Abstract

We examine profit-maximizing nonlinear pricing under a stylized version of the FCC's price-cap plan for AT&T, whereby the firm's average revenue in each period is constrained not to exceed some fixed level. When average revenue in each period is calculated as the ratio of total revenue in that period to output in the preceding period (as in the FCC's plan for AT&T), incentives are created for the firm to engage in strategic nonlinear pricing. These incentives can lower both consumers' surplus and total surplus under price-cap regulation. We propose alternative implementations of price-cap regulation that eliminate these incentives for strategic pricing. We also examine whether current profits should influence future revisions of the cap. We show that small amounts of such linkage can enhance total surplus, due to pricing distortions that arise under price-cap regulation.