompanying text.

result for consumers in those markets — and its conduct should be applauded, not condemned.

IV. THE CLAYTON ACT

As previously discussed, an economic price discrimination occurs when, in spite of differences in the cost of providing a product or service to different customers, the product is sold to both at the same price.[41] However, under the Clayton Act "price discrimination" refers simply to a price difference.[42] Section 623(d) will probably be interpreted in the same manner.[43] Therefore, under section 623(d) in order to establish a prima facie case of illegal price discrimination by a cable operator it would be necessary only to establish the existence of a substantial price discrimination between competing purchasers over time.[44] Thus, while cable operators' territorial pricing policies are economically defensible, they may expose the operator to charges of illegal price discrimination.

In recognition of the fact that under certain circumstances price discrimination might not result in any harm to competition but, rather, might be a legitimate tool of competition, section 13(b) of the Clayton Act provides that:

> [N]othing herein contained shall prevent a seller rebutting the prima facia case thus made by showing that his lower price . . . was made in a good faith to meet an equally low price of a competitor.

The language of section 13(b) has come to be known as the "meeting competition defense." Obviously the language of section 623(d) of the '92 Cable Act differs substantially from that contained in the Clayton Act. Most significantly it contains no explicit "meeting competition defense." However, three factors contribute to the conclusion that such a provision would be implied. First, key terms in section 623(d), such as "geographic area" are left undefined, or are defined in such a way as to cast no light on how section 623 should be interpreted. For example the definition for the term "cable system" is held over from the 1984 Cable Act. This definition, intended to distinguish between community antenna television systems and other types of video delivery systems, is of no use in interpreting section 623. Consequently the Court's will have great leeway in how they interpret that provision. Second, an extensive body of case law has developed under the Clayton Act, which contains an explicit meeting competition defense. These decisions are the most readily available source of authority for interpreting section 623(d). Third, to interpret section 623(d) in such a way as to preclude meeting competition would fly in the face of conventional economic theory. Barring one of two competitors from engaging in effective competition would be logically inconsistent with one of the major purposes of the act which is to promote competition.[45]

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41. *See* POSNER, *supra* note 27, at 62 n.35.
42. *Anheuser-Busch, Inc.*, 363 U.S. at 549.
43. Court decisions interpreting the Clayton Act represent the most highly developed body of law in this area and those decisions are undoubtably the first source Courts will turn to for guidance in interpreting section 623(d).
44. *See* FTC v. Morton Salt Co., 334 U.S. 37, 45 (1948) (interpreting the Clayton Act).
45. The Act is after all, the Cable Television Consumer Protection and *Competition* Act of 1992.

Indeed, as will be discussed, there is sound reason to believe that a meeting competition defense should be considered an implicit part of any legislation intended to prevent price discrimination and it is possible that the constitution requires that the defense of "meeting competition" be available. Consequently, the Clayton Act remains the best model for examining the legality of incumbent cable operators' territorial pricing policies.

Thus far, other than those decisions finding that cable television is a service rather than a product, there have been few significant court decisions on price discrimination in the cable television context[46], and none that have directly addressed the availability of a meeting competition defense. However, there has been at least one United States Supreme Court decision involving a case which came to the court under circumstances similar to those commonly encountered in cable overbuild situations.

In that case, *Falls City Industries, Inc. v. Vanco Beverage, Inc.*,[47] the plaintiff, Vanco Beverage ("Vanco"), successfully sued Falls City Industries ("Falls City") for price discrimination under the Clayton Act because Falls City had established a territorial pricing policy similar to the policies employed by incumbent cable operators to compete with overbuilders.[48] The trial court's decision in favor of Vanco was affirmed by the United States Court of Appeals for the Seventh Circuit and Falls City petitioned the United States Supreme Court for review.[49] Both the District Court[50] and the Circuit Court had concluded that Falls City could not justify its conduct on the grounds that it was meeting competition.[51]

Vanco was the sole distributor of Falls City's beer in Vandenburgh County, Indiana.[52] Vanco claimed that Falls City was engaged in illegal price discrimination because Falls City sold its beer to a distributor in Henderson County, Kentucky for a lower price than it charged Vanco.[53] While in a different state, Henderson County, Kentucky was immediately adjacent to Vandenburgh County, Indiana.[54] Vanco's claim of competitive injury was based on the fact that beer purchasers would drive to neighboring Vandenburgh County to get the benefit of the lower price being charged there.[55]

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46. There is one Federal decision that may have some remaining vitality. In Storer Cable Communications v. The City of Montgomery, Case No. 90-T-958-N (M. Dist. Ala. Oct. 9, 1992), it was necessary for the Court to decide whether a municipal uniform pricing ordinance was preempted under the 1984 Cable Act. The Court found that a portion of the ordinance directed at predatory pricing was preempted because it attempted to regulate rates for basic cable service. *Id.* at 51-52. However, after making note of the fact that 47 U.S.C. 202(a) prohibits price differences only where they lack a "neutral, rational justification", *id.* at 50, the Court found that the portion of the ordinance dealing with price discrimination was not preempted *so long as* it was interpreted in the same manner as 47 U.S.C. § 202(a). *Id.* at 51. Also worthy of mention is Dunlap v. Colorado Springs Cablevision, Inc., 799 P.2d 416 (Colo. App. 1990), discussed more fully, *infra* note 85, which interprets the Colorado price discrimination statute in a manner favorable to incumbent cable operators.

47. 460 U.S. 428 (1983).

48. *See id.* at 431-435.

49. *Id.* at 435.

50. *Id.* at 434-435.

51. *Id.* at 434.

52. *Id.* at 431.

53. *Id.* at 432.

54. *Id.* at 431.

55. *Id.* at 433.

In examining the facts, the Supreme Court noted that the meeting competition defense "requires the defendant to show only that its 'lower price was made in good faith to meet an equally low price of a competitor.'"[56] Thus, the Court found that if Falls City could demonstrate on remand that its lower Kentucky prices were justified by different competitive pressures than existed in Indiana its pricing policies would be protected by the meeting competition defense.[57]

Significantly, the Court went on to point out that so long as they were set in a good faith effort to meet competition, it did not matter whether the different prices were also "set with the goal of increasing the seller's profits."[58] Thus, if section 623(d) is interpreted to allow price differences, when made in a good faith effort to meet competition, a cable operator's territorial pricing policy would not be illegal even if the operator both lowers its price in competitive areas and raises its price in non-competitive areas.[59]

The Court in *Falls City Industries* stated:

> A seller need not choose between ruinously cutting its prices to all its customers to match the price offered to one, and refusing to meet the competition and then ruinously raising its prices to its remaining customers to cover increased unit costs. Nor, need a seller choose between keeping all its prices ruinously low to meet the price offered to one, and ruinously raising its prices to all customers to a level significantly above that charged by its competitors. A seller is permitted to retain a customer[60] by realistically meeting in good faith the price offered to that customer, without necessarily changing the seller's price to its other customers.
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> Section 2(b) does not require a seller, meeting in good faith a competitors low price to certain customers, to forgo the profits that otherwise would be available in sales to its remaining customers. The very purpose of the [meeting competition] defense is to permit a seller to treat different competitive situations differently. The prudent businessman might well raise his prices to some customers to increase his profits while meeting competitors' prices by keeping his prices to other customers low.[61]

The Supreme Court's analysis in the *Falls City* decision represents more than an effort to interpret the Clayton Act. Rather, what we see in this case is an effort to distinguish between conduct that is undertaken in a legitimate effort to

56. *Id.* at 444.
57. *Id.* at 451.
58. *Id.* at 444.
59. In *Falls City* the District Court established that the price differences resulted not from a reduction in price to the Kentucky distributor but because of increases in price to the Indiana distributor. *Id.* at 434. The Circuit Court's conclusion that this alone was "sufficient" to defeat Falls City's meeting competition defense, *id.* at 439, was specifically overruled. The Supreme Court found that "the meeting competition defense requires the seller to justify only its *lower* price." *Id.* at 442. Thus, in a price discrimination suit based on a cable operator's territorial pricing policy, evidence of price increases in non-competitive areas would be irrelevant. "[T]he prudent businessman . . . might well raise his prices to some customers to increase his profits, while meeting competitors' prices by keeping his prices to other customers low." *Id.* at 445.
60. The court noted elsewhere that the Act does not limit sellers' to reducing prices for the purpose of retaining existing customers. Prices can also be lowered in an effort to meet the competition for new customers. *Id.* at 446.
61. *Id.* at 444-45(citations omitted)(footnote added).

compete and, thus, which should not be condemned, and conduct that is predatory or culpable and which should not be tolerated.

Under this analysis it is evident that an incumbent cable operator who lowers prices in only those areas where an overbuilder has introduced direct competition is engaged in "meeting competition." This is natural competitive conduct that one would expect in a healthy market.[62]

Logically, since no direct competition exists in areas where the overbuilder has elected not to construct a system the incumbent operator should be free in those areas to leave prices as they were before competition was introduced in other areas, or even raise prices if it chooses to do so.[63] The fact that price differences exist for the purpose of maximizing profit, or even that prices might be raised in non-competitive areas for the purpose of increasing profit, is irrelevant.[64] Indeed, if one believes that direct competition in the cable industry is viable then such behavior might be considered laudable because, theoretically, increasing prices in non-competitive areas will tempt others to introduce competition into those areas.[65]

In the market for cable television services, reductions in price in competitive areas should only be condemned, if at all, when the newly established prices are clearly predatory.[66]

V. PREDATORY PRICING

Charges of price discrimination often arise in situations where a competitor is charging prices that are below some measure of cost. Where the other necessary elements of the charge are present, below cost pricing can be considered "predatory" and a violation of the antitrust laws. It is also considered strong evidence of the seller's intent in Clayton Act price discrimination cases. Evidence of a predatory intent is significant to this discussion because, when demonstrated to exist, it negates a defendant's argument that price differences were established in order to meet competition.

62. The recent trend has been to interpret the federal price discrimination statute "[a]s a means of enhancing price competition and increasing consumer welfare." CARLA A. HILLS, ANTITRUST ADVISOR 274 (3d ed. 1985). However, because cable television is a natural monopoly, competition cannot be promoted in a manner that is consistent with the goal of promoting consumer welfare. Indeed, artificially promoting competition, as some municipalities have attempted in the cable television market, runs the risk that upon the inevitable termination of competition the surviving competitor will pass on the cost of the competition to consumers. This is sometimes described as "destructive competition," *see* Pappas, *supra* note 37 at 213.

63. *See Falls City Industries*, 460 U.S. at 441.

64. *Id.* at 445.

65. Posner has noted that even in monopoly markets, "[i]n the long run, a persistently very large spread between price and cost may spur entrepreneurs to devise ingenious methods of challenging or supplanting the monopolist and legislatures of curbing him." POSNER, *supra* note 27.

66. An inference that prices are low enough to be predatory should not be drawn too easily. Since predatorily pricing its product would require a company to forgo profits for long enough to drive competitors from the market, and thereafter maintain low prices for long enough to recover losses and reap additional profit, true predatory pricing schemes are rare. *See* Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986). Furthermore, the defendant might well be able to establish other defenses to a charge of predation. It is also worth noting that once established predatory pricing violates the antitrust laws. *See id.* Thus, one must question the need for a charge of price discrimination based on evidence that prices are predatory.

Courts have applied a variety of tests for determining whether prices are predatory. In recent years, these tests have typically involved modest variations on the now-famous test proposed by Areeda and Turner which establishes a presumption of predation when prices are below marginal cost.[67] Because of the difficulty of establishing when prices are below marginal cost, courts have substituted average total cost as the proper legal measure for determining when prices are predatory.[68] However, the economic structure of cable television makes it no less difficult to establish any meaningful measure of average total cost than it is to establish marginal cost.

In the cable television industry average total cost is a constantly declining number. Thus, it would be difficult to establish the appropriate point in time when average total cost should be measured for the purpose of determining when prices are predatory.[69] Furthermore, because average total cost is constantly declining, a cable operator may have a legitimate business justification for pricing below average total cost that would be sufficient to overcome a presumption of predatory pricing.[70] Thus, we can see that applying the usual predatory pricing analysis to cable systems works an injustice. It would also have the economically undesirable result of reducing production.[71]

Any measure of average total cost applied to a cable system must include customers who have not yet signed on for service but who will eventually do so. To further demonstrate why this is so we examine what happens to average total costs when a new cable system is constructed. The vast majority of costs associated with cable television are fixed. That is, they remain the same regardless of the

67. Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related practices Under Section 2 of The Sherman Act*, 88 HARV. L. REV. 697, 716-18 (1975).

68. *See, e.g.*, McGahee v. Northern Propane Gas Co., 858 F.2d 1487, 1496 (11th Cir. 1988) (finding average total cost a proper measure and discussing the ways in which different courts have applied the Areeda & Turner test).

69. An operator who has a current average total cost of five dollars per customer might well reduce his rates to four dollars per customer in anticipation of signing up enough new subscribers to reduce his average total cost below the 4 dollar level, thereby increasing overall profits. Under traditional analysis, while this process is ongoing a presumption that prices are predatory arises. Ironically, after enough subscribers have been connected to the system to reduce costs to below the four dollar level a presumption arises that because prices are above average total cost they are not predatory. In the context of an industry where costs are continually dropping this approach produces wholly arbitrary results. Determinations of culpability are entirely dependent upon the time when one applies the pricing analysis.

70. *Supra* note 67. It is not even clear that the burden would be on the defendant to establish this point. In a predatory pricing case under Section 2 of the Sherman Antitrust Act a Plaintiff must present evidence that tends to preclude any rational business explanation for the defendant's conduct in order to avoid summary judgment. *Matsushita Electric Industrial Co.*, 475 U.S. at 585-88. This should also be true where predatory pricing serves as the basis of a complaint charging price discrimination. *See also* William Inglis & Son Baking Co. v. I.T.T. Continental Baking Co., 668 F.2d 1014, 1035 (9th Cir. 1981), *cert. denied*, 495 U.S. 825 (1982):

(If the defendants prices were below average total cost but above average variable cost, the plaintiff bears the burden of showing that defendant's prices were predatory. If, however, the plaintiff proves that the defendant's prices were below average variable cost, the plaintiff has established a prima facia case of predatory pricing and the burden shifts to the defendant to prove that the prices were justified.)

71. If a cable operator, by reducing prices to below average total cost in order to sign up new customers, runs the risk of being charged with predatory pricing, he will be inhibited from lowering prices. This will slow the rate at which new customers are signed onto the system; i.e., production will be reduced.

number of subscribers hooked up to the system. When construction of a new system is first completed and only one customer has been connected to the system all of the fixed costs associated with the system are directly attributable to that one customer. Thus, if the system costs $100,000 to install, the average total cost of serving all customers connected to the system — one — would be $100,000. When a second subscriber connects to the system average total cost drops to $50,000, and so on, until all potential customers have been served.[72]

The principles discussed above could be applied to the early introductory sales of any product regardless of the nature of the market. If measured during the time period before full production is reached, per unit costs will always be higher. However, natural monopoly markets like the market for cable television service are unique in that average total costs continue to decline at all stages of production.[73] Thus, even in cable television markets that are substantially developed it would not be inconsistent with sound marketing practice for an operator to sell cable service at below average total cost in anticipation of increasing subscribership, driving down average total costs, and ultimately reaping greater total profits.[74]

Furthermore, there are so many ambiguities regarding which competitor in a cable overbuild situation should be considered the predator,[75] that it would be unreasonable to apply traditional predatory pricing analysis to cable operators.

Given the widespread "good faith" belief[76] among cable operators, economists and other commentators, that cable television is a natural monopoly enterprise,[77] even when price reductions are undertaken for the purpose of deliberately driving an overbuilder out of the market, it is questionable whether lowering prices should be condemned. Statistically, cable overbuilds are extremely rare. Estimates vary but it appears that 99% of all cable television markets are served by only one operator.[78] They are also generally short lived.[79] Ultimately one firm or the other tends to go out of business; often times, one company purchases or merges with the other.[80] If the incumbent is operating under the good faith perception that because of the industry's natural monopoly charac-

72. Obviously, no Court would sustain a claim of predatory pricing against a cable operator based on calculations that were developed from these early stages of production. As an economic matter, to do so would deter all new entry. It has also been noted in discussing tertiary line cases under the Clayton Act that where a "seller's discriminatory pricing occurs in conjunction with its entry into a market" it would be difficult to establish competitive injury. HILLS, *supra* note 62, at 268.

73. Pappas, *supra* note 37, at 214.

74. "[U]ntil a company serves the whole market it will have an incentive to keep expanding in order to lower its average costs." Omega Satellite Products Co. v. City of Indianapolis, 694 F.2d 119, 126 (7th Cir. 1982).

75. *See supra* note 27.

76. *See Falls City Industries, Inc.*, 460 U.S. at 451 (pricing differences justified only where made in "good faith").

77. *See supra* note 11.

78. *See, e.g.*, Senate Hearings *supra* note 4, at 7 (Opening Statement of Senator Gorton).

79. *See* Metro Dade Report, *supra* note 8.

80. *See* Metro Dade Report, *supra* note 8. An excellent example of typical results from a cable overbuild is described by the court in Cable Alabama Corporation v. City of Huntsville, 768 F. Supp. 1484 (N.D. Ala. 1991). The court estimated that the two competing companies in that case sustained $25 million in losses over a three year period before reaching an agreement that called for the incumbent operator, Comcast, to buy out the overbuilder, Cable Alabama.

teristics only one cable firm can survive within a given geographic market, the incumbent can hardly be faulted for seeking to ensure that it is the survivor. "[A] prudent businessman responding fairly to what he reasonably believes are the competitive necessities" should not be punished for doing so.[81]

Assuming that the overbuilder entered the market with knowledge of the natural monopoly situation, it must necessarily have been operating under the belief that it would be able to drive the incumbent from the market.[82] Under these circumstances, perhaps it is the overbuilder, however misguided, who engaged in predatory conduct by electing to enter the natural monopoly market.

VI. CONCLUSION

Absent the defense of meeting competition, the application of section 623(d) of the '92 Cable Act to overbuilt cable television markets would have the effect of outlawing legitimate competition.[83] Even though section 623(d) does not explicitly incorporate a meeting competition defense, any court addressing the issue should, and probably would, find that such a defense is implicit[84] or would otherwise avoid reading the ordinance in such a way as to proscribe legitimate competitive conduct.[85] As the Supreme Court noted in the *Falls City* decision, "[t]erritorial pricing, . . . can be a perfectly reasonable method—*sometimes the most reasonable method*—of responding to rivals' low prices."[86]

Furthermore, because this is the case, and because section 623(d) does not apply equally to both cable competitors, it may lack the fundamental fairness that is required under the Federal Constitution.[87]

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81. *Falls City Industries, Inc.*, 460 U.S. at 450.

82. "If the prospective entrant realizes there is room for only one firm in the market it will not enter unless confident of being able to supplant the existing monopolist." Posner, *supra* note 36, at 611-612.

83. "It would be very difficult to draft a decree forbidding systematic price discrimination that did not constrain or inhibit legitimate pricing behavior as well." POSNER, *supra* note 27, at 65.

84. Implying the existence of a meeting competition defense would have a narrower result than would most of a Court's other options. For example, finding Section 623(d) unconstitutional would altogether forbid its future application, whereas, imposing a meeting competition defense would allow future applications under appropriate circumstances. Furthermore, there is some precedent for the Courts to follow in implying a meeting competition defense. Section 202(a) of the Communications Act, 47 U.S.C. § 202(a) (1992), states in pertinent part that "[i]t shall be unlawful for any common carrier to make any unjust or unreasonable discrimination in charges . . . directly or indirectly, by any means or device. . . ." This section contains no explicit meeting competition defense. However, it has been interpreted so as to allow common carriers to raise the defense that discriminations are justified by "competitive necessity." *See* American Broadcasting Companies, Inc. v. FCC, 663 F.2d 133, 139 (1980)(competitive necessity to be raised in the context of determining whether discrimination is unjust or unreasonable), *citing*, Western Union International, Inc. v. FCC, 568 F.2d 1012, 1019 (2d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978); American Telephone & Telegraph Co., (Tariff FCC No. 267), 62 F.C.C.2d 774(1977); American Telephone & Telegraph Co. (Hi/Lo), 55 F.C.C.2d. 225 (1975), *aff'd mem. sub nom.*, Commodity News Service, Inc. v. FCC, 561 F.2d 1021 (D.C. Cir. 1977).

85. There are several other alternative means besides "implying" a meeting competition defense that a court could employ to avoid an anti-competitive result. Indeed, one of the few state courts to address the issue of territorial pricing in cable services found that neither a local cable pricing ordinance, nor, the Colorado Price Discrimination Statute precluded territorial pricing by Cable operators. Dunlap v. Colorado Springs Cablevision, Inc., 799 P.2d. 416 (Colo. App. 1990). In avoiding a decision against the defendant cable operator the court found, *inter alia*, that the plaintiffs (residents of a non-competitive area) had suffered no injury from paying more for cable services. *Id.* at 417.

86. *Falls City Industries, Inc.*, 460 U.S. at 450.

87. It is well established that, even independent of any ordinance or law, governments have an

It is highly questionable whether direct competition in cable television is the panacea that some public officials once perceived it to be.[88] Until such time as steps are taken to change the fundamental structure of the cable industry[89] there will always be some question about whether cable services are fairly priced. In the interim, establishing and enforcing price discrimination rules in a punitive manner would only work an injustice. Other aspects of the '92 Cable Act will undoubtably be revisited within the next year or two. Congress should also revisit section 623(d) to incorporate an explicit meeting competition defense. Until that occurs cable operators and consumers will have to rely on the courts to read justice into the new law. In those communities where attempted cable overbuilds are underway, city officials and others would be wise to examine the incumbent operator's territorial pricing policies under the light of case law construing the Clayton Act to determine whether the operator's conduct is truly culpable before pursuing enforcement

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obligation to *treat* all similarly situated persons the same. Yick Wo v. Hopkins, 118 U.S. 356, 373 (1886)(even an ordinance "fair on its face and impartial in appearance" can be applied so as to deny equal protection). This principal is true of all activities a city seeks to regulate but because cable television implicates First Amendment interests, equal protection claims by cable television operators receive a heightened level of review. Tele-Communications of Key West, Inc. v. United States, 757 F.2d 1330 (D.C. Cir. 1985). After determining that it should have two cable operators a City is obligated to treat both operators equally. Cities cannot discriminate between First Amendment speakers. *See, e.g.*, Arkansas Writers Project Inc. v. Ragland, 481 U.S. 221 (1987); Minneapolis Star & Tribune Co. v. Minnesota Comm'r of Revenue, 460 U.S. 575 (1983); Grosjean v. American Press Company, 297 U.S. 233 (1936).

88. *See e.g.*, Neil W. Hamilton & Anne M. Caulfield, *The Defense of Natural Monopoly in Sherman Act Monopolization Cases*, 33 DePaul L. Rev. 466 (1984) ("Under natural monopoly conditions competition cannot regulate the market because inevitably only one firm will survive."). Posner, *supra* note 36, ("Competition is thus not a viable regulatory mechanism under conditions of natural monopoly.")

89. *See e.g.*, Bell *supra* note 14 (suggesting "unbundling" cable programming from the cable grid for regulatory purposes as a possible solution to many of the problems that plague the industry).