ECO 498 – Spring 2004 **Andreas Syz**
WSJ Assignment #2 **ID: 000005699**

Due: February 11

Case Study: AT&T's Big Gamble: Matching Discounts On Business Calling

A war of attrition is a price war in which the n players within an industry compete against each other until some rivals, or at most n-1 drop out. By analyzing this game in some detail one can show that there is a continuum of equilibrium strategies. In fact, there are several subgame-perfect (Nash) equilibria where the players with the lower value drop out immediately. In this case, the players with the highest value for the oligopoly (monopoly) win the oligopoly (monopoly) without having to compete at all! Engaging in this kind of price war is very costly. And as long as the ultimate equilibrium, where price equals marginal costs and thus zero profits, is not reached, the competitors still have an incentive to deflect by lowering prices and forcing other rivals out of the market!

Take, for example, n telecom firms that contemplate pricing below cost in order to build market share. If AT&T is known to have more cash and fatter profit margins than its rivals, perhaps due to significantly lower production costs, it is not implausible that firms with a lower value would give up at the outset, realizing that they would not be able to compete effectively against AT&T and other big companies.

AT&T’s statement that the company does not intend to lose on price clearly indicates that the company is ready to engage in this very costly war of attrition! Moreover, it can be interpreted as a signal of the willingness to regain market shares and accept a price close to the equilibrium price where no more profits can be extracted. Furthermore, a company as big as AT&T can afford this strategy because of possible cross subsidies and, therefore compensating these losses with profits in other business units. However, the telecom sector is a closely watched industry by regulatory agencies and so it is questionable how long these business practices will be tolerated, and thus makes this a successful strategy.

Eventually, this price war drives profit margins down to zero—a situation no one likes. But in today’s business environment it is all about market share. In the first place, this is a painful process; however, after the war of attrition AT&T tries to bond its customers, enhance services, and provide other special rates and plans. As soon as they have regained customer confidence they can build upon this reputation and may charge for the various services they offer, and squeeze out any profits from this services.

Furthermore, it is no coincidence that AT&T is launching this strategy during the economic recovery. With a bigger “war chest” AT&T is probably more prepared for this aggressive pricing strategy than its rivals, and therefore hopes to burn out its rivals’ cash. Moreover, with lower prices and more attractive offers AT&T will lure customers from MCI and other Baby Bells. In addition, AT&T is signaling to the market that it has survived the recession, is dominating the ongoing competition, comes out of the economic downturn in an invigorated manner, and is ready to serve the market and the customer needs. Whether AT&T will be able to accomplish its strategic concept and will work out remains to be seen.