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January 11, 1999

465p

Mrs. Blanca S. Bayo'
Director, Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

990000

Re: Comments of Sprint Communications Company Limited Partnership on the Merger
of GTE Corporation and Bell Atlantic Corporation

Dear Mrs. Bayo':

Enclosed are the original and fifteen (15) copies of the above-referenced Comments as well as ten (10) copies of Attachments A and B for filing.

An extra copy of this transmittal letter is enclosed which I ask you to please date stamp and return to the undersigned in the enclosed self-addressed stamped envelope.

Thank you for your assistance. Should you have any questions regarding this matter, please feel free to contact me.

Sincerely,

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ORIGINAL

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In re:)
Merger of GTE Corporation and)
Bell Atlantic Corporation)
_____)

Filed: January 11, 1999

COMMENTS OF
SPRINT COMMUNICATIONS COMPANY LIMITED PARTNERSHIP

I. BACKGROUND

On July 28, 1998, GTE Corporation ("GTE") and Bell Atlantic Corporation ("Bell Atlantic") announced their agreement to combine the two corporations in a merger of equals. Thereafter, on October 1, 1998, GTE and Bell Atlantic filed a Petition with the Florida Public Service Commission ("Commission") seeking approval of the transaction pursuant to Section 364.33, Florida Statutes. The Commission considered the Petition at the Agenda Conference held on November 17, 1998. On December 7, 1998, the Commission issued Order No. PSC-98-1645-FOF-TP, approving the Joint Petition pursuant to its authority contained in Section 364.33, Florida Statutes. In approving the Petition, the Commission stated: "...our approval in no way precludes us from addressing any of our concerns that may arise regarding this transaction to the appropriate federal agency." Order at p. 3.

During its internal affairs meeting held on January 4, 1999, the Commission decided to seek comments from interested persons on the impact the merger between GTE and Bell Atlantic would have on competition, market power and economic development. Accordingly, Sprint Communications Company Limited Partnership

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("Sprint"), by and through its undersigned attorney, files these Comments with the Commission.

II. INTRODUCTION

The Federal Communications Commission ("FCC") is reviewing the proposed Bell Atlantic/GTE merger in CC Docket NO. 98-184¹. Sprint has filed a Petition to Deny in that proceeding a copy of which is Attachment A to these Comments and incorporated by reference herein. Sprint's Petition outlines five fundamental reasons why the FCC should deny the Bell Atlantic/GTE merger petition. They are:

1. The merger will preclude competition between Bell Atlantic/GTE in local exchange markets.
2. The increase in local markets controlled by the merged entity would have significant anti-competitive effects on local, long distance, and new services markets.
3. The merger will diminish the effectiveness of regulation by reducing the number of available benchmarks.
4. The applicants have failed to describe how they intend to comply with the requirements of Section 271.
5. The claim that the merger will permit the Parties to enter 21 Out-of-Region Markets is not credible or enforceable, and it cannot in any event compensate for the anticompetitive effects of the merger.

While many of Sprint's issues and concerns are "national" in scope and appropriately considered by the FCC, the implications of this merger, especially in terms

¹ In re: Application of GTE CORPORATION, Transferor, and BELL ATLANTIC CORPORATION, Transferee, for Consent to Transfer Control.

of issues one and two, have a direct and material effect on the consumers of Florida and are therefore relevant to the Commission. Rather than reiterate the entire, Petition Sprint will highlight its concerns below.

III. THE IMPACT OF THE MERGER

1. The Bell Atlantic-GTE Merger Will Further Impede Local Exchange Competition

The consolidation that has been occurring in the telecommunications industry recently, particularly among ILECs, represents an enormous aggregation and concentration of market power that will halt the development of effective local exchange competition to the detriment of Florida consumers.² Absent the merger, Bell Atlantic would most likely be a formidable competitor to GTE as envisioned by the Telecommunications Act of 1996 ("Act").³

The merger of large ILECs spells death to local competition in contravention of the sound pro-competitive goals and policies of the Act and this Commission. As noted by the FCC in the Bell Atlantic-NYNEX merger, "[i]n telecommunications markets that are virtual monopolies or that are not yet developed, however, the loss of even one significant market participant can adversely affect the development of competition and the attendant proposals for deregulation."⁴

² The impact of ILEC mergers, including the Bell Atlantic-GTE merger, on competition was addressed at the NARUC 110th Annual Convention on November 11, 1998. Attached and incorporated herein as Attachment B is the panel presentation of Susan M. Baldwin, Senior Vice President of Economics and Technology, Inc., Boston, Massachusetts, on the issue of mergers.

³ Pub. L. No. 104-104, 110 Stat. 56. The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§151 *et seq.* ("Act").

⁴ Petitions of NYNEX Corporation and Bell Atlantic Corporation. For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, FCC File No. NSD-L-96-10, *Memorandum Opinion and Order*, 12 FCC Rcd 19985 (1997) ("FCC Bell Atlantic-NYNEX Order"), at ¶ 66, citing Areeda & Hovenkamp, 3

a. Absent the Merger, GTE Would Be A Strong Competitor of Bell Atlantic

Prior to announcement of the proposed merger, GTE indicated that it planned to expand its local presence outside of its regions and compete against the regional Bell Operating Companies ("RBOCs") in their territories. In this regard, through its subsidiary, GTE Communications Corporation ("GTECC"), GTE has been certified as a CLEC in several Northeast states served by the Bell Atlantic monopoly. Significantly, in Virginia, *GTE withdrew its application for statewide CLEC authority the day before filing for approval of the merger with this Commission and the FCC.*⁵

GTE would enjoy substantial advantages in negotiating interconnection agreements with its fellow ILEC, Bell Atlantic, since GTE would have better access to information regarding the local operations of ILECs than other possible entrants.⁶ Typically, CLECs trying to negotiate with ILECs have a significant disadvantage because of the asymmetry in information available to each side in understanding issues such as technical feasibility, the costs of providing interconnection, new means of interconnecting, etc. Another large incumbent is far better able to assess and contest claims by an ILEC that one form of interconnection is not feasible or too costly, and thus the product of these negotiations can be expected to produce more efficient arrangements for competitive entry. The consequences of this, given Section 252(i)'s most favored

Antitrust Law (rev. ed. 1996) at ¶ 170d ("merger with a potential competitor acquires special significance when one of the firms is a monopolist.").

⁵ *GTE Application for Public Convenience and Necessity to Provide Local Exchange Telecommunications Services*, Case No. PUC980080.

⁶ As the FCC noted in the FCC Bell Atlantic-NYNEX Order, "an incumbent LEC entering an out-of-region local market would bring particular expertise to the interconnection negotiation and arbitration process because of its intimate knowledge of local telephone operations." FCC Bell Atlantic-NYNEX Order ¶ 107.

nations obligations, are to improve interconnection for other CLECs and bring about competitive entry that much more efficiently and quickly.

If this proposed merger is allowed to proceed, GTE will be eliminated as a potential competitor in Bell Atlantic's territory and the development of local competition will be even slower. The presence of such a huge and financially strong national ILEC as the merged Bell Atlantic-GTE company would tend to discourage other large ILECs from attempting to enter the BA/GTE local market. Thus, consumers may ultimately be deprived of the benefits of this important mode of local exchange competition without any other tangible benefits or savings.

b. Bell Atlantic and GTE Have Not Opened Their Local Markets To Viable Competition As Required Under the Act

To date, Bell Atlantic and GTE have failed to open their local exchange markets to true competition. Viable local market entry is being delayed to the detriment of both would-be competitors and consumers because of the inferior operational support systems ("OSS") being offered to CLECs. Until fully electronic interfaces are more widely available, Bell Atlantic and GTE cannot be said to be offering operations support systems to competitors equal to what it provides itself. Without methods to process trouble reports electronically, competitors operate at a significant disadvantage, one clearly visible to the end-user. For example, in New York Bell Atlantic has not refuted CLECs' assertions that they receive far slower, less reliable, and more manual operations support than [Bell Atlantic] provides itself.⁷ Effective competition will never develop without commercially viable OSS.

⁷ *Case 97-C-0271, Petition of New York Telephone Company for Approval of its Statement of Generally Available Terms and Conditions and Draft Filing of Petition for InterLATA Entry, Ruling Concerning the Status of the Record at 22 (July 8, 1997).*

Bell Atlantic's refusal to provide unbundled network element ("UNE") combinations on reasonable terms also impedes the development of local competition. In fact, in New York Bell Atlantic continues to breach the terms of its interconnection contract with Sprint in which Bell Atlantic agreed to provide UNE combinations to Sprint.⁸ Moreover Sprint's recent Motion for Resolution of Disputed Issue filed with the Virginia Corporation Commission sets forth Bell Atlantic's delay tactics in reaching an interconnection agreement for Virginia and other Bell Atlantic South states.⁹

Yet another serious impediment to local competition is Bell Atlantic's provision of collocation, in terms of space availability, service delivery timeliness and cost.¹⁰ These proceedings demonstrate Bell Atlantic's erection of barriers to local market entry in the forms of inferior and costly interconnection, access to unbundled network elements and collocation arrangements, in addition to willful violation of voluntarily executed interconnection contracts. As demonstrated above, Bell Atlantic's actions or lack thereof, have been contrary to its commitment to open its markets to competition. This proposed merger may very well strengthen Bell Atlantic's and GTE's resolve to keep their local markets closed to competition.

⁸ N.Y. Public Service Commission, Case 96-C-0864, *Petition of Sprint Communications Company L.P. for Arbitration under Section 16 of the Interconnection Agreement* dated December 2, 1997.

⁹ Bell Atlantic refused to sign an interconnection agreement with Sprint for Virginia despite the fact that the arbitration had been completed and the language it objected to was proposed by Bell Atlantic and agreed to by Sprint. See Motion of Sprint Communications Company L.P. for Resolution of Disputed Issue filed December 16, 1998, in *Petition of Sprint Communications Company L.P. for Arbitration of Unresolved Issues From Interconnection Negotiations With Bell Atlantic-Virginia, Pursuant to Section 252 of the Telecommunications Act of 1996*, Case No. PUC960128.

¹⁰ Case 98-C-0690, *Proceeding on Motion of the Commission to Examine Methods by Which Competitive Local Exchange Carriers Can Obtain and combine Unbundled Network Elements*, Proposed Findings of Administrative Law Judge Eleanor Stein at 10 (August 4, 1998). As Judge Stein concluded, none of Bell Atlantic-NY's collocation methods offered to CLECs are adequate.

2. **The Bell Atlantic-GTE Merger Would Adversely Impact Competition in the Interexchange Market**

Approval of the merger would also harm competition in the long distance market, once the merged company gains Section 271 authority. Again, while the opportunity to discriminate in the provision of access to interexchange carriers currently exists, the potential for discrimination will be greater upon consummation of the merger.

Moreover, with the merger, the amount of traffic that would originate and terminate in-region, *i.e.*, in the combined region of the new Bell Atlantic-GTE, would materially increase. Sprint estimates that the new firm would terminate a weighted average of 42% of minutes that it controls on the originating end.¹¹ This represents a material increase in the weighted average number of minutes that each firm individually controls at both ends today: 38% of all minutes originating in each carrier's territory also terminate there. The fact that considerably more traffic will become 'in-region' for both ends of the call means that the merged entity can raise its long distance rivals' costs at both ends of more calls.

3. **The Bell Atlantic-GTE Merger Would Impede the Delivery of New Services to the Florida Market**

As carriers search for new, innovative ways to provide customers with improved services, they will require access to new and additional capabilities in the local exchange network. In Sprint's case, there is no better example of this than Sprint ION, or Integrated On-Demand Network. In order to bring this new and desired set of services fully to market, Sprint will need modifications to standard access and interconnection

¹¹ Weighted averages were used to remove the bias that would otherwise be created by the disparity in the amount of minutes that are originated and terminated by each carrier separately.

arrangements. This presents another opportunity for the ILEC to deny or delay services to CLECs dependent on the ILEC's network.

The merger would increase Bell Atlantic's and GTE's incentives to refuse to provide carrier-to-carrier services related to the delivery of new services like ION, because, as in the local and long distance markets, there will be no viable choice for new service providers other than the merged monopoly. As with competitive local exchange and interexchange services, new services, like Sprint ION, need access to ILEC facilities and to interconnect with ILEC networks. In addition to potential competitors, Florida consumers are disadvantaged in this process because they are denied the benefit of new innovative services at competitive prices. Consequently, the Commission should encourage the Federal Communications Commission to deny Bell Atlantic/GTE's Petition.

4. **The Proposed Merger Will Impede Local Exchange Access Competition and Could Result in Price Squeezing**

Additionally, the proposed merger gives Bell Atlantic/GTE absolute control over the origination and termination of an enormous amount of competitors' telephone calls in their regions. Sprint estimates that Bell Atlantic/GTE will terminate approximately 42 percent of all telephone calls. Sprint purchases a great deal of local exchange access services. Like other interexchange carriers, Sprint depends on local networks to reach its customers. Because approximately one half of interexchange carriers' costs are composed of access charges due to ILECs, Sprint, as well as other interexchange companies, are vitally interested in seeing local competition develop so long distance companies can have meaningful choices in local access suppliers. One avenue of

promise lies in large phone company entry into other companies' regions, but mergers like these preclude such competition.

Further, elimination of local exchange access competition guarantees that carrier access rates will never be based on forward-looking costs, thereby creating the potential for price squeezing by the proposed merged Bell Atlantic/GTE company. Bell Atlantic's and GTE's access rates continue to be well in excess of forward-looking costs. Consequently, the potential for anti-competitive price squeezing by Bell Atlantic/GTE is a reality.

5. **The Proposed Merger would be inconsistent with §271 Requirements for RBOC In-Region InterLATA Authority**

Although Bell Atlantic is currently prohibited from providing in-region interexchange services pursuant to Section 271 of the Act, GTE already provides these services. GTE/BA assert that if Bell Atlantic has not obtained 271 approval prior to consummation of the merger, the merged company will seek "transitional relief" from the FCC.¹² To date, Bell Atlantic has failed to satisfy the 271 checklist requirements and has not obtained the requisite approval from the Commission. "Transitional relief" is not available under the Act. Accordingly, any arrangement that would continue to give the merged company any interest in businesses or markets that are currently foreclosed to Bell Atlantic would be inconsistent with Section 271 of the Act. This is yet another reason merger approval must be withheld.

Prior to receipt of interLATA authority pursuant to Section 271, no Bell Operating Company ("BOC") is able to invest or acquire more than a 10 percent interest in an interexchange carrier in its region. That statutory proscription cannot be waived in

¹² Petition at 9.

any way, "transitionally" or otherwise. Without full divestiture of the forbidden businesses, the transaction is unlawful.

Pursuant to Section 271(a), neither a BOC nor "any affiliate" of a BOC may provide interLATA services, "except as provided in this section."¹³ Section 271 goes on to provide that, aside from certain "incidental" interLATA services not relevant here,¹⁴ no BOC or BOC affiliate may provide interLATA services "originating in any of its in-region States" until the FCC approves the BOC's application for such state under Section 271(d)(3).¹⁵

Consequently, at a minimum, the FCC should require the Petitioners to make a supplemental submission to demonstrate in detail how they will divest GTE's interLATA long distance businesses within Bell Atlantic's service territories prior to any Commission consideration of the merits of the Petition.

6. **Claims of Merger-Related Cost and Operational Efficiencies are not Supported**

In its Petition, Bell Atlantic claims that the proposed merger will create efficiencies that will result in cost savings and the adoption of the "best practices" of each of the individual companies to improve the quality and efficiency of service. These claimed efficiencies of the merger are unsupported. Bell Atlantic and GTE, as the proponents of the merger, bear the burden of proof regarding the sufficiency of these claims of merger-related efficiency. The Petition, however, offers no empirical evidence and thus no confirmation of the potential for these efficiencies or whether the claimed

¹³ 47 U.S.C. § 271(a).

¹⁴ 47 U.S.C. § 271(b)(3). These permitted activities are in any event subject (in most instances) to the structural separation requirements established in Section 272 of the Act, another provision ignored by the Petitioners.

efficiencies are achievable solely through the merger of these two companies. Moreover, the Petition is silent as to whether there will be merger-related savings passed on to consumers. As a condition to the Bell Atlantic-NYNEX merger, the New York Commission directed Bell Atlantic to flow through merger-related savings to its customers, however, to date, there has been no showing of savings to New York consumers resulting from the merger of NYNEX and Bell Atlantic.

Regarding the claimed efficiencies resulting from the merged company's adoption of the best practices of each firm, the adoption of the best practices of a comparable company is not limited to mergers. Bell Atlantic and GTE could improve their respective operations by adopting each other's best practices without a merger of the two companies. The merger, if approved, will eliminate another telecommunications company, and thereby, reduce the number of available benchmarks to compare company performance.

7. **Post-Merger Conditions Have Not Been Effective and Thus Cannot Be Relied Upon to Diminish the Adverse Competitive Effects**

As demonstrated, the proposed Bell Atlantic-GTE merger is anticompetitive, harmful to consumers, and therefore, approval of the merger must be denied.

Past experience confirms that a merger contrary to the public interest will not be remedied by attaching post-merger conditions to merger approval. The FCC approved the Bell Atlantic-NYNEX merger with post-merger conditions. These conditions relate to performance standards and associated remedies, performance monitoring reports, OSS and pricing. Bell Atlantic has attempted to evade compliance with the FCC's post-

¹⁵ 47 U.S.C. § 271(b)(1).

merger conditions facilitating the opening of markets to competitors. Accordingly, competitors have been forced to seek relief from the FCC.

In late 1997, AT&T and MCI each filed a complaint alleging that Bell Atlantic refused to price in accordance with the FCC Bell Atlantic-NYNEX merger conditions.¹⁶ AT&T complained that "[i]n none of [its seven pre-merger]¹⁷ jurisdictions has Bell Atlantic offered competing LECs access to network elements and interconnection at truly TELRIC-based rates."¹⁸ Rather, Bell Atlantic interpreted the Commission's TELRIC standard to permit Bell Atlantic to recover its "actual" costs -- including embedded costs. Furthermore, AT&T demonstrated that "Bell Atlantic's obligations regarding this forward-looking cost standard applied to existing offerings, not just those that post-dated the Commission's Merger Order."¹⁹ Bell Atlantic has ignored the thrust of the FCC Bell Atlantic-NYNEX Order, which contemplates that all competitors will benefit from prices established at costs (see FCC Bell Atlantic-NYNEX Order, at ¶ 200) including the condition #9 attached thereto, and has argued that only post-merger prices need be based upon forward-looking costs, and that pre-merger prices are not affected by the terms of *Bell Atlantic-NYNEX*.²⁰ The 1997 MCI Complaint echoed the problems identified in

¹⁶ See MCI Complaint, MCI Telecommunications Corp. and MCImetro Access Transmissions Services, Inc., File No. E-98-12 (FCC, filed Dec. 19, 1997) ("1997 MCI Complaint"); AT&T Complaint, AT&T Corp. v. Bell Atlantic Corp., File No. E-98-05 (FCC, filed Nov. 5, 1997) ("AT&T Complaint"). These complaints, by their own terms, only apply to the former Bell Atlantic states. See AT&T Complaint at n.1; 1997 MCI Complaint at n.1.

¹⁷ Delaware, District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia and West Virginia.

¹⁸ AT&T Complaint ¶ 21.

¹⁹ AT&T Complaint ¶ 4 (citing *Bell Atlantic-NYNEX* ¶ 185 -- "Bell Atlantic-NYNEX must, irrespective of whether either Bell Atlantic or NYNEX has a prior agreement with a competing carrier, offer all of the terms contained in the conditions to all competing carriers upon request.").

²⁰ See Bell Atlantic Answer, AT&T Corp. v. Bell Atlantic Corp., File No. E-98-05 (FCC, filed Dec. 15, 1997).

AT&T's complaint, using Bell Atlantic's proposals before the Pennsylvania PUC as a proxy for Bell Atlantic's activities before each of its respective state commissions.

MCI filed a subsequent complaint in March 1998,²¹ which alleged that Bell Atlantic again violated the merger conditions by "refusing to negotiate in good faith to develop adequate performance standards, remedies, and associated reporting."²² The 1998 MCI Complaint chronicled MCI's submission to Bell Atlantic of a comprehensive proposal addressing performance reporting, standards, and remedies, followed by Bell Atlantic's tactics to slow and extend the process.

In addition to these complaints to the FCC, MCI has documented that Bell Atlantic has failed to satisfy the conditions to the FCC Bell Atlantic-NYNEX Order in at least one other respect. In a filing with the NYPSC, MCI noted that

Bell Atlantic-South's current [OSS is] different from the systems available in Bell Atlantic-North. MCI has requested that Bell Atlantic-NY identify which systems will be in place in compliance with [Bell Atlantic-NYNEX], but to date MCI has not received an answer from Bell Atlantic-NY.²³

Bell Atlantic's failure to implement, within 15 months after its merger with NYNEX (i.e., by November 15, 1998), uniform OSS interfaces covering the entire Bell Atlantic-NYNEX combined regions and develop uniform interfaces within their current respective regions within 120 days of the Bell Atlantic-NYNEX merger as required by the FCC's Bell Atlantic-NYNEX merger conditions demonstrates that post-merger conditions are ineffective.

²¹ *MCI Complaint, MCI Telecommunications Corp. and MCImetro Access Transmissions Services, Inc. v. Bell Atlantic Corp.*, File No. E-98-32 (FCC, filed Mar. 17, 1998) ("1998 MCI Complaint").

²² 1998 MCI Complaint ¶ 8.

²³ See MCI Comments filed re: NYPSC Case 97-C-0271, at 12 (Aug. 18, 1998).

The FCC's experience overseeing compliance with the conditions they imposed on their approval of the Bell Atlantic-NYNEX merger exposes the limitations of imposing conditions to govern the future conduct of two local monopolies subsequent to a merger. Therefore, if the merger, as filed, is found to be contrary to the public interest, it must be denied.

IV. CONCLUSION

The preceding merely highlights the negative consequences of the merger. The vertical effects in the local, long distance, and new services markets are anticompetitive because the merger increases the incentive and the ability of the merged firms to exploit their monopoly control over interconnection and access services necessary to the provision of those downstream services. These conclusions, which are more fully discussed in Attachment A, demonstrate that the merger is contrary to the public interest. The FCC has repeatedly reviewed transactions for their vertical effects, including the likelihood of increasing incentives to raise rivals' costs through price and non-price discrimination. See, e.g., Merger of MCI Communications Corp. and British Telecommunications plc. GN Dkt. No. 96-245, *Memorandum Opinion and Order*, 12 FCC Rcd. 15351, 15412 (1997) ("we are concerned whether the merger . . . will increase the ability or the incentive of the vertically integrated firm to affect competition adversely in any downstream end-user market"): Sprint Corporation Petition for Declaratory Ruling Concerning Section 310(b)(4) and (d) and the Public Interest Requirements of the Communications Act of 1934, as amended, ISP-95-002, *Declaratory Ruling and Order*, 11 FCC Rcd. 1850, ¶¶ 58-60 (1996). In the specific context of its review of prior ILEC mergers, the FCC has expressly stated its concern not only for the market power and

possible misconduct that characterize the Regional Bell Operating Companies (RBOCs) pre-merger, but also “the incremental increase in that power or misconduct that will result from the proposed transfer.” Applications of Pacific Telesis Group and SBC Communications, For Consent to Transfer Control of Pacific Telesis Group and its Subsidiaries, Report No. LB-96-32, *Memorandum Opinion and Order*, 12 FCC Rcd. 2624, ¶ 120 (rejecting argument made by opponents because they had not shown how the merger would “increase applicants’ incentive or ability to engage in non-price discrimination”). Here, both the incentive and the ability to engage in anticompetitive conduct worsen with the merger.

Section 364.01(3), Florida Statutes provides: “[t]he Legislature finds that the competitive provision of telecommunications services, including local exchange telecommunications service, is in the public interest and will provide customers with freedom of choice, encourage the introduction of new telecommunications service, encourage technological innovation, and encourage investment in telecommunications infrastructure. Sprint believes the proposed merger will impede rather than promote the competitive goals of Chapter 364, Florida Statutes, and the Telecommunications Act of 1996.

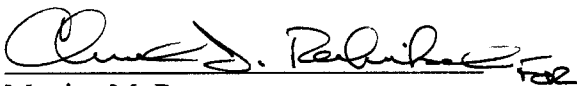
The Florida Legislature has directed the Commission to exercise its exclusive jurisdiction to ensure that all providers of telecommunications services are treated fairly, by **preventing** anticompetitive behavior. See Section 364.01(4)(g). Sprint urges the Commission to consider the effects of the merger on Sprint now. The anticompetitive effects of the merger will impact Sprint’s ability to provide consumers with the services the Legislature sought to promote with the revisions to Chapter 364, Florida Statutes.

The Commission's statutory mandate extends beyond merely correcting bad acts; it obligates the Commission to act affirmatively to assure the development of fair and effective competition.

Wherefore, Sprint respectfully requests the Commission to consider the anticompetitive effects of the proposed merger and to communicate its concerns to the FCC.

Respectfully submitted this 11th day of JANUARY, 1999.

Sprint Communications Company Limited
Partnership



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Atlanta, Georgia 30339
(404) 649-6221

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

In re Applications of)
)
GTE CORPORATION,)
Transferor,)
)
and) CC Docket No. 98-184
)
BELL ATLANTIC CORPORATION,)
Transferee)
)
for Consent to Transfer Control)

PETITION TO DENY OF SPRINT COMMUNICATIONS COMPANY L.P.

WILLKIE FARR & GALLAGHER
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20036
(202) 328-8000

November 23, 1998

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- ATTACHMENT A Declaration of Stanley M. Besen, Padmanabhan Srinagesh, and John R. Woodbury, Charles River Associates Incorporated, *An Economic Analysis of the Proposed Bell Atlantic-GTE Merger*
- ATTACHMENT B Declaration of Dr. Michael L. Katz and Dr. Steven C. Salop, *Using a Big Footprint to Step On Competition: Exclusionary Behavior and The SBC-Ameritech Merger*
- ATTACHMENT C Declaration of Joseph Farrell and Bridger M. Mitchell, *Benchmarking and the Effects of ILEC Mergers*

- ATTACHMENT D Declaration of John B. Hayes, Market Power and the
Bell Atlantic-GTE Merger
- ATTACHMENT E Affidavit of Kevin E. Brauer
- ATTACHMENT F Affidavit of Gene Agee
- ATTACHMENT G Affidavit of Steven Signoff
- ATTACHMENT H Bell Atlantic and GTE Appeals Under the
Telecommunications Act of 1996

BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

In re Applications of)
)
GTE CORPORATION,)
Transferor,)
)
and) CC Docket No. 98-184
)
BELL ATLANTIC CORPORATION,)
Transferee)
)
for Consent to Transfer Control)

PETITION TO DENY OF SPRINT COMMUNICATIONS COMPANY L.P.

Sprint Communications Company L.P. ("Sprint"), by its attorneys, hereby petitions the Commission to deny the above-captioned application of GTE Corporation and Bell Atlantic Corporation.¹ The proposed transaction is contrary to the public interest and should be disapproved.

I. INTRODUCTION AND SUMMARY.

In a time of nearly unprecedented consolidation, growth and integration in numerous industries across the American economic landscape, it is easy to get swept away with enthusiasm for the alleged unbridled opportunity promised by such trends. However, the proposed merger of Bell Atlantic and GTE, like the proposed

¹ Merger of GTE Corporation and Bell Atlantic Corporation, Application for Transfer of Control (Oct. 2, 1998) ("Application"). The Application was placed on Public Notice on October 8, 1998, Public Notice DA 98-2035.

merger of SBC and Ameritech, must not be confused with other, potentially welfare-enhancing proposals. Rather, the proposed merger of Bell Atlantic and GTE must be recognized for what it is: a consolidation that would significantly reduce both actual and potential competition in the provision of numerous telecommunications services, thereby harming consumers of these services.² Because such a result is antithetical to the public interest, the Communications Act mandates that the Application be denied.

The diminution of competition and the increase in harm to consumers occur on several fronts:

- First, the merger would preclude competition between the parties in specific local exchange markets. Although the Application attempts to minimize GTE's planned entry into Bell Atlantic's markets prior to the merger, the public record shows that GTE would have provided direct and significant competition in Bell Atlantic's territory absent the merger. This is particularly true with respect to certain areas of Pennsylvania and Virginia where GTE and Bell Atlantic have contiguous service areas.
- Second, the merger would increase the merged entity's incentive to deny, delay and degrade services upon which competition in

² An overview of the economic analyses supporting these conclusions is provided in the attached declaration of Dr. Stanley M. Besen, Dr. Padmanabhan Srinagesh and Dr. John R. Woodbury, "An Economic Analysis of the Proposed Bell Atlantic-GTE Merger," November 23, 1998, Attachment A ("Besen, Srinagesh and Woodbury").

several markets is dependent and thereby inhibit or prevent competition in these markets. The monopoly facilities and services under Bell Atlantic's and GTE's control are essential inputs for competitors in the downstream markets for local, long distance, and new services. While both Bell Atlantic and GTE have substantial incentive and ability to raise rivals' costs even before the merger, the increase in the number of local markets controlled by the merged entity will further increase these incentives and abilities. As explained in full by Dr. Michael L. Katz and Dr. Steven C. Salop in "Using a Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998, Attachment B ("Katz and Salop"), mergers between large ILECs, such as the proposed Bell Atlantic-GTE merger, would allow the merged firm to internalize certain spillover effects from exclusionary conduct, thereby making such conduct more profitable and increasing the incentive to discriminate against rivals. Moreover, the merger would increase the coordination of currently separate local exchange operations thereby increasing the ability to discriminate.

- Third, because the merger will diminish the number of independent firms, it will reduce the efficacy of benchmarking by regulators, making it more difficult for them to restrain the abuse of market power by ILECs. Benchmarking has become a very valuable regulatory tool to this Commission since the Bell System divestiture, as explained by Dr. Joseph Farrell

and Dr. Bridger M. Mitchell in their declaration, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998, Attachment C ("Farrell and Mitchell"). By decreasing the number of comparable independent firms (ILECs), the proposed Bell Atlantic-GTE merger would increase ILEC incentives to provide services inefficiently and would make discrimination and other exclusionary conduct less discernible and thus more likely to occur.

- Fourth, the applicants fail to substantively address how they would comply with Section 271 of the Act; instead, the applicants merely express their hope that the requisite 271 approvals will have been obtained prior to consummation or that the merged entity will obtain "transitional relief." The applicants' cavalier approach is entirely insufficient. The Commission cannot grant the Application based upon the applicants' hope that the transaction will comply with the Act, nor is "transitional relief" available. Compliance with Section 271 requires pre-merger divestiture of GTE's interLATA operations in all of the states in Bell Atlantic's region. Until and unless the applicants can demonstrate that the merger would not violate Section 271, the Application cannot be granted.
- The applicants' claim that the merger would allow the merged parties to enter 21 out-of-region markets is neither credible nor enforceable. Further, it cannot in any event compensate for the anticompetitive effects of the merger. As analyzed in

the Besen, Srinagesh and Woodbury declaration, the strategy has not been shown to be merger-specific nor likely to result in lower prices. By its terms, the strategy requires Section 271 authority throughout the Bell Atlantic region and thus cannot be implemented within the asserted time frame.³

Finally, even if accepted at face value, the strategy to enter as a competitor out-of-region cannot as a matter of law or policy override the anticompetitive effects of the merger in-region. Similarly, as explained in the Besen, Srinagesh and Woodbury declaration, the other efficiencies claimed by the applicants are neither supported⁴ nor are they sufficient to overcome the anticompetitive effects of the merger.

* * * *

It is noteworthy that the Application is devoid of economic analysis of the likely competitive effects of the proposed merger. The Application fails fundamentally in its public interest burden on this ground alone. The only semblance of such an analysis is a commissioned analysis of the stock prices of certain of Bell Atlantic-GTE's "competitors," which the applicants claim demonstrates that investors view the transaction "not as creating or maintaining market power but . . . creating

³ The monopoly control enjoyed by the two applicants in their respective regions is analyzed in the attached declaration of Dr. John B. Hayes, "Market Power and the Bell Atlantic-GTE Merger," November 23, 1998, Attachment D ("Hayes").

⁴ Indeed, both the cost reductions and revenue enhancements claimed by the applicants are little more than mere assertions.

significant new competition to AT&T, MCI WorldCom, Sprint, and SBC-Ameritech."⁵ In essence, the applicants claim that because the stock prices of these entities fell upon the announcement of the Bell Atlantic-GTE merger, investors view the transaction as promoting competition between those entities. As an initial matter, reliance on the expectations of investors to assess the competitive impact of a transaction is a dubious proposition at best.⁶ Indeed, Dr. Hazlett's conclusion does not follow from his statistical results, even if those results are assumed to be correct. Simply put, the analysis considers AT&T, MCI WorldCom, and Sprint only as horizontal competitors, and ignores that fact that AT&T, MCI WorldCom, and Sprint are also rivals to the ILECs and thus dependent upon the essential inputs (interconnection and access) supplied by Bell Atlantic-GTE. In these circumstances, the reduction in stock prices of interexchange companies is just as likely the result of investors' expectations that the merged entity would increase its efforts to foreclose competitive entry. Thus, Hazlett's factual findings are consistent with the Katz-Salop analysis that predicts increased incentives and ability to deny, delay, and degrade access to essential inputs.

5 See Application at Exhibit A.4; Public Interest Statement at 6 n.2 ("Public Interest Statement") (citing attached Declaration of Thomas W. Hazlett, Ph.D.).

6 The uncertainties of the stock market make it a poor indicator of the competitive impact of the merger. The study is evaluated in the Besen, Srinagesh and Woodbury declaration.

For the reasons set forth above, Sprint urges the Commission to deny the Application. Most importantly, the proposed merger would consolidate control over facilities that are essential inputs and thereby increase both the market power of the merged entity as well as its incentive to exercise that power to the detriment of competition, consumers, and, therefore, the public interest. The risk of harm here is palpable, direct, and insoluble through any means short of denying approval of the transaction.

II. THE MERGER WOULD PRECLUDE COMPETITION BETWEEN BELL ATLANTIC AND GTE IN LOCAL EXCHANGE MARKETS.

The merger would diminish actual and potential competition in local exchange markets. It is clear that both GTE and Bell Atlantic have significant advantages as ILECs seeking to enter other local service areas, including each other's service areas. Moreover, there is significant evidence demonstrating that GTE in fact planned to enter Bell Atlantic's region.

A. Commission Precedent Establishes That Reductions In Potential Competition Resulting From ILEC Mergers Are A Substantial Public Interest Concern.

In Applications of NYNEX Corporation and Bell Atlantic Corporation, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, FCC File No. NSD-L-96-10, *Memorandum Opinion and Order*, 12 FCC Rcd. 19985 (1997) ("Bell Atlantic-NYNEX"), the Commission stated that it relies upon the competitive effects analysis generated by general antitrust tools, such as the DOJ Merger Guidelines and the Herfindahl-

Hirshman Index.⁷ As in the Bell Atlantic-NYNEX proceeding, the Commission should rely upon the actual potential competition doctrine in conjunction with its own expert understanding of the telecommunications industry and laws to determine the potential harm to competition posed by the Bell Atlantic-GTE merger.

Under the actual potential competition doctrine, a merger between two firms may be found unlawful where the merger eliminates the "possibility of entry . . . in a more procompetitive manner."⁸ These effects are likely to be found where the relevant market is highly concentrated, entry barriers are substantial, and the merging firm is one of "a few firms that have the same or comparable advantage in entering" the market.⁹ While subjective evidence of intent to enter is unnecessary to find a firm to be a likely entrant into the market,¹⁰ both objective and subjective evidence indicating likely entry are probative.¹¹

⁷ See, e.g., DOJ Comment and Petition for Hearing, filed in Triathlon Broadcasting Company and Capstar Radio Broadcasting Partners, Inc., For Consent to Assignment of Licenses of Stations (Oct. 19, 1998) ("It is well established that the Commission may consider antitrust concerns when evaluating whether the public interest is being served.") (citations to U.S. Supreme Court cases omitted).

⁸ DOJ Merger Guidelines § 4.112 (1984).

⁹ Id. § 4.133.

¹⁰ See, e.g., United States v. Falstaff Brewing Corp., 410 U.S. 526, 545 (1973) (Marshall, J., concurring); Mercantile Tex. Corp. v. Board of Governors, 638 F.2d 1255, 1270 (5th Cir. 1981).

¹¹ Subjective evidence that the firm would not have entered is in fact discounted as "it may be motivated by a wish to

The Commission has already ruled that its own analysis of the potential competitive effects of a proposed merger under the public interest standard is not rigorously tied to a specific number of other possible entrants. The Commission has reasoned that, especially in light of the highly concentrated and evolving nature of local telecommunications markets,¹² it is not bound by the set number in the Guidelines developed for stable markets. An examination of these factors warrants the conclusion that the merger will have adverse competitive effects in the markets for local exchange and exchange access in numerous local markets throughout the service territories of Bell Atlantic and GTE.

B. The Service Areas Of Bell Atlantic And GTE Are Not Competitive.

Local exchange and exchange access services have been repeatedly found by the FCC to constitute discrete relevant economic markets.¹³ In *Bell Atlantic-NYNEX*, the Commission also identified relevant submarkets formed by clusters of consumers with similar demand patterns. These include large businesses/government users, medium-sized businesses, and residential/small business users (mass-market).

influence merger litigation." See Areeda & Turner, 5 Antitrust Law ¶ 1121b2 (1980).

¹² "In telecommunications markets that are virtual monopolies or that are not yet developed, however, the loss of even one significant market participant can adversely affect the development of competition and the attendant proposals for deregulation." *Bell Atlantic-NYNEX* ¶ 66, citing Areeda & Hovenkamp, 3 Antitrust Law (rev. ed. 1996) ¶ 170d ("merger with a potential competitor acquires special significance when one of the firms is a monopolist.").

¹³ See, e.g., *Bell Atlantic-NYNEX* ¶ 51.

Competition for these services occurs within a specific LATA as well as in a market comprising a metropolitan area. The Commission also considered, but found unnecessary to analyze, additional geographic areas in which the economic effects of the merger could be measured. A full economic analysis for these product and geographic market definitions is provided in the declaration of Dr. John Hayes, Attachment D.

These relevant markets (and submarkets) are unquestionably concentrated, with Bell Atlantic and GTE operating telephone companies enjoying virtual monopolies for these services.¹⁴ This conclusion does not warrant extensive fact gathering; it is a matter subject to official notice within the Commission's administrative expertise. Notwithstanding the Application's mischaracterizations of these markets,¹⁵ one need only consider the fact that not one of the states involved has found that Bell Atlantic is facing sufficient competitive entry under Track A of Section 271 -- a standard that itself falls short of a finding that the markets are robustly competitive.¹⁶ Further, these markets are characterized by high entry barriers. As the Commission observed in *Bell Atlantic-NYNEX*, the large ILECs' failure to agree to and implement effective interconnection arrangements has significantly slowed the removal of entry

14 See Hayes passim.

15 See Public Interest Statement at 29-30 ("Even today, Bell Atlantic is already facing extensive competition in Pennsylvania and Virginia.").

16 See infra n.131 and accompanying discussion.

barriers that the 1996 Act had set as a principal Congressional goal.¹⁷ The added legal uncertainties created by the litigiousness of the ILECs prevents the FCC from remedying these difficulties.

C. Bell Atlantic And GTE Are Among The Most Likely Potential Entrants Into Other Service Areas, Including Each Other's.

There is also substantial objective evidence that Bell Atlantic and GTE can each be considered one of a small number of actual or likely entrants into each other's local markets. These carriers have advantages in entering local markets that are unavailable to virtually all other potential entrants. These advantages include experience in providing local services, particularly expertise in established complex systems to handle administrative capabilities (billing, order taking, customer care, etc.) not enjoyed by other possible entrants such as cable companies or CAPs. Bell Atlantic and GTE also serve adjacent areas in Pennsylvania and Virginia, enabling either of them to deploy in-region switches, transport facilities, and rights-of-way to serve out-of-region contiguous areas. In addition, adjacency would also facilitate ease of provisioning, maintenance and repair. Their adjacent operations, coupled with existing out-of-region businesses such as interLATA services (GTE only), cellular and PCS, also aid in consumer brand recognition out-of-region.¹⁸ The applicants have themselves emphasized the

¹⁷ *Bell Atlantic-NYNEX* ¶ 4.

¹⁸ These factors distinguish the FCC's finding in *SBC-PacTel*,

advantage of adjacent operations to competitive entry.¹⁹ Further, extensive national advertising campaigns, discussed in the following sections, have made both companies household names.

Bell Atlantic and GTE also enjoy substantial advantages in negotiating interconnection agreements with other ILECs, since they have better access to information regarding the local operations of ILECs than other possible entrants.²⁰ Typically, CLECs trying to negotiate with ILECs are at a significant disadvantage because of the asymmetry in information available to each side in understanding issues such as technical feasibility, the costs of providing interconnection, and new means of interconnecting. Another large incumbent is far better able to assess and contest claims by an ILEC that one form of interconnection is not feasible, or too costly, and thus the product of these negotiations can be expected to produce more efficient arrangements for competitive entry. The consequences of these advantages, given Section 252(i)'s most favored nation

where "the two merging companies' territories were not adjacent (and certainly without a major center of population and telecommunications on their border); neither company had assets, customers or a recognized brand name in the other's territory; and there was no realistic suggestion that either one had ever considered entering the other's markets for local exchange service." *Bell Atlantic-NYNEX* ¶ 69.

¹⁹ See Public Interest Statement 1, 7-8, 13.

²⁰ As the Commission noted in *Bell Atlantic-NYNEX*, "an incumbent LEC entering an out-of-region local market would bring particular expertise to the interconnection negotiation and arbitration process because of its intimate knowledge of local telephone operations." *Bell Atlantic-NYNEX* ¶ 107.

obligations, are to improve interconnection for other CLECs and bring about competitive entry that much more efficiently and quickly.

In *Bell Atlantic-NYNEX*, the Commission found that other entrants, such as wireless carriers, cable companies and CAPs, are not as significant potential entrants as are RBOCs.²¹ Given the fact that GTE is larger than four of the original seven RBOCs (measured by 1997 revenues), GTE should be included along with the RBOCs as among the first tier of potential CLEC entrants. The applicants have not put forth any persuasive case here to the contrary. And while the Commission found MCI, AT&T and Sprint to be among the most significant likely entrants in *Bell Atlantic-NYNEX*, the advantages enjoyed by Bell Atlantic and GTE in entering each other's markets make the large long distance carriers run "second" by a considerable margin among the most significant entrants.

This evidence standing alone indicates substantial anticompetitive effects of the merger because it would eliminate the potential competition these companies will face if they enter each other's territories. Moreover, the public record reflects specific evidence regarding planned entry by GTE into local markets served by Bell Atlantic in Pennsylvania and Virginia. The Application also strongly suggests that further inquiry is required in order to understand why Bell Atlantic apparently

²¹ Id. ¶ 94.

tabled plans to enter GTE's markets after the Bell Atlantic-NYNEX merger.

D. Evidence Suggests That GTE Planned To Enter Bell Atlantic's Region Prior To The Merger.

Prior to its agreement to merge with Bell Atlantic, GTE appears to have devoted substantial resources and to have taken fundamental steps toward competing outside of its local service areas, including those areas served by Bell Atlantic and adjacent to GTE's local service areas -- Pennsylvania and Virginia -- as well as other Bell Atlantic states -- Connecticut, Maryland, New Hampshire, and Rhode Island. Not only has GTE established a CLEC subsidiary, GTE Communications Corporation ("GTECC"), to enter those areas, it has obtained or applied for the necessary regulatory approvals, negotiated the required interconnection agreements with Bell Atlantic (among others), and secured the necessary financing for this out-of-region strategy from its parent corporation. GTE already is authorized to provide interLATA services in all 50 states, enabling it to provide a package of local and toll services. And GTE instituted a highly extensive and successful national advertising campaign specifically intended to increase brand name awareness for this out-of-region strategy.

Until the day prior to filing the merger application -- when it withdrew its CLEC application in Virginia²² -- GTE's actions

²² See Application at Exhibit A.4, Declaration of Hubert Stallard ¶ 4 ("Stallard") (GTE withdrew its certification application in Virginia the day before the Bell Atlantic-GTE Merger Application was filed with the FCC). It is not clear

were those of a carrier seeking to create a nationwide local exchange presence. These procompetitive actions, taken by one of the largest telecommunications companies in the world, will be reversed by the merger.

In its 1997 Annual Report, GTE described its out-of-region strategy:

[In 1997, we formed GTE Communications Corporation -- which is our competitive local-exchange carrier, or CLEC. It will be able to market the full spectrum of GTE services, including local, long-distance, wireless and data services, without regard to franchise boundaries. This unit will help us . . . become a national provider of telecommunications and data services. At year-end 1997, this group was aggressively marketing a full array of bundled services in California and Florida, with plans to market in additional states by year-end 1998.²³

GTECC's actions in Pennsylvania and Virginia (where it has adjacent facilities) and Connecticut, Maryland, New Hampshire and Rhode Island, where it is certified to provide local exchange service, are consistent with its stated plan to enter Bell Atlantic's region by year-end 1998. In Virginia, GTECC applied to the state commission in May 1998 for a certificate to provide

whether GTE has withdrawn its application in Pennsylvania. See Application at Exhibit A.4, Declaration of Daniel J. Whelan ¶¶ 7-8.

²³ GTE 1997 Annual Report at 5; see Application of GTE Communications Corporation of Virginia for a Certificate of Public Convenience and Necessity to Provide Local Exchange Telephone Services, Case No. PUC 980080, Application of GTE Communications Corporation of Virginia ¶ 9 (filed May 27, 1998) ("GTE Communications Corporation has been certified to provide competitive local exchange service in twenty-three states and currently does provide competitive local offerings in eight states (California, Florida, Texas, Washington, Illinois, Indiana, Kentucky and Tennessee)"). ("Virginia Application").

"competitive local exchange service throughout Virginia . . . to both residence and business customers"24 Not only has GTE applied for or obtained certification in these states, in Connecticut and Rhode Island it has made the additional effort to re-apply to the respective state commission in order to extend its authority from resale only to facilities-based as well.25

In each of these states, GTE stated that it was financially qualified to pursue its competitive entry.26 In its Virginia application, GTE touted its technical and managerial qualifications, as well as its financial qualifications for such competitive entry.

Applicant's financial qualification is derived from the financial resources of GTE Communications Corporation, its parent entity, and ultimately, GTE Corporation. GTE Corporation will provide all funding necessary for the start-up operations of Applicant.27

24 Virginia Application at 1 & ¶ 14. GTE not only applied for a certificate in Virginia, but it already had existing facilities in Virginia that it could use to provide service as a local exchange competitor. See Declaration of Jeffrey C. Kissell ¶ 15 ("Kissell") ("GTE South, an incumbent local exchange carrier, has had a small fiber ring in Virginia since the late 1980s that it uses to provide access for AT&T and MCI . . . points of presence in Bell Atlantic's territory.").

25 Application of GTE Communications Corporation to Expand its Certificate of Public Convenience and Necessity, CtPUC Dkt. No. 97-09-32, Decision (Oct. 28, 1997); GTE Communications Corporation Application for Expansion of Authority to Provide Local Exchange Services throughout the State of Rhode Island, filed with RiPUC (Mar. 4, 1998).

26 See, e.g., GTE Communications Corporation Application for Expansion of Authority to Provide Local Exchange Services throughout the State of Rhode Island at 4, filed with RiPUC (Mar. 4, 1998).

27 Virginia Application ¶ 8.

In Pennsylvania, GTECC attached a letter certification from GTE to its application specifying that "GTE Corporation will financially support GTECC's competitive local exchange carrier activities in the state of Pennsylvania."²⁸ In its other CLEC applications, GTECC similarly relied upon the financial qualification of GTE Corp. to demonstrate its financial qualification to compete as a CLEC.²⁹

In its Public Interest Statement to this Commission, however, GTE implies that it is not financially capable of pursuing such CLEC entry, insofar as the applicants claim that competitive entry can only effectively be pursued with the financial backing of Bell Atlantic in conjunction with the resources of GTE.³⁰ However, GTE's certification applications and representations to state commissions -- as well as simple common sense -- establish that GTE has the resources to enter Bell Atlantic's service area on its own.

²⁸ Application of GTE Communications Corporation for approval to offer, render, furnish, or supply telecommunication services as a competitive local exchange carrier to the public in the Commonwealth of Pennsylvania within territories of incumbent local exchange carriers who are not rural telephone companies or otherwise exempt from interconnection, PaPUC Dkt. No. A-310291F0002, at Exhibit C (Apr. 9, 1998) ("Pennsylvania Interconnection Application").

²⁹ See, e.g., GTE Card Services Inc., Application for Certificate to Provide Local Exchange Telecommunications Service at 5, filed with the FLPSC (Nov. 20, 1996) ("GTE . . . is relying on the financial strength of GTE Corporation as represented in the consolidated financial statements contained in the annual reports and Securities and Exchange Commission 10-K reports . . .").

³⁰ Public Interest Statement at 7.

GTE's intent to enter is also evidenced by its interconnection agreements with Bell Atlantic in several states,³¹ as well as GTE's efforts to create a national brand in support of its out-of-region CLEC strategy. GTE's prosecution of these interconnection agreements speaks volumes about the immediacy of its intentions to enter and compete in the provision of local exchange services. For example, in its application for approval of its interconnection agreement with Bell Atlantic in Pennsylvania, GTECC stated

The [Pennsylvania] Agreement is an integrated package that reflects a negotiated balance of many interests and concerns critical to both parties. . . . The parties respectfully request that the [Pennsylvania] Commission expedite its review of the Agreement to facilitate implementation of competition in the local exchange market.³²

Perhaps not surprisingly in light of its present aspirations, GTE now urges the Commission to ignore this evidence of its anticipated entry in Bell Atlantic's region, claiming that the agreements were merely "cloned" from agreements of other CLECs.³³ This assertion is wholly without merit.

³¹ See, e.g., Joint Petition of Bell Atlantic - Pennsylvania, Inc. and GTE Communications Corporation of an Interconnection Agreement Under Section 252(i) of the Telecommunications Act of 1996, PUC Dkt. No. A-310291F0002, *Joint Petition* (filed Aug. 28, 1998) ("Pennsylvania Interconnection Application"); Joint Application of Bell Atlantic - Virginia, Inc. and GTE Communications Corporation of Virginia of an Interconnection Agreement Under Section 252(e) of the Telecommunications Act of 1996, Case No. PUC 980120, *Joint Application* (filed Aug. 13, 1998).

³² Pennsylvania Interconnection Application ¶¶ 4, 9 (emphasis added).

³³ See Kissell ¶ 15.

Section 252(i) of the 1996 Act specifically provides for most favored nation adoption of other interconnection agreements in order to expedite competitive entry. A CLEC's election under Section 252(i) does not somehow render the agreement less meaningful. GTE has elsewhere demonstrated a remarkable appreciation for the value of Section 252(i) elections; it challenged Sprint's right to make a Section 252(i) election in no fewer than nine states. Sprint was forced to pursue costly litigation, including two court appeals, before GTE would (apparently) abandon its frivolous position. Thus, the fact that GTE's interconnection agreements may have been established through 252(i) elections is not relevant; the interconnection agreements are clear evidence of GTE's entry intentions.

Further evidence of GTE's intent and ability to enter other local exchange service areas, including Bell Atlantic's, is found in its recent national advertising campaign. GTE retained the national advertising firm of Ogilvy & Mather to launch this campaign with the stated intent to become a "national player."³⁴ In his 1998 Chairman's Message, GTE's Chairman Charles R. Lee discussed the campaign:

"People Moving Ideas" is both the theme of this annual report and our new national advertising campaign. These three words capture the spirit and direction of today's GTE: We are a company on the move. We're people who move ideas, one person to another, one company to another, anywhere in the world.³⁵

³⁴ "A Bigger Player," Delaney Report, No. 1, Vol. 9 (Jan. 12, 1998).

³⁵ GTE 1997 Annual Report at 2, Chairman's Message, Charles R.

Moreover, GTE's traditional advertising focus has "emphasized national, strategic branding."³⁶ As explained below, this evidence further demonstrates that GTE is a likely potential entrant in its own right, despite GTE's protestation to the contrary.

In his affidavit, Mr. Kissell asserts that "GTE's brand has little weight outside of its wireline and wireless territories,"³⁷ which allegedly limits its ability to enter as a CLEC. This claim, however, is contradicted by recent public statements of Glen Gilbert, GTE's Vice President of Advertising stating just the opposite -- that GTE's national campaign has been effective in out-of-region markets:

Before we started our "People Moving Ideas" campaign, our target audience wasn't sure exactly who GTE was. . . . Our research suggests awareness is now up in and out of our franchise markets, as is purchase intent. Now we need to take the next step and say now that you know us, here's why we're beneficial to you with different products.³⁸

Lee, Chairman and Chief Executive Officer (Feb. 20, 1998).

³⁶ Jeffrey D. Zbar, The Business Marketing Top 100, Advertising Age Website, <http://www.adage.com/news_and_features/special_reports/bm100-1995/top3.html> ("The branding focus on GTE's telecommunications core business has gone on for years, said Edward MacEwen, VP-corporate communications. While regional telecommunications business-including telephone, wireless, data service, telephone directories and the company's in-flight Airfone product . . . receives what he called 'tactical advertising' through short-term campaigns, the company traditionally has emphasized national, strategic branding.") (visited Nov. 17, 1998) (emphasis added).

³⁷ Kissell ¶ 11.

³⁸ "Strategies focus on products, services: Telecommunications -- Pitch to niches a priority over image ads," Advertising Age, Oct. 5, 1998, at s20 (emphasis added).

Curiously, and in contradiction to this, Mr. Kissell further asserts that "[n]either company [has] the plans or the resources required to create a national brand on its own."³⁹ Mr. Kissell's claim that GTE lacks the resources to create a national brand is equally contrary to the facts: GTE's 1997 total U.S. advertising budget was the 109th largest for any corporation or entity -- \$185.4 million.⁴⁰ GTE's efforts to suggest that it lacks certain resources to enter Bell Atlantic's and other "necessary" regions are simply contrary to the facts. Its protestations to the contrary notwithstanding, GTE is one of a small group of likely potential entrants into Bell Atlantic's region and accordingly, the Application must be denied.

E. Bell Atlantic's Statements Suggest That It Planned To Enter GTE's Region.

Just as GTE is a likely entrant into Bell Atlantic's region, Bell Atlantic is a likely entrant into GTE's region. Though Sprint is not privy to internal documents and reports that would

³⁹ Kissell ¶ 11.

⁴⁰ Numerous corporations maintain strong national brand names while spending less on advertising than does GTE. The following are a representative sample: Goodyear Tire & Rubber Co. (\$175.5 mil.); The Gap (\$174.9 mil.); BMW (\$160.9 mil.); Dominos Pizza (\$159.6 mil.); CompUSA (\$142.4 mil.); Reebok International (\$137.4 mil.); CBS Corp. (\$134.4 mil.); Federal Express Corp. (\$125.6 mil.); Bausch & Lomb (\$117.8 mil.); Xerox Corp. (\$116.6 mil.); Delta Air Lines (\$109.2 mil.); Apple Computer (\$107.9 mil.); United Parcel Service of America (\$100.5 mil.); Staples, Inc. (\$85.2 mil.). See R. Craig Endicott, "43rd Annual: GM Knocks P&G from Top Spot; Ends Package-Goods Giant's Consecutive Streak at 7: Leaders Swell Spending by 8.6%, to \$ 58 Billion," Advertising Age, Sept. 28, 1998, at s8.

shed additional light upon Bell Atlantic's intentions prior to agreeing to merge with GTE, Bell Atlantic's corporate characteristics, geographic coverage, and abilities suggest that it is one of a small number of likely entrants into GTE's local exchange region. Moreover, affidavits to the merger application suggest that Bell Atlantic once had, even if it no longer has, plans and reports regarding such entry. The Commission must undertake further inquiry of these initial plans and the causes for their abandonment.

Many of the explanations Bell Atlantic proffers for not entering the adjacent territory of GTE in Pennsylvania and Virginia cannot withstand even minimal scrutiny. Bell Atlantic denies any intent or interest to compete in any of GTE's territories, but then explains that it has in fact pursued several different competitive opportunities involving Dulles International Airport in Virginia. It also describes a "possible alliance" with a significant cable television-based CLEC (Cox) in Virginia Beach.⁴¹ Since these areas are not represented to be the only competitive ventures considered by Bell Atlantic into any of GTE's territories, there may well be others.

There are significant areas of governmental presence and dramatically growing commercial activities in such areas as Norfolk and Manassas, Virginia. In addition to the well-known military presence, NationsBank, for example, maintains its mid-Atlantic headquarters in Norfolk. Moreover, Norfolk has been

⁴¹ See Stallard ¶¶ 5, 13-14.

central to the growth of technology-based businesses in Virginia. According to a recent study by Microsoft Corporation, Norfolk leads the state of Virginia with 1,152 high-tech companies, having total sales of over \$1 billion dollars.⁴²

Mr. Stallard claims that Bell Atlantic, unlike other CLECs, would be prevented from going after such larger users:

I doubt that Bell Atlantic, as the largest carrier in the state, would be permitted to simply cherry-pick the most lucrative customers of the smaller telephone companies elsewhere in the state. To the contrary, I expect that we would be saddled with more onerous requirements to serve a large customer base, making the economics of providing competing local service unattractive.⁴³

This statement is grounded in pure conjecture, and indeed is inconsistent with the very business activity described with respect to Dulles Airport and Virginia Beach. In addition, it appears to be a misreading of Virginia state law.⁴⁴ Bell

⁴² See "Microsoft and Microsoft Solution Providers Invest in Development Of Richmond IT Market; Virginia Leads Region in High Tech Growth -- Richmond, Charlottesville, Norfolk Strong Players," PR Newswire, Nov. 11, 1998, available in LEXIS, News Library, Crnews File.

⁴³ Stallard ¶ 16.

⁴⁴ Virginia regulations state: "to the extent economically and technically feasible, the new entrant should be willing and able to provide service to all customers in the same service classification in its designated geographic service area in accordance with its tariff offerings." 20 Va. Admin. Code § 5-400-180 (1997) (emphasis added). This does not appear to require the provision of service to both residential and business customers, nor does it require immediate, ubiquitous coverage if doing so is economically infeasible. See also Va. Code Ann. § 56-265.4:4C.1 (Michie 1995). Depending upon the particular market circumstances, for a state government to do otherwise may even constitute the erection of an insurmountable barrier to entry to competition in the local exchange, contrary to the 1996 Act.

Atlantic is under no special obligation in this regard. Virginia state regulations specifically classify and treat incumbent LECs such as Bell Atlantic as a "new entrant" for the provision of service outside its region -- the same classification as any other CLEC.⁴⁵

Bell Atlantic's implausible reasons for non-entry, while other CLECs are entering Virginia and while GTE's number of access lines continues to grow at an industry-leading rate of 8 percent,⁴⁶ appear to be litigation/merger-motivated. Indeed, Mr. Stallard's declaration alludes to the existence of analysis and reports regarding earlier plans for entry, apparently abandoned around the time Bell Atlantic agreed to acquire NYNEX:

I am aware of no analysis undertaken since 1996 by Bell Atlantic of the merits of establishing a competing local exchange operation in GTE's Virginia territory. Since the NYNEX merger, no group or person within Bell

See 47 U.S.C. § 253 (preempting any state or local statute or regulation that has the effect of prohibiting the provision of intra- or interstate telecommunications service).

⁴⁵ See 20 Va. Admin. Code § 5-400-180 ("'New entrant' means an entity certificated to provide local exchange telephone service in Virginia after January 1, 1996, under § 56-265.4:4C of the Code of Virginia. An incumbent local exchange telephone company shall be considered a new entrant in any territory for which it obtains a certificate to provide local exchange service on or after January 1, 1996, in accordance with these rules and which is outside the territory it is certificated to serve as of December 31, 1995.") (emphasis added).

⁴⁶ "GTE Announces Strong Financial Results, Generating Double-Digit Consolidated Revenue Growth and 11% Core EPS Growth in Second Quarter," Edge (July 27, 1998); see also Bell Atlantic-NYNEX ¶ 63 ("[W]e also consider matters that would be material to the entry of all precluded competitors as a class. . . [such as] whether the relevant market is expanding. . . .").

Atlantic has had the mandate of undertaking such an analysis.⁴⁷

The Commission must investigate these earlier analyses, and the actual reasons for their (apparent) abandonment.⁴⁸

III. THE INCREASE IN LOCAL MARKETS CONTROLLED BY THE MERGED ENTITY WOULD HAVE SIGNIFICANT ANTICOMPETITIVE EFFECTS IN LOCAL, LONG DISTANCE AND NEW SERVICES MARKETS.

ILECs enjoy monopoly control over interconnection and access services -- the inputs necessary for the provision of numerous downstream services, including local exchange, long distance, and new services. ILECs can exploit their monopoly power to maximize profits either by raising the price of interconnection charged to rivals or by impairing their access to essential inputs. Because interconnection prices are subject to regulatory oversight, non-price exclusionary behavior is more readily available to ILECs and far more difficult to regulate and correct. As explained by Drs. Katz and Salop, a discriminatory interconnection policy will be profitable for an ILEC so long as its gains in the downstream retail market exceed the revenues it foregoes from wholesale interconnection with rivals.

⁴⁷ Stallard ¶ 5 (emphasis added); see id. ¶ 9.

⁴⁸ Without full understanding of the actual facts, the Commission cannot adequately consider the merits of the Application. See Bell Atlantic-NYNEX ¶ 75 ("[W]e consider all plans . . . as potentially relevant to the analysis of market participants. Accordingly, the facts and circumstances concerning such planning should be forthrightly presented to the Commission.").

Significantly, the adverse effects from ILECs' discriminatory practices go far beyond the harm imposed on competitors. As explained by Drs. Katz and Salop:

The market suffers efficiency losses because the incentives to invest in R&D and physical infrastructure to provide these competitive local and long-distance services are reduced. Moreover, the costs of retail services will be increased, which can be expected to raise the retail prices paid by consumers and thus lower consumer welfare and suppress output below efficient levels.⁴⁹

Increasing the number of local markets within the merged entity's control would give it an increased ability and incentive to disadvantage rivals by discriminating in interconnection or refusing to deal altogether. This incentive and ability are heightened beyond those already held by Bell Atlantic and GTE separately. As explained by Drs. Katz and Salop, the anticompetitive incentives of ILECs to engage in exclusionary conduct increases substantially as the size of their monopoly service areas increases. Thus, the merger would have serious anticompetitive effects on new entrants into local telephony, would adversely affect competition between ILECs and IXCs both in anticipation of and when they are free to enter long distance markets, and will delay and potentially foreclose new innovative services and/or combinations of services that threaten the BOC monopoly.

⁴⁹ Katz and Salop at 33.

A. Anticompetitive Effects On Local Markets.

In each local market, Bell Atlantic and GTE have the ability to exercise monopoly power over essential inputs in order to deter new entry.⁵⁰ This is of course the fundamental insight of the 1996 Act, and its imposition of numerous obligations upon incumbent telephone companies to provide the necessary inputs on a commercially viable basis. As a matter of legislative finding, then, competitors in local markets are especially vulnerable to discrimination by the incumbent monopolies.⁵¹

However, discriminatory conduct is especially difficult to regulate since the availability of many of the needed inputs for local telephony interconnection is still uncertain. In some cases, this uncertainty flows directly from litigation brought by GTE, Bell Atlantic, and other large ILECs.⁵² In other cases,

⁵⁰ See generally Hayes at 21-22.

⁵¹ It should be noted that the RBOCs will retain considerable monopoly power even when the Section 271 standards for entering long distance markets are met.

⁵² The litigation pursued by each GTE and Bell Atlantic in efforts to forestall implementation of the 1996 Act is listed in Attachment H.

Another source of uncertainty can be created when ILECs take advantage of regulatory changes for anticompetitive purposes. For example, Bell Atlantic has demonstrated a disregard for the most favored nation provision of Section 252(i) of the Act. On October 23, 1998, Sprint requested that Bell Atlantic make available to Sprint the interconnection terms and conditions set forth in the Bell Atlantic-Maine/COMAV Telco, Inc. contract approved July 2, 1998, the Bell Atlantic-Rhode Island/Brooks Fiber contract effective April 10, 1997, and the Bell Atlantic-New Hampshire/Freedom Ring Communications, L.L.C. contract approved January 13, 1997. As of November 18, Bell Atlantic had not provided the requested documents despite repeated telephone inquiries, which prompted a letter of that date

such as OSS, complete standards and interfaces have either not been implemented or even designed and agreed upon by the industry. Performance measures that would monitor discriminatory provisioning are similarly not in place. Access to other necessary inputs (UNEs, etc.) is also in doubt because of restrictions placed on such access by the large ILECs.⁵³ All of these factors point to the ability of Bell Atlantic and GTE to "deny, delay or degrade" access, as Drs. Katz and Salop explain.⁵⁴ For the reasons explained in detail in their declaration, briefly summarized below, the merger would increase the merged entity's incentive to act on this ability.

Discrimination practiced in one local market creates effects in other local markets. When an RBOC currently engages in discrimination against a CLEC, it weakens that CLEC's ability and incentive to enter and compete in other regions. As explained by Drs. Katz and Salop, "if a CLEC suffers lower quality or higher

indicating that enforcement action by the appropriate state commissions would be requested if the agreements were not forthcoming. On November 19, Bell Atlantic responded by claiming that the Commission's recent decision regarding ISP traffic justifies modifications of the previously-approved interconnection agreements, and that Bell Atlantic would not execute any proposed agreements absent such modifications.

⁵³ See generally Affidavit of Kevin E. Brauer, Attachment E ("Brauer").

⁵⁴ See Katz and Salop at 17; see also Farrell, Joseph, "Creating Local Competition," 49 Fed. Comm. L.J. 201, 207 (Nov. 1996) (An ILEC's ability to deny, delay or degrade access is a problem that is "hard to regulate away, because the withdrawal of cooperation from rivals may be subtle, shifting, and temporary, but yet have real and permanent effects.").

costs, reduced market share, and lower profitability in one region, those factors will reduce the likelihood that it enters other regions"⁵⁵ or will cause the CLEC "to enter [other regions] at a lower scale, with higher prices, or reduced service offerings."⁵⁶ Especially for potential entrants planning to enter at a sufficiently large scale as to include numerous major markets, i.e., national CLECs such as major IXCs, the discrimination practiced in one region or one local market may impair their national or multi-regional plans.

Thus, the discriminating ILEC is not able to capture the full benefits of its discrimination because its misconduct raises its rivals' costs both inside and outside the discriminating ILEC's region; in other words, the discriminating ILEC's misconduct "spills over" into the region of other ILECs, which in effect "free ride" on the misconduct of the discriminating ILEC.

These spillover effects are heightened where, for example, CLEC entry entails common research, product development and marketing costs that must be covered by the sum of the CLEC's market-specific profits. Because these conditions hold for large scale CLECs, ILEC discrimination in one region against such firms reduces their profitability and thus the likelihood of entry in all regions.

Discrimination practiced by one ILEC in one market therefore creates anticompetitive spillover benefits for other ILECs

⁵⁵ Katz and Salop at 42.

⁵⁶ Id.

controlling other local markets. The merger increases the extent to which this effect becomes internalized, because it increases the number of local markets under the control of the merged entity. Thus, the larger the ILEC "investing" in discrimination the more fully it is able to appropriate the gains from its "investment."⁵⁷ By increasing the size of the "footprint" of the merged entity, the merger increases the rewards of discrimination and thus makes it more certain to be practiced in both Bell Atlantic's and GTE's service areas.

Drs. Katz and Salop identify several detriments to the public interest that will result from the merged entity's increase in exclusionary conduct. Obviously, rival CLECs will be injured and will become less effective competitors to the ILECs. As competition is weakened, consumers will suffer higher prices and reduced quality and choices, resulting in reduced consumer welfare. This harm is magnified if excluded or disadvantaged competitors could have offered consumers new services, lower cost services, or higher quality services absent the discriminatory practices of the ILEC.

The fundamental basis of the concerns described by Drs. Katz and Salop -- the increased harmful incentives and ability to disadvantage rivals flowing from the aggregation of horizontal

⁵⁷ Moreover, the merged entity may benefit in multiple markets from exclusionary behavior practiced in one market if it gains "a reputation among entrants as a firm that excludes rivals, and thereby may deter the entrants from attempting to enter to begin with, or it may slow down their entry plans." Katz and Salop at 41 n.56; see Areeda & Hovenkamp, 3 Antitrust Law ¶ 727g (1996).

monopolies -- is not new to competition jurisprudence. Indeed, the seminal Supreme Court case on monopoly leveraging fifty years ago specifically alluded to the dangers of increasing the number of local monopolies held by a firm bent on leveraging its power:

A man with a monopoly of theaters in any one town commands the entrance for all films into that area. If he uses that strategic position to acquire exclusive privileges in a town where he has competitors, he is employing his monopoly power as a trade weapon against his competitors. It may be a feeble, ineffective weapon where he has only one closed or monopoly town. But as those towns increase in number throughout a region, his monopoly power in them may be used with crushing effect on competitors in other places.⁵⁸

As recognized in this seminal case and described in detail by Drs. Katz and Salop, the statutory mandate in favor of competition in the local loop dictates that the Commission must not allow the proponents of the merger to obtain such a large footprint that they can crush local competition.

B. Anticompetitive Effects On Interexchange Markets.

A similar analysis yields the conclusion that the merger would also produce anticompetitive effects in long distance markets, once the merged firm gains Section 271 authority. Again, as Drs. Katz and Salop demonstrate, the incentive and ability to discriminate in the provision of access to IXCs exist pre-merger, and they worsen with the merger.

As long as Bell Atlantic and GTE succeed in maintaining their dominance in their local markets, "they have the power to

⁵⁸ United States v. Griffith, 334 U.S. 100, 107 (1948) (Douglas, J.) (emphasis added).

technically discriminate in favor of their own competitive long-distance operations."⁵⁹ Mr. Hatfield, now Chief, Office of Engineering and Technology, has explained that recent developments in local networks have in fact increased the risk of technical discrimination. The development and deployment of intelligent (software-driven) networks, in conjunction with the demand for multimedia applications, materially changes the environment from the traditional, standardized voice and data interconnections to a substantially more dynamic environment in which individual customers and carriers can be given customized arrangements to enable either more efficient use of traditional services and/or new services. This complexity, while making new services possible, also gives the ILECs new opportunities to favor their own operations.

The merger increases the incentive to discriminate because the merged entity is able to secure a larger share of the benefits of discrimination than either ILEC can secure separately. The merger will allow the merged entity to capture the benefit of its exclusionary actions on both ends of the call in both Bell Atlantic's and GTE's region. Thus, by internalizing the payoff (the anticompetitive spillover benefits), the merger makes discrimination more profitable and thus more likely.

⁵⁹ Affidavit of Dale N. Hatfield, Ex. H to Comments of MCI Communications Corp. (filed in FCC CC Dkt. No. 97-137, Application of Ameritech Michigan Pursuant to Section 271 to Provide In-region, InterLATA services in Michigan) ("Hatfield").

The merger would exacerbate the ability to discriminate as well. An IXC requires interconnection at both ends of the call in order to provide service. As described by Drs. Katz and Salop, "[i]f the ILEC providing terminating access to the IXC denies or degrades that access, then an ILEC competing with the IXC to offer long distance service at the originating end also will benefit."⁶⁰ Moreover, with the merger, the amount of traffic that would originate and terminate in-region, i.e., in the combined region of the new Bell Atlantic-GTE, would materially increase. Sprint estimates that the new firm would terminate 43% of the minutes that it controls on the originating end, which compares to a weighted average of 36% for the two companies separately. Thus, the merger would increase the number of minutes controlled at both ends by about 20%. An even more dramatic increase occurs for traffic that originates in GTE's territory. Only 16% of that traffic terminates in GTE's territory today but 29% would terminate in the combined territory of Bell Atlantic and GTE after the merger. The fact that considerably more traffic will become "in-region" for both ends of the call means that the merged entity can raise its long distance rivals' costs at both ends of more calls.

C. Anticompetitive Effects On New Services.

A comparable analysis holds for new services and/or combinations of services. The Commission must fully consider the ways in which these new service providers (or combined service

⁶⁰ Katz and Salop at 41.

providers, or "CSCs") are put at risk by the increased incentives and opportunities for discrimination described herein: service innovation is a stated priority of this Commission.⁶¹ As discussed above, technical advancements to local exchange networks make possible and desirable customized access and interconnection arrangements. Competitors' needs to acquire ILEC inputs in nontraditional forms or in new price configurations gives the ILECs an improved opportunity for denial and delay notwithstanding the most vigilant regulatory oversight.

As carriers search for new, innovative ways to exploit technology to give customers service improvements, they will require access to new and additional capabilities in the local exchange network. In Sprint's case, there is no better example of this than Sprint ION, or Integrated On-demand Network. In order to bring this new and desired set of services fully to market, Sprint will need modifications to standard access and interconnection arrangements.⁶²

As Mr. Hatfield explained in the FCC's Michigan 271 proceeding, ILECs can discriminate against competitors or potential competitors in such cases through outright refusals of appropriate interconnection arrangements or by "slowrolling"

⁶¹ See Inquiry Concerning the Deployment of Advanced Telecommunications Capability, CC Dkt. 98-146, Notice of Inquiry (rel. Aug. 7, 1998); Inquiry Concerning the Deployment of Advanced Telecommunications Capability, CC Dkt. 98-146, Notice of Proposed Rulemaking (rel. Aug. 7, 1998).

⁶² See Brauer passim.

competitors. "The ability to refuse or delay such requests puts Ameritech in the position of controlling the development of new and competitive services, both as to whether the new service is created at all, or more subtly, when it comes to market and who can provide it."⁶³

The combination of GTE and Bell Atlantic would increase these ILECs' incentives to refuse to cooperate for new services like ION, because, like the effects in local and long distance, the combined entity's presence in a very large number of markets means that the rewards of discrimination in one market are more fully captured in the larger region.

Two of the mechanisms that create these spillover effects for CSCs are the same as those for CLECs and IXC. Like CLECs and IXCs, CSCs (like Sprint ION) need access to ILEC facilities and to interconnect with ILEC networks. As described above, an ILEC that discriminates in the provision of these inputs creates anticompetitive benefits for other competitors of the CSCs. Similarly, some if not most CSCs (like Sprint ION) confront common fixed costs and investment decisions that affect more than one market, as well as other economies of scope.⁶⁴ Denial of these economies in one market effectively denies them in all markets, to the detriment of competition both inside and outside the merged entity's service area.

⁶³ Hatfield at 21.

⁶⁴ Affidavit of Gene Agee passim, Attachment F ("Agee").

The third source of spillovers for CSCs is an application of the network effect. For CSCs such as Sprint's ION, which are in essence a network of services the value of which rises as more customers are added to the network, discrimination in one market will ripple throughout other markets. Where a service (like Sprint ION) offers increased value to subscribers for on-net communications, exclusionary conduct that reduces the number of subscribers in one region reduces the value of the service in other regions. As a result, the payoff to the RBOCs from exclusionary behavior is materially greater post-merger.⁶⁵

D. The Commission Should Deny The Application On The Basis Of These Adverse Vertical Effects.

The preceding demonstrates that the competitive consequences of the merger are unambiguously negative. As shown, the vertical effects in the local, long distance, and new services markets are anticompetitive because the merger increases the incentive and the ability of the merged firms to exploit their monopoly control over interconnection and access services necessary to the provision of those downstream services.⁶⁶

⁶⁵ See Katz and Salop at 44-45; Agee at 11-13.

⁶⁶ In a footnote, the applicants contend without analysis that the Commission's jurisdiction over the Application is limited by Section 2(b) of the Act, that the Commission's public interest analysis of the transfer of licenses and certificates is limited to the interstate uses of those authorizations, and that the Commission lacks authority to enforce Section 7 of the Clayton Act with regard to this merger. The Commission rejected these arguments in *Bell Atlantic-NYNEX*, stating that "[t]here is long-standing precedent supporting fulsome public interest analyses of the competitive implications of transfers of Title II certificates and Title III licenses, and for review of

These consequences warrant the conclusion that the merger is contrary to the public interest. The Commission has repeatedly reviewed transactions for their vertical effects, including the likelihood of increasing incentives to raise rivals' costs through price and non-price discrimination. See, e.g., Merger of MCI Communications Corp. and British Telecommunications plc, GN Dkt. No. 96-245, *Memorandum Opinion and Order*, 12 FCC Rcd. 15351, 15412 (1997) ("we are concerned whether the merger . . . will increase the ability or the incentive of the vertically integrated firm to affect competition adversely in any downstream end-user market"); Sprint Corporation Petition for Declaratory Ruling Concerning Section 310(b)(4) and (d) and the Public Interest Requirements of the Communications Act of 1934, as amended, ISP-95-002, *Declaratory Ruling and Order*, 11 FCC Rcd. 1850, ¶¶ 58-60 (1996). In the specific context of its review of prior ILEC mergers, the Commission has expressly stated its concern not only for the market power and possible misconduct that characterize the RBOCs pre-merger, but also "the incremental increase in that power or misconduct that will result from the proposed transfer." Applications of Pacific Telesis Group and SBC Communications, For Consent to Transfer Control of Pacific

larger merger transactions even where the Commission authorized licenses represent only a very small part of the overall transaction," and that "the public interest analysis necessarily includes a review of the nature and extent of local competition, as exemplified by the fact that Section 271 of the Act specifically applies the public interest standard to, inter alia, a review of local market conditions." *Bell Atlantic-NYNEX* ¶ 35.

Telesis Group and its Subsidiaries, Report No. LB-96-32, Memorandum Opinion and Order, 12 FCC Rcd. 2624, ¶ 42 (1997); see Bell Atlantic-NYNEX ¶ 120 (rejecting argument made by opponents because they had not shown how the merger would "increase applicants' incentive or ability to engage in non-price discrimination"). Here, the showing has been plainly made; both the incentive and the ability to engage in anticompetitive conduct worsen with the merger.

The Commission has plenary authority over questions of industry structure. The Commission's statutory mandate extends well beyond merely correcting bad conduct; it obligates the FCC to act affirmatively to assure efficient industry structures that themselves will minimize such conduct. On numerous occasions, reviewing courts have upheld the FCC's use of its broad authority to prescribe a particular industry structure in order to achieve perceived benefits or to avoid potential problems.

The FCC's initial Computer Inquiry proceeding provides a clear example of such action. In Computer I, the FCC promulgated regulations that required common carriers to provide non-regulated data services through a structurally separate corporate entity. The Second Circuit upheld the FCC's authority to regulate common carrier entry into the unregulated field of data processing services:

The burgeoning data processing activities of the common carriers pose, in the view of the Commission, a threat to efficient public communications services at

reasonable prices and hence regulation is justified under its broad rule-making authority.⁶⁷

In so doing, the Court rejected petitioners' attempts to narrow the FCC's authority.

It is irrelevant that the [separation] rule is aimed at potential rather than actual domination or restraints, or that the Commission is not certain that the developments forecast will occur if the rule is not enacted.⁶⁸

The FCC's authority over the structures of the industries it regulates extends to outright proscription of certain entities participating in some markets. The FCC's cable-telephone cross-ownership rules promulgated in 1970, and eventually removed by Congress after the rules had served their purpose, are a prime example of this.⁶⁹ In reviewing the agency's initial decision, the Fifth Circuit explained the Commission's broad authority under the Communications Act, specifically relying upon Sections 151, 152(a), and 214:

The Commission is obliged to discharge its responsibilities in this area as best it can and it has chosen in this instance to implement the national policy by limiting the involvement of common carriers, over which the Commission has unquestioned jurisdiction, in CATV operations. . . . Although [the

⁶⁷ GTE Serv. Corp. v. FCC, 474 F.2d 724, 730 (2d Cir. 1973).

⁶⁸ Id. at 731 (citation omitted): In Computer II, the Commission required AT&T to provide data services through a separate subsidiary and once again the appellate court deferred to the Commission's determination of the appropriate industry structure. Computer & Communications Indus. Ass'n v. FCC, 693 F.2d 198 (D.C. Cir. 1982).

⁶⁹ These rules were ultimately codified by Congress, and subject to constitutional challenges. See Chesapeake & Potomac Tel. Co. v. United States, 42 F.3d 181 (4th Cir. 1994). The litigation was mooted by the amendments made by the Telecommunications Act of 1996.

FCC] does not yet know how broadband cable services will or should develop, it is unwilling at this point to allow the telephone companies to pre-empt the field simply by virtue of their control over means. . . . [The elimination of this danger is consistent with the Commission's broad duties under the Communications Act.⁷⁰

These cases demonstrate the prophylactic nature of the FCC's powers over industries it regulates. Plainly the FCC has the authority -- indeed the obligation -- to consider transactions in light of whether they promote efficient market structures. It need not and must not acquiesce in proposals that force it to await the inevitable inefficient outcomes and search for after-the-fact remedies. The proposed combination will harm both competition and consumers; the Commission must avoid this result by denying the Application.

IV. THE MERGER WILL DIMINISH THE EFFECTIVENESS OF REGULATION BY REDUCING THE NUMBER OF AVAILABLE BENCHMARKS.

The Communications Act requires common carriers to offer services with "just and reasonable" terms and conditions, and common carriers may not engage in "unjust or unreasonable discrimination" in their provision of services.⁷¹ Similarly, ILECs are required to provide interconnection to other carriers on "rates, terms, and conditions that are just, reasonable, and nondiscriminatory."⁷² These matters must be resolved by regulation, at present, due to the substantial and persisting

⁷⁰ General Tel. Co. v. FCC, 449 F.2d 846, 854-857 (5th Cir. 1971) (emphasis added) (citation omitted).

⁷¹ 47 U.S.C. §§ 201(b), 202(a).

⁷² 47 U.S.C. § 251(c)(2)(D).

market power wielded by the ILECs resulting from their monopoly control of bottleneck facilities. One key way in which the Commission can determine whether common carriers are meeting their statutory obligations is to compare the varying practices of different carriers. As explained in full in the attached declaration of Dr. Joseph Farrell and Dr. Bridger Mitchell, "Benchmarking and the Effects of ILEC Mergers," benchmarking is a significant regulatory tool.

Benchmarks aid the Commission in overcoming the substantial asymmetry in information availability that otherwise impedes effective regulation. For example, benchmarking allows the Commission to better assess what practices are technically feasible, to ascertain whether rates are reasonable, and to scrutinize unusually poor performance and remedy it. As the number of comparable carriers decreases through merger, however, the Commission's ability to establish and rely on benchmarks declines. And as regulatory effectiveness diminishes, the risk of detection of misconduct decreases, making engaging in such misconduct less costly and therefore more likely. This predictable increase in anticompetitive behavior constitutes an independent basis for denying the pending Application.⁷³

⁷³ Bell Atlantic's CEO suggested to the Commission that other entities would be more appropriate benchmarks than its ILEC brethren. This suggestion is without merit. Whatever the future structure of the industry, ILECs such as Bell Atlantic and GTE possess substantial and persisting market power by virtue of their control over essential inputs. Until and unless this market power is dissipated by substantial competitive entry, benchmarking of the rates, terms and conditions set by ILECs for use of these

A. Benchmarking Is An Essential Regulatory Tool.

The ability of regulators to use benchmarks for ILEC regulation since the divestiture of AT&T has been well-recognized:

There is a lot of evidence that the break-up and other recent developments have enhanced regulatory capability [T]he existence of seven [R]BOCs increases the number of benchmarks that can be used by regulators to detect discriminatory pricing Indeed, federal and state regulators have in fact used such benchmarks in evaluating compliance with equal access requirements . . . and in comparing installation and maintenance practices for customer premises equipment.⁷⁴

The Commission must make complex decisions regarding the pricing of monopoly services and inputs (e.g., interstate access) and the quality of such services and inputs (e.g., access to UNEs). However, the FCC's ability to perform these tasks is greatly impaired by the fact that it inevitably has less information than do the firms that it regulates. As explained by Drs. Farrell and Mitchell, benchmark regulation has been used in material ways to ameliorate this fundamental problem. Moreover, benchmarks can also help to diminish the perverse incentives created by regulation itself (the "ratchet effect").

The Commission uses benchmarking in three principal ways: average practice, best practice, and heightened scrutiny for poor performance. The FCC's use of each of these, described briefly below, improves regulatory outcomes and consumer welfare.

facilities will remain not only a critical regulatory tool, but a public interest obligation.

⁷⁴ United States v. Western Elec. Co., 993 F.2d 1572, 1580 (D.C. Cir. 1993).

Average practice benchmarking. This form of benchmarking implicates primarily the FCC's obligation to ensure just and reasonable rates. For average practice benchmarking, the Commission uses an industry-wide average as its standard. As explained by Drs. Farrell and Mitchell, the two most important uses of average benchmarking for the FCC's regulation of ILECs are establishing the productivity factor for price cap regulation and setting the appropriate levels of universal service subsidies.

In price cap regulation, the regulated firm's price index must be adjusted annually by any exogenous changes in cost and by the estimated annual rate of productivity gain (the "X-factor"). However, the estimated rate of productivity gain cannot be based on a firm's own past performance because of the "ratchet effect." If the X-factor were based on individual performance, an ILEC would understand that a good performance by it would cause the Commission to raise the X-factor. Anticipating that result, an ILEC would exert less effort to improve its performance than it would if its future prices were independent of its own performance.⁷⁵ By instead basing the X-factor on the behavior of numerous comparable ILECs, the FCC can largely avoid this problem. If the X-factor is based on average performance, an ILEC that cuts costs significantly is able to retain a large

⁷⁵ If price cap regulated entities are certain that extremely poor profit performance will cause regulators to reduce the X-factor, their incentive to provide service inefficiently increases.

portion of the resulting gain, providing an incentive to continue such innovation. Stated another way, average practice benchmarking is beneficial because the regulated entity's incentive to behave inefficiently is ameliorated.

Best practice benchmarking. The Commission relies upon best practice benchmarking to identify the best practice among regulated firms and requires all other firms to implement that practice. The Commission recently acknowledged the utility of best practice benchmarking in *Bell Atlantic-NYNEX* by stating that the existence of numerous large ILECs allows for differences to arise among the carriers, resulting in faster solutions to issues and problems and thereby accelerating competition.⁷⁶ As explained by Drs. Farrell and Mitchell:

By probing the practices of individual ILECs, the Commission endeavors to assess whether ILECs' claims about technical feasibility are warranted [i]t can then establish as a standard for all ILECs a benchmark based on the best observed (or offered) practice.⁷⁷

If regulated entities were all identical, then they presumably would choose functionally identical practices, thereby negating regulators' ability to employ best practice benchmarking. However, there is often considerable diversity among regulated entities, and they make different choices. As catalogued by Drs. Farrell and Mitchell, the Commission has frequently employed best practice benchmarking to mandate the

⁷⁶ *Bell Atlantic-NYNEX* ¶ 154.

⁷⁷ Farrell and Mitchell at 14.

implementation of the best practice throughout the industry. Examples include critical issues such as technical feasibility of interconnection arrangements, charges for collocation, and OSS development and deployment.

"Worst practice" benchmarking. The FCC engages in "heightened scrutiny for poor performance" (or "worst practice") benchmarking to identify problem cases. This both corrects ILECs' performance after the fact and improves their incentives to perform better in the future. If ILECs understand that regulators will recognize and discipline sub-standard performance, then they have an incentive to ensure that their performance does not fall outside of acceptable norms.

For example, the Commission recently acknowledged the importance of heightened scrutiny benchmarks in discussing the use of Automated Reporting Management Information System ("ARMIS") report data to compare price cap ILECs:

[B]enchmarking promotes the Commission's uniform reporting goals and is indispensable in monitoring the impact of price cap regulation on ILEC service quality and infrastructure development. . . . "[t]he benefit of benchmarking in price cap ILEC monitoring is that the benchmark is as dynamic as the telecommunications industry."⁷⁸

An ILEC that allows its service quality to degrade in order to extract greater profits from its capped rates would be identified

⁷⁸ Amendment of Part 61 of the Commission's Rules to Require Quality of Service Standards in LEC Tariffs, CC Dkt. No. 87-313, *Memorandum Opinion & Order*, 12 FCC Rcd. 8115, ¶¶ 57-58 (1997) (citations omitted).

by comparison to other ILECs and its behavior remedied.⁷⁹ Another example, as explained by Drs. Farrell and Mitchell, entailed the FCC's calculation of an industry mean and one standard deviation from the mean to evaluate the appropriateness of physical collocation charges. As explained in the next section, the merger would impair the FCC's ability to exploit this important tool.

B. The Merger Will Substantially Impair The Commission's Ability To Employ Benchmarks For The Regulation Of ILECs.

As the number of large ILECs declines through mergers, the Commission's ability to identify and set benchmarks declines as well, thereby severely hampering the ability of the Commission to effectively and efficiently regulate ILECs. The Commission recognized the impact that mergers have on its regulatory ability in *Bell Atlantic-NYNEX*. In that decision, the Commission noted its concern that the declining number of large ILECs will adversely affect its:

ability to carry out properly its responsibilities to ensure just and reasonable rates, to constrain market power in the absence of competition, and to ensure the fair development of competition that can lead to deregulation⁸⁰

⁷⁹ See also Peter Huber, The Geodesic Network: 1987 Report on Competition in the Telephone Industry at 3.24, 3.54-3.55 ("Benchmarking one LEC's performance against another in the post-divestiture marketplace has proved an effective regulatory tool. Laggard or eccentric LEC performance stands out when eight large holding companies line up for periodic regulatory inspection").

⁸⁰ *Bell Atlantic-NYNEX* ¶ 16.

The Commission accordingly held in *Bell Atlantic-NYNEX* that future applicants proposing to merge would bear an additional burden in establishing that a proposed merger is in the public interest.⁸¹

The Commission's ability to rely upon average practice benchmarking will be diminished by the merger. As Drs. Farrell and Mitchell explain, a price-cap regulated ILEC such as Bell Atlantic retains an incentive to be more productive because, notwithstanding eventual X-factor adjustments, it initially benefits substantially from cost reductions. Put slightly differently, there is a relatively low "tax" on profits generated from cost savings. However, "[a]s a result of the merger, the amount of the 'tax' increases because the effect on the merging partner is internalized."⁸² As Drs. Farrell and Mitchell note, "the larger the ILEC, the worse the ratchet effect."⁸³

This analysis thus readily predicts that the merger will reduce the incentives of ILECs to increase productivity and this will lead to higher prices. Moreover, the intended use of average practice benchmarking to implement universal service subsidies means that this regulatory policy is also put at risk by the merger.

The effect of the merger on best practice benchmarking is equally troublesome. As the number of ILECs is reduced, the best

81 Id.

82 Farrell and Mitchell at 40.

83 Id.

observed practice is likely to become worse simply because there are fewer observations. In addition, when ILECs merge, their incentives are aligned so that one may be unwilling to adopt a particular practice knowing that it will be imposed on the other.⁸⁴ "This may result in the post-merger incumbent LEC cooperating less than the pre-merger incumbent LECs would have in enabling competition to grow."⁸⁵

For example, GTE and Sprint PCS have entered into an arrangement whereby Sprint PCS customers can roam in regions where GTE's service area overlaps Sprint PCS's service area, but where Sprint PCS has not completed building out its own facilities. GTE receives revenues from this arrangement and GTE's customers can similarly roam on the Sprint PCS network. Bell Atlantic, on the other hand, does not permit Sprint PCS customers to do the same, even though automatic roaming arrangements are standard industry practice and constitute a substantial percentage of cellular carrier revenues. If Bell Atlantic and GTE were to merge, however, Bell Atlantic's practice, which is apparently intended to protect its wireless service areas from competitors, may be adopted by GTE, to the detriment of Sprint PCS. Without the merger, Bell Atlantic may eventually be forced to adopt GTE's practice through best practice benchmarking.

⁸⁴ *Bell Atlantic-NYNEX* ¶ 154.

⁸⁵ Id.

Similarly, Drs. Farrell and Mitchell identify a reduction in the efficacy of worst practice benchmarking. Among other things, they show that fewer observations make it less likely that deviations from the norm will be identified confidently as unreasonable, thereby making regulators willing to tolerate more misconduct than would occur with a larger number of ILECs.

Moreover, as described by Drs. Katz and Salop, because the merger increases the merged entity's incentive to discriminate against rivals, the merger makes the merged entity a less useful benchmark. This is because the merged entity can be expected to offer less competitive access and interconnection arrangements as it internalizes the spillover effects discussed in Section III.

Finally, as described by Drs. Farrell and Mitchell, an ILEC "merger can increase the threat that a common understanding will develop (explicitly or implicitly) not to engage in [actions that are socially desirable and profitable but that harm the interests of other ILECs]." ⁸⁶ Indeed, as the number of relevant independent firms shrinks to a small few, the probability of such collusion significantly increases. ⁸⁷ This must be addressed given the reality that the pending consolidation threatens a nation of telephone users served by "Bell East" and "Bell West."

⁸⁶ Farrell and Mitchell at 44.

⁸⁷ Significantly, GTE's and Bell Atlantic's representations in their Application suggest that only very large firms are viable local telephone competitors. If true, this suggests that the reduction in the number of large firms that would result from this merger would make coordinated action by the remaining firms much more likely. This threat is further exacerbated by the proposed merger of SBC and Ameritech.

C. The Commission Must Account For The Effects Of The Proposed Merger On Its Ability To Regulate.

The impairment of regulatory effectiveness through the loss of benchmarks is squarely part of the public interest analysis necessary to this Application's evaluation. Certainly, the Commission anticipated this in *Bell Atlantic-NYNEX* when it held that due to the reduction in the number of independently controlled large ILECs, "future applicants bear an additional burden in establishing that a proposed merger will, on balance, be pro-competitive and therefore serve the public interest, convenience and necessity."⁸⁸

The diminution in regulatory effectiveness is contrary to the fundamental intent of the 1996 Act: to promote competition, and thereby the ultimate deregulation of telecommunications markets.⁸⁹ In light of the competition/deregulation goals of the 1996 Act, the Commission requires applicants to demonstrate that their proposed mergers will affirmatively promote the public interest in both competition and deregulation.⁹⁰ Of course, the

⁸⁸ *Bell Atlantic-NYNEX* ¶ 16.

⁸⁹ Joint Explanatory Statement of the Committee of Conference, S. Rep. No. 104-230, at 1 (1996); see also *Bell Atlantic-NYNEX* ¶ 145 ("Increased market power would be fundamentally inconsistent with the primary policy goal of the 1996 Act -- the development of competition in, and the deregulation of, telecommunications markets.").

⁹⁰ Applications of Teleport Communications Group Inc., and AT&T Corp. for Consent to Transfer of Control of Corporations Holding Point-to-Point Microwave Licenses and Authorizations to Provide International Facilities-Based and Resold Communications Services, CC Dkt. No. 98-24, Memorandum Opinion and Order, 13 FCC Rcd. 15236, ¶ 12 (1998) ("Teleport/AT&T"); see also *Bell Atlantic-NYNEX* ¶ 2.

two goals are related. Actions and industry structure that are procompetitive will generally improve the ability of regulators to move toward deregulation; anticompetitive steps and structure will increase the need for regulation. This relationship works in the other direction as well; as regulatory effectiveness diminishes, anticompetitive actions by regulated firms are more likely to occur.

The Commission stated in *Bell Atlantic-NYNEX* that,

[u]ntil competition develops sufficiently to erode market power and permit deregulation, we will be concerned with the impact of proposed mergers on the effectiveness of this Commission's and state commissions' ability to constrain market power and ensure fair rules for competition. A reduction in the number of separately owned firms engaged in similar businesses will likely reduce this Commission's ability to identify, and therefore to contain, market power.⁹¹

Consequently, the Commission has ample authority to deny the Application on this basis.⁹²

91 *Bell Atlantic-NYNEX* ¶ 147. Moreover, the Commission has recognized that without competition, deregulation cannot be accomplished without risking monopoly prices for consumers. See Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in Michigan, CC Dkt. No. 97-137, *Memorandum Opinion and Order*, 12 FCC Rcd. 20543, ¶ 19 (1997).

92 General Tel. Co. v. United States, 449 F.2d 846, 857 (5th Cir. 1971) ("It is settled that practices which present realistic dangers of competitive restraint are a proper consideration for the Commission in determining the public interest, convenience, and necessity, . . . and the elimination of this danger is consistent with the Commission's broad duties under the Communications Act.") (citations omitted); Cease and Desist Order Directed Against Video Enterprises, Inc., Holyoke and South Hadley, Mass., 52 FCC 2d 630, 637 (1975) (to deny the Commission its right to determine what is in the public interest would be inimical to sound effective regulation).

Moreover, the industry structure that would result from this merger, particularly in tandem with the announced SBC-Ameritech merger, would be dramatically worsened from that considered one year ago in *Bell Atlantic-NYNEX*.⁹³ At that time, the Commission stated that "further reductions in the number of Bell Companies or comparable incumbent LECs would present serious public interest concerns."⁹⁴ As demonstrated above, the merger of Bell Atlantic and GTE raises critical issues regarding the ability of the Commission and state regulators to regulate Bell Atlantic post-merger effectively. If the Bell Atlantic-GTE and SBC-Ameritech mergers are permitted, even fewer benchmarks will be available for the Commission and state regulators to restrain ILEC market power.

Even if one sets aside the anticompetitive consequences of the loss of benchmarks, the costs of alternative forms of regulation that the Commission would be forced to use in the wake of diminished benchmarks would independently compel the conclusion that the merger is contrary to the public interest. In order to fulfill its regulatory duties, the Commission would have to insist on more intrusive and much costlier regulatory oversight of large ILECs. Absent benchmarking, the Commission would have to investigate directly and at substantial cost the actual motivations and/or results of challenged conduct.

⁹³ See *Bell Atlantic-NYNEX* ¶ 155.

⁹⁴ *Id.* ¶ 156.

More direct measures to assess the reasonableness of BOC conduct or positions would need to be implemented. Tools such as increased audits, use of document and *in personae* subpoenas to examine internal decisionmaking, and a vastly stepped-up need for after-the-fact complaint adjudication are just some of the inferior alternative tools the FCC would be forced to adopt. Broad on-the-record hearings to discern anticompetitive conduct from legitimate defenses, reminiscent of the FCC's Docket 19129 of the Bell System, might be necessitated.⁹⁵

The Commission could not of course merely acquiesce in its newfound state of diminished regulatory effectiveness. Just as the Commission cannot regulate where there is no issue to address,⁹⁶ and just as it must review regulations periodically to ensure that such regulations are still required,⁹⁷ so too must the Commission not fail to regulate where such action is demanded in the public interest.⁹⁸ Such a failure would be contrary to the general public interest mandates as well as the Act's specific requirements that the Commission ensure just and

⁹⁵ See American Telephone & Telegraph Co., the Associated Bell System Companies Charges for Interstate Telephone Service, AT&T Transmittal Nos. 10989, 11027, 11657, Phase II Final Decision and Order, 64 FCC 2d 1 (1977); id., Phase II Initial Decision, 64 FCC 2d 131 (1977).

⁹⁶ See Home Box Office v. FCC, 567 F.2d 9, 34 (D.C. Cir. 1977).

⁹⁷ See Geller v. FCC, 610 F.2d 973 (D.C. Cir. 1979).

⁹⁸ See generally Amendment of Section 64.702 of the Commission's Rules and Regulations (Second Computer Inquiry), Dkt. No. 20828, Final Decision, 77 FCC 2d 384, 433 (1980) ("Commission regulation must be directed at protecting or promoting a statutory purpose.").

reasonable rates and practices. It would also violate the 1996 Act's command that the Commission forbear from its statutory and regulatory obligations only where such forbearance "will promote competitive market conditions, including the extent to which such forbearance will enhance competition among providers of telecommunications services."⁹⁹

Plainly, the radically escalated need for direct regulation would be viewed with great disfavor by regulated firms, but more importantly by taxpayers and their representatives in Congress. The increased regulatory burdens -- keeping in mind that they represent less effective solutions in any event -- dictate the conclusion that the merger is contrary to the public interest.

Finally, the Commission should consider the fact that the decrease in benchmarks will affect the ability of private parties to negotiate favorable conditions with ILECs. Just as the Commission uses benchmarks as regulatory tools to keep firms with market power in check, private parties use benchmarks in their negotiations with ILECs. As a result of the merger, competitors would have less opportunity to exploit the differences among ILECs in this manner, thereby adversely affecting the efficiency of the market and the ability of new entrants to offer competitive services.

The proposed merger between Bell Atlantic and GTE would further reduce the already small number of ILECs regulators can use to establish benchmarks, thereby weakening regulators'

⁹⁹ 47 U.S.C. § 160(b).

ability to rely upon benchmarks to oversee RBOC and ILEC behavior and impairing their ability to successfully implement the Act.¹⁰⁰ Because Bell Atlantic and GTE have not carried the burden of demonstrating that their merger will be procompetitive and serve the public interest, convenience, and necessity, the Commission must reject the proposed merger.

V. THE APPLICANTS HAVE FAILED TO DESCRIBE HOW THEY INTEND TO COMPLY WITH THE REQUIREMENTS OF SECTION 271.

The Application states that Bell Atlantic "hopes" to have 271 approvals for its states by the time the merger would close.¹⁰¹ If this "hope" is not realized, the "applicants will request any necessary transitional relief from the Commission."¹⁰² This remarkably truncated treatment of the Bell Atlantic's 271 obligations and restraints is wholly inadequate. Prior to receipt of interLATA authority pursuant to Section 271, no BOC is able to invest in or acquire more than a 10 percent interest in an interexchange carrier in its region. That statutory proscription cannot be waived in any way, "transitionally" or otherwise. Without full divestiture of the forbidden businesses, the transaction is unlawful.

100 "Reducing the number of Bell Companies makes it easier to coordinate actions among them, and increases the relative weight of each company's actions on average performance." *Bell Atlantic-NYNEX* ¶ 16. In fact, if the SBC-Ameritech merger is approved, there would be even fewer benchmarks available for regulators to use in comparing ILEC behavior.

101 Public Interest Statement at 19 n.14.

102 Id.

Pursuant to Section 271, no BOC or BOC "affiliate" may provide interLATA services, "except as provided in this section."¹⁰³ A BOC or BOC affiliate may not provide interLATA services originating in any state within its region until it receives Commission approval pursuant to Section 271(d)(3). The term "affiliate," as defined in Section 3 of the Communications Act, as amended by the 1996 Act, includes "a person that (directly or indirectly) owns or controls, is owned or controlled by, or is under common ownership or control with, another person," with the term "own" defined to mean "to own an equity interest (or the equivalent thereof) of more than 10 percent."¹⁰⁴ Plainly, GTE and its operating companies would become "affiliates" of Bell Atlantic if the merger were to proceed, and the merged entity is statutorily prohibited from originating any interLATA traffic in any state in Bell Atlantic's region.

Any attempt to shelter the interest in GTE's long distance services originating within Bell Atlantic's region or otherwise "waive" its illegality would necessarily fail under this provision. The Commission has no authority to relax these statutory mandates, as numerous rulings by the FCC acknowledge. Section 10 of the Act, granting the FCC authority to forbear from

¹⁰³ 47 U.S.C. § 271(a). Section 271(b) allows BOCs and BOC affiliates today to engage in certain categories of interLATA activities, not relevant here. These permitted activities are in any event subject (in most instances) to the structural separation requirements established in Section 272 of the Act, another provision ignored by the applicants.

¹⁰⁴ 47 U.S.C. § 153(1).

regulating carriers, explicitly prohibits the FCC from forbearing from Sections 251(c) and 271 until those requirements have been fully implemented.¹⁰⁵ The remaining provisions of the Act granting FCC authority are comparably limited by this provision. For example, in the context of construing its forbearance authority under Section 706, the Commission found that Section 10's limitation controls throughout the statute:

Sections 251(c) and Section 271 are cornerstones of the framework Congress established in the 1996 Act to open local markets to competition. The central importance of these provisions is reflected in the fact that they are the only two provisions that Congress carved out in limiting the Commission's otherwise broad forbearance authority. . . .¹⁰⁶

It is most ironic that the applicants seek to waive these "centrally important" provisions in the context of a transaction that itself threatens those policies.

Consistent with this precedent, the parties in *SBC-SNET*¹⁰⁷

¹⁰⁵ See Petition for Declaratory Ruling Regarding U S West Petitions to Consolidate LATAs in Minnesota and Arizona, 12 FCC Rcd. 4738, 4751 ("The Act expressly prohibits the Commission from abstaining in any way from applying the requirements of Section 271 until those requirements have been fully implemented"); Southwestern Bell Telephone Co. Petition for Limited Modification of LATA Boundaries, 1998 FCC LEXIS 2342, ¶ 5 (rel. May, 1998) ("While the Commission may forbear from applying certain provisions of the Act, the Commission may not forbear from the requirements of Section 271").

¹⁰⁶ Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Dkt. No. 98-147, *Memorandum Opinion and Order and Notice of Proposed Rulemaking* ¶ 73 (rel. Aug. 7, 1998).

¹⁰⁷ Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Southern New England Telecommunications Corp., Transferor to SBC Communications, Inc., CC Dkt. No. 98-25, *Memorandum Opinion*

fully divested SNET's long distance businesses within SBC's service areas prior to obtaining FCC approval for the merger. This divestiture was a prominent factor in the FCC's decision, and FCC approval was explicitly conditioned upon

Applicants' complete and continued fulfillment of the measures described above that are designed to ensure that this merger does not result in SBC providing interLATA services in its current region in violation of Section 271 of the Communications Act. . . .¹⁰⁸

This conditioned approval was given only after the Commission had been assured of complete divestiture, including: 1) evidence that all of SNET's customers within SBC's territory had been moved to a lawful interexchange carrier of their choice; 2) no current or future compensation would transfer between SNET and the new interexchange carrier; 3) all of SNET's state certificates to provide service in those states had been rescinded by the relevant public utility commissions; 4) all related tariffs had been canceled; and 5) the provision of service by SNET pursuant to calling cards and pre-paid cards had been brought into compliance with Section 271's in-region proscriptions.¹⁰⁹

The cavalier approach of Bell Atlantic and GTE in this application stands in stark contrast to the regulatory obligations set forth in the statute and Commission precedent. At an absolute minimum the Commission should require the

and Order (rel. Oct. 23, 1998) ("*SBC-SNET*").

108 Id. ¶ 51.

109 Id. ¶ 37.

applicants to make a supplemental submission to demonstrate in specific detail how they will divest this business to bring themselves into Section 271 compliance prior to any FCC consideration of the merits of the application.

VI. THE CLAIM THAT THE MERGER WILL PERMIT THE MERGED PARTIES TO ENTER 21 OUT-OF-REGION MARKETS IS NOT CREDIBLE OR ENFORCEABLE, AND IT CANNOT IN ANY EVENT COMPENSATE FOR THE ANTICOMPETITIVE EFFECTS OF THE MERGER.

The Commission should approach the applicants' promise of entry into 21 markets out-of-region with great skepticism. The Application does not on its own terms demonstrate its most fundamental assertion: the 21-market strategy is not shown to be merger-specific. As fully analyzed by Drs. Besen, Srinagesh and Woodbury, and supported by the affidavit of Steven Signoff, Vice President, Strategic Business Development, Attachment G, the "follow the anchor customer" premise of the strategy defies commercial realities as well as common sense and does not, in any event, have any substantiated tie with the merger. Contrary to the claims made in the Application, moreover, Drs. Besen, Srinagesh and Woodbury conclude that the merger is likely to result in higher -- not lower -- local prices in the 21 markets. The strategy also necessarily assumes Section 271 authority for the merged entity and thus is highly contingent and unlikely to be implemented within its stated time frame. Finally, even if accepted at face value, the strategy cannot as a matter of law or policy compensate for the in-region anticompetitive effects of the transaction.

A. The Strategy Has Not Been Shown To Be Merger-Specific.

Drs. Besen, Srinagesh and Woodbury fully analyze the claimed benefits of the 21 market strategy in their attached declaration, "Economic Analysis of the Proposed Bell Atlantic-GTE Merger." As demonstrated there, even if one assumes the credibility of the plan, the merger does not appear necessary to its implementation. In a number of critical respects, the assumptions that underlie the assertion that the merger is necessary to implement the 21 market strategy are inconsistent with other assumptions and assertions claimed in the Application.

For example, the parties' claim that they can compete effectively only for customers in their respective service areas is inconsistent with their previous investment in international and cellular divisions out-of-region. Bell Atlantic has cellular properties in Arizona, Georgia, and New Mexico, far from its in-region markets. Through its PrimeCo PCS partnership with U S WEST, Inc. and AirTouch Communications, Bell Atlantic also provides cellular service in numerous out-of-region areas, including Alabama, Florida, Illinois, Indiana, Louisiana, Michigan, Mississippi, North Carolina, Oklahoma, Texas, and Wisconsin. GTE also provides cellular out-of-region in Tennessee. Internationally, the applicants have holdings in cellular companies, and in landline companies in Canada, India, New Zealand, the Philippines, Thailand, and Venezuela, among other distant countries.¹¹⁰ In light of these successful

¹¹⁰ Application at Exhibit A.2 (map of Bell Atlantic and GTE

ventures, neither Bell Atlantic nor GTE can credibly claim that it lacks the resources, name brand, or expertise to compete out-of-region.

As demonstrated below, the merger is not needed to obtain the benefits that are claimed by the applicants.

1. GTE Can Expand Without The Merger.

At bottom, GTE argues that it cannot provide service and compete for business outside its region without first merging with Bell Atlantic and obtaining Bell Atlantic's large business customer accounts and financial resources. GTE presents four explanations to justify why it is unable to enter out-of-region: (1) substantial fixed, up-front investments are required; (2) economical entry requires proximate facilities, which cannot be economically deployed without larger scale and more customers; (3) acquiring customers is difficult without a base of anchor customers; and (4) GTE needs a national brand and brand name awareness it can only attain by merging with Bell Atlantic.¹¹¹ Each of these four justifications rings hollow, especially in light of the empirical evidence that CLECs smaller than GTE are entering on precisely the basis that GTE claims it cannot without the resources of Bell Atlantic. As discussed below and in the attached declaration of Besen, Srinagesh and Woodbury, GTE cannot credibly claim that a merger with Bell Atlantic is a prerequisite to out-of-region entry.

worldwide assets); see also Besen, Srinagesh and Woodbury at 39.

¹¹¹ See Public Interest Statement at 7.

As an initial matter, GTE's claim that it needs Bell Atlantic is contrary to its own actions. Prior to its decision to merge with Bell Atlantic, GTE engaged in ongoing, extensive efforts to become a nationwide competitive local exchange carrier.¹¹² GTE apparently already provides competitive local exchange services in 8 of the 12 states identified by the applicants in their 21 market strategy (California,¹¹³ Florida, Illinois, Indiana, Kentucky, Tennessee, Texas, Washington).¹¹⁴ GTE is licensed as a CLEC in the remaining four states (Michigan, North Carolina, Ohio and Oregon). Although GTECC primarily competes on a resale basis, there is no particular reason that GTE could not enter on a facilities basis.

As analyzed in the Besen, Srinagesh and Woodbury declaration, GTE's "claims should be afforded little, if any credibility."¹¹⁵

[T]here would appear to be nothing to prevent GTE from seeking to serve the needs of businesses that are located in Bell Atlantic's service territory but that have operations in or near GTE's service territory.

¹¹² 1997 GTE Annual Report at 5 (describing formation of GTECC in order to enable GTE to realize its goal of becoming a nationwide provider of telecommunications and data service). See generally discussion at Section II, supra.

¹¹³ GTE recently installed a switch at the University of Southern California, in SBC's local service area, in order to provide local exchange and exchange access service to the university. This is precisely the type of competitive expansion GTE now argues it is unable to implement alone.

¹¹⁴ See Virginia Application ¶ 9. It is not clear whether in some states GTECC is reselling services of the GTE ILEC, or whether it provides services outside its ILEC's service area, or both.

¹¹⁵ Besen, Srinagesh and Woodbury at 35.

Indeed, if GTE's services are as attractive as they are claimed to be, GTE could compete effectively . . . even within Bell Atlantic's service territory. By using a combination of its own and leased facilities, GTE can extend its within-region expertise to compete for large business customers in Bell Atlantic's service area. . . . There is no sense in which Bell Atlantic's large business customers are an "essential facility" for GTE because GTE can win those customers from Bell Atlantic.

Further, GTE currently possesses a significant competitive advantage in competing for businesses in Bell Atlantic's service territory that would likely be lost, at least for a time, if the merger were to take place.¹¹⁶

In short, the competitive benefits that the merging parties claim for the merger can be largely or completely attained by GTE acting alone.

Further, as the Commission is well aware, other CLECs are entering local markets across the country without the benefit of a preexisting group of large customers. Small, start-up enterprises lacking significant capital for up-front investments, proximate facilities, a base of anchor customers, or a national brand name are nevertheless entering through a combination of independent facilities and access to ILEC facilities. Nonetheless, GTE argues it cannot enter unless it is permitted to merge with Bell Atlantic.

The suggestion that GTE cannot enter without access to Bell Atlantic's "anchor customers" is particularly suspect. Large business customers are sophisticated, and there is no reason to believe that GTE would have a competitive handicap, vis-a-vis other CLECs, in pursuing large businesses outside GTE's in-region

¹¹⁶ Id. at 36.

service area.¹¹⁷ Indeed, GTE is better situated than other CLECs due to its size, its experience in local exchange markets, and its current ability to bundle local with long distance and data services.

As recently as February 1998, just months prior to its July 1998 merger announcement, GTE boasted of its aggressive efforts to become a national out-of-region player in the local exchange markets. Furthermore, GTE sought expedited state regulatory approvals so it could speed new services to out-of-region customers it did not yet serve. In addition, GTE has aggressively pursued its CLEC strategy by spending significant amounts on a national advertising campaign to support such CLEC entry.¹¹⁸ Less than five months later, however, and concurrent with its July 1998 merger announcement, GTE would have the Commission believe that everything has changed and that it can no longer enter without first merging with Bell Atlantic. While it is to be expected that GTE would recast its actions in order to gain the FCC's approval of this merger, it is impossible to believe the Commission would be fooled by such a ploy.

2. Bell Atlantic Can Expand Without The Merger.

The applicants similarly argue that Bell Atlantic cannot follow its "legion of anchor customers" into GTE's service areas without the merger: "Bell Atlantic cannot reach these customers alone because it lacks the facilities, platform capability, and

¹¹⁷ Affidavit of Steven Signoff ¶¶ 17-25, Attachment G ("Signoff").

¹¹⁸ See supra discussion at Section II.D.

marketing and distribution channels required to reach so far beyond its concentrated franchise."¹¹⁹ While Bell Atlantic may not have existing facilities in the 21 markets, none of the identified barriers, separately or in combination, has the effect of precluding Bell Atlantic from pursuing its "anchor customers" out-of-region without GTE.¹²⁰

In support of their Application, the parties claim that Bell Atlantic's brand lacks sufficient national weight to warrant pursuing the 21 market strategy alone.¹²¹ Contrary to these claims, Bell Atlantic, as the incumbent local exchange provider, clearly has name brand recognition with these "anchor customers," who are, by definition, in-region companies. Moreover, as discussed above, the large users that are the initial targets of the strategy are sophisticated users who are certainly familiar with the name of Bell Atlantic.¹²² Further, this exercise in modesty over Bell Atlantic's brand name belies reality. Bell Atlantic spent over \$580 million -- more than any other telecommunications company, with the exception of AT&T -- on national advertising last year.¹²³ Nor does Bell Atlantic need

119 Kissell ¶ 8.

120 See Besen, Srinagesh and Woodbury at 32-33, 37-39.

121 Kissell ¶ 11.

122 See Signoff ¶ 23.

123 See Kissell ¶ 5.

GTE for its expertise. Bell Atlantic has extensive technical capabilities and expertise in offering local exchange service.¹²⁴

The parties also fail to explain how other CLECs can successfully market their products to large customers, while Bell Atlantic and GTE cannot. Bell Atlantic concedes that other CLECs, including "MFS, Winstar, TCG and many others," have successfully begun to enter out-of-region using some combination of resale, UNEs, and facilities-based options.¹²⁵ In spite of this fact, the applicants ignore these strategies when assessing Bell Atlantic's ability to follow its "anchor customers" out-of-region. Indeed, if other CLECs -- with fewer financial resources and facilities, and no regional (let alone national) name brand -- can enter and compete against the incumbent carrier, it is inconceivable that Bell Atlantic -- with more financial resources, more experience offering local service, and a strong (regional if not national) brand name -- would be unable to implement an out-of-region strategy without GTE. This argument essentially boils down to a claim that a carrier, even one with extensive experience offering local service in-region, cannot compete in out-of-region, non-contiguous markets unless that carrier merges with the incumbent monopoly LEC in or adjacent to the targeted market.¹²⁶ Such an argument is an anathema to the

124 See *id.* ¶ 11.

125 Stallard ¶¶ 12, 18.

126 Besen, Srinagesh and Woodbury at 31-32.

procompetitive goals of the Act and contrary to the evidence regarding CLEC entry.¹²⁷

Finally, the parties claim that "[t]he merger will therefore give the combined company the scale and traffic volume necessary to support a national long distance network."¹²⁸ First, the long distance market is competitive, so any arguable increment to long distance competition is readily eclipsed by the entrenchment the merger would cause for local markets. Second, because of the effects of Section 271, the merger would actually remove GTE as a long distance provider in Pennsylvania and Virginia, and as discussed infra, Section 271 approval for Bell Atlantic's in-region states is not likely any time soon. Third, GTE appears to concede that it will not be contributing any "anchor customers" to this critical mass.

It should be noted that this rationale is different from that offered by SBC-Ameritech in support of their merger. SBC-Ameritech instead claimed that each had an insufficient number of large business customers to warrant "following" those customers to new regions. Here, GTE claims that Bell Atlantic could not follow its anchor customers to GTE's regions because Bell Atlantic lacks nearby facilities.

Drs. Besen, Srinagesh and Woodbury have also taken issue with SBC-Ameritech's "follow the customer" strategy. See

¹²⁷ See, e.g., Trends in Telephone Service, Report, 1998 FCC LEXIS 3511, at Table 8.1 (rel. July 16, 1998) (quantifying extent of CLEC entry between 1993-97).

¹²⁸ Declaration of Debra Covey ¶ 2.

Declaration of S. M. Besen, P. Srinagesh, and J. R. Woodbury, "An Economic Analysis of the Proposed SBC-Ameritech Merger," Oct. 14, 1998. However, as noted in the attached declaration, "at least there the merging parties do not contend that they must merge with the ILECs in the regions they plan to enter for their strategy to be successful."¹²⁹ This alone indicates that Bell Atlantic could pursue its customers out-of-region without GTE. While GTE's existing facilities might be used by Bell Atlantic to serve these customers, the merger is not necessary for that to occur. Without evidence that the merger is required to achieve such efficiency, the applicants cannot meet their burden of demonstrating that the public interest will be served by the merger.

B. By Its Terms, The Strategy Requires Section 271 Authority Throughout The Bell Atlantic States And Thus Will Not Be Implemented Within The Asserted Time Frame.

Bell Atlantic asserts that it plans to enter, by relying on GTE's proximate facilities, 21 out-of-region markets to provide a bundle of telecommunications services to its anchor customers within 18 months of closing.¹³⁰ Because the Application describes the need to first follow the largest customers who then become "anchor customers" and a base for smaller business and residential users, the internal logic of the schedule suggests near-immediate commencement of business service offerings.

¹²⁹ Besen, Srinagesh and Woodbury at 38.

¹³⁰ Public Interest Statement at 6-8.

What the applicants omit here is the critical fact that the plan requires Bell Atlantic to obtain Section 271 authority in its in-region states in order to succeed on its own terms, and thus necessarily assumes that Section 271 authorization will be granted in those states within this 18 month time period. This is because the 21 market "follow the anchor customer" plan hinges upon satisfying the majority of those customers' telecommunications needs. Until Bell Atlantic obtains 271 authority, it will not be able to handle any interLATA calls from its existing, in-region anchor customers to out-of-region destinations, or to in-region, interLATA destinations. Given the remoteness of Section 271 compliance for Bell Atlantic throughout its states, the plan necessarily fails on this ground as well.

Bell Atlantic is nowhere near ready for 271 authority. A review of the status of 271 proceedings in its states is revealing on this point. None of these states has found that Bell Atlantic is in compliance with the full set of 271 requirements.¹³¹ New York provides the definitive example of

¹³¹ See, e.g., Petition of New York Telephone Company for Approval of its Statement of Generally Available Terms and Conditions and Draft Filing of Petition for InterLATA Entry, NYPSC Case 97-C-0271, Ruling Concerning the Status of the Record 1 (July 8, 1997); To Determine Prices Bell Atlantic-Virginia, Inc. is Authorized to Charge Competitive Local Exchange Carriers in Accordance with the Telecommunications Act of 1996 and Applicable State Law, Case No. PUC 970005, Order (Va. Corp. Comm'n Nov. 19, 1998) (additional filings in this pricing docket due December 11, 1998); Bell Atlantic-Pennsylvania's Entry into In-Region InterLATA Services Under Section 271 of the Federal Telecommunications Act of 1996, Docket No. M-00960840, Opinion and Order (Pa. Pub. Util. Comm'n May 12, 1998); "Bell Atlantic Moves to Enter Long Distance Market in New Jersey; Proposes Measures

just how far Bell Atlantic is from gaining regulatory approval. Following hearings and her review of thousands of pages of evidence, a NYPSC Administrative Law Judge found that Bell Atlantic-New York had not met its burden of proof with respect to its Section 271 Prefiling Statement, and noted the difficulty in obtaining services and elements in a timely manner and clear lack of OSS parity. The same judge also recently found "as a matter of fact on this record" that none of BA-NY's proposed UNE combination methods constitutes a nondiscriminatory form of obtaining and combining unbundled elements.¹³² In addition, an independent consultant tasked with analyzing Bell Atlantic's OSS platform has yet to issue any determination. Finally, significant issues remain pending before the Supreme Court pursuant to its review of the 8th Circuit's Iowa Utilities Board decision. This makes the 21 market strategy, contingent as it is on 271 authority, even more uncertain and remote.

C. Even If Accepted At Face Value, The Strategy To 'Jump-Start' Competition Out-Of-Region Cannot As A Matter Of Law Or Policy Override The Anticompetitive Effects Of The Merger In-Region.

Even if the Commission were to accept everything the parties have promised as true, the 21 market strategy would still not overcome the plainly anticompetitive effects of the merger in other

to Hasten Local Competition," PR News Wire via Dow Jones, Nov. 16, 1998.

¹³² Proceeding on Motion of the Commission to Examine Methods by Which Competitive Local Exchange Carriers Can Obtain and Combine Unbundled Network Elements, NYPSC Case 98-C-0690, *Proposed Findings of Administrative Law Judge Eleanor Stein* at 10 (Aug. 4, 1998).

markets, e.g., interLATA services, in-region local telecommunications markets, and new services. The applicants are thus simply wrong in asserting the "substantial pro-competitive benefits [of the merger] will far outweigh any minimal loss in potential competition inside the Bell Atlantic region."¹³³ Under a traditional competitive analysis, as required by the Clayton Act, alleged procompetitive benefits in one set of markets cannot be used to justify a merger that would have predictable anticompetitive effects in other markets. The public interest may be a more flexible standard, but it nevertheless will not tolerate consumer welfare being diminished in one market to supposedly improve it in another.

The Clayton Act prohibits mergers that lessen competition "in any line of commerce or in any activity affecting commerce in any section of the country."¹³⁴ The courts have consistently interpreted this language as meaning that an acquisition is unlawful if it has anticompetitive effects in any line of commerce in any section of the country. For example, the merging parties in United States v. Bethlehem Steel¹³⁵ admitted that their merger would reduce competition in certain areas of the country.¹³⁶ In defense of the merger, the parties insisted that

¹³³ Public Interest Statement at 2. Of course, the competitive losses occur both inside and outside the Bell Atlantic region, as the preceding sections demonstrate.

¹³⁴ 15 U.S.C. § 18.

¹³⁵ 168 F. Supp. 576 (S.D.N.Y. 1958).

¹³⁶ Note, they argued that this decrease would not

the total steel production capacity of the resulting company would expand and stimulate competition both in current and new markets.¹³⁷ Further, they argued that the merger would allow Bethlehem Steel to challenge the dominant position of the U.S. Steel Corporation. The court rejected these arguments:

The simple test under § 7 is whether or not the merger may substantially lessen competition "in any line of commerce . . . in any section of the country." A merger may have a different impact in different markets -- but if the proscribed effect is visited on one or more relevant markets then it matters not what the claimed benefits may be elsewhere.¹³⁸

In United States v. Philadelphia Bank,¹³⁹ the Supreme Court specifically rejected the argument that anticompetitive effects in one market can be justified by procompetitive benefits in another.¹⁴⁰ The banks contended that the proposed merger would increase the resulting bank's lending limit and thereby enable it to compete with large out-of-state banks, particularly New York banks, for very large loans. The court held that this defense would lead to an absurd conclusion:

If anticompetitive effects in one market could be justified by procompetitive consequences in another, the logical upshot would be that every firm in an industry could, without violating § 7, embark on a series of mergers that would make it in the end as large as the industry leader. For if all the commercial banks in the Philadelphia area merged into one, it would [still] be smaller than the largest bank

"substantiially" reduce competition in these areas.

137 Id. at 581.

138 Id. at 618.

139 374 U.S. 321 (1963).

140 Id. at 370.

in New York City. This is not a case, plainly, where two small firms in a market propose to merge in order to be able to compete more successfully with the leading firms in that market.¹⁴¹

The courts and antitrust policymakers reject the multi-market balancing approach because it would force them to favor one group of consumers (those in the new market) over another group of consumers (those in the target market). In both Bethlehem Steel and Philadelphia Bank the merger proponents argued that, viewed as a whole, their respective mergers would result in net welfare gains to society. The Bethlehem Steel court specifically rejected this form of selective favoritism.

Any alleged benefit to the steel consumer in the Chicago district because of reduced freight charges and an increased supply, cannot, under the law, be bought at the expense of other consumers of numerous other steel products where the effects of the merger violate the Act.¹⁴²

Areeda and Turner conclude that the defense of an otherwise anticompetitive merger with a multi-market balancing approach has been rejected for a broad policy reason:

[T]o balance gains in one market against potential losses in another would necessarily favor one group of consumers over another . . .¹⁴³

Bell Atlantic and GTE argue that the purported actual benefits to competition resulting from their merger should outweigh any possible anticompetitive harms caused by eliminating

141 Id. at 370-371.

142 Bethlehem Steel, 168 F. Supp. at 618.

143 Areeda, Hovenkamp, & Solow, 4A Antitrust Law ¶ 972(a) (rev. ed. 1998).

a potential competitor in the Bell Atlantic markets.¹⁴⁴ The argument that increases in actual competition resulting from Bell Atlantic-GTE's entry in 21 new markets should outweigh the anticompetitive effects due to a loss of potential competition in other markets is not supported by the case law or theory. When competitive benefits occur in the same market where a potential competitor is eliminated, the negative and positive effects can be weighed against one another to determine the net effect in the relevant market. Where the effects are experienced in distinct markets, as here, policymakers would be forced to choose the importance of competition in one market over another. Bell Atlantic and GTE are essentially asking the Commission to choose (ostensibly) competitive entry outside of the merged entity's region at the expense of foreclosing competitive entry in-region. Plainly, consumers in Philadelphia are entitled to the benefits of local telephone competition as much as consumers in Portland, Oregon.

While the Communications Act grants the FCC more flexible decisionmaking authority than the FCC would have when it is constrained by the language of the Clayton Act, the public interest test requires the same conclusion here. It is hornbook law that the public interest standard is a broad, flexible standard, encompassing the "broad aims of the Communications

¹⁴⁴ Public Interest Statement at 2.

Act."¹⁴⁵ This breadth of discretion does not allow the FCC to ignore actual anticompetitive effects, however.

The public interest standard of course requires consideration of the effect of the transfer on competition,¹⁴⁶ although the impact on competition is one of many issues the FCC may consider when deciding whether a given merger would be in the public interest:¹⁴⁷

Our examination of a proposed merger under the public interest standard includes consideration of the competition policies underlying the Sherman and Clayton Acts . . . but the public interest standard necessarily subsumes and extends beyond the traditional parameters of review under the antitrust laws.¹⁴⁸

FCC concerns other than competition include, but are not limited to: deregulation policy, universal service, and technological innovation.¹⁴⁹

The traditional articulation of the public interest standard and the relevance of competition analysis has changed dramatically over time. Legal scholars recognize that competition may be only one consideration among many in the FCC's

¹⁴⁵ Bell Atlantic-NYNEX ¶ 2 (quoting Western Union Div., Commercial Telegrapher's Union v. United States, 87 F. Supp. 324, 335 (D.D.C. 1949), aff'd, 338 U.S. 864 (1949)).

¹⁴⁶ Craig O. McCaw & AT&T For Consent to the Transfer of Control of McCaw Cellular Communications, Inc. & its Subsidiaries, FCC 94-238, Memorandum Opinion and Order, 9 FCC Rcd. 5836, ¶ 9 (1994), recon. denied, 10 FCC Rcd. 11786 (1995), aff'd, SBC Communications Inc. v. FCC, 5 F.3d 1484 (D.C. Cir. 1995) ("AT&T-McCaw").

¹⁴⁷ United States v. FCC, 652 F.2d 72, 96 (D.C. Cir. 1980).

¹⁴⁸ Bell Atlantic-NYNEX ¶ 2.

¹⁴⁹ Id.

calculus, but conclude that it has become an increasingly important consideration.¹⁵⁰ Indeed, in the context of its Title II duties, the statutory context that defines the parameters of the public interest standard has changed dramatically from the original Act. Congress at one time presumed that telecommunications services subject to the Act would have to be provided on a monopoly basis, and generally accepted that competition would be "wasteful" or "ruinous." Subsequently, the Commission struggled to reinterpret the public interest as it became aware that at least some of these assumptions were inaccurate, or at least were worth testing.¹⁵¹ The Act, as amended by the 1996 Act, has now brought this learning into the statute: Congress has declared that competition should be presumed possible -- indeed it compels that substantial steps be undertaken to bring about competition. Thus, a traditional public interest calculus, leaving competition as just one factor among many to be considered, does not capture the current law as prescribed by Congress.¹⁵²

¹⁵⁰ Friedrich, Jason E., 6 Commlaw Conspectus 261, 266 (1998).

¹⁵¹ See FCC v. RCA, 346 U.S. 86, 93 (1953); All Am. Cables & Radio v. FCC, 736 F.2d 752, 755 (D.C. Cir. 1984);); Computer & Communications Indus. Ass'n, 693 F.2d 198, 217 (D.C. Cir. 1983); Telocator Network of Am. v. FCC, 691 F.2d 525, 544 (D.C. Cir. 1982); Hawaiian Tel. Co. v. FCC, 498 F.2d 771, 775-76 (D.C. Cir. 1974).

¹⁵² The competition element within the public interest standard is harder to satisfy than the Clayton Act. "In order to find that a merger is in the public interest, we must, for example, be convinced that it will enhance competition." Bell Atlantic-NYNEX ¶ 2 (emphasis added).

Research discloses no case in which the FCC opted to promote competition in one market at the expense of diminishing competition in another.¹⁵³ Whether under the new public interest standard as derived from the 1996 Act or a more traditional articulation, the FCC has never forced itself to select one set of consumers over another. Bell Atlantic's and GTE's invitation to do so should be summarily denied.

In *Bell Atlantic-NYNEX*, the FCC concluded that the merger, on its face, would have anticompetitive effects:

taking the merger on its terms alone and without any other considerations, we believe that Applicants have failed to carry their burden of showing, under the public interest standard, that entry would be sufficiently easy to mitigate the potential harms to competition from merging the leading and no less than fifth most significant participant in the market for providing telecommunications services to residential and small business customers.¹⁵⁴

Despite these anticompetitive consequences, the FCC permitted the merger provided the parties adhered to certain conditions.

We believe these conditions create pro-competitive benefits that at least in part mitigate the potentially negative impacts of the proposed merger on competition in LATA 132 and the New York metropolitan area, and that, when extended through the Bell Atlantic and NYNEX regions, outweigh any other adverse effects in those areas. These conditions will make it more likely that

¹⁵³ See, e.g., AT&T/McCaw, 9 FCC Rcd. 5836 (1994), recon. denied, 10 FCC Rcd. 11786 (1995), aff'd, SBC Comm. v. FCC, 5 F.3d 1484 (D.C. Cir. 1995) (FCC found that the merger would not impose any anticompetitive effects but nonetheless required the merging parties to agree to certain equal access provisions); United States v. FCC, 652 F.2d 72, 106 (D.C. Cir. 1980) (upholding FCC grant to SBS to operate three domestic satellites, finding that FCC reasonably concluded that entry by SBS into satellite communications service would not be anticompetitive).

¹⁵⁴ *Bell Atlantic-NYNEX* ¶ 12.

other market participants can enter, expand or become more significant market participants that are capable of mitigating in the relevant market, the competitive harms that we otherwise foresee as likely resulting from the elimination of Bell Atlantic as a likely independent market participant.¹⁵⁵

While the FCC did give consideration to the fact that the procompetitive effects would extend into geographic markets beyond those in which the anticompetitive effects would occur, it also found the procompetitive promises made and conditions imposed offset the anticompetitive harms within the same geographical markets that suffered the predicted competitive harms. Bell Atlantic and GTE, on the other hand, propose to offset the anticompetitive harms in one market with procompetitive gains in another. As demonstrated, neither the Clayton Act nor the Communications Act permits such a rationale.

* * * *

The foregoing shows that the 21 market strategy is not merger-specific, it is not credible, and it is not relevant under the appropriate legal and policy tests. Even if all of this could somehow be overcome, there remains the fundamental problem of how the promise to enter 21 markets could ever be enforced by the Commission. What if, as has certainly happened with other companies in similar situations, business strategies are altered after the merger?¹⁵⁶ It is implausible that the Commission could

¹⁵⁵ Id. ¶ 14.

¹⁵⁶ Similar promises were made to regulators by SBC in the context of its acquisition of Pacific Telesis and its video businesses. These businesses were shut down soon after the

actually hold Bell Atlantic and GTE to their promises: how could the government successfully command private firms to enter markets and compete?

Perhaps the most disconcerting aspect of the 21 market strategy claim is its implicit vision of the scale needed to compete -- a vision directly contrary to the goals underpinning the 1996 Act and contrary to evidence of CLEC market entry. To accept Bell Atlantic's and GTE's views, the Commission would have to conclude that there is room for no more than two extraordinarily large local telephone companies in the U.S. telecommunications marketplace.

Competitive entry at the local level is beginning to occur;¹⁵⁷ this potential should be vigorously pursued rather than abandoned to the megamerger requests now pending before the FCC. Contrary to Congress' vision, the Commission's efforts, and the marketplace reality of CLEC entry, Bell Atlantic and GTE have cynically concluded that competition should be replaced with consolidation. On this ground alone, the 21 market strategy and the Application should be rejected.

VII. OTHER CLAIMED EFFICIENCIES ARE NOT SUPPORTED.

The other claimed efficiencies of the merger are at best unsupported and, in practice, unlikely to be realized. The Application identifies essentially three additional efficiencies

transaction was consummated.

¹⁵⁷ See Trends in Telephone Service, Report, 1998 FCC LEXIS 3511 at Table 8.1 (rel. July 16, 1998) (measuring average annual growth of CAPs and CLECs from 1993-96).

purported to be achieved by the proposed merger: (1) cost savings, (2) revenue enhancements, and (3) diffusion of best practices. However, the Application offers no evidence, and thus no confirmation, of the potential for these efficiencies. Indeed, considered inquiry suggests that the efficiencies may be realized without a merger or, alternatively, would not, in fact, be achieved by the proposed transaction. These are each discussed briefly below, and more fully examined in the declaration by Drs. Besen, Srinagesh and Woodbury.¹⁵⁸

Cost Reductions. The Commission has placed the burden to prove claimed cost efficiencies on the parties to a merger.¹⁵⁹ The Commission specifically stated that "Applicants bear the burden of proving that the asserted efficiencies are not another form of reducing output" ¹⁶⁰ This burden has been ignored here; the parties simply assert that the merger will produce \$2 billion in cost savings due to "eliminating duplicative staff and information and operation systems, more efficiently using long-distance capacity, and reducing procurement costs."¹⁶¹ Bell Atlantic argues that these savings are "real budget commitments that department heads must meet or exceed."¹⁶² According to the

¹⁵⁸ Besen, Srinagesh and Woodbury at 46-50.

¹⁵⁹ See *Bell Atlantic-NYNEX* ¶¶ 168-71.

¹⁶⁰ See id. ¶ 171.

¹⁶¹ Application at Exhibit A.4, Declaration of Doreen Toben ¶ 3 ("Toben").

¹⁶² Toben ¶ 4. Another \$.5 billion in capital expenditure cuts are asserted. Id. ¶ 2.

parties, because a corporate officer's compensation will be based upon whether he achieves the set budget commitments, the targeted amount will be met.¹⁶³ No other support for this claimed \$2 billion savings is provided, and thus the applicants have not satisfied their burden of proof.

As noted in the attached declaration, "[r]ecent econometric studies on the economies of scope and scale in local telecommunications networks do not support the claim that mergers of firms serving non-overlapping territories would result in cost savings."¹⁶⁴ Except in certain limited locations, Bell Atlantic and GTE serve disjointed territories and do not own duplicative and redundant facilities. These facts alone largely refute the parties' assertion that the merger will result in the claimed savings. Indeed, consolidation may actually reduce net public benefits by raising costs and resulting in inefficient behavior by the merged entity.¹⁶⁵

Revenue Enhancements. The applicants project approximately \$2 billion in increased revenue synergies as a result of the merger.¹⁶⁶ These projected "enhancements will come from the . . . penetration of vertical services like second lines;

¹⁶³ Id.

¹⁶⁴ Besen, Srinagesh and Woodbury at 46-47.

¹⁶⁵ Id. at 47 ("Using recent 1984-91 data, [Ying and Shin] f[ou]nd that LECs are not natural monopolies in the post-divestiture era. Having two firms produce the monopoly output could potentially result in over 20 percent cost savings.") (citation omitted).

¹⁶⁶ Toben ¶ 2.

improving the value and speeding the widespread deployment of long-distance offerings; and creating better and more widely distributed data services."¹⁶⁷ Like cost savings, these synergies are claimed to be "real budget commitments" by department heads.¹⁶⁸

Even if one were to assume that such enhancement projections are reasonable, the Application fails to present sufficient evidence to conclude that post-merger revenue growth is attributable to the merger, rather than to general market trends existing outside the context of the merger such as independent growth in demand for the identified services.¹⁶⁹ Without sufficient evidentiary support, there is no reason to assume that post-merger revenue growth is indicative of merger-related public benefits. Indeed, the contrary conclusion is equally plausible because the merger may provide the merged entity an increased ability to engage in anticompetitive practices.

Even if increased revenues to the merged firm were directly tied to the public interest (by demonstrably serving ratepayers, not shareholders), each source of enhancement should be independently viewed with caution.¹⁷⁰ For example, the claim

¹⁶⁷ Id. ¶ 3.

¹⁶⁸ Id. ¶ 4.

¹⁶⁹ See supra n.159 and accompanying discussion (citing *Bell Atlantic-NYNEX* ¶¶ 168-71).

¹⁷⁰ It bears noting that Ms. Toben has underscored her company's commitment to "Wall Street analysts and their investors" rather than its regulatory obligations. Toben ¶ 4.

that the merger will allow more rapid deployment of better long distance and advanced data services is questionable. To the extent that these advantages arise from GTE receiving "better" (as opposed to equal) access to Bell Atlantic's customers, such access would unfairly disadvantage competitors and competition and cannot be counted as public interest benefits.¹⁷¹

In an attempt to document analogous synergies elsewhere, the parties rely on alleged cost savings and revenue enhancements from the merger of Bell Atlantic's wireless operations with NYNEX's cellular properties and the recent Bell Atlantic-NYNEX merger.¹⁷² This evidence consists of the observation that per-subscriber costs for cellular customers have fallen, and that the estimated merger-related gains for Bell Atlantic-NYNEX "are being achieved."¹⁷³ However, these statements are "not sufficient to demonstrate either the magnitude of any gains attained subsequent to the merger or that the gains were merger-related."¹⁷⁴

Best practices. The parties also argue that the combined carrier will benefit from adoption of the best practices of each firm.¹⁷⁵ Taken at face value, Bell Atlantic's and GTE's contention that they had no intention of competing with one another suggests that the diffusion of best practices could occur

¹⁷¹ Besen, Srinagesh and Woodbury at 48-49.

¹⁷² Toben ¶¶ 6-7.

¹⁷³ Id. ¶ 7.

¹⁷⁴ Besen, Srinagesh and Woodbury at 50.

¹⁷⁵ Public Interest Statement at 22.

without a merger (e.g., contractually exchanging best practice technology).¹⁷⁶ Indeed, the diffusion of best practices and the purportedly concomitant lowered costs appear more likely absent a merger. Indeed, as discussed above, the merger may actually diminish the firms' incentives to adopt one another's efficiency-generating practices due to benchmarking considerations.

* * * *

The absence of any support (empirical or other) for the asserted merger efficiencies and the logically predictable net public welfare and efficiency losses strongly counsel against approval of the Application on these bases. As noted, some claims (e.g., purported economies of scale) are inconsistent with recent econometric studies. Other claims (e.g., increased vertical services' revenue) are equally questionable. In short, Bell Atlantic and GTE have failed to credibly establish that the merger will generate some \$4.5 billion in efficiencies within three years of closing.

VIII. POST-MERGER CONDITIONS HAVE NOT BEEN EFFECTIVE AND THUS CANNOT BE RELIED UPON TO DIMINISH THE ADVERSE COMPETITIVE EFFECTS.

As demonstrated, the anticompetitive consequences of allowing the merger are unambiguous. The Commission should not content itself with allowing the merger and relying on conduct regulation after the fact. Professors Krattenmaker and Salop, two of the originators and proponents of the "raising rivals'

¹⁷⁶ Besen, Srinagesh and Woodbury at 47.

costs" non-price predation theory, have noted its applicability to merger policy.¹⁷⁷ Further, the Commission's statutory mandate extends well beyond merely correcting bad conduct to assuring efficient industry structures which themselves will aid to minimize such misconduct.¹⁷⁸

Conditions have not been sufficient to date. The *Bell Atlantic-NYNEX* Order set forth multiple conditions subsequent to Bell Atlantic's last acquisition of local monopolies. The conditions became effective upon release of *Bell Atlantic-NYNEX* or shortly thereafter, with all obligations scheduled to sunset in 48 months. These conditions relate to performance standards and associated remedies, performance monitoring reports, Operations Support Systems, and pricing. Within the first few months, however, it became apparent that Bell Atlantic would marshal its efforts in order to evade those requirements or to stall required negotiations with competitors. Accordingly, competitors were forced to file Section 208 complaints seeking relief from the Commission and pursue other remedies before state commissions.

177 See Thomas G. Krattenmaker, Steven C. Salop, "Analyzing Anticompetitive Exclusion," 56 Antitrust L. J. 71, 81-82 (1987). Similarly, in an extensive note on the Cargill case, one commentator has suggested that a merger enabling a firm to predate by raising the price of a rivals' input could satisfy the Cargill standard. Thomas F. Cotter, "Note: Cargill, Inc. v. Monfort of Colorado, Inc., The Supreme Court Restricts Private Antitrust Challenges to Horizontal Mergers," 1987 Wisc. L. Rev. 503, 530-31 (1987).

178 See GTE Serv. Corp. v. FCC, 474 F.2d 724, 730 (2d Cir. 1973); GTE of the Southwest v. FCC, 449 F.2d 846, 853-856 (5th Cir. 1971).

In late 1997, AT&T and MCI each filed a complaint alleging that Bell Atlantic refused to price in accordance with Bell Atlantic-NYNEX conditions.¹⁷⁹ AT&T complained that "[i]n none of [its seven pre-merger]¹⁸⁰ jurisdictions has Bell Atlantic offered competing LECs access to network elements and interconnection at truly TELRIC-based rates."¹⁸¹ Rather, Bell Atlantic interpreted the Commission's TELRIC standard to permit Bell Atlantic to recover its "actual" costs -- including embedded costs. Furthermore, AT&T demonstrated that "Bell Atlantic's obligations regarding this forward-looking cost standard applied to existing offerings, not just those that post-dated the Commission's Merger Order."¹⁸² For its part, Bell Atlantic has ignored the thrust of *Bell Atlantic-NYNEX*, which contemplates that all competitors will benefit from prices established at costs (see Bell Atlantic-NYNEX ¶ 200) including the condition #9 attached thereto, and has argued that only post-merger prices need be based upon forward-looking costs, and that pre-merger prices are not affected by the

¹⁷⁹ See *MCI Complaint, MCI Telecomm. & MCImetro Access Transmissions Serv., Inc.*, File No. E-98-12 (FCC, filed Dec. 19, 1997) ("1997 MCI Complaint"); *AT&T Complaint, AT&T Corp. v. Bell Atl. Corp.*, File No. E-98-05 (FCC, filed Nov. 5, 1997) ("AT&T Complaint"). These complaints, by their own terms, only apply to the former Bell Atlantic states. See *AT&T Complaint* n.1; *1997 MCI Complaint* n.1.

¹⁸⁰ Delaware, District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia, and West Virginia.

¹⁸¹ *AT&T Complaint* ¶ 21.

¹⁸² *Id.* ¶ 4 (citing *Bell Atlantic-NYNEX* ¶ 185 -- "Bell Atlantic-NYNEX must, irrespective of whether either Bell Atlantic or NYNEX has a prior agreement with a competing carrier, offer

terms of *Bell Atlantic-NYNEX*.¹⁸³ The 1997 MCI Complaint echoed the problems identified in AT&T's complaint, using Bell Atlantic's proposals before the Pennsylvania PUC as a proxy for Bell Atlantic's activities before each of its respective state commissions.

MCI filed a subsequent complaint in March 1998¹⁸⁴ that alleged that Bell Atlantic again violated the merger conditions by "refusing to negotiate in good faith to develop adequate performance standards, remedies, and associated reporting."¹⁸⁵ The 1998 MCI Complaint chronicled MCI's submission to Bell Atlantic of a comprehensive proposal addressing performance reporting, standards, and remedies, followed by Bell Atlantic's tactics to slow and extend the process.

In addition to these complaints to the Commission, MCI has documented that Bell Atlantic has failed to satisfy the conditions to *Bell Atlantic-NYNEX* in at least one other respect. In a filing with the NYPSC, MCI noted that

BA-South's current [OSS is] different from the systems available in BA-North. MCI has requested that BA-NY identify which systems will be in place in compliance

all of the terms contained in the conditions to all competing carriers upon request.").

183 See Bell Atlantic Answer, AT&T Corp. v. Bell Atl. Corp., File No. E-98-05 (FCC, filed Dec. 15, 1997).

184 MCI Complaint, MCI Telecomm. Corp. & MCI metro Access Transmissions Serv., Inc. v. Bell Atl. Corp., File No. E-98-32 (FCC, filed Mar. 17, 1998) ("1998 MCI Complaint").

185 Id. ¶ 8.

with [Bell Atlantic-NYNEX], but to date MCI has not received an answer from BA-NY.¹⁸⁶

Bell Atlantic's failure to implement, within 15 months after the FCC approved its merger with NYNEX (i.e., by November 15, 1998), uniform OSS interfaces covering the entire Bell Atlantic-NYNEX combined regions and its failure to develop uniform interfaces within their current respective regions within 120 days of the Bell Atlantic-NYNEX merger as required by the FCC's Bell Atlantic-NYNEX merger conditions¹⁸⁷ demonstrates that post-merger conditions are ineffective.

As discussed supra, the New York local market remains closed to competition.¹⁸⁸ Moreover, AT&T recently filed with the NYPSC affidavits of several AT&T executives that underscore Bell Atlantic's continued intransigence regarding opening markets in New York. The general problems identified are Bell Atlantic's provisioning of "hot cut" installations, LNP implementation, OSS (among other things, response times for AT&T orders and trouble reports), collocation, and nondiscriminatory trunking.¹⁸⁹ Specifically, AT&T demonstrated that "BA-NY's performance for AT&T in hot cut installations and LNP implementation has been

¹⁸⁶ See MCI Comments filed re: NYPSC Case 97-C-0271, at 12 (Aug. 18, 1998).

¹⁸⁷ See Bell Atlantic-NYNEX ¶ 13 & App. C ¶¶ 2b, c.

¹⁸⁸ See supra n.131 and accompanying discussion.

¹⁸⁹ The filings were made subject to the protective order in NYPSC Case No. 97-C-0271. Sprint's Petition, therefore, does not refer to any specific figures or allegations not included in AT&T's public filing.

poor under any standard."¹⁹⁰ AT&T (and its customers) have experienced various technical difficulties with hot cuts including premature cutovers, failure to apply the LNP trigger in the switch, performing the cutover incorrectly, untimely notifying AT&T that facilities are not available, and premature removal of the switch translation by BA-NY.¹⁹¹ In addition, AT&T complains that "[t]he overwhelming majority of AT&T hot cut orders are not completed by BA-NY within the 5-day interval."¹⁹² Also, "AT&T has thirty-seven pending collocation applications and, with one excuse or another (and sometimes with no excuse), BA-NY essentially admits that it cannot provision a single one in the 76-business day time frame by which even BA-NY defines its Section 271 obligation."¹⁹³

Bell Atlantic-New York also continues to breach the terms of its interconnection contract with Sprint, in which Bell Atlantic expressly agreed to provide UNE combinations to Sprint upon request. As a result, Sprint filed a Petition with the New York Public Service Commission to enforce the terms of the interconnection contract.¹⁹⁴ Moreover, Bell Atlantic-Vermont's

¹⁹⁰ Joint Supplemental Reply Affidavit of Richard E. Fish, Jr., and S. Jeannine Guidry on Behalf of AT&T Communications of New York, Inc., filed in NYPSC Case 97-C-0271, ¶ 8 (Oct. 27, 1998).

¹⁹¹ See id. ¶¶ 27-37.

¹⁹² See id. ¶ 47.

¹⁹³ Supplemental Reply Affidavit of Maureen A. Swift on Behalf of AT&T Communications of New York, Inc., filed in NYPSC Case C-97-0271, ¶ 3 (Oct. 27, 1998).

¹⁹⁴ Petition of Sprint Communications Company L.P. for

9% increase in customer complaints tracked by the Vermont Public Service Board from August 1996 (pre-Bell Atlantic-NYNEX merger) to July 1998 (post-Bell Atlantic-NYNEX merger) underscores how mergers can make things worse for consumers. This sampling of serious anticompetitive difficulties that AT&T, Sprint and other companies and consumers have encountered underscore the weaknesses of post-merger conditions.

The FCC's and state commissions' experience overseeing the *Bell Atlantic-NYNEX* conditions exposes the limitations of conditions to govern the future conduct of two local monopolies subsequent to a merger. While many of the foregoing problems have been pending for some time, the 48-month sunset provision continues to toll. And, in addition to its failure to comply with agreed-upon merger conditions, Bell Atlantic continues to erect obstacles to block CLEC attempts to enforce the ILEC's statutory duties.¹⁹⁵ In the interim, Bell Atlantic has little incentive to do anything but drag its feet and contest the best efforts of Sprint and other CLECs to enforce their statutory rights and the merger conditions.

In the 271 context, Congress saw the necessity of adopting a carrot or incentive approach to encourage the entrenched local monopolies to open their markets. Even this approach has been

Arbitration under Section 16 of an Interconnection Agreement, filed in Case 96-C-0864 (Dec. 2, 1997).

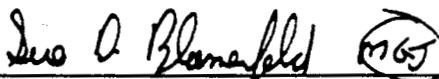
¹⁹⁵ See supra n.52 (discussing Bell Atlantic's most recent efforts to compromise Sprint's statutory right to elect another carrier's agreement under Section 252(i)).

strained, as we have learned that the interLATA carrot is not nearly as satisfying a meal as the *de facto* local monopoly. Sections 251 and 252 obligations have also gone unheeded. There is no basis to believe reiteration of these ILECs' legal obligations as merger conditions would help make their fulfillment any more real.

CONCLUSION

The proposed merger is anticompetitive and contrary to the public interest. Sprint respectfully urges the Commission to deny the Application.

Respectfully submitted,



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November 23, 1998

CERTIFICATE OF SERVICE

I, Trisha McLean, do hereby certify that on the 23rd day of November, 1998, copies of the attached document were served by first class mail, postage prepaid, or hand delivered as indicated, on the following parties:

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**DECLARATION OF STANLEY M. BESEN,
PADMANABHAN SRINAGESH, AND JOHN R. WOODBURY**

**AN ECONOMIC ANALYSIS OF THE
PROPOSED BELL ATLANTIC/GTE MERGER**

**Charles River Associates Incorporated
November 23, 1998**

1. Introduction and Conclusions

In reviewing the Bell Atlantic/NYNEX merger, the Federal Communications Commission concluded that reducing the number of independently controlled large Incumbent Local Exchange Carriers (ILECs) will require "future applicants [to] bear an additional burden in establishing that a proposed merger will, on balance, be procompetitive and therefore serve the public interest, convenience, and necessity."¹ As demonstrated in this and the accompanying declarations, Bell Atlantic and GTE have not established that their proposed merger will be procompetitive and serve the public interest, convenience, and necessity.

This Declaration and the accompanying declarations by Dr. John B. Hayes,² Professors Michael L. Katz and Steven C. Salop,³ and Professor Joseph Farrell and Dr. Bridger M. Mitchell⁴ analyze the competitive effects of the proposed merger of Bell Atlantic and GTE. These analyses show that the anticompetitive effects of the proposed Bell Atlantic/GTE merger are likely to be significant. They also show that the expansion in service offerings the merging parties claim the merger would

¹ *In the Applications of NYNEX Corporation and Bell Atlantic Corporation for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, Memorandum Opinion and Order, FCC 97-286, File No. NSD-L-96-10, released August 14, 1997 (henceforth *Merger Order*), Para. 16.

² Declaration of John B. Hayes, "Market Power and the Bell Atlantic-GTE Merger," November 23, 1998 (henceforth *Hayes Declaration*).

³ Declaration of Michael L. Katz and Steven C. Salop, "Using A Big Footprint to Step on Competition: Exclusionary Behavior and the SBC-Ameritech Merger," October 14, 1998 (henceforth *Katz and Salop Declaration*).

⁴ Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998 (henceforth *Farrell and Mitchell Declaration*).

produce could occur without the merger. On the basis of these analyses, we conclude that the proposed merger is likely to harm competition and consumers, and thus is contrary to the public interest.

The principal conclusions of our analyses are the following:

- Bell Atlantic and GTE possess market power in the sale of local exchange and exchange access services and are likely to retain that power for some time to come.
- The merger would eliminate Bell Atlantic and GTE as potential LEC entrants into each other's service territories.
- An interLATA strategy implemented by the combined Bell Atlantic/GTE would be accompanied by *even greater* anticompetitive harm than would similar strategies implemented independently by Bell Atlantic and GTE. These harms would be felt in those (downstream) markets, such as the market for local calls or the market for interLATA calls, where rivals must rely on essential facilities provided by Bell Atlantic and GTE and on their ability to interconnect with Bell Atlantic and GTE customers. The proposed merger would increase both the incentives and the ability of the combined entity to exploit its control over essential facilities to disadvantage its rivals. Moreover, even if Bell Atlantic/GTE were to satisfy Section 271 conditions, it would still retain the ability to disadvantage rivals. Finally, imposing conditions on the merged entity to deal with these competitive concerns would be ineffective, as demonstrated by Bell Atlantic's failure to meet

the conditions imposed by the Commission in approving the Bell Atlantic/NYNEX merger.

- The merger would impair the ability of regulators to use industry benchmarks to determine whether an incumbent firm is discriminating against rivals while, at the same time, increasing the need for such regulatory supervision.
- The putative benefits from combining the assets of Bell Atlantic and GTE could be obtained without the merger. In particular, GTE is not limited to offering its new telecommunications services in areas that are proximate to its existing service territories in attempting to achieve the scale necessary for successful operation. Moreover, GTE is not limited to offering these services to Bell Atlantic customers, nor does the merger create any significant advantages to GTE in competing for those customers unless Bell Atlantic unfairly favors GTE. Similarly, Bell Atlantic faces no barriers in competing for business customers that are located in or proximate to areas currently served by GTE.
- The claim that the merger will "add another competitor to the small number of firms able to meet the growing demand for 'seamless' full-service offerings across far-flung distances"⁵ is not credible because Bell Atlantic cannot offer in-region long-distance service in the absence of significant local competition. If the merging parties' contention that there will not be large-scale local entry in the

⁵ In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, For Consent to Transfer of Control, Application for Transfer of Control, Public Interest Statement (henceforth Public Interest Statement) October 2, 1998, p. 9.

near term is true, the merged firm will not be able to satisfy the demand for “seamless” service for some time.

The analyses supporting these conclusions, some of which summarize the analyses contained in the accompanying declarations, are presented below. Section 2 summarizes Dr. Hayes’ analysis of the markets for local exchange and exchange access services, and concludes that Bell Atlantic and GTE are dominant providers in their geographic markets. Moreover, given the limited scope of actual entry and the announced plans of potential entrants, it is evident that Bell Atlantic and GTE will remain dominant for some time to come, and will retain control of the essential facilities from which they derive their ability to harm competition. Section 3 explains why the merger would eliminate Bell Atlantic and GTE as potential local exchange entrants into each other’s service territories.

Section 4 draws on the analyses of vertical foreclosure by Professors Katz and Salop. On the basis of these analyses, we conclude that the proposed merger would increase the incentives and ability of Bell Atlantic and GTE to harm competition in the supply of local and interexchange services and the consumers of these services.

Section 5 summarizes the conclusions of Professor Farrell and Dr. Mitchell regarding the impact of the merger on the ability of regulators to rely on industry benchmarks to evaluate the behavior of ILECs. It explains why the merger would make it more difficult for both federal and state regulators to employ either average industry performance or best practices as yardsticks against which to compare the

behavior of ILECs. The merger would also reduce the ability of regulators to engage in heightened scrutiny of "worst practices."

Section 6 analyzes the claimed benefits of the merger and concludes that these claims are unwarranted. Section 7 summarizes the results of all of these analyses and concludes that the merger would not be in the public interest and therefore should not be approved.

2. Market Power in Local Exchange and Exchange Access Markets

If the provision of local exchange and access services were competitive, the merger's likely anticompetitive effects, as described by Professors Katz and Salop and by Professor Farrell and Dr. Mitchell, would not be of antitrust significance. However, the proposed merger of Bell Atlantic and GTE raises significant antitrust concerns because the merging parties control essential facilities that are required to produce a range of communications services, including competitive local services, interexchange communications services, and combinations of such services. In his Declaration, Dr. Hayes concludes that Bell Atlantic and GTE possess market power in the sale of local exchange and exchange access services, and are likely to retain that power for some time to come.⁶

In particular, Dr. Hayes considers the relative position of ILECs as measured by their share of switched access lines within states served by Bell Atlantic (District of Columbia, Delaware, Massachusetts, Maine, Maryland, New Hampshire, New

⁶ Hayes Declaration, Para. 6 and Section IV.

Jersey, New York, Pennsylvania, Rhode Island, Virginia, Vermont, and West Virginia) and GTE (California, Florida, Hawaii, Illinois, Indiana, Kentucky, Michigan, North Carolina, Ohio, Oregon, Pennsylvania, Texas, Virginia, Washington, and Wisconsin). On average, the ILEC in these states accounts for about 99% of switched access lines. Dr. Hayes also considers the position of the ILECs as measured by their share of switched local service minutes of use; in 10 Bell Atlantic states, Bell Atlantic's share of switched minutes ranges from 97.3% in New York to 100% in New Hampshire. In 26 GTE states, GTE's share of switched minutes averages 98.7% and the share is never less than 95.9%. These statistics indicate that the Bell Atlantic and GTE territories have not been subject to substantial CLEC entry. Moreover, according to Hayes, "[t]he unbalanced origination and termination minutes exchanged between ILEC and CLEC networks suggest that CLEC sales are concentrated in a limited market segment, an inference that provides a reason to be cautious about predicting CLEC success in a broader local service market. Additional analysis is needed to understand why CLECs have been especially successful in this market segment."⁷

While these shares are evidence of the continuing dominance of Bell Atlantic and GTE, the shares may nonetheless understate that dominance since they include resale of the ILEC's service by CLECs. As Dr. Hayes points out, "[b]ecause resale rates are not based on the underlying costs of the facilities, resale

⁷ Hayes Declaration, Para. 18.

competition can do relatively little to drive retail rates down towards cost. Facilities-based competitors also represent alternative sources of access services, while resellers do not serve this function."⁸ If resold lines are "counted" as part of the ILECs share of local exchange lines in six Bell Atlantic states (District of Columbia, Delaware, Maryland, New Jersey, Pennsylvania, and Virginia), the ILECs average share of residential lines exceeds 99.9% and the ILECs average share of business lines is 99.3%.⁹

Equally important, Dr. Hayes observes that CLEC facilities in the Bell Atlantic and GTE regions are almost always concentrated in major urban areas and serve large business customers. Thus, while there may be growing competition for large businesses, that competition has yet to increase the rivalry for other businesses and for residential services.

Finally, the failure of any of the ILECs to be found in compliance with Section 271 of the Act suggests that the opening of local exchange markets to competition is not likely to occur in the near term. Given the incentives that the ILECs have to discourage emerging local competition, Dr. Hayes concludes that "the need for ongoing regulation would not soon end."¹⁰

In sum, the Commission cannot rely on either the current degree of competition with the ILEC or the development of near-term competition to eliminate

⁸ Hayes Declaration, Para. 20, footnote omitted.

⁹ Hayes Declaration, Para. 22.

¹⁰ Hayes Declaration, Para. 29.

the heightened incentives that a combined Bell Atlantic/GTE would have to discourage local exchange and interexchange competition. Further, the combination would reduce the efficacy of the Commission's benchmark regulation.

3. The Merger Would Eliminate Bell Atlantic and GTE as Potential Local Exchange Entrants Into Each Other's Service Territories

The proposed merger would eliminate Bell Atlantic as a potential local exchange entrant into GTE's service territories and GTE as a potential local exchange entrant into Bell Atlantic's service territories. Bell Atlantic and GTE have claimed that the elimination of each as a potential entrant into the service territories of the other would not adversely affect consumers because there are so many other potential entrants into the supply of local exchange service. However, because they possess a number of important competitive advantages, the merging firms may well be among the most likely potential entrants. Moreover, despite the claims of the merging parties that "the actual potential-competition doctrine [is] at the outer reaches of competition law,"¹¹ potential entry should remain a concern of the Commission where, as here, an industry has only recently been opened to competitive entry.

First, both Bell Atlantic and GTE have extensive experience as suppliers of local services, including experience in the engineering, design, marketing, and operation of extensive local telephone networks serving all businesses and

¹¹ Public Interest Statement, p. 26.

residences. Second, both possess fully functioning and time-tested Operations Support Systems (OSS) and billing systems that are critically important to the provision of local exchange and exchange access services. The significance of OSS has been most apparent in the Section 271 applications rejected by the FCC.

Third, both Bell Atlantic and GTE possess a clear marketing message based on scores of years of local service provision and brand names that are well known in adjacent service territories. Fourth, the geographic proximity of Bell Atlantic and GTE service territories in a number of geographic areas would allow each to take advantage of limited scope economies.

Finally, Bell Atlantic and GTE are likely to be particularly potent entrants because they have first-hand knowledge of the kind of input provisioning of which an ILEC is capable. If, for example, GTE were to attempt to impede Bell Atlantic's entry by claiming that a service demanded by Bell Atlantic could only be provided in a particularly costly way, Bell Atlantic would be in an excellent position to evaluate the validity of that claim by virtue of its own ILEC experience.

The claims of the merging parties that the Commission should give little weight to potential competition should similarly be rejected. Local exchange entry has only recently become possible. Thus, unlike situations in mature industries in which the absence of "a well-grounded finding that one of the merging firms 'in the near future' would, but for the merger, supply significant competition against the other that would not be forthcoming from other present or potential market

participants”¹² might militate against concluding that a particular firm is a potential entrant, here the Commission could quite reasonably make judgments about the likelihood of entry based on the advantages of rivals even in the absence of firm plans to enter.

Indeed, the parties themselves have called attention to such advantages when they describe GTE's plans for entry “into territory close to its own few urban franchise areas;”¹³ note the ability of the combined firm “to compete more effectively for the business of a host of firms that have offices both in Bell Atlantic's region and near to GTE's franchise areas across the rest of the country;”¹⁴ and claim that “GTE's lack of an adequate high-density customer base...has impaired its ability to roll out new services.”¹⁵ In judging the validity of these claims, the Commission must make a “well-grounded” finding that is no different from the finding it must make in determining whether the merging parties would be potential entrants into each other's service territories in the absence of the merger.

4. The Competitive Risks of the Bell Atlantic/GTE Merger to Interexchange and Local Exchange Markets Are Significant

As noted above, the merging parties claim that the most significant benefits for consumers will arise from their ability to offer the entire array of telecommunications

¹² Public Interest Statement, p. 28.

¹³ Public Interest Statement, p. 7.

¹⁴ Public Interest Statement, p. 13.

¹⁵ Public Interest Statement, p. 17.

services to its largest customers, including interLATA and local exchange services, and that small businesses and residential consumers will eventually benefit. This section explains why the merger would likely increase local exchange and interexchange rates above those that would prevail absent the merger.

ILECs, including Bell Atlantic and GTE, provide an array of "access" inputs (originating and terminating access, Unbundled Network Elements (UNEs), and the resale of the ILEC's local exchange service, among others) to IXCs, CLECs, and firms that offer both interexchange and local exchange services (combined service carriers or "CSCs"). In addition to selling inputs in this upstream market, the ILECs, either currently or prospectively, compete downstream with the IXCs, CLECs, and the CSCs for the patronage of retail customers, businesses, and residences.¹⁶

As Professors Katz and Salop explain, because ILECs like Bell Atlantic and GTE have market power in the sale of access inputs to their downstream rivals, they have the incentive and ability to disadvantage those downstream rivals by raising the price of these inputs. Because both the FCC and the states regulate interconnection prices, Bell Atlantic and GTE may also choose to deny, delay, or degrade the provisioning of inputs to their downstream rivals, thereby disadvantaging those rivals in their attempts to attract consumers. In their Declaration, Professors Katz and Salop explain that these anticompetitive incentives

¹⁶ It should be noted that Bell Atlantic is currently not permitted to provide in-region interLATA service, which would seem to preclude the merged company from implementing the strategy at this time.

are large and that the merger would heighten those incentives. What follows summarizes their analysis.

First, the ILECs generally, and Bell Atlantic and GTE in particular, likely have substantial market power in the supply of access inputs. For example, the current prohibition on RBOC provision of in-region interLATA communications is based on serious concerns that RBOCs can and will use their control of essential facilities to exclude, or discriminate against, competitors in the interLATA market. The rationale for this prohibition is clearly described in the history of the Telecommunications Act of 1996 and in the longstanding policy of the FCC to regulate access and interconnection services offered by ILECs.

The Telecommunications Act of 1996 (Section 271) recognizes the ability and the incentive of the RBOCs to leverage their control over essential local exchange facilities to behave anticompetitively in the long-distance market, and thus prohibits RBOCs from providing interLATA services within their regions until they are subject to some competitive discipline in the sale of access inputs.

Similarly, the Commission has clearly expressed ongoing concern with the potential that ILECs have to frustrate the growth of local exchange competition. For example, the FCC has noted that:

Because an incumbent LEC currently serves virtually all subscribers in its local serving area, an incumbent LEC has little economic incentive to assist new entrants in their efforts to secure a greater share of that market. An incumbent LEC also has the ability to act on its incentive to discourage entry and robust competition by not interconnecting its network with the new entrant's network or by insisting on supracompetitive prices or other unreasonable

conditions for terminating calls from the entrant's customers to the incumbent LEC's subscribers.¹⁷

In summary, the supply of access inputs is characterized by an absence of current and prospective competition.¹⁸ Professors Katz and Salop conclude that, for the foreseeable future, ILECs such as Bell Atlantic and GTE will have the ability to disadvantage their downstream IXC, CLEC, and CSC rivals by denying, delaying, or degrading the provisioning of access inputs to them. The exclusionary behavior might result from (among other possibilities) decreasing the technical quality of interconnection or delaying the installation of new lines, the provisioning of UNEs or collocation cages, or the repair of the rival's leased facilities.

The principal effect of the merger would be to increase the control that a single entity has over access lines and other resources that are needed by the IXCs, CLECs, and the CSCs; as a result, the merger would threaten existing competition in IXC services and emerging competition in CLEC and CSC services.

If an ILEC can divert customers from its downstream rivals to its own service (local exchange service, interexchange service, or some combination), the ILEC gains the profit margin earned on customers that switch to it from its rivals. However, for every customer that it gains from its rivals, the ILEC loses the profits that it previously earned from the sale of inputs to them. If the downstream (retail) margin for an additional customer diverted to the ILEC exceeds the upstream

¹⁷ Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, First Report and Order, CC Docket Number 96-98, (August 8, 1998), Para. 10.

¹⁸ Hayes Declaration, Para. 6.

(wholesale) margin from the sale of inputs to the rival, the ILEC has the incentive to divert customers from the rivals to itself.

For the CSC illustration used in their Declaration, Professors Katz and Salop calculate the monthly local and long-distance revenues generated by the average single-line business customer. They subtract from the revenues the ILEC's monthly costs of providing these services. The difference between the monthly revenues and costs is the retail margin captured by the ILEC for every customer shifted from a CSC to itself.

This retail margin gained on each subscriber diverted is then compared to the upstream margin on the sale of access inputs lost as a result of the diversion. Professors Katz and Salop assume that the CSC owns its own long-distance network, collocates the necessary equipment in the ILEC's central offices, connects the collocated equipment to its interexchange nodes using CAP transport, and purchases unbundled loops from the ILEC. The CSC's only incremental purchases from the ILEC are the unbundled loop.

Based upon the preliminary data available to them, Professors Katz and Salop conclude that the downstream (retail) margin exceeds the upstream (wholesale) margin by a considerable amount. Indeed, they calculate that this would be so even if a substantial fraction of the CSC's lost subscribers do not shift

to the ILEC.¹⁹ Thus, in addition to having the ability to disadvantage its downstream rivals, the ILEC has the incentive to do so as well.

Recent decisions by State Commissions to deny petitions by RBOCs seeking to provide interLATA service in accordance with Section 271 of the Act provide concrete evidence of such incentives. For example, following hearings and her review of thousands of pages of evidence, a NYPSC Administrative Law Judge found that Bell Atlantic-New York had not met its burden of proof with respect to its Prefiling Statement, and noted both the difficulty in obtaining services and elements in a timely manner and the clear lack of OSS parity.²⁰ The same judge also recently found that "as a matter of fact on this record" that none of BA/NYNEX's proposed UNE combination methods constitute a nondiscriminatory form of obtaining and combining unbundled elements.²¹ The affidavit filed with the New York Public Service Commission on September 28, 1998, by Michael Nelson explains some of the problems that Sprint has encountered reselling Bell Atlantic's local service.²² These problems include OSS variances from national standards and Sprint's

¹⁹ Katz and Salop Declaration, Paras. 52-53.

²⁰ See New York Public Service Commission, Case 97-C-0271, *Petition of New York Telephone Company for Approval of Its Statement of Generally Available Terms and Conditions and Draft Filing of Petition for InterLATA Entry*, Ruling Concerning the Status of the Record, Issued July 8, 1997.

²¹ New York Public Service Commission, Case 98-C-0690, *Proceeding on Motion of the Commission to Examine Methods by which Competitive Local Exchange Carriers can Obtain and Combine Unbundled Network Elements*, Proposed Findings of Administrative Law Judge Eleanor Stein, August 4, 1998 at 10.

²² See Affidavit of Michael J. Nelson, attached to Comments of Sprint Communications Company, L.P., State of New York Public Service Commission, Case 97-C-0271, September 28, 1998 (henceforth Nelson Affidavit).

receiving first quarter 1998 performance measurements upon request, both of which are contrary to the conditions imposed by the FCC in connection with its approval of the Bell Atlantic/NYNEX merger. None of the RBOCs has yet succeeded in obtaining approval for a Section 271 application.

In addition, rivals continue to contend that ILEC behavior impedes their entry.

For example, AT&T asserts that:

The recurring and nonrecurring rates for unbundled elements proposed by Bell Atlantic in Delaware, the District of Columbia, Maryland, New Jersey, Pennsylvania, Virginia, and West Virginia are not TELRIC compliant. They do not reflect the costs of efficiently providing unbundled elements, but rather purport to reflect the cost of providing unbundled elements using Bell Atlantic's existing network design and operating practices. Moreover, the values proposed for the specific inputs identified herein are all well in excess of forward-looking economic costs and reflect embedded costs, and/or inefficient network design and operating practices. By proposing prices for network elements (and combinations thereof) that are not based on forward-looking, economic costs, Bell Atlantic has thus violated the pricing conditions that the Commission imposed for approval of the Bell Atlantic/NYNEX merger.²³

Similarly, MCI maintains that:

Bell Atlantic has now proposed interconnection rates in Pennsylvania, New Jersey, Delaware, West Virginia, Maryland, Virginia, and the District of Columbia. Bell Atlantic's rate proposals have followed essentially the same approach in each of these states. That approach is emphatically not TELRIC. Instead, Bell Atlantic's pricing models improperly inflate the costs of network

²³ Complaint of AT&T Corp., *AT&T Corp. vs. Bell Atlantic Corp.*, November 10, 1997 (received), Para. 83.

elements, often by including both Bell Atlantic's embedded costs and costs attributable to inefficient network operations and technology.²⁴

While this behavior is consistent with the view that the ILECs have adopted strategies to disadvantage their downstream rivals, the extent of exclusionary behavior is likely to increase, perhaps substantially, if the Bell Atlantic/GTE merger is approved. Specifically, the merger would increase the incentive for exclusionary behavior by permitting the internalization of important anticompetitive spillovers and, by so doing, would increase the incentive and ability of Bell Atlantic/GTE to engage in such behavior.

For example, suppose that Bell Atlantic currently provides terminating access to GTE's long-distance affiliate as well as to other IXCs.²⁵ In addition, suppose that, absent the merger, Bell Atlantic were to impair the quality of terminating access to all IXCs, except for GTE's long-distance affiliate. As a result, GTE would gain an artificial competitive advantage, and some customers who would otherwise have subscribed to another IXC instead would subscribe to GTE's long-distance service.

Before the merger, Bell Atlantic has no incentive to consider the benefits that its exclusionary behavior generates for GTE. After the merger, however, Bell

²⁴ Complaint of MCI Telecommunications Corporation and MCImetro Access Transmission Services, Inc., *MCI Telecommunications Corp. and MCImetro Access Transmission Services, Inc. vs. Bell Atlantic Corp.*, December 19, 1997, Para. 15, footnote omitted.

²⁵ For its long-distance service, the CSC is likely to require terminating access in both Bell Atlantic's and GTE's territories.

Atlantic would take the spillover effects on GTE's profits into account, and thus would have a greater incentive to degrade interconnection to other IXCs.

Similarly, the merger would likely increase the incentives for Bell Atlantic to engage in exclusionary behavior towards CLECs and CSCs. This occurs because there may be scale and scope economies attained by a CLEC or CSC operating in multiple markets. If this type of carrier is competitively harmed in one market, its ability to compete in other markets is reduced. When Bell Atlantic successfully engages in exclusionary behavior towards these competitors, it raises their costs or reduces their service quality in Bell Atlantic's service territory. But as a result of the exclusion, the competitors' ability to attract customers in other geographic areas may also be impaired. Indeed, the linkages across markets may be sufficiently strong that a CLEC or CSC that experiences harm in one market may not find it profitable to enter any market.

As one example, the higher costs or degraded service quality imposed on a CLEC in Bell Atlantic's territory will result in the CLEC obtaining fewer customers in Bell Atlantic's territory than it would otherwise attract. As a result, the CLEC may engage in less national advertising or invest less in upgrading its service quality than otherwise, and will be a less aggressive competitor in other geographic areas, which would likely include the GTE territory. GTE will then experience less competition and greater profits.

As another example, there may be functionality on the CSC's network that is only available to its customers. Like many other telecommunications services, the

value to any particular customer of the functionality may increase as the number of other CSC customers with that functionality increases. Thus, the more customers a CSC can attract, the greater the value of the CSC to each customer. In this case, if Bell Atlantic disadvantages the CSC in its own territory, the CSC captures fewer customers and its service becomes less attractive to potential subscribers in GTE's territory too.

In these examples, Bell Atlantic's exclusionary behavior generates a spillover benefit for GTE. A merger between Bell Atlantic and GTE would internalize this anticompetitive spillover and increase the incentives for exclusionary behavior. Absent the merger, Bell Atlantic does not share in any of the additional profits that its exclusionary behavior generates for GTE. With the merger, however, Bell Atlantic would take these additional profits into account in choosing the extent of its exclusionary conduct. The amount of exclusion would be higher because of the additional profits earned by GTE. Thus, the merger would likely increase the harm to competition in the market for local services.

In addition to increasing the incentives for exclusionary behavior, the merger would increase the ability of Bell Atlantic/GTE to engage in such conduct against its rivals. As discussed by Professor Farrell and Dr. Mitchell, the regulator's ability to detect exclusionary behavior would be reduced because there would be one fewer firm against which Bell Atlantic's behavior could be gauged. Thus, there would be greater uncertainty about the extent to which deviation from (say) some average measure of performance is a statistical aberration or indicates exclusion. Moreover,

because the post-merger Bell Atlantic/GTE would now be a larger component of any calculated average measure, the average measure itself would worsen, providing the merged firm with greater scope to engage in exclusionary behavior. In addition, the declining average would increase the scope for exclusionary conduct for other ILECs as well, another anticompetitive spillover effect from the merger. The usefulness of the benchmarks would deteriorate even further if the recently proposed SBC/Ameritech merger were approved, providing Bell Atlantic/GTE with even greater scope for conduct that harms competition.

It is also important to observe here that conditioning approval of the merger on an agreement by the parties to accept certain obligations in their dealings with rivals is unlikely to alleviate these competitive concerns. Indeed, Sprint apparently continues to experience considerable difficulty in obtaining services from Bell Atlantic despite the company's obligation to provide these services under the terms of the FCC's approval of the Bell Atlantic/NYNEX merger.²⁶

4.1 Hazlett's Results Are Consistent with Exclusion

The merging parties have presented a Declaration by Professor Thomas Hazlett that they claim provides evidence that "investors viewed the merger not as creating or maintaining market power but, to the contrary, as creating significant new competition to AT&T, MCI WorldCom, Sprint, and SBC/Ameritech."²⁷ Hazlett claims

²⁶ See Nelson Affidavit.

²⁷ Public Interest Statement, p. 6, footnote 2.

to find that “the stock market reactions by the four major BA/GTE competitors to the July 28, 1998 merger announcement reveals little evidence that a decrease in competition was the likely result of the merger. All competitors exhibit negative unadjusted returns over all windows.”²⁸ Hazlett interprets this “as strong evidence that rational investors do not believe that the Bell Atlantic merger with GTE will increase prices for telecommunications customers. The reverse interpretation – that the merger is seen as increasing competitive rivalry – is the most reasonable conclusion.”²⁹

Even if one accepts Hazlett’s empirical evidence at face value, his interpretation of that evidence does not follow. Hazlett has implicitly treated Sprint, AT&T, MCI WorldCom, and SBC/Ameritech as solely *horizontal* rivals to the merged entity. Thus, he interprets the reduction in the share prices of those firms in response to the merger as evidence that they would face additional competition from a stronger Bell Atlantic/GTE. However, Hazlett’s interpretation completely ignores the *vertical* relationships between these firms and Bell Atlantic/GTE. Bell Atlantic and GTE are suppliers of essential inputs to Sprint, AT&T, MCI WorldCom, and SBC/Ameritech. Because the proposed Bell Atlantic/GTE merger would increase the incentive and ability of the combined firm to disadvantage its rivals, these rivals are likely to be made worse off by the merger. Thus, Hazlett’s finding that the share prices of rival firms declined after the merger was announced is

²⁸ Declaration by Thomas W. Hazlett, Para. 6.

²⁹ *Id.*

entirely consistent with the type of analysis described by Professors Katz and Salop, which shows that, after the merger, the combined entity would increase the extent to which it attempts to foreclose rivals. If investors expect foreclosure to increase as a result of the merger, this expectation would lead to declining stock market values of these rivals, now made more vulnerable to anticompetitive behavior by the merged entity.

5. The Effect of the Proposed Merger on Benchmarking

Regulatory policy generally, and the implementation of the Telecommunications Act of 1996 in particular, requires the Federal Communications Commission to reach complex decisions regarding, for example, the pricing of unbundled network elements and the quality of network access. In making such decisions, the Commission inevitably faces a critical, pervasive problem: incomplete information about the true costs and capabilities of the regulated firm.³⁰ In order to overcome this problem, the Commission and state regulators can and do use comparisons of one RBOC's costs, and other measures of performance, with those of other RBOCs and comparably sized LECs. The Bell Atlantic/GTE merger would reduce the quantity and quality of such information that is available to regulators and, therefore, their ability to employ "benchmarking" as a regulatory tool.³¹ This would occur because the merger would further reduce the already small number of

³⁰ See Farrell and Mitchell Declaration, esp. Section I.C.

³¹ The effect would obviously be even greater if both the Bell Atlantic/GTE and SBC/Ameritech mergers were to be approved.

RBOCs whose performance can be used to gauge the performance of any particular RBOC (or other comparably sized ILEC). This section summarizes the Declaration of Professor Joseph Farrell and Dr. Bridger M. Mitchell, which analyzes the impact of the proposed merger on the ability of regulators to rely on benchmarking as they implement procompetitive public policies. Farrell and Mitchell explain the various forms that benchmarking may take and provide an extensive set of examples of their use by telecommunications and other regulators.

5.1 Average-Practice Benchmarking

In average-practice benchmarking, a regulator uses an industry average to determine a maximum price, a minimum quality standard, or some other performance measure for a regulated firm.³² In setting a maximum price benchmark (i.e., price caps), or determining customer revenue per line for high-cost support plans, for example, each regulated firm only partially determines the industry average. As a result, only a fraction of the cost savings or revenue increases achieved by one firm will be reflected in the subsequent period's industry average. This allows the firm to retain a portion of the reward for its innovations and provides the firm with an incentive to innovate.

Average-practice benchmarks typically are based on information from several comparably sized and similarly situated firms. The process of averaging serves to

³² See Farrell and Mitchell Declaration, Section II.A., for a discussion of the use of average-practice benchmarking.

overcome the “noise” in individual observations, thereby permitting the regulator to be more confident about the benchmark used to judge any individual firm's performance.

Farrell and Mitchell identify a number of important examples in which average-practice benchmarking has been used by regulators. The best known example involves the use by the FCC regulators of estimates of average industry productivity improvements in setting price cap formulas. More recently, the FCC has indicated that it will use average revenue per residential line in computing the appropriate universal service subsidies in high-cost areas.

5.2 Best-Practice Benchmarking

In best-practice benchmarking, regulators seek to identify best practices in an industry and induce the firms they regulate to adopt these practices.³³ Best-practice benchmarking may be used either for qualitative characteristics, such as determining whether an ILEC should make available particular forms of interconnection or access to particular network elements, or quantitative characteristics, such as regulating the level of pricing for services used by competing carriers. Farrell and Mitchell note that ILECs often differ in the choices they make, very possibly because they have different attitudes toward cooperation.

³³ See Farrell and Mitchell Declaration, Section II.B., for a discussion of the use of best-practice benchmarking.

Consequently, observing this diversity of practices and requiring all ILECs to follow the best practice can significantly improve industry performance.³⁴

Farrell and Mitchell cite a large number of examples of the use by regulators of best-practice benchmarking. A graphic example involves the FCC's use of Ameritech's willingness to employ the Location Routing Number (LRN) method of implementing local number portability. After Ameritech demonstrated the feasibility of LRN, the Commission required that other ILECs employ the same method. As another example, the Commission concluded that interconnection or access to a particular point on a LEC network is evidence of the technical feasibility of providing the same or similar interconnection in another ILEC network. As a final example, relying on the observation that US West currently offers cageless collocation and that SBC permits CLECs to share collocation space, the Commission has requested comments to determine whether such arrangements should be presumed to be technically feasible at other LEC premises.

5.3 "Heightened Scrutiny for Poor Performance" Benchmarking

Regulators also may use comparative data to identify problem cases.³⁵ ILECs may then use such information to identify sub-standard performance by ILECs, and regulators may subsequently require improved performance or impose sanctions on those firms. This should both directly improve performance of

³⁴ Farrell and Mitchell Declaration, Section II.B.

³⁵ See Farrell and Mitchell Declaration, Section II.C., for a discussion of the use of this type of benchmarking.

individual ILECs and provide incentives for them to avoid poor performance that eventually would be detected.

Farrell and Mitchell report that the FCC has used “heightened scrutiny for poor performance” in disallowing some ILECs’ high charges for physical collocation services, in assessing the overhead rates imposed by ILECs in providing interconnection, and in determining whether the penetration ratios for non-primary ILECs correctly represented residential lines in assessing access charges. The authors also note that the Department of Justice has employed this form of benchmarking in assessing the reasonableness of the speed with which RBOCs had complied with their equal access requirements.

5.4 The Impact of the Merger on Benchmarking

Farrell and Mitchell discuss the effects of mergers on benchmarking under three headings. First, they demonstrate that there are adverse effects even ignoring the effects of mergers on the incentives of the firms. Next, they analyze the adverse unilateral incentive effects on the performance of firms subject to benchmarking. Finally, they examine the increased likelihood of coordinated effects as the result of mergers.

Loss of Information Effects. When a merger leads to more aggregated reporting, the Commission observes less diversity in ILEC practices and loses valuable information that it would otherwise have available for use in establishing performance benchmarks. In many cases, the merged firm may adopt a common practice for pricing of services and supplying network components. Even when the

merged firm reports company-by-company results, the data can be less useful than information obtained from independent firms.

Farrell and Mitchell consider the likelihood that at least one ILEC will report a practice that is cooperative with competitors. They find that mergers of large ILECs significantly reduce the probability that such a favorable practice will be observed even if the mergers had no incentive effects. Similarly, the reduced diversity in observed ILEC practices increases the uncertainty inherent in using a benchmark to determine, for example, whether to disallow some ILECs' direct costs of collocation services.

Unilateral Effects. The establishment of regulatory benchmarks effectively creates 'competition by comparison' between firms that do not directly compete with each other in the same geographic markets.³⁶ This form of competition is akin to product market competition in one important respect. A merger between firms that are not actual or potential competitors in any product market may nonetheless create incentives for unilateral and coordinated actions that harm consumers.

Under average-practice benchmarking, a merged firm will have a larger weight in the computed industry-wide average, and its decision to undertake a cost-saving innovation will have a larger impact on the industry-wide average that regulators will use in the future as a yardstick. Indeed, in its Bell Atlantic/NYNEX Order, the Commission itself expressed concern that the merger would increase the

³⁶ Farrell and Mitchell Declaration, Section III.

relative weight of each company's actions on average performance, and that that increase would adversely affect the incentives of the merged firm to become more effective.³⁷

In addition, the Bell Atlantic/GTE merger would likely result in the merged firm's adopting common practices or uniform standards. If this were to occur, there would be (at least) one fewer independent, firm-specific observation available to regulators in computing the industry-wide average. Such a loss of information handicaps regulators. For example, regulators would inevitably be less confident in identifying unusually poor performance or concluding that it is unreasonable. With poorer information, regulators might have to accept poorer performance.³⁸

Under best-practices benchmarking, if the practice that GTE by itself would prefer were to reduce the profits of Bell Atlantic, after the merger, GTE would account for that fact in deciding whether to adopt the practice. If there were numerous, equally situated ILECs, the effect of this would be small. However, the number of independent observations would fall from five to four as a result of the merger, so the adverse incentives would likely be large.³⁹

Coordinated Effects. Farrell and Mitchell conclude that substantial decreases in the number of large ILECs can significantly increase the threat that ILECs will develop a common understanding on such issues as cooperating with competitors

³⁷ Merger Order, Para. 150.

³⁸ Farrell and Mitchell Declaration, Section III.C.

³⁹ The proposed merger between SBC and Ameritech would reduce this number further.

and avoid "breaking ranks."⁴⁰ One reason is that a reduction in the number of players reduces the probability that one or more will want to be a maverick. In addition, an ILEC considering whether to forego an action it individually would prefer, but that also would break a united front that would be valuable on another issue, must consider whether its action would provoke a break in the united front. Because the probability that the united front would break down in any event will decrease as the number of players falls, a merger makes it more likely that the ILEC would choose to sacrifice its preferred position in order to avoid breaking ranks. In this way, the merger reduces the efficacy of best-practice benchmarking. Indeed, in reviewing the Bell Atlantic/NYNEX merger, the Commission concluded that reducing the number of Bell Companies makes it easier to coordinate actions among them.⁴¹

5.5 Traditional Benchmarking Will Continue to be Needed

Bell Atlantic Vice Chairman Ivan Seidenberg claimed at the FCC Merger En Banc hearing that "[t]he old ones [benchmarks] don't work anymore because you can't compare the future industry by looking in the rear-view mirror of companies that used to be incumbents that are no longer incumbents...we need to create the kind of benchmarks around five or six global players."⁴² Seidenberg reiterated that view in an exchange with Commissioner Ness.⁴³ Although it is not entirely clear

⁴⁰ Farrell and Mitchell Declaration, Section III.B.

⁴¹ Merger Order, Para. 11.

⁴² In re FCC Merger En Banc, October 22, 1998, pp. 74-75.

⁴³ In re FCC Merger En Banc, October 22, 1998, pp. 86-87.

what is meant by the claim that new benchmarks are needed, it cannot mean that the Commission should abandon its practice of using the performance of individual ILECs across the industry as yardsticks. Whatever may happen in the future, it is clear that, for a long time to come, the ILECs will continue to dominate the local exchange market and CLECs, IXCs, and CSCs will continue to require the ILECs' cooperation in order to compete effectively. In these circumstances, the ability of the FCC to employ traditional forms of benchmarking remains an indispensable regulatory tool. Both the proposed Bell Atlantic/GTE and SBC/Ameritech mergers would weaken that tool.

Alternatively, Vice Chairman Seidenberg might be claiming that the traditional industry structure, with ILECs confined to particular geographic areas, is evolving into one in which fewer and larger carriers serve overlapping areas. Although this may be the case – it is difficult to be certain that it is – it does not follow that the Bell Atlantic/GTE merger, or any other ILEC merger should be permitted. If some ILECs expand the geographic reach of their operations and others contract, leaving fewer large telecommunications carriers, that might reflect superior efficiencies of large size. That is, the competitive process might reveal that large size permits lower prices and/or improved service if larger firms are able to attract customers from small ones.⁴⁴ That market test does not occur, however, if growth occurs through merger and especially if, as is the case here, the merged firms have increased

⁴⁴ We say "might" because the market test is a flawed one if large firms grow larger simply because they can deny critical inputs to their smaller competitors.

incentives and ability to deny rivals access to critical inputs. In short, although Vice Chairman Seidenberg's prediction about the future industry structure may be correct, that does not justify short-circuiting the process by which that new market structure evolves.

6. The Merger Is Not Needed to Obtain the Benefits That Are Claimed For It

An important public interest benefit that has been claimed for the proposed Bell Atlantic/GTE merger is that it would permit the merged entity to offer telecommunications services (local exchange, long-distance, high-speed data, and others), either in bundles or separately, in 21 markets outside the Bell Atlantic and GTE service territories to large business customers with headquarters within the Bell Atlantic service territory.⁴⁵ The parties claim that these "anchor tenants" would form a nucleus around which they would build a broader customer base. Specifically, the parties claim that:

GTE's merger with Bell Atlantic will make it possible for the combined company to enter a large number of new local markets by allowing it to build on *Bell Atlantic's* existing account relationships with large businesses.⁴⁶

⁴⁵ Public Interest Statement, pp. 4-7. It is important to observe that the merged company "plans" to enter these markets but is not committed to do so if the merger is approved.

⁴⁶ Declaration of Jeffrey C. Kissell (henceforth Kissell Declaration), Para. 7, emphasis added.

Thus, Bell Atlantic and GTE appear to claim that the merger is essential to the pursuit of the 21-market strategy because, on its own, neither firm could profitably enter markets outside of its region to offer these services.⁴⁷

The benefits that are claimed for the merger result largely from the marrying of GTE's capabilities and Bell Atlantic's customer base. First, it is claimed that the merger is required to permit GTE to expand the potential market for its long-distance and Internet services to include customers that are headquartered in Bell Atlantic's service territory and that have operations in GTE's service territory or are located close to GTE's proposed Global Network Infrastructure (GNI). Second, it is claimed that Bell Atlantic will be unable to offer the services that are demanded by the large business customers located in its region unless it is permitted to acquire GTE. Finally, it is claimed that the merger would permit Bell Atlantic/GTE to achieve the scale at which it could become an effective nationwide competitor.

This section analyzes the validity of the merging parties' claims. We conclude that none of the claims is plausible. GTE is not limited in the customers it can seek to serve; in particular, it can seek to serve customers that are headquartered in Bell Atlantic's service territory. Similarly, Bell Atlantic is not limited in the services it can offer, nor is it limited to "following" customers headquartered in its service territory to their operations out of region. Finally, both companies could

⁴⁷ "Collectively, these anchor customers, brand reputation, and facilities are the *essential* steps for broad-scale entry into local markets across the country" (Public Interest Statement, p. 8, *emphasis added*).

independently pursue the strategy that they propose to pursue together with no loss in efficiency.

6.1 GTE Can Expand Without the Merger

The common thread that weaves together all of the claims that the merger would generate substantial consumer benefits is the simple assertion that GTE has capabilities and assets while Bell Atlantic has customers. For example, with respect to local exchange entry, the merging parties characterize GTE's handicaps in the following way:

GTE, faced with an imperative to compete given its island-like service areas in the other Bells' seas, already has established a separate corporate unit to plan for entry into territory close to its own few urban franchise areas near Los Angeles, Dallas, Tampa, and Seattle. Carrying out this commitment, it has already developed some of the experience, know-how, and systems that are necessary (but not sufficient) for such entry. In so doing, however, GTE has run into significant obstacles: (1) substantial investments are needed in largely fixed-cost operation platforms (which become more economical with larger customer bases); (2) economical local entry requires truly proximate facilities (which can be more efficiently used and economically deployed with larger volumes of business); and (3) acquiring customers is difficult without a base of anchor customers and without a robust national brand (both of which can be more economically obtained with a national presence creating scale and ties to multi-location businesses).⁴⁸

⁴⁸ Public Interest Statement, p. 7. Presumably, GTE's "imperatives" are driven by a fear that it is vulnerable to entry from ILECs in adjacent markets despite the fact that apparently neither NYNEX nor Bell Atlantic felt the same imperatives prior to their merger.

With respect to the provision of long-distance service, the merging parties claim:

GTE's customer base alone will not generate sufficient long distance traffic to deploy a full-fledged national network. The ability to market to Bell Atlantic's customer base will provide the scale necessary to allow the combined company more quickly to construct and operate a national long distance network to compete against the Big Three.⁴⁹

GTE and Bell Atlantic further claim that:

Bell Atlantic's business customers from the Northeast provide a legion of anchor customers – through those businesses' branch offices – in many cities across the Nation, including the few urban areas near current GTE service areas and, in addition, cities currently passed by GTE's planned national long distance network, known as the Global Network Infrastructure or "GNI."⁵⁰

Similar claims are made with respect to Internet and data services:

Bell Atlantic currently has limited experience and presence in Internet and data-services markets. GTE...is one of the leaders in developing and selling such services, but it lacks the critical high-density customer bases to deploy many such services as soon as they are technologically available. The merger of the two companies will give each what it currently lacks alone.⁵¹

In short, the parties claim that GTE has the expertise, facilities, and determination to be a vibrant competitor in these and other areas, but lacks customers, which Bell Atlantic can supply. Thus, an essential aspect of the merging parties' argument is that GTE currently can compete successfully only for those customers, particularly

⁴⁹ Public Interest Statement, p. 4.

⁵⁰ Public Interest Statement, p. 7.

⁵¹ Public Interest Statement, p. 16.

large business customers, who are either located in its home region or near points at which the planned GNI is expected to touch down.

According to the merging parties, the merger is important because it would provide GTE access to "Bell Atlantic's existing relationships with large businesses."⁵²

John T. Curran, Chief Technical Officer for GTE Internetworking, claims that "[b]y affording GTE access to Bell Atlantic's concentrated Northeast customer base, the merger will allow GTE to introduce a host of new Internet services, and a broader range of advanced data services, to customers across the United States."⁵³

Moreover, the parties argue that the merger "will provide the merged company the opportunity to obtain several anchor customers in numerous out-of-franchise markets adjacent to existing GTE territories..."⁵⁴ Thus, according to the theory being advanced by the merging parties, GTE currently cannot be an effective competitor for the telecommunications business of a nationwide firm with headquarters in, say, Philadelphia, even if a very large proportion of the telecommunications needs of that firm are outside Bell Atlantic's service territory, perhaps even if those requirements are largely in or adjacent to GTE's own territory.⁵⁵

These claims should be afforded little, if any, credibility. The large business customers that are the initial targets of the proposed business strategy are highly

⁵² Kissell Declaration, Para. 2.

⁵³ Declaration of John T. Curran, Para. 2.

⁵⁴ Kissell Declaration, Para. 2.

⁵⁵ "GTE's lack of an adequate high-density customer base in, for example, Boston, New York, Newark, Philadelphia, Wilmington, Baltimore, metropolitan Washington, DC, and Richmond has impaired its ability to roll out new services" (Public Interest Statement, p. 17).

sophisticated customers. Thus, there is no reason to believe that large telecommunications suppliers with account teams that are physically located in the same place as the buyer, but with traditional service territories that do not include the buyer's headquarters, face an important competitive handicap. In particular, there would appear to be nothing to prevent GTE from seeking to serve the needs of businesses that are located in Bell Atlantic's service territory but that have operations in or near GTE's service territory. Indeed, if GTE's services are as attractive as they are claimed to be, GTE could compete effectively for the patronage of customers even within Bell Atlantic's service territory. By using a combination of its own and leased facilities, GTE can extend its within-region expertise to compete for large business customers in Bell Atlantic's service area. The anticipation of a growing customer base will provide GTE with the incentive to invest in its brand name, in facilities, and in the development of other services. There is no sense in which Bell Atlantic's large business customers are an "essential facility" for GTE because GTE can win those customers from Bell Atlantic. In short, GTE does not have to merge with Bell Atlantic to obtain access to Bell Atlantic's large-customer base. Moreover, if GTE were to gain access to Bell Atlantic's customers because Bell Atlantic favored GTE after the merger, that would be evidence of anticompetitive harm, not increased efficiency.

Further, GTE currently possesses a significant competitive *advantage* in competing for businesses in Bell Atlantic's service territory that would likely be lost, at least for a time, if the merger were to take place. GTE currently can offer long-

distance service in Bell Atlantic's territory but Bell Atlantic cannot. Unless Bell Atlantic/GTE immediately upon the merger, obtained Section 271 authorization in every state in which it operated, GTE would face a competitive handicap as part of the combined entity.

6.2 Bell Atlantic Can Expand Without the Merger

The merging parties also allege that if the merger were not approved, Bell Atlantic would not enter GTE's service areas to better serve large business customers that are headquartered in its service area and have subsidiaries or affiliates in GTE's service area:

Bell Atlantic cannot reach these customers alone because it lacks the facilities, platform capability, and marketing and distribution channels to reach so far beyond its concentrated franchise. But many of these Bell Atlantic customers operate near GTE's franchise or in cities...where GTE's new national fiber network...will have points of presence.⁵⁶

Just as GTE can compete for large business customers that are in Bell Atlantic's service area, Bell Atlantic can similarly compete for the business of the same kind of customers located in or near GTE's service area. It can hardly be argued that Bell Atlantic lacks name recognition among such customers, or that these customers have doubts about Bell Atlantic's technical capabilities that can only be assuaged through an association with GTE. Indeed, Bell Atlantic is, in some

⁵⁶ Kissell Declaration, Para. 8. We cannot resist observing that Bell Atlantic previously contended that it had no special advantage in competing for customers in New York despite its proximity to the NYNEX service territory, whereas it now contends that this merger would dramatically improve its ability to compete in areas adjacent to GTE's service territory.

respects, *better* able today to compete for these out-of-region customers than for those in its own service territory because it can offer them bundled local and long-distance service.

It should also be noted here that the rationale being offered by the merging parties is different from that being claimed in the SBC/Ameritech merger. There, the merging parties claim that they wish to follow large business customers that are located in their respective service territories into other territories, but that neither has a sufficient number of customers to follow for that to be viable. Here, the claim is not that Bell Atlantic lacks a sufficient number of customers to follow but that Bell Atlantic could not enter areas near GTE's service territory without the merger because it lacks nearby facilities.

Although we have elsewhere taken issue with the claim made by SBC/Ameritech,⁵⁷ at least there the merging parties do not contend that they must merge with the ILECs in the regions they plan to enter for their strategy to be successful. In that merger, SBC would, of course, gain access to facilities in areas served by Ameritech, but that is not the primary benefit claimed for the merger. Instead, SBC and Ameritech claim that the merger is needed to permit them to follow customers headquartered in both companies' service territories into areas currently served by neither of them. Here, it is only, or primarily, large business

⁵⁷ Declaration of S.M. Besen, P. Srinagesh, and J.R. Woodbury, "An Economic Analysis of the Proposed SBC/Ameritech Merger," October 14, 1998.

customers that are headquartered in Bell Atlantic's service territory that will be followed.⁵⁸

6.3 The Merging Parties' Claim Is Inconsistent with Prior Investment Behavior

The claim that the merging parties can compete effectively only for customers in their own service territories is also inconsistent with investments made by their cellular and international divisions. For example, Bell Atlantic has cellular properties in New Mexico and South Carolina, far from its service territory, and GTE has cellular properties in Tennessee, where it has no landline service areas.⁵⁹ The parties also have international holdings in cellular companies in China, Japan and other countries, and in landline telephone companies in India, Thailand, Venezuela, Canada, New Zealand, and other countries.⁶⁰ The apparent success of the parties' holdings in these countries is testament to their ability to compete in areas that are far from their traditional home territories.

6.4 The "One Stop Shopping" Argument

The merging parties also contend that competition and consumers will benefit from one-stop shopping:

The merger of Bell Atlantic and GTE will bring into existence a *fourth* new competitor with the necessary scale and scope to

⁵⁸ The merging parties claim that "Bell Atlantic's business customers from the Northeast provide a legion of anchor customers...."(Public Interest Statement, p. 7). No reference is made to anchor customers that are headquartered in GTE's service territory.

⁵⁹ Public Interest Statement, Exhibits 1 and 3.

⁶⁰ Public Interest Statement, Exhibit 2.

)
participate in this emerging national market for bundled services. The new company will have a national customer base, the full array of competitive offerings in key markets across the country, and the ability to create a national brand to rival AT&T's or MCI WorldCom's.⁶¹

The Affidavit of Mr. Steven Signoff, Vice President of Strategic Business Development at Sprint (henceforth Signoff Affidavit), shows that the merging parties' assumptions about the purchasing behavior of large businesses at best exaggerate the importance of one-stop shopping. Large businesses frequently and deliberately divide their purchases among multiple providers instead of seeking a single source of supply, as the merging parties claim. Mr. Signoff further observes that "[i]f the voice and data continue to be provided separately, there would appear [to be] no overriding reason for buyers to utilize a single vendor."⁶²

It should also be noted that none of Bell Atlantic's or GTE's competitors are capable of offering sole-source arrangements, so there is no competitive necessity for either party to do so.⁶³ No single company now has, or is likely to have in the foreseeable future, this end-to-end capability. Like other third-party vendors, Bell Atlantic and GTE can currently provide a single point of contact for their customers only by combining its services with those of other telecommunications providers. The use of leased facilities by the merging parties to supplement their own offerings is no more of a disqualifier than would be an Interexchange Carrier's (IXC) purchase

⁶¹ Public Interest Statement, p. 2.

⁶² Signoff Affidavit, Para 16.

⁶³ Signoff Affidavit, Para. 9.

of access services to supplement its own services. Indeed, such arrangements are common in international offerings. For example, Global One has combined its offerings with those of local providers to offer one-stop shopping to its customers. It has not provided the entire array of services through the owned facilities of its Global One partners.

Moreover, although some large businesses order their telecommunications services centrally, many others do not. Because the initial targets of the Bell Atlantic/GTE business strategy are highly sophisticated, it is unreasonable to assume that large telecommunications suppliers with account teams that are physically located in the same place as the buyer, but with traditional service territories that do not include the buyer's headquarters, face an important competitive handicap.⁶⁴

6.5 CAPs and CLECs Have Competed Successfully

Finally, there is substantial evidence from the success of Competitive Access Providers (CAPs) and Competitive Local Exchange Carriers (CLECs) like Teleport and MFS that firms can and do compete effectively, and grow to quite considerable size, by serving the communications needs of large business customers *without having a single customer to "follow."*

⁶⁴ We should also note that, whatever role brand-name recognition may have in the competition for residential and small business customers, it is unlikely to be an important factor for the large sophisticated business customers who are the initial targets of the strategy.

After all, these CAPs and CLECs had no local exchange or exchange access customers, nor did they have any interexchange customers, when they began to operate. Neither did the CAPs have a brand name or enjoy proximity to a service area in which they had been incumbents for decades. What they did have were services that could attract large business customers to move some of their requirements away from the ILECs. It seems unlikely that Bell Atlantic or GTE would be any more disadvantaged in competing for the business of, say, Sears in Chicago than was either MFS or Teleport when they began their operations.

6.6 The Bell Atlantic/GTE Merger Would Not Result in Lower Local Exchange Prices

Bell Atlantic and GTE assert that their merger would permit them to become a more effective rival in bidding for the telecommunications business of very large concerns,⁶⁵ in turn permitting them to compete effectively for the patronage of consumers and small businesses. This, they claim, would result in more choices for consumers and small businesses, and (presumably) lower prices.⁶⁶

We explained above why the proposed merger is not necessary for Bell Atlantic and GTE to implement their planned business strategy. However, even if one assumed that the merger was necessary, the consumer benefits of the merger for large business customers would likely be small. As most observers appear to concede, the rivalry for the patronage of large business customers is more

⁶⁵ Public Interest Statement, p. 13.

⁶⁶ Kissell Declaration, Para. 9.

significant than the rivalry for other consumer groups.⁶⁷ More vigorous participation by Bell Atlantic/GTE, therefore, would be unlikely to yield large competitive benefits.

There is little doubt that if the merger were to result in the much-anticipated competition for the patronage of residential and small business customers, the benefits could be considerable. However, the merging parties offer no evidence to support their claim that they would be able to serve most residential customers profitably once they had acquired the patronage of large businesses. Indeed, the experience to date contradicts this claim. Firms with a mixture of owned and leased facilities like TCG and MFS have for years been competing with the ILECs to serve the telecommunications demands of large businesses. Despite that history, however, none of these rivals has become a significant competitive alternative for residential consumers. As Dr. Hayes indicates in his Declaration, entry into local exchange and exchange access services for this market segment has not been competitively important to date. Bell Atlantic/GTE provides no reason why its strategy makes it more likely that it would compete for residential consumers in out-of-region areas when other suppliers of services to large business customers have not done so, despite the fact that they, too, have large businesses as "anchor tenants."⁶⁸

⁶⁷ See the Hayes Declaration for a discussion of the options available to high-volume business customers located in major urban centers.

⁶⁸ The merging parties effectively concede this point when they note that "In the mass market (which was the focus of the Commission's concern in Bell Atlantic-NYNEX), the experience of the last several years has changed original expectations and taught the economic difficulty of mass market entry, particularly in less dense rural and suburban areas" (Public Interest Statement, p. 31).

Finally, the merging parties' analysis neglects the control that they will retain over essential facilities in their own regions and, thus, their ability to foreclose competitors that seek to enter their territories. When control over essential facilities is accounted for by the analysis of the merger, the conclusion that the merger would enhance in-region competition does not appear to be warranted.

Initially, virtually all entrants into the Bell Atlantic/GTE post-merger territory would require access to ILEC facilities or services (UNEs or wholesale offerings) and interconnection in order to compete. As suggested by the analysis of Professors Katz and Salop in their Declaration, the combined Bell Atlantic/GTE would have both increased ability and incentive to foreclose local exchange rivals after the merger. This foreclosure may take several forms, among them: (a) degradation in the quality of service the merged firm offers to entrants, including access to its OSS for pre-ordering, ordering, and provisioning service; (b) delays in repair and maintenance of leased facilities or purchased services; (c) limited access and inflated prices for collocating facilities in the merged firm's central office; and (d) bundling of otherwise separable facilities, and (e) delays in negotiating interconnection contracts and stalling CLECs' exercise of the most favored nations provisions of Section 252(i).⁶⁹ If the combination of Bell Atlantic and GTE were to

⁶⁹ For a useful compendium of the types of problems faced by an entrant in offering new telecommunications services, see Northpoint Communications, "Proposed Remedies for Promoting DSL Competition" (undated). Northpoint observes (p. 1) that "while each ILEC currently provides some unbundled network elements under reasonable terms and conditions, each ILEC also erects a host of onerous and unnecessary barriers to increasing competitive opportunities. Moreover, there is no consistency, as every barrier that one ILEC claims is necessary, another ILEC avoids entirely."

successfully raise their rivals' costs in the resulting enlarged service territories, prices in these service territories would be higher than they otherwise would have been.

As suggested by the analysis of Professors Katz and Salop (and as summarized in Section 4 of this Declaration), the merger would increase Bell Atlantic's and GTE's incentives and ability to engage in strategies that raise the costs of their local exchange rivals. Consequently, the entrants may not be able to discipline the merged parties, and prices in the Bell Atlantic/GTE territory may rise above what they would have been had the merger not occurred. Moreover, because the increase in exclusionary behavior harms the entrant everywhere and not just in the territory of the merging parties, competition in all areas, including the 21 markets that Bell Atlantic and GTE propose to enter after the merger, will be adversely affected.

In sum, the merging parties' analysis is incomplete because it ignores the effects of the merger on the ability and incentives of the merged entity to exclude rivals. Once those effects, which are analyzed in detail by Professors Katz and Salop, are taken into account, the conclusion that local exchange prices would fall in the Bell Atlantic/GTE service territory does not follow. Indeed, once it is recognized that the merger would create incentives for the merging parties to increase the

This suggests that benchmarking may be needed to judge the reasonableness of the terms and conditions imposed by individual ILECs. See the discussion of benchmarking above.

extent to which they exploit their control of transport and termination, one cannot conclude that the merger would result in consumer benefits through lower prices.

6.7 Other Claimed Merger-Related Efficiencies

Almost in passing, the parties claim that the merger would generate substantial synergies, including \$2 billion in cost savings and \$2 billion in revenue enhancements in the third year after the merger closed, as well as additional capital savings of \$0.5 billion.⁷⁰ While each of these claims is examined below, neither claim is supported by any data or analysis on the record.

Cost Reductions. The cost reductions are estimated to arise from the elimination of “duplicative staff and information and operation systems, more efficiently using long distance capacity, and reducing procurement costs.”⁷¹ Instead of providing support for these estimates, they are instead described as “real budget commitments that department heads must meet or exceed” and that the compensation of officers responsible for the lines of business would be based on their ability to meet these commitments.⁷² Similarly, no support is provided for the claim that the merger would permit reductions in capital expenditures.

Recent econometric studies on the economies of scope and scale in local telecommunications networks do not support the claim that mergers of firms serving

⁷⁰ Public Interest Statement, p. 22, and Declaration of Doreen Toben (henceforth Toben Declaration), Para. 2.

⁷¹ Toben Declaration, Para 3.

⁷² Toben Declaration, Para 4.

non-overlapping territories would result in cost savings. For example, Ying and Shin conclude that the large LECs might be too large: "Using recent 1984-91 data, we find that LECs are not natural monopolies in the post-divestiture era. Having two firms produce the monopoly output could potentially result in over 20 percent cost savings."⁷³ In a follow-up study, Ying and Shin found that "the benefits to breaking up the monopoly outputs of existing local exchange carriers substantially outweigh the potential losses in efficiency."⁷⁴

The merging parties also assert that the combined firm would benefit from the adoption of the best practices of each firm, although no quantification of those efficiencies are presented or asserted. Whatever size the related efficiencies may be, most if not all of them are not likely to be merger-specific. If, absent the merger, GTE and Bell Atlantic did not compete with each other, as they assert would be the case, then a contractual relationship between the two firms could serve as a vehicle for exchanging best-practice technology.

However, one risk that the merger poses for consumers is that what is "best practice" for the merged firm may not be that which advances the interests of consumers. Because of competitive circumstances or regulatory oversight, Bell Atlantic, prior to the merger, might find it profitable to adopt certain practices that

⁷³ John S. Ying and Richard T. Shin, "Viable Competition in Local Telephone: Superadditive Costs in the Post-divestiture Period," Federal Trade Commission and University of Delaware Department of Economics, Working Paper: 94-8, Abstract, June 1994.

⁷⁴ John S. Ying and Richard T. Shin, "Unnatural Monopolies in Local Telephone," *Rand Journal of Economics* 23:2, Summer 1992, pp. 171-83.

benefit consumers, such as efficient CLEC interconnection, that GTE would find unprofitable. The adoption of this practice by Bell Atlantic could encourage regulators overseeing GTE to compel GTE to adopt the same practice. However, if the additional profits to Bell Atlantic from the adoption of the practice were outweighed by the losses that GTE would experience from adoption, the merged firm would not adopt the practice, or would more vigorously resist regulators' attempts to compel the adoption of the practice.

Revenue Enhancements. The parties claim that the merger would result in revenue enhancements "from the... penetration of vertical services like second lines; improving the value and speeding the widespread deployment of long-distance offerings; and creating better and more widely distributed data services."⁷⁵ No specifics are offered to support this claim.

The claim that the merger would permit a more rapid deployment of better long-distance and advanced data services should be viewed with caution. The parties do not explain why the merger would speed deployment of these services. One reason may be the "better access" that GTE expects to have to Bell Atlantic's customers. As we have pointed out elsewhere, GTE is currently entitled to equal access to Bell Atlantic's customers. If it enjoyed better access to these customers after a merger, it can be inferred that other competitors would be unfairly

⁷⁵ Toben Declaration, Para 3.

disadvantaged and competition and customers would be hurt. This cannot be counted as a public interest benefit.

In sum, the parties' claims of cost reductions and revenue enhancements are not supported with any detailed analysis or data. Some important claims (e.g., the claimed economies of scale) are inconsistent with the conclusions of recent econometric studies. Other claims (e.g., increased penetration of vertical services) are not clearly benefits, and may instead be harmful to consumers. In short, the parties have not provided a basis for their claim that merger-related efficiencies would amount to \$4.5 billion dollars three years after the merger closed.

Past Experience. The merging parties assert that the experiences of the merger of Bell Atlantic's wireless operations with those of NYNEX and the Bell Atlantic-NYNEX merger demonstrate the ability of the merged firm to attain substantial cost and revenue gains.⁷⁶ With respect to mobile service, the parties assert that reductions in per-subscriber costs have exceeded pre-merger estimates and that Bell Atlantic Mobile subscriber growth and other performance dimensions have improved markedly since the merger. Putting aside the failure of the merging parties to appreciate the likelihood that a reduction in per-subscriber costs and an increase in subscriber growth are related, Bell Atlantic and GTE do not explain what practices and services were utilized by Bell Atlantic to attain these gains and why

⁷⁶ Toben Declaration, Paras. 6-7.

these practices and services would not have been utilized but for Bell Atlantic's acquisition of NYNEX's mobile service.

The claims of the merging parties are not sufficient to demonstrate either the magnitude of any gains attained subsequent to the merger or that the gains were merger-related. Such a demonstration is particularly important in light of the substantial competitive risks posed by the merger.

7. Conclusion

The proposed Bell Atlantic/GTE merger is not in the public interest. It would increase the significant incentives that Bell Atlantic and GTE already have to foreclose the entry of CLECs, especially those that wish to offer innovative communications services. It would also increase both the ability and incentives of the merged company to engage in anticompetitive behavior toward IXCs when and if Bell Atlantic and GTE were permitted to offer long-distance service. Moreover, this situation would persist for the foreseeable future as would-be competitors continue to rely on access to facilities that could be provided only by Bell Atlantic and GTE and remained dependent on interconnection to Bell Atlantic and GTE customers.

In addition, the proposed merger would reduce substantially the ability of the Federal Communications Commission and other regulators to employ benchmarking as a policy tool. By reducing the number of independent ILECs, the merger would increase the impact of any individual ILEC on average industry performance. This would reduce the incentive of all ILECs, not just Bell Atlantic and GTE, to improve

their performance because it would reduce the reward from such improvements. The proposed merger would also reduce the ability of regulators to use best-practice and worst-performance benchmarks because it would reduce their confidence that the observed behavior of any particular firm truly reflected anticompetitive behavior. Given the widespread use of benchmarking by telecommunications regulators, these effects would likely be large.

While denying that the proposed merger would have any anticompetitive effects, Bell Atlantic and GTE have also claimed that it would produce substantial efficiencies. In particular, the parties claim that the merger would permit them to be an effective nationwide competitor and that they would, or could, not be one without the merger. However, the claim that the merger is needed for this purpose is dubious. Neither Bell Atlantic nor GTE is limited to seeking business from large business customers in their current service territories and, indeed, each has significant advantages over others in doing so. The merging parties do not convincingly explain why they can only compete effectively for large business customers that are headquartered in their service territories, nor why they would experience significant cost disadvantages if they could pursue only the customers headquartered in their separate service territories. Indeed, their claims are inconsistent with the experience of Competitive Access Providers in competing successfully for large business customers without a substantial base of such customers to "follow."

For all these reasons, the proposed merger between Bell Atlantic and GTE should be rejected.

**ADDENDUM TO
DECLARATION OF DR. MICHAEL L. KATZ
AND DR. STEVEN C. SALOP**

**USING A BIG FOOTPRINT TO STEP ON COMPETITION:
EXCLUSIONARY BEHAVIOR AND THE SBC-AMERITECH MERGER**

The attached declaration was prepared with respect to the proposed merger of SBC and Ameritech, and was submitted as part of the record of the Federal Communications Commission in that matter. This addendum is submitted to affirm that the economic analysis set forth in the attached declaration applies to the proposed merger of Bell Atlantic and GTE, CC Docket No. 98-184.

**Dr. Michael L. Katz
Dr. Steven C. Salop**

November 23, 1998

**DECLARATION OF DR. MICHAEL L. KATZ
AND DR. STEVEN C. SALOP**

**USING A BIG FOOTPRINT
TO STEP ON COMPETITION:
EXCLUSIONARY BEHAVIOR AND
THE SBC-AMERITECH MERGER**

October 14, 1998

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I. INTRODUCTION AND QUALIFICATIONS

1. My name is Michael L. Katz, and I declare as follows. I am the Edward J. and Mollie Arnold Professor of Business Administration at the University of California at Berkeley. I hold a joint appointment in the Haas School of Business Administration and the Department of Economics. I serve as the Director of the Center for Telecommunications and Digital Convergence at the University of California at Berkeley. I have also served on the faculty of the Department of Economics at Princeton University. I received my A.B. from Harvard University *summa cum laude* and my doctorate from Oxford University. Both degrees are in Economics.

2. I specialize in the economics of industrial organization, which includes the study of antitrust and regulatory policies. I regularly teach courses on microeconomics, business strategy, and telecommunications policy. I am the author of a microeconomics textbook, and I have published numerous articles in academic journals and books. I have written several articles on issues regarding network effects, antitrust policy enforcement, and telecommunications policy, including access and interconnection policy. A copy of my curriculum vitae—attached to this Declaration as Exhibit 1—lists all publications that I have authored or co-authored, with the exception of a few letters to the editor on telecommunications policy. I am a coeditor of the *Journal of Economics and Management Strategy*.

3. In addition to my academic experience, I am a cofounder of The Tilden Group, LLC, a consulting firm that specializes in the application of economic analysis to issues

of antitrust and regulatory policy. I have served as a consultant to both the U.S. Department of Justice and the Federal Communications Commission on issues of public policy in telecommunications markets. I have served as an expert witness before various state and federal courts, and I have provided expert testimony before a state regulatory commission. In 1994 and 1995, I served as Chief Economist of the Federal Communications Commission (the Commission). In addition to advising the Commission on the full range of policy issues before it, I testified before Congress. Since leaving the Commission, I have spoken at several Commission public forums.

4. My name is Steven C. Salop and I declare as follows. I am Professor of Economics and Law at the Georgetown University Law Center, where I have taught since 1981. I received my bachelor's degree from University of Pennsylvania *summa cum laude* with honors in economics and my doctorate in economics from Yale University. Much of my research and teaching focuses on industrial organization economics and antitrust policy and law. I regularly teach courses in basic and advanced antitrust economics and law at the Law Center. I have also taught graduate courses in basic and advanced industrial organization at MIT and the University of Pennsylvania. I have written numerous scholarly articles that analyze oligopolistic competition, mergers, and exclusionary conduct. Among my articles in the area of the economics and law of exclusionary conduct are: "Raising Rivals' Costs," co-authored with David Scheffman; "Antitrust Analysis of Exclusionary Rights: Raising Rivals' Cost to Gain Power Over Price," co-authored with Thomas Krattenmaker; and "Market Power and Monopoly

Power in Antitrust Law,” co-authored with Thomas Krattenmaker and Robert Lande. I have also published an article on vertical mergers that analyzes vertical foreclosure. “Evaluating Vertical Mergers: A Post-Chicago Approach,” co-authored with Michael Riordan. A copy of my curriculum vitae is attached to this declaration as Exhibit 2.

5. In addition to my academic experience, I have consulted on a variety of matters involving telecommunications, many of which raise issues of network effects and the incentives for exclusionary conduct. These matters include the acquisition of McCaw Communications by AT&T, the attempted acquisition of MCI’s Internet assets by Worldcom, Primestar’s proposed acquisition of the MCI/NewsCorporation high powered direct broadcast satellite assets, and Time Warner’s acquisition of Turner Broadcasting.

6. We have been asked by counsel for Sprint to assess the effects of the proposed merger of SBC and Ameritech on the likelihood of exclusionary conduct by these carriers and the resulting ability of other carriers to bring competition to local exchange service and access markets in the United States.

7. In this declaration, we assess from the perspective of antitrust and industrial organization economics the effects on competition and consumers of exclusionary conduct flowing from the proposed merger of SBC and Ameritech. Drawing on our training and experience as economists, and our review of the relevant facts available to us, we conclude that—by threatening the entry and expansion of innovative rivals to the incumbent local service providers—the proposed merger raises significant public interest concerns.

II. OVERVIEW OF FINDINGS

A. Access to the ILECs' Networks is Efficient and in the Public Interest.

8. Because a subscriber to a network benefits from being able to communicate with others, and because of the potential inefficiencies associated with building overlapping facilities, it generally is efficient for carriers to rely on one another's facilities to complete calls made by subscribers on one network to subscribers on another. Thus, giving competitors access to the ILECs' networks generates significant benefits in terms of lower costs and higher quality of service.¹ Access can take several forms. In the case of two local exchange carriers, each carrier may purchase transport and termination from the other to complete calls originating on one network and terminating on the other. In the case of a local exchange carrier and interexchange carrier ("IXC"), the IXC interconnects with the local exchange network to obtain either originating or terminating access. Access can take other forms as well. For instance, a competitive local exchange carrier ("CLEC") may purchase unbundled network elements ("UNEs") from an incumbent local exchange carrier ("ILEC"). The purchase of UNEs can be viewed as a form of access or interconnection because it allows a carrier to use its facilities in combination with those of another carrier (*i.e.*, the ILEC) to deliver services to end users.

¹ See, for example, Katz, Michael L., Gregory Rosston, and Jeffrey Anspacher, "Interconnecting Interoperable Systems: The Regulators' Perspective," *Information Infrastructure and Policy*, 4 (1995):327.

In what follows, we generally will use the term *access* to include all these forms of access and interconnection.

9. The need for, and value of, access arises whenever there are multiple carriers providing public services. Thus, the need for access will not disappear even if local competition takes hold. Indeed, the availability of high-quality, efficiently priced UNEs and interconnection among local networks is a necessary structural prerequisite for local exchange markets to make the transition to competition. In the presence of such an interconnection policy (for both UNEs and transport and termination), CLEC investment in local telecommunications infrastructure is stimulated by the fact that a carrier can count on being able to use its infrastructure to provide services that also rely on the availability of access to the ILEC's network on reasonable terms. The availability of access to local exchange carriers (in the form of originating and terminating access) similarly stimulates investment in interexchange services, including advanced telecommunications services. Carriers like Sprint that are investing in services that combine local and long distance offerings in integrated packages (combined service carriers, or "CSCs") also will have greater investment incentives for both reasons.

B. The Merger of SBC and Ameritech Poses a Significant Threat to the Provision of Efficient and Innovative Access and thus Poses a Significant Threat to Competition.

10. Efficient access is essential to realizing the full benefits that telecommunications networks can provide. Unfortunately, the proposed merger between SBC and Ameritech poses a significant threat to the provision of efficient access by increasing the companies'

incentives and ability to carry out exclusionary access policies. Our economic analysis concludes that:

- CLECs, IXCs, and CSCs all will continue to depend on ILEC access services (*i.e.*, UNEs as well as various forms of originating and terminating access services) in order to be able to provide commercially viable services themselves. CLECs, IXCs, and CSCs will need an array of new and innovative forms of access in the future.
- Ameritech and SBC currently possess significant market power in the provision of access services in their respective service regions. This market power may be exercised by setting high access prices (in the absence of price regulation) or by pursuing exclusionary access policies under which Ameritech and SBC delay, deny, or degrade the access provided to other carriers.²
- By permitting effective coordination between what are today separate and independent local exchange operations, the proposed merger of Ameritech and SBC would increase both parties' incentives and ability to disadvantage CLECs, IXCs, and CSCs by reducing their provision of the high-quality, efficient, and innovative forms of access that those competitors will require to compete.
- Regulation is an imperfect check on the exercise of ILEC market power. The proposed merger would make it even more difficult for the state and federal policy makers to prevent SBC and other ILECs from refusing to provide efficient, high-quality and innovative access at reasonable prices.
- The proposed merger of SBC and Ameritech thus poses a significant threat to telecommunications competition and the public interest.

11. In the remainder of this Declaration, we explain the economic logic and factual analysis that has led us to these conclusions.

² Throughout, we use the term *exclusionary* to refer to practices that impair the ability of rival firms to compete, even if the practices do not drive the rivals completely out of the market. Thus, it includes conduct that impairs rivals' quality, raises rivals' costs, slows rivals' entry or expansion, as well as similar conduct.

III. SBC AND AMERITECH POSSESS SUBSTANTIAL MARKET POWER IN THE PROVISION OF ACCESS

12. A first step to analyzing whether the merger poses the threat of anticompetitive behavior is to assess whether SBC and Ameritech possess substantial market power in the provision of access services. In particular, we are interested in the question of whether SBC and Ameritech have the ability to disadvantage rival carriers by refusing to provide access on efficient and reasonable terms. In this section we briefly review the evidence that they do.

A. For Many Customers and Services, there are No Economic Substitutes for ILEC Access Services.

13. In analyzing the market power of the ILECs and their incentives to exclude rivals, both upstream and downstream markets are relevant.³ First, there are *downstream* product markets for various retail services, including local exchange services, interexchange services, and combined (local exchange and interexchange) services.^{4,5}

³ For a discussion of market definition, see the Declaration of John B. Hayes, "Market Power And The SBC-Ameritech Merger," October 14, 1998 and *In the Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, FCC 97-286, *Memorandum Opinion and Order*, released August 14, 1997, at 49-57. For a discussion of market definition in the context of exclusionary conduct see Thomas Krattenmaker, Robert Lande and Steven Salop, "Monopoly Power and Market Power in Antitrust Law," *Georgetown University Law Review* 76 (1987):241.

⁴ Wireless providers also offer local and interexchange services. Wireless services are differentiated by mobility and, at present, generally do not compete directly with wireline services. The issues, however, are very similar for wireline and wireless carriers seeking ILEC access services, and we write below using wireline terminology as a short hand for all types of interconnection and access.

Second, there are *upstream* product markets for the provision of access services to carriers who are in turn providers of retail telecommunications services. For example, an IXC participates in the downstream market as a provider of long distance services to end users, and the IXC participates in the upstream market as a buyer of access services (originating and terminating access). Similarly, CLECs are sellers in downstream local exchange markets and are buyers of UNEs and transport and termination in upstream markets.⁶

14. ILECs have monopoly power in the provision of access services to CLECs, CSCs and IXCs. This conclusion follows directly from the fact that these carriers currently have no economically feasible alternatives to the use of ILEC facilities (whether through the purchase of UNEs, transport and termination, interexchange access, or local exchange resale) to reach the vast majority of telecommunications subscribers in the U.S.

15. The absence of viable substitutes for SBC and Ameritech's access services that would otherwise limit their market power can be seen from available market share data.

⁵ Combined services compete with both local and interexchange services, and some industry observers believe that the three markets may blend into one in the future. For simplicity of exposition, we treat local exchange, interexchange, and combined services as three separate product markets. However, the results of our analysis would not be changed if markets evolved to the point where combined services constituted the sole downstream product market. Similarly, our analysis applies to the situation in which combined services do not yet constitute a distinct relevant market.

⁶ Of course, a CLEC may also be a seller in upstream markets, providing transport and termination to other local exchange carriers and originating and terminating access to IXCs. By excluding CLECs, an ILEC can maintain this market power in the upstream

The ILECs' shares of access lines exceeded 98.5 percent in the first two states for which Ameritech and SBC filed Section 271 applications for long-distance authority. In Michigan, the aggregate market share for CLEC's fell between 1.2 and 1.5 percent.⁷ And the U.S. Department of Justice found that Southwestern Bell's "market share in Oklahoma is so near 100 percent as to be practically indistinguishable from a complete monopoly."⁸ And these are states in which Ameritech and SBC have (unsuccessfully) represented that local exchange markets are open to competition. Moreover, even the 1.5 percent share for CLECs overstates the options for a carrier seeking to reach most residential subscribers—competitive carriers' access lines are highly concentrated in urban areas and for business subscribers.

16. Market shares alone do not tell the whole story. However, examination of the conditions of entry confirms the conclusion that ILECs have significant market power as providers of access services. There are high barriers to entry facing potential entrants into the provision of access services in competition with the ILECs. First,

access markets.

⁷ See *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide in-Region, InterLATA Services in Michigan*, CC Docket No. 97-137, *Evaluation of the United States Department of Justice*, filed June 25, 1997, at B3. These share data are for switched access. Resold lines are included in the CLECs' share for these calculations.

⁸ *In the Matter of Application by SBC Communications Inc., Pursuant to Section 271 of the Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in Oklahoma*, CC Docket No. 97-121, *Evaluation of the United States Department of Justice*, filed May 16, 1997, at 52.

telecommunications markets are characterized by strong network effects. Thus, any CLEC seeking to offer public telecommunications services must itself interconnect with ILEC local exchange networks to be competitively viable.⁹ The need to interconnect with the ILECs' networks to realize network effects will continue as long as ILECs remain the only way to connect to significant numbers of end users. This need to interconnect with the ILECs' networks gives ILECs the power to reduce the threat of entry by raising entrants' costs, either by raising the price of access or by denying, delaying or degrading the necessary access. In addition to network effects, there are economies of scale (density) in providing access services. Local network infrastructure has large fixed costs that must be incurred even if the carrier is serving only a small percentage of telephone subscribers in a given area. Thus, small-scale entry is difficult, which raises the cost of entry.

17. SBC might argue that an ILEC needs interconnection as much as other carriers, but the facts indicate otherwise. A CLEC, DXC, or CSC seeking access services from the ILEC needs that interconnection much more than does the ILEC. To see why the bargaining positions are unbalanced, consider what would happen if the interconnection negotiations between an ILEC and a CLEC were to break down. If the parties failed to reach any

⁹ There is one limited exception. A firm offering solely originating and/or terminating interexchange access could offer service without directly connecting to an ILEC network. That carrier's DXC customers, however, would still need to purchase access from ILECs to reach the vast majority of telecommunications subscribers.

interconnection agreement at all, the CLEC would likely be forced out of business as the result of being unable to offer its customers the ability to call to and from the ILEC's network. Given the comparatively low share that any CLEC has today, the ILEC could largely continue with business as usual. Indeed, not only would the ILEC not be significantly harmed by the lack of interconnection with the CLEC, the ILEC would positively benefit from the weakening of competition and the diversion of customers to its own retail services.

18. The bargaining between an IXC and an ILEC is similarly one-sided. Because competition among local carriers is so limited, an IXC typically has only a single means of reaching the vast majority of potential subscribers in a given geographic area, the ILEC. A given ILEC, however, will be dealing with multiple IXCs and may be able to discriminate among them.¹⁰ Indeed, in the future, SBC may be discriminating in favor of its own interexchange services. If an IXC cannot provide high quality service for calls that originate or terminate in a significant portion of the country, then that carrier can expect to lose significant amounts of traffic to rival IXCs. An ILEC that offers a particular IXC poor interconnection, however, faces much less of a threat that it will see the bulk of its customers turn to other local carriers. Thus, the bargaining positions of an ILEC and an IXC are asymmetric.¹¹

¹⁰ As we discuss further below, while such discrimination would typically violate state and/or federal regulatory policy, such policies cannot be perfectly enforced.

¹¹ The bargaining power between the ILEC and a CSC could be one-sided for the reasons identified for both CLECs and IXCs.

19. The Commission itself has long recognized that ILECs possess substantial market power; indeed, this recognition is the basis of the Commission's regulation of interstate access charges as well as the terms of interconnection between ILECs and commercial mobile radio service providers.¹² Moreover, the interconnection provisions of Telecommunications Act of 1996 also are based on recognition of ILEC market power.¹³

B. Competitive Services Such as Sprint ION Will Increasingly Need Innovative New Access Arrangements With ILECs

20. Sprint ION is an innovative new service that promises to bring the benefits of an integrated package of advanced telecommunications services to millions of subscribers. Sprint ION is a combined service that has both local and long distance components for both data and voice. The service integrates traditional voice traffic, Internet traffic, frame relay traffic, and other data traffic on one customer access facility and carries this traffic in the Asynchronous Transfer Mode data format through the Sprint network.¹⁴ For communications terminating to end users that are not Sprint ION customers, Sprint will convert the Sprint ION format to the formats needed to communicate with the non-Sprint ION customers at a Sprint Service Node.

¹² See, for example, *Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, CC Docket No. 95-185, *Notice of Proposed Rulemaking*, released January 11, 1996.

¹³ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§ 151 et. seq.

¹⁴ For a more complete description of Sprint ION, see Affidavit of Kevin E. Brauer (*Brauer*

21. After an initial roll out period, Sprint plans to increase the functionality of Sprint ION service to include the ability to combine what had previously been local voice calling with other communications on the all-distance Sprint ION platform. Sprint ION will allow a customer to integrate its local service with all of its other services using a single access facility to the customer premises. Once fully deployed, Sprint ION can help bring competition to local exchange markets—something that, to date, has been almost non-existent.¹⁵

22. Innovative CSCs like Sprint are particularly vulnerable to exclusionary access policies by the ILECs because these CSCs need the timely availability of access services from the ILECs for which adequate regulatory safeguards do not exist. Sprint will rely on dedicated access to reach large customers and will offer Sprint ION to smaller customers through alternative means, such as xDSL. Sprint plans to implement xDSL by collocating its xDSL equipment in ILEC central offices in order to make use of ILEC unbundled loops.

23. The roll-out of Sprint ION requires innovative access arrangements for which there are not existing standards or benchmarks, and there are a variety of ways in which the ILECs can drag their feet or otherwise fail to provide high-quality access on efficient

Affidavit) at 2-6.

¹⁵ It is, however, important to recognize that, for the vast majority of residential subscribers, Sprint will remain dependent on ILEC to provide significant underlying local facilities.

terms. Three problems that have arisen and can be expected to worsen if the proposed merger is approved are: (a) the provision of Operational Support System ("OSS") capabilities; (b) access to ILEC central offices and other facilities so that a competitive carrier may collocate its equipment with those of the ILEC; and (c) the availability of suitably conditioned ILEC facilities that are provided on an unbundled basis.

24. With regard to OSS, Mr. Brauer of Sprint has testified that "OSS and related problems at the RBOCs (including SBC and Ameritech) result in a significant loss of revenue to Sprint due to delayed cut-over of service, loss of customers and damage to Sprint's reputation as a quality telecommunications provider."¹⁶ The Commission itself is no stranger to the difficulties of setting OSS standards, as they have proved to be one of the more contentious issues in the 271 proceedings.

25. Turning to access to ILEC facilities, Mr. Brauer raises a number of concerns. For instance, many loops are behind Digital Loop Carrier ("DLC") equipment that prevents the provision of xDSL service on these loops. The RBOCs as a rule have refused to entertain requests to collocate CLEC equipment at RBOC DLC locations and to perform sub-loop unbundling for the twisted-pair copper from the DLC to the end user premises.¹⁷ Other parties have raised concerns about collocation. For example, Covad Communications Company, a California-based digital subscriber line ("DSL") provider,

¹⁶ *Brauer Affidavit* at 12.

¹⁷ *Brauer Affidavit* at 14-15.

has complained that its expansion efforts have been hampered by SBC's physical collocation practices. In comments filed with the Commission, Covad asserts that SBC had unilaterally declared that no space existed in at least 50 of the 165 central offices in which Covad had applied for collocation, but that it later became clear through an SBC ADSL Service tariff filing that SBC was able to find room for its own DSL equipment in 20 of those 50 central offices.^{18,19}

26. The technical capability of ILEC facilities will be a particularly important issue when Sprint and others begin to use unbundled loops to provide xDSL service. Many existing local loops will require individual treatment in terms of conditioning in order to carry the high-speed digital signals directly to the customers' premises. Moreover, the ongoing performance of the conditioned loops depends largely upon whether interfering digital signals are carried within the same cable sheath or binder. The conditioning of the loops and the placement of digital signals within a binder group of loops provide two

¹⁸ *In the Matter of Southwestern Bell Telephone Company, Pacific Bell, and Nevada Bell Petition for Relief from Regulation Pursuant to Section 706 of the Telecommunications Act of 1996 and 47 U.S.C § 160 for ADSL Infrastructure and Service*, CC Docket No. 98-91, *Comments of Covad Communications Company*, filed June 1998, 24, at 4-5.

¹⁹ SBC was eventually able to accommodate Covad equipment in many of these offices, but only after Covad filed an antitrust lawsuit for a preliminary injunction. See *In the Matter of Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 98-147, *Comments of Covad Communications Company*, filed September 25, 1998, at 6-7.

mechanisms through which an ILEC can degrade the quality of access services provided to Sprint and other CSCs or CLECs.²⁰

IV. ILECS' PRIVATE INCENTIVES TO OFFER ACCESS AND INTERCONNECTION DO NOT ALIGN WITH THE PUBLIC INTEREST

27. In evaluating the public interest effects of the proposed merger between Ameritech and SBC, policy makers must take into account two fundamental points. First, even without the proposed merger, both SBC and Ameritech have unilateral incentives to exercise market power in the provision of access in ways that do not serve the public interest. Second, the proposed merger will increase these incentives. The remainder of this section examines these incentives in the absence of the proposed merger. Sections V and VI then examine the ways in which the proposed merger would increase SBC and Ameritech's incentives and ability to engage in anticompetitive behavior.

A. ILECs have Incentives to Exercise Market Power in the Provision of Access

28. A profit-maximizing ILEC has incentives to exercise market power in the provision of access services and, in the absence of effective regulatory constraints, will do so. Even if an ILEC did not compete downstream in either the local exchange, interexchange, or CSC markets, that ILEC would have incentives to exercise market power as a seller of access services by setting high prices. Moreover, because it does compete in the downstream

²⁰ *Brauer Affidavit* at 13-15.

markets, an ILEC has further incentives to raise the price and incentives to deny, delay or degrade the provision of access to its competitors as a means of disadvantaging these competitors.²¹

1. Monopoly pricing of access by an unintegrated access monopolist

29. The first reason why an ILEC may seek inefficient, non-competitive terms for access comes under the general rubric of monopoly pricing by an unintegrated access monopolist. An ILEC can be expected to elevate its access charges above costs to the extent that regulators and the elasticity of demand allow it to do so profitably. An ILEC with significant market power in the provision of access has the incentive to set monopolistic access prices in order to extract greater economic rents for itself. Thus, even an ILEC that did not compete with the carriers to whom it was selling access could be expected to charge inefficiently high prices for that access.²²

²¹ See, for example, Michael L. Katz, "Economic Efficiency, Public Policy, and the Pricing of Network Interconnection Under the Telecommunications Act of 1996," in *Interconnection and the Internet: Selected Papers from the 1996 Telecommunications Policy Research Conference*, G. Rosston and D. Waterman (eds.), Mahwah, New Jersey: Lawrence Erlbaum Associates, Publishers (1997).

²² When an ILEC has limited information about the exact economic value that each interconnecting provider places on access, the ILEC cannot transfer economic rents efficiently to itself from interconnecting carriers.

2. Raising rivals' costs with price and non-price exclusionary conduct,

30. The second reason why an incumbent LEC may seek inefficient, non-competitive terms for the provision of UNEs, interexchange access, and transport and termination falls under the general heading of raising rivals' costs.²³ ILECs compete, or have plans to compete, against the carriers to whom they sell access services. At present, SBC and Ameritech compete with CLECs in the provision of local services (albeit to a limited extent) and with IXCs in the provision of intraLATA toll services. SBC and Ameritech also are planning to compete with IXCs and CSCs in the provision of interLATA services in the future. By raising the costs (or degrading the quality, or delaying or denying access)²⁴ of competing carriers' services, SBC and Ameritech can achieve, enhance, or maintain market power in the retail markets in which they compete with these disadvantaged rivals.

31. An ILEC has incentives to disadvantage actual and potential entrants in both the local exchange services and interexchange services markets in which it participates or plans to enter in the near future. While there are significant differences between local and long-distance markets in terms of the degree of competition and the role of ILECs, there is one common factor: ILECs control necessary access to the vast majority of telephone subscribers.

²³ See, for example, S. Salop and D. Scheffman, "Raising Rivals' Costs," *American Economic Review Papers and Proceedings* 73 (May 1983):267; T. Krattenmaker and S. Salop, "Antitrust Analysis of Exclusionary Rights: Raising Rivals' Costs to Gain Power Over Price," *Yale Law Journal* 96 (December 1986):209.

²⁴ We refer to all of these forms of exclusionary conduct collectively as "raising rivals'

By denying efficient access to CLECs and CSCs, an ILEC is able to sustain its market power in the provision of local exchange services.²⁵ The vigor with which ILECs have used legal and regulatory maneuvers to resist the introduction of competition suggests that their current market positions are very valuable. By denying efficient access to IXCs and CSCs, an ILEC also may be able to create an artificial—and profitable—competitive advantage for its own in-region interexchange operations.

32. Rivals may be disadvantaged in a number of ways, by both price and non-price means. One way to raise rivals' costs is to increase the charges for access. A firm generally benefits from an increase in the marginal costs faced by its rivals because such cost increases raise the rivals' profit-maximizing prices and reduce their profit-maximizing output levels at current prices. And raising the costs of *potential* rivals may delay or deter their entry. Put another way, by charging its competitors more for originating and completing their customers' calls, an ILEC can drive up the retail prices of these competitors, to its own benefit and consumers' detriment. In addition, by disadvantaging CLECs and CSCs that might themselves offer access services, the ILEC also maintains its market power in the provision of access services in the upstream market. Thus, an ILEC can have incentives

costs.”

²⁵ This incentive to exclude CLECs and CSCs exists even before Section 271 approval is granted to the ILEC. For a further discussion of the constraints created by Section 271, see ¶59 below.

to charge wholesale access prices above the monopoly prices that would have been set by an unintegrated access monopolist that did not compete with its customers.²⁶

33. A second general method of disadvantaging rivals is by denying, delaying, or degrading provision of the access needed to support the services these competitors provide to consumers. As discussed in Part III.B above, there are many different ways in which an ILEC can disadvantage its rivals through its control of essential access services and facilities. For example, consider a CSC with an innovative new combined service that it would like to offer in competition with an ILEC. Suppose this CSC entrant can offer the service efficiently only if it obtains a particular type of access arrangement from the ILEC. The ILEC's refusal to provide that access in a timely fashion could destroy the entrant's ability to compete. In less extreme circumstances, this refusal will raise the entrant's cost of competing or reduce the quality of its service offerings. Either way, the CSC will be a weaker competitor in both the local exchange and interexchange markets, permitting the ILEC to profit in both of these markets. As discussed in Part IV.D below, this second type of exclusion is very hard for policy makers to monitor, and we believe that it is impossible for policy makers fully to prevent abuse. As regulators succeed in

²⁶ It does not automatically follow that any vertically integrated firm will want to disadvantage its customers in order to promote its own downstream division. The integrated firm must balance the foregone profits from lost upstream sales against the increased profits of its downstream division. Under some conditions, it will not be profitable to elevate the input price charged to downstream rivals. We address the specific incentives of SBC and Ameritech in the downstream markets below.

holding down the charges for various types of access services to lower levels, an ILEC gains the incentive to employ these non-price means to raise rivals' costs.^{27,28} The threat of non-price exclusionary conduct is particularly strong against CSCs that require innovative access arrangements that are the most difficult for regulators to monitor effectively. And, as a new entrant trying to roll out its services rapidly on a nationwide basis, a CSC is very vulnerable to ILECs' actions that delay or degrade the CSC provider's ability to offer service.

B. A Formal Model of ILEC Incentives to Exclude Competition with Exclusionary Access Policies

34. In this part, we develop a simple, formal analytic framework and apply it to the issue of exclusionary conduct directed at competing CLECs, IXCs, or CSCs. As discussed earlier, SBC and Ameritech have and will continue to have substantial market power in the provision of access services required by CLECs, IXCs, and CSCs. For any

²⁷ If access and interconnection prices were fully unregulated, then the ILEC may not have the incentive to use these non-price means of exclusion. This conclusion follows from the fact that increasing the price of access generates increased revenue in the upstream market at the same time that it disadvantages rivals in the downstream market. Note that in situations where price discrimination is infeasible but non-price discrimination is not, the ILEC may have the incentive to use non-price means of exclusion even when interconnection fees are unregulated.

²⁸ There is considerable evidence of exclusionary conduct by the ILECs. For a discussion, see Declaration of Stanley M. Besen, Padmanabhan Srinagesh, and John R. Woodbury, "An Economic Analysis of the Proposed SBC/Ameritech Merger," October 14, 1998.

unregulated access services,²⁹ SBC and Ameritech will have the ability to raise access prices in order to disadvantage rivals. For regulated access services, SBC and Ameritech will have the incentive to raise competitors' costs by denying, delaying, or degrading access, if regulators cap access prices sufficiently below the (integrated firm) monopoly price.

35. By engaging in non-price exclusionary conduct, SBC and Ameritech sacrifice profits from the sale of wholesale access in return for increased market power in the provision of local exchange, interexchange, and combined services. The carriers also run the risk of incurring regulatory sanctions in the event that the regulators are able to detect and punish this exclusionary conduct.³⁰ To choose the degree to which to carry out such exclusionary conduct, an ILEC must balance the benefits of exclusion against these costs. In part, the benefits depend on the way in which the ILEC exercises the increased market power that results from exclusionary conduct. In this section, we develop two expressions for the ILEC's incentives to engage in non-price exclusionary conduct, which we refer to as the *relative-margin incentive* and the *increased-price incentive*.

²⁹ For example, certain broadband access services might not be regulated in the future.

³⁰ As discussed below, the ability of regulators to detect exclusionary behavior is limited. However, the greater the extent of exclusionary conduct, the more likely it is that the ILEC will be caught and punished.

1. The Relative-Margin Incentive

36. The *relative-margin incentive* is based on a scenario in which the ILEC increases its retail unit sales at current prices in response to the weakening of competition.

Suppose that SBC pursues this strategy. In this case, the exclusion permits SBC to replace upstream sales of *access* to competitors with a certain quantity of downstream *retail* sales to end users.³¹ Algebraically, we can express this relationship as

$$\text{Gain from Exclusion} = \Delta Q^r \times m^r - \Delta Q^a \times m^a \quad (\text{eqn. 1})$$

where ΔQ^r is the additional retail traffic that SBC gains as a result of the exclusionary behavior, m^r is the margin (price minus incremental cost) that SBC earns on those retail services, ΔQ^a is the volume of access services that SBC loses as a result of the fact that rivals no longer purchase as much access when SBC engages in exclusionary behavior, and m^a is the margin that SBC would have earned on those access services. In other words, Equation (1) implies that, if the incremental retail business gained is more profitable than the incremental access business lost, then SBC would have incentives to exclude its rivals in the particular retail segment.

³¹ This condition is sufficient, but not necessary. Even if this scenario is not profitable at current prices, it nonetheless may be profitable to exclude if SBC increases its retail price somewhat instead of increasing its output by the full amount of the reduction in its rivals' output. For regulated services facing new competition, preventing price from falling is treated as a price increase.

37. This general framework can be applied to exclusionary access conduct directed towards the CLECs, IXCs, and CSCs. When excluding CLECs, SBC sacrifices wholesale access volume and revenues, but gains retail local exchange volume (both in terms of lines and, in the case of local measured service, minutes).³² When excluding IXCs, SBC trades the loss of switched and special access traffic against the gain in retail long distance traffic. When excluding CSCs, increased local and long distance profits are weighed against lost access profits. Moreover, as access charges are adjusted toward cost-based levels, m^a will fall and the ILEC's incentive to engage in non-price exclusionary conduct will rise.

38. The change in profits also has to be balanced against the risk of regulatory sanctions. Let S denote the expected sanctions when the ILEC engages in amount d of exclusionary behavior. One would expect S to rise as d rises for two reasons. One, the probability of detection will increase as the behavior becomes more egregious. Two, the penalties levied upon detection may increase in the level of activity undertaken. To capture this relationship between S and d , we write $S(d)$. The volume changes will also depend on d , so we express them as $\Delta Q^r(d)$ and $\Delta Q^a(d)$. Using this notation, SBC has incentives to choose the level of exclusionary conduct to maximize its gains net of enforcement costs,

³² In the longer run, the SBC may not be sacrificing much wholesale traffic. By disadvantaging the CLECs, SBC can raise barriers to entry into the access market and

$$\text{Net Gain} = \Delta Q^r(d) \times m^r - \Delta Q^a(d) \times m^a - S(d) . \text{ (eqn. 2)}$$

39. One can express this simplified scenario in more detail to facilitate computation of a particular ILEC's incentives to engage in exclusionary conduct. Suppose that SBC delays, denies, or degrades the provision of access by amount d , and these actions lead its competitors in one of the retail markets to reduce their collective retail unit sales by $\Delta Q(d)$ at the current retail price. Suppose that a fraction, δ , of these sales are diverted to SBC at the current retail price; in other words, SBC's unit sales rise by $\Delta Q^r = \delta \Delta Q(d)$. The proportion δ is known as the *diversion ratio*.³³ If the services are perfect substitutes, then $\delta = 1$. For differentiated products, $\delta < 1$.

40. The increase in d will also reduce SBC's sales of access minutes to other carriers; as they cut back their retail sales, other carriers will have less demand for SBC access services. We use λ to denote the amount of access traffic that SBC loses due to its exclusionary behavior, expressed as proportion of the retail traffic that the disadvantaged carriers lose.³⁴ The value of λ calculated over all lost traffic will depend on the mix of traffic. Using this notation, we have $\Delta Q^a = \lambda \Delta Q(d)$.

better maintain its market power in the provision of these services.

³³ For additional discussion, see Carl Shapiro, "Mergers with Differentiated Products," *Antitrust* (Spring 1996):23.

³⁴ Suppose, for example, that SBC has received Section 271 approval and disadvantages all other IXCs purchasing access services from it. Further, suppose that these carriers cut back their retail sales by 100 minutes and that carriers reduce their purchases of access

41. Armed with this new notation, we can re-write Equation (2) as

$$\text{Net Gain} = \Delta Q(d) \times \{ \delta \times m^r - \lambda \times m^a \} - S(d). \quad (\text{eqn. 3})$$

As long as the *relative margin*, $\delta \times m^r - \lambda \times m^a$, is positive and it is difficult for regulators to detect a small increase in exclusionary conduct, SBC has incentives to raise rivals' costs.³⁵

2. The Increased-Price Incentive

42. A second sufficient condition for the profitability of raising rivals' costs also can be formulated. The *increased-price incentive* is based on a different scenario in which SBC exercises its increased market power (which results from its exclusionary conduct) by holding its output fixed and obtaining a higher price (than would occur otherwise). As in the previous scenario, exclusion that reduces rivals' retail output by $\Delta Q(d)$ units reduces SBC's sales of access by $\Delta Q^a = \lambda \Delta Q(d)$ units, and thus reduces its access profits by $\lambda \Delta Q(d) \times m^a$. The difference between the two scenarios comes in the retail market. Now, instead of increasing its output level, SBC gains from a price increase, $\Delta p(d)$, times

from SBC by 150 minutes. Then, in this example, λ would be equal to 1.5 (*i.e.*, 150/100).

³⁵ If the access price were unregulated and price discrimination were feasible and unconstrained, then the incentive to exclude by degrading, delaying, or denying access would disappear because SBC would increase the price of access (and thus m^a) instead. As noted earlier, restrictions on the access margin increase the ILEC's incentives to engage in non-price exclusionary conduct.

the SBC's output in the retail market Q_i . The gain in retail profits is thus $Q_i \times \Delta p(d)$.³⁶

Taking the expected sanction, $S(d)$ into account,

$$\text{Net Gain} = Q_i \times \Delta p - m^a \times \lambda \times \Delta Q(d) - S(d) . \quad (\text{eqn. 4})$$

43. Even if regulators capped retail prices at levels leading to a retail margin so low that the *relative-margin* incentive were negative, the *increased-price incentive* still may be satisfied. This latter incentive may also be satisfied even when regulators prevent the ILEC from raising retail prices. This outcome is possible because exclusionary access policies raise or maintain barriers to entry and expansion. These barriers can permit the ILEC to profitably maintain the current regulated price rather than being led to *reduce* retail prices to meet the threat or actuality of new competition. In this way, the ILEC's exclusionary conduct prevents price from falling to a lower, more competitive level. Deterring such price decreases is, of course, an exercise of market power.³⁷

44. It also is important to emphasize that these expressions may understate actual incentives. They are based on the assumption that the ILEC exercises its market power either (a) solely by increasing output at the current price, or (b) solely by taking a higher price (or forestalling a price decrease) on current output. These calculations ignore the

³⁶ David S. Sibley and Dennis L. Weisman, "The Competitive Incentives of Vertically Integrated Local Exchange Carriers: An Economic and Policy Analysis," *Journal of Policy Analysis and Management* 17 (1998):74, take a similar approach.

³⁷ See Krattenmaker, Lande and Salop, *supra* note 3. In what follows, we will include in the meaning of "raising price" the conduct of "preventing price decreases."

potential for the ILEC to choose a possibly more profitable intermediate combination of higher price and higher output.

3. An Illustrative Example

45. This part illustrates the *relative-margin incentive* in a calibrated simulation to show that an ILEC can have significant incentives to engage in exclusionary conduct. The particular example considered involves an ILEC delaying the provision of essential facilities required by a hypothetical CSC planning to offer single-line business customers a bundle of local and long distance services.³⁸ The ILEC's net gains from delaying or deterring the hypothetical CSC's entry are computed below. These computations are illustrative. A given ILEC's incentives to exclude a rival depend, in part, on the business models of both the ILEC and the specific rival, so we first discuss those business models. We then compute the ILEC's upstream and downstream margins to allow calculation of the *relative-margin incentive*.

46. The hypothetical CSC has a business model in which its usage-sensitive charges mirror those of current ILEC and IXC usage-sensitive charges, but the monthly fees are lower than those charged by the ILEC and IXCs.³⁹ As a consequence, we assume that the

³⁸ Actual CSCs are expected to build networks that can offer the full range of local and long distance services that are available from LECs and IXCs today plus new advanced services and applications that can be used when *both* ends of the call are directly attached to a CSC network. We return to the effects of these additional services below.

³⁹ Subscribers might also be attracted to the CSC by the convenience of integrated billing if the ILEC cannot offer this feature.

usage pattern of a given customer will not change when he or she shifts to the CSC.

47. Suppose that the CSC offers its bundle of local and long distance services over a mix of owned facilities and UNEs leased from the ILEC. In particular, the CSC is assumed to: (a) own its long-distance network;⁴⁰ (b) provide service over unbundled loops purchased from the ILEC; (c) provide its own local switching; and (d) use transport leased from a CAP.

48. The ILEC in our hypothetical example is assumed to provide local services and in-region long distance services over its own network facilities.⁴¹ The ILEC is assumed to purchase bulk long distance minutes from an IXC to transport calls from its subscribers that terminate outside of the ILEC's region.⁴² The ILEC earns terminating access charges on long-distance calls from subscribers outside the ILEC's region to its local exchange subscribers. In addition, the ILEC earns interstate and intrastate access charges on in-region calls originated by other carriers operating in its region, and it pays applicable terminating access charges to other carriers whose in-region subscribers are called by

⁴⁰ Equivalently, the CSC could lease a network or purchase bulk capacity from a carrier other than the ILEC.

⁴¹ Local calls from the ILEC's subscribers to competing CLECs are assumed to be in balance and reciprocal compensation rates are assumed to be symmetric. Thus, the ILEC's payments for originating local calls that terminate on CLEC networks equal the payments ILEC receives for terminating calls that originated on CLEC networks.

⁴² These calls are terminated over the facilities of the access providers serving that region, and terminating access charges are paid on this traffic.

ILEC customers.⁴³

49. We next evaluate the *relative-margin incentive* in this example. We assume that the ILEC engages in exclusionary conduct by delaying or denying the provision of conditioned unbundled loops that the CSC needs to serve single-line business customers. As a result, the CSC's subscriber growth (in terms of number of customers) is reduced. We assume that the ILEC expands its own output to make up for the reduced output of its competitor, leaving the usage-sensitive market price for the various retail services unaffected.⁴⁴

50. Based on the assumptions described in more detail in the Appendix A, we find that in the retail market, the ILEC gains monthly revenue of approximately \$89.50 per subscriber diverted from the CSC. These revenues are derived from the sale of both local and long-distance service. Our underlying assumptions lead to the ILEC's having retail costs of about \$37.50 per subscriber per month. The resulting retail margin is approximately \$52.00 per month per customer diverted from the CSC.⁴⁵

51. On the wholesale side, for every customer diverted from the CSC, the ILEC

⁴³ As with local calls, intra-region traffic is assumed to be in balance and net payments are assumed to be zero.

⁴⁴ Note that consumers are worse off as the result of the ILEC's exclusionary behavior—they are denied the benefits of the lower monthly charge and the convenience noted in footnote 39 *supra*.

⁴⁵ In explaining this scenario, we find it clearer to include the profits from terminating access in the retail side of the incentive. Only the unbundled loop margin is included on the

sacrifices the margin earned on an unbundled loop. We assume that the price per loop is \$14.50 and the long run incremental cost is \$12.00. Thus, the assumed wholesale margin is \$2.50. If instead we used short-run marginal cost (which is assumed to be zero), then the upstream margin would equal \$14.50.

52. Applying these assumptions to calculation of the *relative-margin incentive*, we find that the exclusion is highly profitable. Using either short-run or long-run incremental costs, the retail margin is substantially larger than the access margin. The retail margin exceeds the access margin by approximately \$37.50 (*i.e.*, \$52.00 – \$14.50) even taking the marginal cost per loop to be zero.⁴⁶ The difference rises to approximately \$49.50 (*i.e.*, \$52.00 – \$2.50) in the longer run, using the long run incremental cost for the loops. Given the way in which we have parametrized our example, $\lambda = 1$.⁴⁷ Substituting the relevant values into Equation (3) shows that, when the diversion ratio is equal to unity, exclusionary conduct increases profits in the absence of detection and regulatory sanction.

53. Even if the ILEC does not capture all of the customers lost by the CSC (that is, even if the diversion ratio δ is less than one), it is still likely that exclusion would be

wholesale side. This choice of labeling has no effects on the conclusions.

⁴⁶ This comparison uses the long-run incremental cost of the loop (\$12) when computing the retail margin, and the short-run marginal cost (\$0) of the loop in computing the wholesale margin, and thus is conservative.

⁴⁷ This follows from the assumption that the CSC reaches each of its customers through an

profitable. Ignoring the risk of sanctions, as long as the diversion ratio exceeds 28 percent, the exclusion is profitable using the short-run marginal cost of loops. Using long-run costs, exclusion is profitable as long as the diversion ratio exceeds 5 percent. The diversion ratio is likely to be much closer to unity in the light of the ILECs' near-monopoly positions in local exchange markets and the likelihood that they would disadvantage all of their CSC rivals simultaneously. Thus, the ILEC in this example would likely have strong incentives to delay or deny the provision of unbundled loops to the CSC. These exclusionary incentives would then have to be balanced against the risk of regulatory detection and sanctions. In the light of imperfections of regulation, the fear of regulatory sanctions is unlikely to dominate the incentives to exclude.

54. While the scenario is hypothetical, the example suggests that ILECs like SBC and Ameritech can have significant incentives to engage in exclusionary behavior even in the absence of the merger. As shown in Section V, these incentives would be even larger if the proposed merger were allowed to be consummated.

C. The Exercise of ILEC Market Power Harms Efficiency, Competition, and the Public Interest

55. Competing telecommunications providers obviously are harmed when an ILEC has significant market power and exercises that power by setting inefficiently high monopolistic access prices or by denying, delaying, or degrading the access below the efficient level. The

unbundled loop purchased from the ILEC.

adverse effects on consumers and efficiency go beyond this harm to competitors. These broader adverse effects raise serious public policy concerns. The market suffers efficiency losses because the incentives to invest in R&D and physical infrastructure to provide these competitive local and long-distance services are reduced. Moreover, the costs of retail services will be increased, which can be expected to raise the retail prices paid by consumers and thus lower consumer welfare and suppress output below efficient levels.

D. Regulators Will Be Unable to Prevent the Anticompetitive Exercise of ILECs' Market Power Over Innovative New Access Arrangements

56. In the light of these welfare-reducing effects of this exclusionary conduct, there is a public interest in limiting such behavior. This is, however, very difficult for regulators to do for two fundamental reasons. First, as discussed in the remainder of this part, regulation is imperfect at detecting and correcting such conduct, particularly for new and innovative forms of access. Second, as discussed in Section VI below, the potential for continued consolidation of the large ILECs will further reduce policy makers' ability to exercise effective oversight. SBC and Ameritech have argued that, even if there were problems with the potential exercise of market power, regulatory oversight could sufficiently handle any potential problems.⁴⁸ Analysis of the facts indicate otherwise.

⁴⁸ See, *Merger of SBC Communications Inc. and Ameritech Corporation: Description of the Transaction, Public Interest Showing and Related Demonstrations*, filed with the Federal Communications Commission, July 24, 1998, at 90-91. "Within SBC's or

Even if the Commission were to believe that it can prevent serious abuses in the standard provision of "plain vanilla" interexchange access—a position that some market participants might dispute—future interconnection and access issues will be much more difficult to resolve.⁴⁹ For existing interLATA arrangements, policy makers have built up experience over a number of years in detecting and addressing problems with the provision of access. The development of performance standards has been facilitated by the possibility of benchmarking, whereby the performance of one ILEC is judged in comparison with the performance of other ILECs. In this regard, it is significant that these standards were set when ILECs had less incentive to engage in exclusionary or discriminatory behavior than they do in the present economic and regulatory environment.

Ameritech's regions, the merger will not in any way alter or diminish the ability of others to compete in local exchange markets. Neither competitors, state commissions nor this Commission will allow any backsliding in the market-opening process."

⁴⁹ For example, a recent affidavit submitted by Dale Hatfield observed that the ILECs have been substantially increasing the extent to which their networks are intelligent, a change that increases the ILECs' ability to tailor their services to individual customers. "But this very ability to customize means that the BOCs or other [ILECs] can 'fine tune' their local exchange networks to favor (a) their own interexchange operations over their interexchange carrier competitors and/or (b) their own end user customers over the end user customers of their interexchange competitors. Stated another way, the incumbent local exchange carriers, including Ameritech, will have additional—and generally more subtle—methods of discrimination available to them." [Note omitted.] Affidavit of Dale N. Hatfield on Behalf of MCI Telecommunications Corporation, Before the Federal Communications Commission, *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA services in Michigan*, CC Docket No. 97-137 (June 5, 1997), at 15.

57. The situation is quite different for access between ILECs and CLECS, and for access in support of new interexchange and combined services. Access arrangements between ILECs and local service providers are far from fully set in place. Both market participants and regulators have little experience with how these arrangements will work under commercial conditions. Moreover, as both local and long distance service providers launch new services, there will be a variety of new, innovative access arrangements needed to facilitate xDSL and other new technologies. For these arrangements, policy makers do not have the benefit of long experience in detecting and correcting problems. Nor have policy makers had the chance to develop comprehensive performance standards. Further, the information needed to regulate ILEC behavior may be extremely difficult to obtain. How, for example, would the regulators rapidly determine that an ILEC was leaving unused (or underused) equipment in a central office in order to block CLEC or CSC collocation? And what sort of rules would govern interference among digital signals in a binder group? In addition, as discussed in more detail in Section VI below, the merger will make benchmarking more difficult by reducing the number of ILECs and distorting their incentives. For all of these reasons, if SBC were to refuse to provide efficient new access arrangements, delayed or slowed deployment, or reduced the quality of the access below the efficient level, regulators would face significant difficulties detecting the distortions and inducing SBC to correct its misbehavior.

58. The fact that SBC and Ameritech must obtain Section 271 approval before providing interLATA services does not change this conclusion. Unless the Commission interprets the Section 271 standard as requiring that a Bell company face very substantial actual local exchange competition before being allowed to offer in-region interLATA services, a Bell company's meeting this standard will not imply that the company has a non-dominant market position. In all likelihood, CLECs and CSCs will remain dependent on the ILEC for the UNEs they need to compete long after Section 271 approval has been granted. And CLECs, CSCs, and IXCs will remain dependent on the ILEC for various other access services as well. All of the problems of detection and enforcement discussed above will arise whether or not Section 271 approval has been granted. And, perhaps most important, all of these problems will occur for the significant interim period prior to the granting of Section 271 approval.

59. In summary, the roll-out of Sprint ION and similar services by competing carriers is threatened by exclusionary behavior by ILECs. Long, drawn-out litigation and regulatory proceedings will not resolve the issues soon enough to facilitate the rapid entry and expansion that Sprint has planned.⁵⁰ This is unfortunate because such entry would help to bring increased competition to local exchange markets. While policy makers should not give up trying to limit exclusionary conduct through direct oversight, it is important to ensure that competitive market forces can be used wherever possible. And it

is equally important that market conditions not be allowed to deteriorate in ways that increase the incentive and ability of ILECs to exercise market power. As the next section explains, blocking the proposed merger is one way to promote competitive market forces and limit the incentives and ability for SBC and Ameritech to carry out exclusionary conduct.⁵¹

V. THE PROPOSED MERGER WOULD INCREASE SBC AND AMERITECH'S INCENTIVES AND ABILITY TO EXCLUDE RIVALS BY DENYING ACCESS

A. Exclusion By One ILEC Benefits Other ILECs

60. In the light of the strong network effects and the ILECs' dominant position as providers of local loop services, the ILEC provision of access services to other carriers under reasonable terms is essential to the ability of rivals to compete effectively in the local exchange and interexchange markets. As already discussed, ILECs have an incentive to raise rivals' costs in order to achieve, maintain or enhance market power in the provision of local exchange and interexchange services. The proposed merger between SBC and Ameritech would increase their incentives to disadvantage CLEC, CSC and IXC competitors by foreclosing them from efficient access at reasonable prices.

⁵⁰ *Brauer Affidavit* at 20.

⁵¹ Moreover, as discussed in Section VI below, blocking the proposed merger will preserve competitive benchmarks as a means of using market-generated information to improve the regulation of all large ILECs.

61. The basic logic underlying this anticompetitive effect of the proposed merger is straightforward. In many instances, rival carriers require access from multiple ILECs in order to compete efficiently. The merger of two ILECs increases their incentives and ability to foreclose access to competing carriers because it allows each ILEC to capture the anticompetitive benefits that spillover to the other ILEC.

62. When a competing carrier's ability to serve customers depends upon its ability to obtain efficient access arrangements at reasonable prices from multiple ILECs, the degradation, delay, or denial of access in one ILEC's region may weaken the competing carrier in the region of another ILEC. Because of these multi-market effects, one ILEC's exclusion of competitors from efficient access will create anticompetitive benefits for other ILECs. For example, when SBC raises the cost of access to the IXCs, CLECs or CSCs in its region, SBC's foreclosure action may weaken the rivals' ability to offer services in Ameritech's region as well. If so, Ameritech derives an anticompetitive benefit from SBC's exclusionary conduct. Of course, before the merger, SBC would not take this spillover benefit to Ameritech into account. However, after the merger, SBC will take this spillover benefit accruing to Ameritech into account. As a result of internalizing these spillovers, SBC's incentives to raise rivals' costs would be increased. Similarly, the merger would raise the merged entity's incentives to engage in exclusionary behavior in Ameritech's region.

63. Thus, this analysis predicts that the merger would lead both SBC and Ameritech to search for new methods to exclude competitors and intensify their exclusionary conduct.

This may mean more significant denials of access by both divisions of the merged entity, further delays in granting access, and lower quality access than would have been provided absent the merger.⁵² The fact that SBC and Ameritech may have incentives to exclude without the merger does not alter this conclusion. Worsened incentives will mean more exclusion as each division is willing to undertake a greater risk of regulatory sanctions in return for the increased rewards from successful exclusion.⁵³

64. As a result of this increase in exclusionary conduct, rival carriers will be injured and will become less formidable competitors to the ILECs than they otherwise would.

⁵² SBC might argue that the merger reduces the amount of exclusion in that the merger would lead SBC to stop following an exclusionary policy towards Ameritech in markets in which they compete (such as the interexchange market), and vice versa. This could be a beneficial effect of the merger. However, it should not be given much weight by policy makers for two reasons. First, it will be offset by the increased exclusion of other competitors. Second, it would turn policy on its head to reward an ILEC's exclusionary conduct by permitting it to acquire its victims. This policy would increase SBC's incentives to exclude other rivals even more intensely because doing so would increase its ability to exclude others as well as lower the cost of acquiring them.

⁵³ Our analysis demonstrates that the merger increases SBC's benefits of exclusion as a result of internalizing the anticompetitive benefits that spillover to Ameritech, and vice versa. As benefits increase, SBC's benefit-cost balance likely will lead it to expand its efforts to exclude rivals. In principle, these increased benefits could be offset by increased regulatory sanctions in the event that exclusion is detected. However, state regulators in (say) Texas are unlikely to bring sanctions against SBC for exclusionary conduct towards CLECs or CSCs in (say) Illinois or Connecticut. Nor has the Commission shown any inclination to increase regulatory sanctions in response to mergers. Moreover, even if this scenario were plausible, there are offsetting effects. In particular, SBC may have economies of scope in defending itself from such charges in multiple state proceedings. And, even if there is a chance of sanctioning SBC, entrants may not be willing to wait around at a disadvantage for the outcome of the proceedings. In any case, the whole point of encouraging CLEC and CSC entry is to reduce the need for regulation over time; it is not to expand the need for regulation by permitting mergers that enhance the ILECs'

Consumers also will be harmed as competition is weakened. Service prices likely will be higher, and qualities and choices will be lower, leading to a reduced level of consumer welfare. To the extent that the disadvantaged competitors have differentiated products or would have lower costs or higher quality than the ILECs in the absence of discrimination, efficiency will be reduced and consumer harm will be further magnified.

65. The merger of SBC and Ameritech also will increase their *ability* to engage in exclusionary conduct that raises rivals' costs in three ways.⁵⁴ First, the regulators will no longer be able to monitor, detect, and prove the existence of exclusionary conduct by SBC by using Ameritech's conduct as a benchmark, or vice versa. Second, after the merger, SBC and Ameritech may gain the ability to coordinate and rationalize their exclusionary conduct to make detection and proof more difficult.⁵⁵ By controlling both ends of access, the integrated company may be better able to evade regulatory oversight of the quality of the access it provides by better rationalizing its exclusionary tactics.

incentives to exclude.

⁵⁴ In addition to the issues discussed here, the increased *incentive* to exclude discussed already can be stated as an increased *ability* to exclude. If one treats the merger as SBC acquiring Ameritech, then SBC gains an increased *ability* to exclude SBC's interexchange rivals by raising their costs of interconnecting to the Ameritech local exchange network. In the previous paragraph, we treated these effects as an increase in Ameritech's incentive to exclude, rather than as an increase in SBC's ability to exclude. Regardless of how it is stated, the effect is the same. Rivals' costs will be raised, or their service quality reduced, leading to reduced competition in the interexchange market.

⁵⁵ While SBC and Ameritech emphasize the possible sharing of "best practices" post-merger, they may well share "worst practices" (from a public interest perspective) too.

Finally, SBC may benefit from economies of scope in fighting regulatory battles in multiple state forums.⁵⁶

B. The Sources of Anticompetitive Spillovers

66. Because of their importance in understanding how the proposed merger would increase SBC and Ameritech's incentives to engage in exclusionary conduct, we examine the cross-market linkages that give rise to anticompetitive spillovers. We will then develop the logic more fully using graphical and algebraic analysis.

1. Exclusion of Rival IXCs

67. Competing carriers' dependence on multiple ILECs is most easily seen in the case of IXCs, so we begin with them. An IXC providing traffic among regions requires an interconnection at both ends of the call. If the ILEC providing terminating access to the IXC denies or degrades that access, then an ILEC competing with the IXC to offer long distance service at the originating end also will benefit. Thus, in the interexchange market, an exclusionary access policy by one ILEC towards IXCs will spill over and benefit other ILECs in other regions.

68. Consider the case of foreclosing efficient interconnection to rival IXCs. IXC competitors require access to the local exchange network from two regions, the region in

⁵⁶ In addition, to the extent that state proceedings do not take place simultaneously, SBC can gain a reputation among entrants as a firm that excludes rivals, and thereby may deter the entrants from attempting to enter to begin with, or it may slow down their entry plans.

which the call is originated and the region in which the call is terminated. In most cases, IXCs will have to purchase access from the respective ILEC. As a result, foreclosing the IXCs from efficient interconnection in its region will raise rivals' costs and thus may give the ILEC in that region market power in the downstream interexchange market in that region. This market power may be exercised with a higher interexchange market share, higher price or some combination of the two. Moreover, the IXC competitors in Region 2, whose calls originate in Region 2 and terminate in Region 1, are disadvantaged by inferior terminating access in Region 1. It follows that, if ILEC 1 forecloses the IXC competitors in Region 2 from efficient terminating access in Region 1, then those IXCs also will be placed at a competitive disadvantage in Region 2, providing an anticompetitive benefit to ILEC 2. Exclusion of the IXC competitors by ILEC 2 provides an analogous benefit to ILEC 1.

2. Exclusion of rival CLECs

69. Exclusionary access policy by one ILEC directed toward multi-market CLECs can also benefit other ILECs. This will occur when harming the CLECs in one region weakens their ability or incentives to compete in another region. That is, if a CLEC suffers lower quality or higher costs, reduced market share, and lower profitability in one region, those factors will reduce the likelihood that it enters other regions as well. Even if the exclusionary conduct in one market does not deter CLECs' entry altogether, it may lead the CLECs to enter at a lower scale, with higher prices, or reduced service offerings. Either way, the CLECs will become less of a competitive threat to both ILECs.

70. These cross-region effects can arise for several reasons. First, even if the multiple local markets are distinct, there may be common research, product development, supporting software development, and promotional costs for a CLEC entrant.⁵⁷ In deciding whether to enter the business at all, a potential carrier will evaluate its overall expected profits for entry. Thus, the potential entrant would take the sum of its expected market-specific profits across all of the areas into which it is contemplating entering and compare this sum with the development and other common costs. If the market-specific profits sum to less than the required return on their capital and common costs, then entry will be unattractive. Thus, an ILEC's actions that reduce the profitability of entry in one region can lower the likelihood of entry in all regions.

71. Exclusionary actions also may reduce the speed with which a CLEC finds it profitable to enter or the extent to which a CLEC finds it profitable to make investments that improve its service quality. Suppose that the exclusion reduces the potential customer base in the first region for a CLEC. That lower potential customer base means that its rate of return on investments will be lowered. For example, suppose that a contemplated investment in product quality would allow a CLEC to increase the number of people that would be attracted to its service. If its potential customer base is reduced by exclusionary conduct in the first region, then fewer new customers can be obtained and it

⁵⁷ For example, SBC itself emphasizes in its filing that there are significant development and roll-out costs for local entry that can be spread across markets if an entrant pursues a

would earn a lower return on that investment. As a result, the investment may not earn a large enough return to justify undertaking it. In that case, potential new customers in the second region also would be denied the quality improvement, so the CLEC would not be able to expand there either. Thus, the ILEC in the second region will gain from the exclusionary conduct of the ILEC in the first region.

72. There also may be economies of scope associated with offering service in multiple local markets that affect variable costs (*e.g.*, reduced costs of obtaining certain pieces of equipment whose use varies with the number of subscribers or calling volume). In this case, exclusion that reduces the entrant's volume in one market increases the entrant's variable costs in the other markets in which it is competing.

3. Exclusion of rival CSCs

73. Exclusionary access policy by one ILEC directed towards CSCs can weaken them across other regions for the reasons identified for both IXCs and CLECs above. First, as with IXCs, a CSC may need terminating access from multiple ILECs. Second, a CSC may be offering advanced services that are subject to service-specific network effects (*i.e.*, each service derives value from the fact that it is offered in a lot of places and allows many end users to communicate with one another). Exclusionary tactics in one region can weaken a CSC's ability to sell its entire suite of combined services in other regions

multi-market strategy. See Affidavit of James S. Kahan, July 20, 1998.

by reducing customers' perceived quality of the advanced services that are included in that suite. These effects arise when on-net features do not extend to off-net communications. Third, as with CLECs, even if the multiple local markets are distinct, there may be common fixed costs across markets, joint investment decisions, or other sources of economies of scope.

74. Sprint ION is an example of a combined service that exhibits such multi-market dependence. Denying appropriate collocation, integration of OSS, and other tactics will weaken Sprint's ability to offer its ION suite of combined services. The full roll-out of Sprint ION will trigger the need to spend hundreds of millions of dollars for billing systems and other software platforms, centralized databases, centralized network engineering and monitoring facilities, and national advertising.⁵⁸ For example, just the software to run the Sprint Service Nodes has an estimated cost of \$100 million.⁵⁹ Multi-market effects also arise because Sprint will have to bear higher costs to carry traffic for which one end is forced to either originate or terminate off of the Sprint ION network as a result of SBC exclusionary conduct.⁶⁰

⁵⁸ These common costs are discussed in much greater detail in the Affidavit of Gene Agee, October 14, 1998 ("*Agee Affidavit*") at 7-9.

⁵⁹ *Agee Affidavit* at 8.

⁶⁰ These costs arise from the need to translate the transmission. See *Agee Affidavit* at 12.

C. Graphical Analysis

75. The incentives to pursue such a vertical foreclosure strategy—and the ways in which the merger increase the incentives to exclude—can be illustrated graphically. The impact of the merger in internalizing anticompetitive spillovers is illustrated in Figure 1. The top diagram shows the profitability to ILEC 1 in its downstream market from increasing the effective cost of competing CLECs, IXCs or CSCs. Profits are maximized when ILEC 1's marginal benefits of exclusion equal the marginal costs. Non-price exclusionary access conduct is costly to the ILEC in terms of the likelihood of being interdicted and penalized by the regulators, the resource costs of avoiding detection, and the possible efficiency losses in the ILEC's own operation caused by foreclosing rivals. Absent a merger, ILEC 1 will choose to set rivals' access cost at the level at which its profits are maximized (point C* in the diagram).

76. The middle panel shows the spillover profits achieved by ILEC 2 when ILEC 1 increases the terminating access costs (or degrades the access quality) of carriers that compete with ILEC 2. ILEC 2's profits rise from the increase in its rivals' access costs because ILEC 2 becomes more attractive to consumers relative to its disadvantaged rivals and because ILEC 2 does not share in the costs of exclusion carried out by ILEC 1.⁶¹ Before the merger, ILEC 1 would ignore these anticompetitive benefits to ILEC 2.

⁶¹ This figure reflects the fact that state regulators in one state are unlikely to bring sanctions against SBC for exclusionary conduct towards CLECs or CSCs in another state.

However, after the merger, ILEC 1 would take the profit spillover to ILEC 2 into account in deciding the level of costs to inflict on competitors. The bottom panel shows the combined profits of ILEC 1 and ILEC 2 as a function of the discriminatory treatment of competitors in Region 1. Joint profits reach a maximum at a higher cost level (C^{**} in the diagram) than before the merger. This is because the benefits to ILEC 2 are taken into account by the merged entity, whereas they were not before the merger.

77. The merger will increase SBC and Ameritech's incentives and ability to exclude rivals. If rivals require the inputs from multiple ILECs in order to compete effectively, then the merger of two ILECs increases the incentives to foreclose access to interconnection and access inputs, by allowing each ILEC to "internalize" the benefit it gives to the other ILEC by foreclosing access. This overcomes a coordination problem that two independent ILECs would otherwise have.

78. This graphical analysis illustrates how a merger between two ILECs increases the incentives of each ILEC to pursue an exclusionary access policy. Thus, we would expect that a merger would lead the ILECs to attempt a greater degree of exclusion than they each would attempt independently before the merger. Coupled with the fact that their ability to exclude also increases, the conclusion is clear: A merger between SBC and Ameritech would increase the magnitude of the exclusionary access problem and thereby harm consumers and competition.

D. Quantifying the Impact of the Merger on SBC and Ameritech's Incentives to Exclude

79. In this part we analyze the magnitude of these anticompetitive spillovers. The effect of the merger on internalizing these spillovers can be gauged by extending the analysis of the *relative-margin* and *price-increase incentives* discussed earlier. We illustrate the methodology by extending the *relative-margin incentive*. This incentive is based on the assumption that an ILEC benefiting from exclusionary conduct reacts to the weakening of competition by holding its retail service prices constant and increasing its retail output levels.

80. Suppose that ILEC 1 is choosing its level of exclusionary behavior before the merger. ILEC 1 balances the value of these increased retail sales against the foregone profits from lost sales of access services to other carriers. Recall from our earlier analysis that ILEC 1 earns expected net benefits from exclusionary behavior d equal to

$$\Delta Q^r(d) \times m^r - \Delta Q^a(d) \times m^a - S(d). \quad (\text{eqn. 5})$$

81. Now consider ILEC 2, which is affected by competitive spillovers from ILEC 1's exclusionary behavior. Suppose that these spillovers permit ILEC 2 to increase its retail output by $\sigma \times \Delta Q^r(d)$ units. Suppose also that ILEC 2's sales of access services to other carriers fall by $\sigma \times \Delta Q^a(d)$ as the result of the exclusionary behavior by ILEC 1. In this case, the change in ILEC 2's profits is

$$\sigma \times \{ \Delta Q^r(d) \times m^r - \Delta Q^a(d) \times m^a \}. \quad (\text{eqn. 6})$$

82. In choosing how much exclusionary conduct to undertake in ILEC 1's region, the

merged entity would aggregate the effects in both Equations (5) and (6). Assuming that the retail and access margins are identical in both geographic markets, the total gain would be

$$(1-\sigma) \times \{ \Delta Q^r(d) \times m^r - \Delta Q^a(d) \times m^a \} - S(d) \quad .^{62} \quad (\text{eqn. 7})$$

The merged entity's gross incentives to engage in exclusionary conduct—which are balanced against the threat of regulatory sanctions—are 100σ percent larger than those of the independent ILEC 1 before the merger. A similar analysis can be carried out with respect to the incentives to engage in exclusionary conduct in ILEC 2's region.

83. The magnitude of the spillover parameter σ depends on the target and the type of exclusionary access conduct undertaken by the ILECs. With respect to CLEC entry, exclusionary conduct by one ILEC can benefit the other ILECs in a number of ways. For example, because of shared development, roll-out, and upgrade costs and because of other economies of scope, exclusionary conduct that deters entry and expansion in one region can lead to a comparable degree of deterrence in the other region by reducing the overall profitability of a CLEC's multi-market entry or expansion strategy, with the result that the CLEC is either slowed or deterred from entering the other region. This type of deterrence could suggest a spillover rate of around unity for each of the merging ILECs, if

⁶² A similar incremental net benefit can be derived with respect to the increased-price incentives. In principle, it is also possible to mix the incentives. The benefit to the one ILEC could involve increased output whereas the benefits to the other ILEC could involve

the expected sales of the CLEC entrants were the same in both regions and the exclusion deterred entry or expansion in both regions.⁶³ In this case, the merger would double the gross incentive to exclude rivals.

84. More extreme values of σ also could arise from this type of entry deterrence. For example, suppose that exclusionary conduct in one region reduces the number of CLEC subscribers in that region by a small amount and that there are shared development costs that must be recovered from product sales in both regions. On the one hand, this could lead to no deterrence effects in the other region at all, if the economics of entry in the other region remain profitable, in which case σ would equal zero. On the other hand, a small reduction in the number of subscribers in the first region could tip the profitability of entry in the other region to be negative and thus deter entry altogether in that second region. In that case, σ would be very large.

85. Similar considerations arise when the targets of the exclusionary conduct are CSCs. In the case of CSCs, there also is an interexchange component, which creates another mechanism for spillovers. Moreover, when on-net features do not extend to off-net communications at equal cost, exclusionary tactics in one region can weaken a CSC's ability to sell its suite of combined services in other regions by raising the CSC's costs

higher prices.

⁶³ If the CLECs would get more customers in the second ILEC's region absent the exclusion, say because that region is larger, then the σ would exceed unity. If the second

and/or reducing customers' perceived quality of its service suite. These effects would tend to increase the value of σ .

86. Exclusionary conduct directed at plain vanilla IXCs also can have a spillover effect. As discussed earlier, exclusionary conduct by SBC against IXCs in its region will raise their costs. This will disadvantage those IXCs in competing against Ameritech for interexchange customers in its region. In this case, σ would depend on the fraction of the interexchange traffic of Ameritech's rivals that flows from Ameritech's region to SBCs.⁶⁴

VI. THE SBC-AMERITECH MERGER WILL WEAKEN REGULATORS' ABILITY TO LIMIT EXCLUSIONARY CONDUCT BY OTHER ILECS

87. The proposed merger's impact on SBC and Ameritech's incentives to engage in exclusionary behavior can have harmful effects on competition and consumer welfare that go beyond the combined region of the two merging carriers. These broader effects can arise because the Commission and state regulators may rely on inter-firm comparisons to limit the exercise of ILEC market power in the provision of access. The proposed merger would weaken the ability of regulators to use benchmarking to ensure appropriate access arrangements. 87. As already discussed, the proposed merger would eliminate

region were smaller, then the σ would be less than unity.

⁶⁴ It is our understanding that 16.8 percent of all Sprint interexchange minutes that originate in Ameritech's region terminate in SBC's region.

Ameritech as a benchmark for SBC and vice versa. By reducing the number of benchmarks, the efficacy of the benchmarking process is reduced. This loss of benchmarks will be exacerbated if the Bell Atlantic/Nynex acquisition of GTE is permitted to proceed. Indeed, if there are few enough major ILECs remaining, they may have the incentives and ability to reach a tacit understanding to reduce their cooperation with rival carriers, so that no ILEC serves as a useful competitive benchmark.

88. The fact that the merger enhances SBC and Ameritech's joint incentives to carry out exclusionary access policies creates an additional benchmarking problem.⁶⁵ Suppose that the Commission were to approve the merger and then relied on SBC's conduct as a benchmark against which to grade other ILECs' access policies. Because, as discussed above, the merger would increase SBC's unilateral incentive to discriminate against rivals, the merged entity can be expected to offer less competitive access arrangements. After the merger, SBC and Ameritech's conduct will not reflect best practice, but rather the outcome of a more discriminating ILEC than before the merger. Hence, this conduct will become a less useful basis of comparison in assessing the competitiveness of other ILECs' access conduct. That is, if the other ILECs follow the same practices as SBC, that conduct does not imply that they are acting competitively, since SBC has an

⁶⁵ A variety of benchmarking issues are discussed in detail in the Declaration of Joseph Farrell and Bridger M. Mitchell, "Benchmarking and the Effects of ILEC Mergers," October 14, 1998. Our focus here is on how the proposed merger would reduce the value of benchmarks based on the post-merger conduct of SBC and Ameritech.

enhanced incentive to exclude. The best benchmark is a firm with no incentives to exclude, not the opposite.

89. By reducing the value of SBC and Ameritech as competitive benchmarks, the overall anticompetitive effects of the merger will be enhanced beyond the SBC-Ameritech regions. Not only will SBC and Ameritech increase their magnitude of exclusionary conduct, the loss of the benchmarks also will permit other ILECs such as Bell Atlantic/Nynex to increase the magnitude of their exclusionary conduct as well.^{66, 67}

VII. CONCLUSION

90. One response to the increased threat of discrimination and foreclosure from the proposed merger might be to increase regulatory oversight. However, regulatory authorities are unable to prevent this discrimination and foreclosure very effectively. First, as discussed earlier, regulation is imperfect at detecting and correcting such conduct, particularly for new and innovative forms of access. Second, the potential for continued consolidation of the large ILECs will further reduce regulators' ability to

⁶⁶ When Bell Atlantic/Nynex chooses the magnitude of its profit-maximizing exclusionary conduct, it will have the incentive to take into account the likelihood that it is sanctioned by regulators. That likelihood is reduced if SBC and Ameritech merge since its post-merger incentives to exclude are increased. Thus, Bell Atlantic/Nynex will have an increased incentive to exclude because the SBC/Ameritech merger decreases Bell Atlantic/Nynex's risk of a sanction.

⁶⁷ Of course, this effect flows both ways. If the proposed merger of Bell Atlantic and GTE is permitted to proceed, the adverse effects of SBC's proposed merger with Ameritech will be magnified by the loss of Bell Atlantic and GTE as independent benchmarks for

exercise effective oversight. For example, if their merger is approved, Bell Atlantic and GTE also would be lost as independent benchmarks for SBC and Ameritech. Third, because a merged firm becomes a poor competitive benchmark, the anticompetitive effects of each merger extend beyond its region into other regions.

91. If it is allowed to proceed, the proposed merger of SBC and Ameritech will increase the incidence of exclusionary conduct and regulation will be unable to prevent it. The result will be to hinder the development of local competition and to slow the introduction of innovative new services for both local and long distance. For these reasons, the proposed merger of SBC and Ameritech poses a threat to the public interest.

VIII. APPENDIX

92. In this appendix, we provide details of the calculations underlying the access market and retail market margins presented in the text of Part IV.B.3.⁶⁸

A. The Access Margin⁶⁹

93. Given the CSC's business model described in the text, the (operating) margin per customer earned by the ILEC in the access market is the price of an unbundled loop less

SBC and others.

⁶⁸ In the footnotes, we relate our assumptions to rough estimates of the corresponding figures for actual carriers. These estimates are intended solely to demonstrate that the figures in the hypothetical example are plausible.

⁶⁹ As discussed in the text, we find it clearer to explain the exclusion scenario by including the profits from terminating access in the retail margin. This choice of labeling does not

its cost. We assume that the price is \$14.50.⁷⁰ and the long-run incremental cost is \$12.00.⁷¹ Thus, in its capacity as a wholesaler of loops, our hypothetical ILEC stands to lose \$2.50 per month in the long run when the CSC purchases one fewer unbundled loop from the ILEC. In the light of the fact that loop costs are largely sunk in the short run, short-run marginal costs are close to zero, and the short-run access margin is close to the wholesale price of \$14.50. The charge for collocation in a given central office is assumed to be insensitive to the number of customers and their usage levels, and thus it is not affected by ILEC exclusionary actions that slow the growth of the CSC but do not fully deter it.

B. The Retail Margin

94. Current prices of the individual elements of combined service sold to a single-line business customer include: the monthly fee for local service and usage charges for local

affect our conclusions.

⁷⁰ Taking a weighted average of the default proxy ceilings set by the FCC in its Local Competition Order, (*In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket No. 96-98, *First Report and Order*, released August 8, 1996, Appendix D) with the number of single-line business lines taken from Hatfield Model version 5.0a (*The Hatfield Model*, Hatfield Associates Inc., Boulder, Colorado, January 27, 1998) used as the weighting factor, one obtains an estimated wholesale price of unbundled loops of \$14.22.

⁷¹ This is the estimated cost of an unbundled loop obtained by taking a weighted average of the Hatfield Model estimates for 49 states, using single-line businesses as the weighting factor.

calls (assumed to be \$32.00⁷²); the Subscriber Line Charge (assumed to be \$3.50⁷³); usage charges for long distance calls (assumed to average \$46.50 per month⁷⁴), and terminating access on long distance calls originating out of region (assumed to be \$7.50⁷⁵). Summing

⁷² In 1996, the national average monthly rate for a single line business for local service, including the cost of 200 messages per month if flat rates were not available, was \$32.54 (Federal Communications Commission, *Statistics of Common Carriers, 1996*, (SOCC) at Table 8.5).

⁷³ In 1996, the average single-line business Subscriber Line Charge was \$3.56. (SOCC at Table 8.5).

⁷⁴ This hypothetical figure can be compared with actual data. InterLATA and intraLATA revenues are separately estimated as follows. (1) InterLATA Revenues. Total (interstate plus intrastate) InterLATA originating and terminating billed access minutes are obtained from Table 2-6, 1996 SOCC, and divided by 2 to obtain long distance minutes. The number of business, public payphone, and residential lines was obtained from Table 2-5, 1996 SOCC. The long distance minutes were apportioned to business and residential customers so that the average business line (defined to include single-line and multiline businesses and public payphones) had twice as many interLATA minutes per line per month as the average residential line. (Bridger Mitchell, *Incremental Costs of Telephone Access and Local Use*, Rand Report R-3909-ICTF, RAND Corporation, Santa Monica, at 53, cites evidence that business long distance use per line is twice residential use.) Finally, the monthly minutes of use per business line was multiplied by \$0.116, the average revenue per minute for direct dialed interstate calls (*Trends in Telephone Service*, Federal Communications Commission, Released January, 1998, Table 14.3) to obtain interLATA revenue per line of \$28.15. (2) IntraLATA Revenues. Mitchell's study (*op cit*) of California customers contained data on intraLATA revenues per line for business and residential customers. His data showed that single-line business customers had average intraLATA toll bills of \$18.50, for 103 minutes of use, and an average revenue per minute of \$0.18.

⁷⁵ The number of actual interstate toll minutes originating outside SBC's region were obtained from the Hatfield Model 5.0a and multiplied by the fraction of SBC's terminating minutes that originate outside SBC's region (Source: Sprint proprietary data). These minutes are then apportioned to single business lines, assuming as before that businesses have twice the usage per line as residential users do. The number of business and residential lines is obtained from the Hatfield Model. The revenue is obtained by multiplying these business minutes by an access charge of \$0.03 per minute. (*1997 Monitoring Report*, Federal-State Joint Board, Table 5-12, access charge per conversation minute divided by 2). This procedure yields an estimate of \$7.34 per month per line.

these revenue components, the hypothetical ILEC earns an average of \$89.50 per month per customer purchasing its local and long distance services.⁷⁶

95. To compute the retail margin, we subtract costs from revenues. The ILEC's costs of providing combined service include: the network cost per line of local service, local calling, and access to long distance POPs (assumed to be \$16.50⁷⁷), the cost of customer service (assumed to be \$8.00 per line⁷⁸), the cost of long distance calls (assumed to be \$7.00⁷⁹) and the cost of terminating calls from the ILEC's long distance subscribers to subscribers served by other interexchange access providers (assumed to be \$6.00⁸⁰). The

⁷⁶ This number is likely to understate the actual average revenues that an ILEC would earn because it ignores revenues from vertical services.

⁷⁷ This figure can be compared with the long-run incremental cost of local exchange and exchange access service reported in the default runs of the Hatfield Model. The model reports the cost per line of the unbundled network elements required to provide local exchange and exchange access service for the 50 states. The (single-business line) weighted average of this cost across 49 states and Washington D.C. is \$16.34 per line, per month. The computed costs included the cost of a network connection, local usage and access to an IXC's POP.

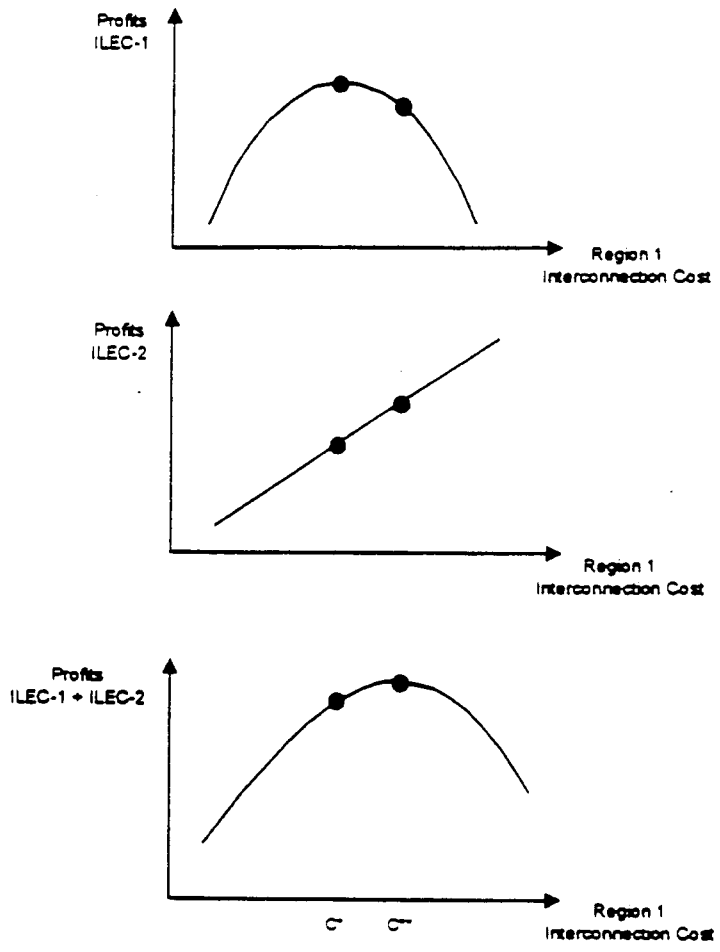
⁷⁸ The Commission estimated that the avoided costs of an ILEC that loses a customer to a reseller of local service is 17-25 percent of the retail price. (*Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket Number 96-98, rel. August 6, 1998, at ¶933). Applying these percentages to the average retail price of local service, we obtain customer care costs of \$5.53 to \$8.14 per line per month.

⁷⁹ The average cost of long-distance service for an actual ILEC can be estimated by multiplying total long distance minutes used to calculate long distance revenue by \$0.02 per minute (*i.e.*, 350 minutes x \$0.02 = \$7.00). The unit cost was obtained from Robert Crandall and Leonard Waverman, *Talk is Cheap*, Brookings, 1996, at 92.

⁸⁰ ILECs' actual average costs of purchasing terminating access from other networks can be estimated using a process similar to that used to compute ILEC's terminating revenue above. The resulting figure is \$5.89 per line per month.

total costs of providing local and long-distance services combined service in our hypothetical example is thus \$37.50 per month, per single line business subscriber. The resulting retail margin is $\$52.00 = \$89.50 - \$37.50$.

FIGURE 1: EFFECT OF MERGER ON INCENTIVES



IX. EXHIBIT 1: CURRICULUM VITAE OF MICHAEL L. KATZ

ADDRESS

The Tilden Group, LLC
5335 College Avenue
Oakland, CA 94618

EMPLOYMENT

July 1987 to present **Arnold Professor of Business Administration**
Director, Center for Telecommunications and Digital Convergence
University of California at Berkeley

Joint appointment in the Economics Department and School of Business. Initial appointment as an associate professor July 1987. Promoted to full professor July 1989. Granted an endowed chair July 1995. Research on competitive strategy in systems markets, strategic standard setting, vertical integration, strategic alliances, and cooperative research and development. Chaired Strategic Planning Committee, Policy and Planning Committee, and the Economic Analysis and Policy Group. Teach MBA courses in business strategy and microeconomics, and doctoral courses in accounting and microeconomics. Author of economics textbook.

January 1994 to **Chief Economist**

January 1996 **Federal Communications Commission**

Responsible for integrating economic analysis into all aspects of Commission policy making. Reported directly to the Chairman of the Commission. Formulated and implemented regulatory policies for all industries under Commission jurisdiction, including cable and broadcast television, and local, long distance, and wireless telephony. Managed teams of lawyers and economists to design regulatory policies and procedures. Significantly strengthened Commission's ability to gather industry data and conduct empirical studies. Extensive public speaking to specialist and general audiences in the United States and abroad.

July 1981 to **Assistant Professor of Economics**

June 1987 **Princeton University**

Research on sophisticated pricing, standards development, cooperative R&D, and intellectual property licensing. Served as Assistant Director of Graduate Studies. Taught courses in microeconomics, industrial organization, and antitrust and regulation to undergraduate and doctoral students.

EDUCATION

D.Phil. 1982

Oxford University

Doctorate in Economics. Thesis on market segmentation and sophisticated pricing strategies.

A.B. *summa cum laude* 1978

Harvard University

As an undergraduate, completed all courses and general examinations for doctorate in economics.

AWARDS AND HONORS

Chairman's Special Achievement Award, Federal Communications Commission, 1996.

The Earl F. Cheit Outstanding Teaching Award, Berkeley, 1992-1993 and 1988-1989. Honorable Mention, 1996-1997.

Alfred P. Sloan Research Fellow, 1985-1988.

National Science Foundation Graduate Fellow, 1978-1981.

John H. Williams Prize (awarded to the Harvard College student graduating in Economics with the best overall record), 1978.

National Merit Scholar, 1975-1976.

GRANTS

Berkeley Committee on Research Grant, 1996-1997.

Berkeley Program in Finance Research Grant, 1990.

Researcher, Pew Foundation grant: "Integrating Economics and National Security," 1987-1990.

Principal Investigator, National Science Foundation grants:

"A More Complete View of Incomplete Contracts," joint with Benjamin E. Hermalin, 1991-1993.

"Game-Playing Agents and the Use of Contracts as Precommitments," 1988-1989.

"The Analysis of Intermediate Goods Markets: Self-Supply and Demand Interdependence," 1985-1986.

"Imperfectly Competitive Models of Screening and Product Compatibility," 1983-1984.

"Screening and Imperfect Competition Among Multiproduct Firms," 1982.

PROFESSIONAL ACTIVITY

Coeditor of *Journal of Economics and Management Strategy*.

PUBLICATIONS

- "Multiplant Monopoly in a Spatial Market," *Bell Journal of Economics* Vol. 11, No. 2 (Autumn 1980).
- "Non-uniform Pricing, Output and Welfare Under Monopoly," *Review of Economic Studies* Vol. L, No. 160 (January 1983).
- "A General Analysis of the Averch-Johnson Effect," *Economic Letters* Vol. 11, No. 3 (1983).
- "The Socialization of Commodities," co-authored with L.S. Wilson, *Journal of Public Economics* Vol. 20, No. 3 (April 1983).
- "The Case for Freeing AT&T," co-authored with Robert D. Willig, *Regulation* (July/August 1983) and "Reply to Tobin and Wohlstetter," *Regulation* (November/December 1983).
- "Plea Bargaining and Social Welfare," co-authored with Gene M. Grossman, *American Economic Review* Vol. 73, No. 4 (September 1983).
- "Firm-Specific Differentiation and Competition Among Multiproduct Firms," *Journal of Business* Vol. 57, No. 1, Part 2 (January 1984).
- "Nonuniform Pricing with Unobservable Numbers of Purchases," *Review of Economic Studies* Vol. LI (July 1984).
- "Price Discrimination and Monopolistic Competition," *Econometrica* Vol. 52, No. 6 (November 1984).
- "Tax Analysis in an Oligopoly Model," co-authored with Harvey S. Rosen, *Public Finance Quarterly* Vol. 13, No. 1 (January 1985).
- "Network Externalities, Competition, and Compatibility," co-authored with Carl Shapiro, *American Economic Review* Vol. 75, No. 3 (June 1985).
- "On the Licensing of Innovations," co-authored with Carl Shapiro, *Rand Journal of Economics* Vol. 16, No. 4 (Winter 1985).
- "Consumer Shopping Behavior in the Retail Coffee Market," co-authored with Carl Shapiro, in *Empirical Approaches to Consumer Protection* (1986).
- "Technology Adoption in the Presence of Network Externalities," co-authored with Carl Shapiro, *Journal of Political Economy* Vol. 94, No. 4 (August 1986).
- "How to License Intangible Property," co-authored with Carl Shapiro, *Quarterly Journal of Economics* Vol. CI (August 1986).

- "An Analysis of Cooperative Research and Development," *Rand Journal of Economics* Vol. 17, No. 4 (Winter 1986).
- "Product Compatibility Choice in a Market with Technological Progress," co-authored with Carl Shapiro, *Oxford Economic Papers: Special Issue on Industrial Organization* (November 1986).
- "The Welfare Effects of Third-Degree Price Discrimination in Intermediate Goods Markets," *American Economic Review* Vol. 77, No. 2 (March 1987).
- "R&D Rivalry with Licensing or Imitation," co-authored with Carl Shapiro, *American Economic Review* Vol. 77, No. 3 (June 1987).
- "Pricing Publicly Provided Goods and Services," in *The Theory of Taxation for Developing Countries*, D.M. Newbery and N.H. Stern (eds.), Washington, D.C.: World Bank (1987).
- "Vertical Contractual Relationships," in *The Handbook of Industrial Organization*, R. Schmalensee and R.D. Willig (eds.), Amsterdam: North Holland Publishing (1989).
- "R&D Cooperation and Competition," co-authored with Janusz A. Ordover, *Brookings Papers on Economic Activity: Microeconomics* (1990).
- Intermediate Microeconomics*, co-authored with Harvey S. Rosen, Burr Ridge, IL: Richard D. Irwin (1st ed. 1991, 2nd ed. 1994, 3rd ed. 1997).
- "Game-Playing Agents: Unobservable Contracts as Precommitments," *Rand Journal of Economics* Vol. 22, No. 3 (Autumn 1991).
- "Moral Hazard and Verifiability: The Effects of Renegotiation in Agency," co-authored with Benjamin E. Hermalin, *Econometrica* Vol. 59, No. 6 (November 1991).
- "Product Introduction with Network Externalities," co-authored with Carl Shapiro, *Journal of Industrial Economics* Vol. XL, No. 1 (March 1992).
- "Defense Procurement with Unverifiable Performance," co-authored with Benjamin E. Hermalin, in *Incentives in Procurement Contracting*, J. Leitzel and J. Tirole (eds.), Boulder, Colorado: Westview Press (1993).
- "Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach," co-authored with Benjamin E. Hermalin, *Journal of Law, Economics, & Organization* Vol. 9, No. 2 (1993).
- "Systems Competition and Network Effects," co-authored with Carl Shapiro, *Journal of Economic Perspectives* Vol. 8, No. 2 (Spring 1994).

- "Joint Ventures as a Means of Assembling Complementary Inputs," *Group Decision and Negotiation* Vol. 4, No. 5 (September 1995). Also printed in *International Joint Ventures: Economic and Organizational Perspectives*.
- "Interconnecting Interoperable Systems: The Regulator's Perspective," co-authored with Gregory Rosston and Jeffrey Anspacher, *Information, Infrastructure and Policy*, Vol. 4, No. 4 (1995).
- "Interview with an Umpire," in *The Emerging World of Wireless Communications*, Annual Review of the Institute for Information Studies (1996).
- "An Analysis of Out-of-Wedlock Childbearing in the United States," co-authored with George Akerlof and Janet Yellen, *Quarterly Journal of Economics*, Vol. 111, No. 2 (May 1996).
- "Remarks on the Economic Implications of Convergence" *Industrial and Corporate Change*, Vol. 5, No. 4 (1996).
- "Regulation to Promote Competition: A first look at the FCC's implementation of the local competition provisions of the telecommunications act of 1996," co-authored with Gerald W. Brock, *Information Economics and Policy*, Vol. 9, No. 2 (1997).
- "Ongoing Reform of U.S. Telecommunications Policy," *European Economic Review*, Vol. 41 (1997).
- "Economic Efficiency, Public Policy, and the Pricing of Network Interconnection Under the Telecommunications Act of 1996," in *Interconnection and the Internet: Selected Papers from the 1996 Telecommunications Policy Research Conference*, G. Rosston and D. Waterman (eds.), Mahwah, New Jersey: Lawrence Erlbaum Associates, Publishers (1997).
- "Introduction: Convergence, Competition, and Regulation," co-authored with Glenn A. Woroch, *Industrial and Corporate Change*, Vol. 6, No. 4 (1997).
- "Public Policy and Private Investment in Advanced Telecommunications Infrastructure," co-authored with Joseph Farrell, *IEEE Communications Magazine* (July 1998).
- "Antitrust in Software Markets," co-authored with Carl Shapiro, Progress & Freedom Foundation conference volume (forthcoming).
- "The Effects of Antitrust and Intellectual Property Law on Compatibility and Innovation," co-authored with Joseph Farrell, *The Antitrust Bulletin* (forthcoming).

X. EXHIBIT 2: CURRICULUM VITAE OF STEVEN C. SALOP

ADDRESS Georgetown University Law Center Telephone: (202) 662-9095
600 New Jersey Ave., N.W.
Washington, D.C. 20001

PERSONAL Born, December 23, 1946; Married, three children; U.S. Citizen

FIELDS OF SPECIALIZATION

Industrial Organization, Competition and Antitrust Policy, Economics of Information, Law and Economics.

DEGREES Ph.D. Economics, Yale University, 1972
M. Phil. Economics, Yale University, 1972
B.A. University of Pennsylvania, 1968

AWARDS Summa Cum Laude, with Honors in Economics, University of Pennsylvania, 1968; Schoenbaum Prize in Economics, University of Pennsylvania, 1968; NSF Graduate Fellowship, 1968-72; Phi Beta Kappa, 1968.

EMPLOYMENT EXPERIENCE

Professor of Economics and Law, Georgetown University Law Center, 1982 - Present.

Guest Scholar, Brookings Institution, 1990-1991.

Visiting Professor, Massachusetts Institute of Technology, Spring 1986.

Visiting Interdisciplinary Professor, Georgetown University Law Center, July 1981-June 1982.

Associate Director for Special Projects, Bureau of Economics, Federal Trade Commission, January 1980-June 1981.

Assistant Director for Industry Analysis, Bureau of Economics, Federal Trade Commission, September 1979-January 1980.

Deputy Assistant Director for Consumer Protection, Bureau of Economics, Federal Trade Commission, December 1978-September 1979.

Economist, Division of Consumer Protection, Bureau of Economics, Federal Trade Commission, July 1978-December 1978.

Economist, Office of Economic Analysis, Civil Aeronautics Board, September 1977-July 1978.

Economist, Federal Reserve Board, July 1972-September 1977.

Adjunct Professor, Department of Economics, University of Pennsylvania, September 1977-June 1978.

Adjunct Professor, Department of Economics, George Washington University, September 1975-January 1978.

PROFESSIONAL ACTIVITIES

Advisory Committee, FTC Hearings on Global and Innovation-Based Competition (1996).

Associate Editor (Industrial Organization), *Journal of Economic Perspectives* (1987-1993).

ABA Antitrust Task Force on Second Requests (1990).

Advisory Board, Georgetown Project on Treble Damages (1986-1987).

Associate Editor, *Journal of Industrial Economics* (1983-1988).

Associate Editor, *International Journal of Industrial Organization* (1984-1989).

Secretary, Antitrust Section, American Association of Law Schools (1983-1984).

Memberships: American Economic Association, American Bar Association, Phi Beta Kappa.

Nominating Committee: American Economic Association, 1982.

Economics Editorial Advisor, *Journal of Consumer Research*, 1982.

OTHER ACTIVITIES

Board of Directors, Charles River Associates Incorporated.

Management Advisory Committee, La Leche League International.

Board of Trustees, The Lowell School (1989-1995).

HONORS AND AWARDS

NSF Graduate Fellowship, 1968-1972.

Graduated Summa cum Laude, with Honors in Economics, from the University of Pennsylvania, 1968.

Schoenbaum Prize in Economics, University of Pennsylvania, 1968.

Phi Beta Kappa, 1968.

PUBLICATIONS

Books

Strategy, Predation and Antitrust Analysis. Editor. Federal Trade Commission, 1981.

Consumer Post-Purchase Remedies. With H. Beales et al. Federal Trade Commission Staff Report.

1980.

Consumer Information Remedies. With L. Kantor et al. Federal Trade Commission Staff Report.
1979

Articles

"Decision Theory and Antitrust Rules." With C.F. Beckner III. *Antitrust Law Journal* (Forthcoming)

"You Keep On Knocking But You Can't Come In: Evaluating Restrictions on Access Rules to Input Joint Ventures." With D. Carlton. *Harvard Journal of Law and Technology* (1996)

"Evaluating Vertical Mergers: A Post-Chicago Approach." With M. Riordan. *Antitrust Law Journal* (1995).

"Exclusionary Vertical Restraints: Has Economics Mattered?" *American Economic Review* (May 1992).

"An Economic Analysis of Copyright Collectives." With S. Besen and S. Kirby. *Virginia Law Review* (1991).

"Competition Among Complements, and Intra-Network Competition." With N. Economides. *Journal of Industrial Economics* (1992).

"Rowing Against the Tidewater: A Theory of Voting by Multi-Judge Panels." With D. Post. *Georgetown University of Law Review* (1992).

"Evaluating Network Pricing Self-Regulation." In *Electronic Services Networks: A Business and Public Policy Challenge of Electronic Shared Networks*, edited by Guerin-Calvert and Wildman. (1991).

"Equilibrium Vertical Foreclosure." With J. Ordover and G. Saloner. *American Economic Review* (1990).

"Deregulating Self-Regulated Shared ATM Networks." *Economics of Innovation and New Technology* (1990).

"Monopoly Power and Market Power in Antitrust Law." With T. Krattenmaker and R. Lande. *Georgetown University Law Review* (1987).

"Analyzing Anticompetitive Exclusion." With T. Krattenmaker. *Antitrust Law Journal* (1987).

"Cost-Raising Strategies." With D. Scheffman. *Journal of Industrial Economics* (1987).

"Information, Welfare and Product Diversity." With J. Stiglitz. In *Arrow and the Foundations of the Theory of Economic Policy*, edited by Feiwel et al., (1987).

"Antitrust Analysis of Exclusionary Rights: Raising Rivals' Costs to Gain Power Over Price." With T. Krattenmaker. *Yale Law Journal* (December 1986).

"Competition and Cooperation in the Market for Exclusionary Rights." With T. Krattenmaker. *American Economic Review* (May 1986).

"Private Antitrust Litigation: Introduction and Framework." With L. White. *Georgetown University Law Review* (1986).

"Economics of Private Antitrust Litigation." With L. White. *Antitrust Law Journal* (1986). Reprinted

- by the Senate Judiciary Committee.
- "Quantifying the Competitive Effects of Production Joint Ventures." With T. Bresnahan. *International Journal of Industrial Organization* (1986).
- "Measuring Ease of Entry." *Antitrust Bulletin* (1986).
- "Firm-Specific Information, Product Differentiation and Industry Equilibrium." With J. Perloff. In *Strategic Behavior and Industrial Competition*, edited by Morris et al., (1986).
- "Practices that (Credibly) Facilitate Oligopoly Coordination." In *New Developments in the Analysis of Market Structure*, edited by Stiglitz et al., (1986).
- "Equilibrium with Product Differentiation." With J. Perloff. *Review of Economic Studies* (January 1985).
- "A Practical Guide to Merger Analysis." With J. Simons. *Antitrust Bulletin* (Winter 1984).
- "A Bidding Model of Special Interest Regulation: Raising Rivals' Costs in a Rent-Seeking Society." With D. Scheffman and W. Schwartz. In *The Political Economy of Regulation: Private Interests in the Regulatory Process*, (1984).
- "Judo Economics: Capacity Limitations and Coupon Competition." With J. Gelman. *Bell Journal of Economics* (Autumn 1983).
- "Raising Rivals' Cost." With D. Scheffman. *American Economic Review* (May 1983).
- "Defects in Disneyland: Quality Control as a Two-Part Tariff." With A. Braverman and J.L. Guasch. *Review of Economic Studies* (January 1983).
- "The Theory of Sales: A Simple Model of Equilibrium Price Dispersion with Identical Agents." With J. Stiglitz. *American Economic Review* (December 1982).
- "A Framework for Evaluating Consumer Information Regulation." With H. Beales, M. Mazis, and R. Staelin. *Journal of Marketing* (Winter 1981).
- "Efficient Regulation of Consumer Information." With H. Beales and R. Craswell. *Journal of Law and Economics* (December 1981).
- "Consumer Search and Public Policy." With H. Beales, M. Mazis, and R. Staelin. *Journal of Consumer Research* (June 1981).
- "Information Remedies for Consumer Protection." With H. Beales and R. Craswell. *American Economic Review, Papers and Proceedings* (May 1981).
- "Introduction." In *Strategy, Predation and Antitrust Analysis*, edited by S.C. Salop. Federal Trade Commission, 1981.
- "Strategic Entry Deterrence." *American Economic Review, Papers and Proceedings* (May 1979).
- "Monopolistic Competition with Outside Goods." *Bell Journal* (Spring 1979).
- "A Model of the Natural Rate of Unemployment." *American Economic Review* (March 1979).
- "Alternative Reservations Contracts." Civil Aeronautics Board, 1978.
- "Parables of Information Transmission in Markets." In *The Effect of Information on Consumer and*

Market Behavior, edited by Mitchell. (1978).

"The Noisy Monopolist: Information, Price Dispersion and Price Discrimination." *Review of Economic Studies* (October 1977).

"Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion." With J. Stiglitz. *Review of Economic Studies* (October 1977).

"Self-Selection and Turnover in the Labor Market." With J. Salop. *Quarterly Journal of Economics* (November 1976).

"Information and Monopolistic Competition." *American Economic Review*, Papers and Proceedings (May 1976).

"Wage Differentials in a Dynamic Theory of the Firm." *Journal of Economic Theory* (August 1973)

"Systematic Job Search and Unemployment." *Review of Economic Studies* (April 1973).

Reviews and Comments

"Efficiencies in Dynamic Merger Analysis." Testimony at FTC Hearings on Global and Innovation-Based Competition (November 1995). A slightly revised version has been published as "Efficiencies in Dynamic Merger Analysis: Summary." With G. Roberts. *World Competition* (June 1996).

"Exclusionary Access Rules in Standards and Network Joint Ventures." Testimony at FTC Hearings on Global and Innovation-Based Competition (December 1995).

"Evaluating Vertical Mergers: Reply to Reiffen and Vita Comment." With M. Riordan. *Antitrust Law Journal* (1995).

"More Value for the Legal Dollar: A New Look at Attorney-Client Fees and Relationships." With R. Litan. *Judicature* (1994).

"Kodak as Post-Chicago Law and Economics." *CRA Perspectives*, April 1993. Reprinted in Texas Bar Association, *Antitrust and Business Litigation Bulletin* (November 1993).

"Vertical Foreclosure Without Commitment: Reply to Reiffen." With J. Ordover and G. Saloner. *American Economic Review* (1992).

"Antitrust Goes to College." With L. White. *Journal of Economic Perspectives* (Summer 1991).

"Analysis of Entry in the New Merger Guidelines." Brookings Papers on Economic Activity (1991).

"Mergers and Antitrust." *Journal of Economic Perspectives* (1987).

"Comment on Golbe and White, 'Time Series Analysis of Mergers.'" In Auerbach et al., *Mergers and Acquisitions*, NBER.

"Policy Implications of Conference Papers." In Auerbach et al., *Mergers and Acquisitions*, NBER.

"Evaluating Uncertain Evidence with Sir Thomas Bayes." *Journal of Economic Perspectives* (Summer 1987).

"Implications of the Georgetown Project for Treble Damages Reform." Senate Judiciary Committee, March 21, 1986.

"Policing Deceptive Advertising," Serial No. 97-134, 97th Congress.

"Entry Barriers, Consumer Welfare and Antitrust Reform." In Bock et al., *Antitrust and New Views of Microeconomics*. Conference Board, 1986.

"Buy American, Save Your Job?" In J. Tobin et al., *Macroeconomics, Prices and Quantities*. Brookings Institution, 1983.

"Selling Consumer Information." With H. Beales. In J. Olson et al., *Advances in Consumer Research*, Vol. VII. 1980.

"Comment on R. Schmalensee, 'On the Use of Economic Models in Antitrust.'" In O. Williamson et al., *Antitrust Law and Economics*, 1980.

"Review of K. Lancaster, 'Variety, Equity and Efficiency,'" *Journal of Economic Literature*, 1980

**ADDENDUM TO
DECLARATION OF JOSEPH FARRELL AND BRIDGER M. MITCHELL**

BENCHMARKING AND THE EFFECTS OF ILEC MERGERS

The attached declaration was prepared with respect to the proposed merger of SBC and Ameritech, and was submitted as part of the record of the Federal Communications Commission in that matter. This addendum is submitted to affirm that the economic analysis set forth in the attached declaration applies to the proposed merger of Bell Atlantic and GTE, CC Docket No. 98-184.

**Dr. Joseph Farrell
Dr. Bridger M. Mitchell**

November 23, 1998

BENCHMARKING AND THE EFFECTS OF ILEC MERGERS

**DECLARATION OF
JOSEPH FARRELL AND BRIDGER M. MITCHELL**

October 14, 1998

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Benchmarking and the Effects of ILEC Mergers

**Declaration of
Joseph Farrell and Bridger M. Mitchell**

Executive Summary. We discuss the role of comparative information, benchmarking, and relative-performance schemes, both in traditional telecommunications regulatory activities (including support of universal service) and in the active promotion of competition called for in the Telecommunications Act of 1996. As has been widely recognized in the United States and internationally, benchmarking is a powerful and beneficial tool in a wide variety of such contexts. We discuss average-practice benchmarking (as for price caps and high-cost support), best-practice benchmarking (as for number portability and interconnection), and heightened scrutiny of worst practices (as for interconnection and access reform). Mergers among large ILECs significantly weaken the power and effectiveness of benchmarking.

I. The Value of Benchmarking

Until facilities-based competition is widespread, regulators will be called upon to regulate Incumbent Local Exchange Carriers (ILECs). Benchmarking, also known as yardstick competition, or relative-performance evaluation, is a very valuable regulatory tool because it helps regulators, customers, and nascent competitors become better informed about incumbents' capabilities. This can enable society to achieve some of the benefits of competition even before workable market competition exists. In this report, we explain how the practice of benchmarking can and does work in U.S. telecommunications, and why the ability to compare the performance or behavior of large ILECs is therefore valuable and not lightly to be sacrificed.

A. The Fundamental Information Disadvantage

The modern economic analysis of regulation¹ starts from the view, which is wholly consistent with our own experience in telecommunications regulation, that regulators generally have much less accurate and less complete information about the opportunities and constraints facing a regulated firm than does the firm itself.

For example, the firm is likely to be much better informed than regulators about its economic costs (and perhaps even its accounting costs) and the extent to which the firm might be able to reduce those costs if given sufficient incentives to do so. The same is true of other aspects of performance, such as measurable service quality or delivery intervals. The firm will

¹ See, for example, David P. Baron, "Design of Regulatory Mechanisms and Institutions," p. 1347, in R. Schmalensee and R. Willig, eds., *Handbook of Industrial Organization*, Volume 2, p. 1347-1447, (Amsterdam: Elsevier Science Publishers), 1989.

also be better informed about “softer” qualitative indicators, such as the level and types of access to unbundled network elements, provisioning and ordering practices, and harder-to-measure quality characteristics of services. Most especially, a single regulated firm is likely to be far better informed than its regulators about the opportunities for innovation.

Modern economic analysis traces much, if not all, of the problems of efficient regulation to this fundamental information disadvantage. If regulators knew what the firm could, and could not, accomplish with efficient effort, they could design an incentive system that simultaneously brings prices close to costs and also creates efficient incentives for the firm.² Because the regulator is imperfectly informed, however, its efforts to control the firm’s pricing almost inevitably conflict with creating incentives for efficient behavior. Regulation in the public interest is the art of trading off these two goals. As a result, anything that reduces the regulator’s informational disadvantage is likely to help achieve more efficient outcomes.

B. The Ratchet Effect and Incentive Regulation

Regulation often aims to keep prices commensurate with costs and not to allow a firm to exploit its monopoly position by charging excessive prices. Because of the information problem outlined above, regulators have often used a dominant firm’s historic costs as a basis on which to set future prices; absent better information, past costs may be a sensible predictor of future costs.

² See, for example, David Sappington and Dennis L. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*, The MIT Press and the AEI Press, 1996, p. 3.

However, this “cost of service” approach creates an incentive problem, known as the *ratchet effect*. Consider a regulated firm that, by exerting some unverifiable effort, or incurring some costs that are difficult to identify, can reduce its verifiable costs. If regulators adjust the prices the firm is allowed to charge, to keep them aligned with its verifiable or recorded costs, the firm’s incentive to undertake this effort, or incur these costs, will be weakened. A similar ratchet problem can arise if the firm’s prices for existing services are adjusted downwards by regulators – through a cost-allocation proceeding or otherwise – in response to the firm’s introduction of new and profitable services.

The ratchet effect is generally recognized as one of the most troubling inefficiencies associated with traditional “cost-of-service” or “rate-of-return” regulation. For this reason, and others, regulators have increasingly turned from cost-plus regulation to incentive regulation mechanisms, most notably price caps. For example, the Federal Communications Commission first used price caps to regulate the interstate retail prices of dominant Interexchange Carriers (IXCs) and currently applies price caps to the interstate access charges of large ILECs. Once the initial level of a firm’s price index has been established, the index (net of inflation) must be adjusted annually by the X-factor – the estimated annual rate of productivity gain – and by any exogenous changes in costs.

An *ideal* price cap would perfectly predict the *optimized* path of *future* productivity improvement by each ILEC and employ that as the X-factor. The firm’s future prices would then be independent of its actual productivity performance, and the firm would thus have the correct incentives to achieve productivity gains; at the same time, consumers would not have to pay charges or fees in excess of cost.

Regulators can, of course, only estimate this optimal X. Because they have very limited information, they cannot have complete confidence that the right value of X has been chosen.³ Given this (rational and proper) limited confidence, however, a further problem arises. If the monopolist's profits are higher than expected, it may be difficult to insist that the chosen X-factor was correct, and there will be pressure to revise the X-factor upward. Similarly, if the monopolist's profits are lower than expected, there will be pressure to revise the X-factor downward. There may also be perceived legal restrictions on the regulator's ability to sustain a price-cap constraint for a carrier whose rate of return falls too low.

However, any such *ex post* revision recreates the *ratchet effect* – a good performance today results in a higher target in the future. If a regulated firm anticipates this effect, it foresees that some of the rewards for good current performance will be counterbalanced later when a higher level of performance is demanded. Anticipating the adjustment, the firm will exert less effort to improve its performance than it would if its future prices were (as in the ideal price cap) independent of its own performance. Thus, the ratchet effect, in tandem with other “softenings” of incentives, such as sharing rules and low-end adjustments, undermines the desirable incentive properties of price-cap regulation for a single monopolist, and blurs the distinction between price-cap regulation and old-fashioned cost-plus regulation. If regulators lack the information needed to set and confidently adhere to a choice of X over a long period, a substantial portion of the potential gains from incentive regulation may be unattainable.⁴ Thus, *ideal* price caps are unrealistic, and

³ As FCC Chairman Kennard recently remarked, “[s]ome say the current X-factor of 6.5% is too low, others say it is too high.” Press Statement by Chairman William E. Kennard on Access Charge Reform, October 5, 1998.

⁴ See, for example, Statement of Stanley M. Besen, Reply Comments of the National Cable Television Association, Inc., *In the Matter of Policy and Rules Concerning Rules for Dominant Carriers*, CC 87-313, August 3, 1989.

realistic price caps for a single monopolist do not fully overcome the fundamental information and incentives problem.

These problems are by no means restricted to the regulation of interstate access. Another important area in which very similar issues arise is the following. To provide universal service support, regulators must determine an appropriate level of support for serving customers in a high-cost area. Clearly the revenues available from customers – not only for supported services, but also available “follow-on” revenues – should enter into this calculation. Yet, there would be a ratchet problem if a high-cost carrier’s subsidy were reduced dollar-for-dollar in response to increases in the per-line revenue that it achieves. Better information on the *potential* for such revenue increases, from sources that do not create such a ratchet effect, would allow the Commission and the Joint Board to calculate sufficient subsidies without adverse incentive effects.

C. Limiting Exclusionary Conduct

The Commission, of course, does much more than simply set the maximum prices for interstate access charges. In most or all of its activities, better information about the actual and potential abilities of dominant firms would help the Commission to combine efficient incentives with protection of consumers. We restrict ourselves here to one important and topical example.

Especially since the passage of the Telecommunications Act, the Commission has rightly been concerned to open up local exchange and exchange access markets to competition. Because of the special features of those markets, Congress judged that mere removal of legal barriers to entry would be insufficient, and instead set up a competitive scheme under which ILECs are required, even against their interests, to cooperate with competitors. ILECs control local network services and resources that are essential to rival Competitive Local Exchange Carriers (CLECs).

Similarly, IXCs and competitors offering combined local and long-distance voice and data services rely, to varying degrees, on interconnection and access arrangements with the ILECs. Until facilities-based local competition is sufficiently widespread (or can be rapidly created by these competitors), therefore, state and federal regulators must enforce ILECs' duties to provide such cooperation.

This is a very difficult regulatory task and requires information that is difficult to acquire. The ILECs' competitors – particularly those wishing to offer innovative services – often require new network services and access arrangements, in particular for interconnection to the local network and collocation of competitors' equipment at ILEC facilities. Especially in these cases, the Commission is unlikely to have sufficient independent information about what arrangements are technically feasible, how the particular arrangements affect the quality of service provided to rivals, and what costs the ILECs must incur to supply them. As a result of this information problem, there is a real risk that ILECs may refuse to provide access, engage in delay and slow deployment, and then finally only offer service at degraded quality, or (especially) offer new services in an inefficient manner.⁵

D. Benchmark Regulation Ameliorates the Information and Incentives Problem

Fortunately, telecommunications regulators in the United States have a powerful tool that can greatly improve their acquisition of information relative to that of a regulator facing a single monopolist. Using information about a number of similarly-situated ILECs, the regulator can set benchmarks or yardsticks by which to assess past performance of an individual ILEC and

⁵ See Declaration of Michael L. Katz and Steven C. Salop, "Using a Big Footprint To Step On Competition: Exclusionary Behavior and The SBC-Ameritech Merger," October 14, 1998 (henceforth Katz and Salop). See also B. Douglas Bernheim and R. D. Willig, *The Scope of Competition in Telecommunications*, The American Enterprise Institute for Public Policy Research, Working Paper, October 25, 1996, Chapters 3 and 4.

establish incentives for its future performance. Benchmarks improve the operation of incentive regulation for two closely related reasons.

First, comparisons against the performance of a number of other ILECs provide the regulator with more *information*. In the case of price caps, additional information increases the regulator's ability to estimate the actual, but unknown, efficiently-achievable performance (X^*) of a regulated ILEC. This not only tends to make the chosen X-factor closer to the correct level, but should strengthen the regulator's resolve (crucial to achieving the incentive benefits of price caps) not to renegotiate in the face of unexpectedly profitable or unprofitable results for an individual company. In other cases, comparisons with other ILECs allow the regulator better to assess what practices are technically feasible, to scrutinize unusually poor performance, or even to set as a standard the best practice. In short, the regulator's *information problem* is ameliorated.

Second, if future performance standards to be applied to an ILEC are based on a benchmark such as industry-wide average productivity, then an individual ILEC's own behavior affects those future standards to only a limited extent. As a result, the ILEC has less *incentive* to alter its current behavior to account for future revisions in the performance standard than it would if that standard were based primarily on the ILEC's own past performance. In short, the regulated firm's "ratchet" *incentive problem* is ameliorated.

E. Value of Benchmarking Widely Recognized

This observation that benchmarking is a valuable tool of efficient regulation is neither novel nor surprising. In contrast to "ideal" but infeasible price-cap mechanisms, the use of benchmarks based on average performance is a robust regulatory tool that greatly reduces the ratchet problem *without* the need for the regulator to obtain extraordinary levels of information.

Similarly, the use of benchmarks makes it much easier for regulators to make credible long-term commitments to desirable incentive mechanisms. Best-practice benchmarking and the use of comparative information to focus heightened scrutiny on poor practices are similarly robust and valuable tools of regulation and emerging competition.

Since the divestiture of the local bottleneck portions of the former AT&T into seven independent holding companies, the Commission has correctly recognized that the ability to make benchmark comparisons among BOCs, RBOCs, and ILECs in general constitutes an important regulatory tool. As described more fully in the attachment to this Declaration,⁶ since the 1984 divestiture of the Bell System the Commission, the Justice Department, and the Courts have all acknowledged and relied upon the ability of regulators to employ benchmarking. The existence of a number of large, independently-managed ILECs provides a range of technical, economic, and operating experience from which the Commission can draw to assess proposed regulatory actions, establish performance standards, and set parameters in incentive-regulation formulas.

The U.S. Court of Appeals for the District of Columbia Circuit noted:

[T]he existence of seven [R]BOCs increases the number of benchmarks that can be used by regulators to detect discriminatory pricing. . . . Indeed, federal and state regulators have in fact used such benchmarks in evaluating compliance with equal access requirements . . . and in comparing installation and maintenance practices for customer premises equipment.⁷

⁶ See "Benchmark Comparisons," Attachment A to Ameritech's Comments on the Report and Recommendations of the United States Concerning the Line-of-Business Restrictions (*United States v. Western Electric Co.*), 1987, D.C. Cir. Civ. Action No. 82-0192, filed Mar. 13, 1987.

⁷ *United States v. Western Electric Co.*, 993 F.2d 1572, 1580 (D.C. Cir.), *cert. denied*, 126 L. Ed. 2d 438 (1993).

Outside the United States, other regulatory bodies and competition authorities have also recognized the value of benchmarking in dealing with monopoly or dominant firms. For example, in the United Kingdom the regulator of the water and sewerage industry uses industry-wide data to set a price cap for each firm.⁸ The European Commission has adopted benchmarks for evaluating access prices that are based on the lowest interconnection rates charged in each Member State. These examples are discussed in more detail below.

II. Forms of Benchmarking

Although there are many ways in which benchmarking may be implemented, it is helpful to consider three categories: the use of *averages*, the use of *best practices*, and the use of *heightened scrutiny of worst practices*.

A. Average-Practice Benchmarking

In its price-cap regulation of interstate access charges, the Commission has rightly expressed concern that reviewing the level of the X-factor every two years and updating it periodically, if undertaken on an ILEC-specific basis, would substantially weaken the incentive for the ILEC to improve its productivity (the ratchet effect). However, different ILECs' capabilities for productivity improvement are highly correlated, because many of the same technological opportunities, new products, and demographic trends apply to all. Consequently, this is a suitable opportunity for a relative-performance scheme, in which price changes can be set based on industry-average rather than on carrier-specific productivity measures.⁹

⁸ Office of Water Services (OFWAT), "Future Charges for Water and Sewerage Services," July 1994, pp. 17-19.

⁹ FCC 97-159, *Price Cap Performance Review for Local Exchange Carriers*, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, adopted May 7, 1997, released May 21, 1997, paras. 167 and 181 (henceforth *Price Cap Performance Review for Local Exchange Carriers*).

When the average is made up of a large number of ILECs, each constituting only a small share in the industry average, the resulting ratchet effect is small. That is, each single ILEC's incentive to increase its productivity is only modestly weakened through the ratchet effect: its own productivity experience is only a small part of the industry averages that will affect the updated standard in the future. In setting X-factors in price caps for access services, the initial level of charges for each ILEC was established on the basis of that ILEC's historic costs, while the X-factor which that determines the annual reduction in the access price index is set based on *industry-wide* trends in productivity. Specifically, the Commission has adopted measures of annual productivity increases based on studies that estimate productivity changes using historical data for large ILECs. Several studies use RBOC-only data or data for RBOCs plus several larger independents.

Similarly, in setting high-cost support for universal service, the Joint Board decided to base subsidies on the difference between an estimate of cost and an average of monthly revenue per residential line.¹⁰ The assumed "benchmark" customer revenue per line is intended to be based on *industry-wide average* figures that will evolve over time.

In this sub-section, we discuss the use and efficiency of such "average-practice benchmarking," in which each ILEC is held to a standard that depends on (past, or expected) *industry-wide performance* rather than its own.

To fix ideas, suppose that annual adjustments to each ILEC's access charges are constrained by an *industry-wide benchmark* — a price index based on an *industry-wide average* of all ILECs' productivity changes — rather than directly determined by the performance of the individual ILEC.

¹⁰ Federal Communications Commission, CC Docket 96-45, *In the Matter of Federal-State Joint Board on Universal Service*, Report and Order, adopted May 7, 1997, released May 8, 1997, para. 259.

Roughly speaking, the ratchet effect under such a price cap regime is proportional to the extent to which an ILEC's lower costs affect the access prices that it receives. Suppose, for example, that a large ILEC has 20% of the nation's access lines and that it reduces its own interstate access costs by \$1 per line. Under "average-performance" benchmark regulation, the firm's profits will initially rise by the amount of its lowered costs, \$1 per line.¹¹ In due course, the Commission will recalibrate the X-factor to account for the nationwide improvement in average productivity. How much of the gain from this productivity improvement is thus recovered from the more efficient ILEC?

First, we should note that under the access price-cap system as it exists, no change would be likely for some period of time. There are lags in reporting cost data, in estimating recent industry-wide productivity gains, and in implementing a new X-factor based on such estimates.¹² In addition, the Commission has tended to adjust the X-factor rather than the levels of access charges (thus bringing levels down only gradually).¹³ With all this in mind, it may be reasonable to suppose that, on average, the level of interstate access price responds to the hypothetical \$1 reduction in per-line costs some three to five years after that reduction takes place.¹⁴

¹¹ This assumes that the firm's prices do not change. If the firm instead chooses to lower its prices below the cap, profits will presumably rise by more – by a revealed-preference argument. When regulation is binding, however, this is unlikely to be a major consideration.

¹² In setting the currently applicable X-factor in May 1997, the Commission relied on a series of multi-year averages of the total factor productivity of the RBOCs and gave the most weight to averages calculated between 1987 and 1995. The new 6.5% X-factor was then made effective from 1996, the beginning of the interim access charge period. *Price Cap Performance Review of Local Exchange Carriers*, para. 139.

¹³ In principle, such a feedback could lead to all kinds of complexities. But it seems likely that in the medium- or long run there will tend to be convergence of levels. In this connection, the fact that the new X-factor set in 1997 was made effective from 1996 may suggest an interest in levels as well as in rates of change.

¹⁴ This analysis addresses only the Federal component of the problem. States differ in their treatment of ILEC productivity improvements. Many states apply price-cap regulation to the intrastate charges of large ILECs. In some, the rates mirror the interstate access rates, but in others it is not clear to what extent regulation relies on benchmarks.

A large ILEC with 20% of the nation's access lines keeps its \$1 per line saving for perhaps four years; after that it keeps just 80% of it, because recalibration based on industry-wide average performance recaptures 20% of the saving.¹⁵ At a real discount rate of 10%, the net present value of the ILEC's gross private return per line is the sum of these discounted savings for many years, or approximately

$$$(1 + .91 + .83 + .75) + .8*(.68 + .62 + .56 + \dots) = $9.50$$

compared to the

$$$(1 + .91 + .83 + .75 + .68 + \dots) = $11$$

that it would gain if its prices never had to respond to its cost reduction – the case of an “ideal price cap.”¹⁶ Thus, under these assumptions, the adjustment of the X-factor “taxes” away approximately 14% (i.e., $9.50/11 = .86 = 1 - .14$) of the ILEC's incentive to reduce its access costs.

This compares with a 68% tax if the price facing an individual ILEC were adjusted, with the same timing, based on its own recorded performance.¹⁷ In other words, the relative-performance scheme, in this case average-practice benchmarking, leads to a very substantial improvement in these incentives. As we will discuss below, however, as LECs consolidate by merger, the ratchet disincentive that concerns the Commission becomes considerably more severe.

¹⁵ Note that access lines that are not controlled by ILECs whose performance enters into the productivity estimates should not be counted in the assessment of these shares.

¹⁶ The numbers 1, .91, .83, .75, .68, ... are successive powers of the one-year discount factor (1/1.10).

¹⁷ The ILEC retains only the first four terms above, $$(1 + .91 + .83 + .75)$, or \$3.49, out of the gross present value of \$11.

B. Best-Practice Benchmarking

A second, and perhaps even more important, use of benchmark or yardstick techniques is less formal and can be applied to qualitative as well as quantitative characteristics of ILEC service offerings. Rather than calculating an industry-wide average figure and applying it to all ILECs, regulators may be able to use a "best" practice offered by one ILEC to learn what is possible for all and to require all ILECs to implement it.

Interconnection arrangements for rivals may be particularly suited to "best-practice" benchmarking. Under the 1996 Telecommunications Act, an ILEC has the duty to provide interconnection at any technically feasible point within its network.¹⁸ By probing the practices of individual ILECs, the Commission endeavors to assess whether ILECs' claims about technical feasibility are warranted, and to monitor the quality of interconnection. It can then establish as a standard for all ILECs a benchmark based on the best observed (or offered) practice.

Number Portability Example

A telling example of best-practice benchmarking is provided by the standards established for local number portability. In the Commission's proceedings, many ILECs claimed that the Location Routing Number (LRN) method was not a cost-effective way of implementing local number portability and instead proposed initially to implement a query-on-release (QOR) method. Specifically, six RBOCs, GTE, and USTA petitioned the Commission to be allowed to use the QOR implementation, claiming they would achieve significant cost savings by using this method.¹⁹ If implemented, however, the QOR method would result in lower-quality service on

¹⁸ Telecommunications Act of 1996, Sec. 251 (c)(2)(C).

¹⁹ FCC 97-74, *Telephone Number Portability*, First Memorandum Opinion and Order on Reconsideration, released March 11, 1997, para. 34.

calls to telephone numbers ported to competing local carriers and thus help ILECs to exclude rivals from local service markets. A single exception (Ameritech) planned to deploy the LRN method, which provides equal-quality service to calls of all carriers, at the outset.

The Commission concluded, on the basis of this experience, that it was feasible for all ILECs to implement the LRN method. It found that the LRN method would most likely result in long-run cost savings and that the QOR method, if implemented, would harm competitors who must rely on ILEC networks in order to route calls.²⁰ As a result, the Commission adopted best-practice performance standards based on the LRN method.²¹ Had Ameritech joined the other large ILECs in claiming that LRN was impracticable, it seems unlikely that the Commission would have had the knowledge or confidence to require such standards, or to do so on the same timetable. Depending on the relative strength of Ameritech's motive for implementing LRN and SBC's motive for not doing so, LRN might well have been substantially delayed had the proposed merger of SBC and Ameritech been accomplished (or even contemplated) at the time.

Effects of Best-Practice Benchmarking

Broadly, we analyze the effects of best-practice benchmarking by considering two aspects. First, setting aside incentive issues for the moment, best-practice benchmarking diffuses "best practice" across ILECs. If the practice judged best is indeed best, this is a desirable effect, and the more so, the greater the diversity in ILECs' initial practices or proposals. Second, we must consider incentive effects.

²⁰ Id., paras. 13 and 38.

²¹ Id., para. 38.

The incentive effects of best-practice benchmarking differ from those of average-practice benchmarking. Suppose that an ILEC knows that best-practice benchmarking will ultimately be applied, and that there is no reward for initially employing what turns out to be the "best" industry-wide practice and no sanction for initially using other practices. Then, although many complexities could arise, a first cut is that the ILEC's incentive would be the same as that of a single monopolist. The reason this is true, of course, is that any one ILEC's choice matters only if it turns out to be "best," in which case that choice will be applied to all ILECs, including the one who chose it. So, each ILEC has an incentive to select a practice as if its own choice will apply to it (even though, in fact, that may not happen). The prospect that this kind of best-practice benchmarking will be uniformly applied after all ILECs' choices are observed does not then affect each ILEC's incentives.²²

Because the incentive effects are likely to be modest or unclear, if ILECs were identical, there would be no gain from best-practice benchmarking. However, experience shows that there is often considerable diversity among ILECs' choices.²³ These differences might result from differences in (a) strategy (e.g., one ILEC may seek early Section 271 approval whereas another

²² This analysis assumes that there is no reward to being the best nor punishment for not being the best, but simply a low-cost *ex post* dissemination of best practice. Obviously, other possibilities could be considered.

²³ Entrants seeking to purchase unbundled network elements from ILECs propose that regulators set detailed performance standards for maximum times for quotations and for delivery of service, cost-sharing arrangements, and similar service conditions. They frequently document a wide range of actual practices across large ILECs. For example, Northpoint Communications observes that some ILECs' requirements for ordering collocation require a CLEC to have state certification, and that these conditions delay collocation by a minimum of six months compared with other ILECs that have tariffed physical collocation. Northpoint also notes that obtaining collocation quotations from SBC in Texas required almost four months, whereas Ameritech provides quotes within 10 days. Similarly, charges for collocation-related services vary greatly across ILECs. For example, application fees range from \$0 (Pacific Bell) to \$7500 (Bell Atlantic North); cage construction charges vary from \$10,000 (Georgia) to more than \$100,000; power, heating and ventilation and installation charges vary from \$2,000 to \$12,000; and charges for OSS access vary from \$0 (Florida) to \$4700 per month (SWBT). Ex Parte, Letter from Steven Gorosh, Vice-President and General Counsel, Northpoint Communications, to Ms. Magalie Roman-Salas, Secretary, Federal Communications Commission (July 7, 1998), (transmitting attached document, *Proposed Remedies for Promoting DSL Competition*, on file with Federal Communications Commission in CC Docket Nos. 98-11, 98-26; 98-32; and 98-91.

seeks to maximize barriers to local competition), (b) demand structure, (c) previously established state regulatory requirements, or other factors. Whatever the source, it is clear that ILECs often make rather different choices from one another.

The next question then becomes whether the differences primarily reflect different efficient choices, or whether they reflect different degrees of candor or of cooperation, in addressing a fundamentally similar problem. If they reflect different efficient choices, it could be inappropriate to impose a "one-size-fits all" policy. If, however, the differences reflect different attitudes towards cooperation, then promulgating the "best" of the ILECs' initial choices throughout the industry is desirable (provided any costs of changing other ILECs' behavior are not too large). Moreover, given the complex and novel problems sometimes posed by interconnection requests, different responses may simply reflect different arbitrary choices.

Thus, in the case of number portability, the Commission found that the observed diversity was not a matter of different efficient choices, but rather that Ameritech's proposal could be taken as indicating that there was scope to implement LRN generally.

Recognition of the Value of Best-Practice Benchmarking

The value of best-practice benchmarks has been recognized by the Commission, the Department of Justice, competitors of the ILECs, and the ILECs themselves. In particular, the Commission has relied on the diversity of ILEC practices to determine the feasibility of regulatory standards and yardsticks for a wide variety of practices, as the following examples illustrate:

- *Technically feasible interconnection.* The Commission concluded that interconnection or access at a particular point in one LEC network is evidence of the

technical feasibility of providing the same or similar interconnection in another ILEC network.²⁴ Further, the Commission found that successful interconnection at a particular level of quality in one network is substantial evidence of the feasibility of interconnection at the same level of quality in another network.

- *Access to OSS functions.* The Commission found that ILEC competitors would be severely disadvantaged, if not precluded altogether, from fairly competing if they are unable to obtain the functions of pre-ordering, ordering, provisioning, maintenance and repair, and billing for network elements and resale services in substantially the same time and manner as the incumbent. The Commission observed that ILECs now provide IXCs with different types of electronic ordering and trouble interfaces, and that some ILECs are testing and operating interfaces for real-time access to OSS functions. These performance yardsticks enabled the Commission to conclude that providing nondiscriminatory access to OSS functions is technically feasible.²⁵
- *Shared transport.* The Commission observed that Bell Atlantic, NYNEX, and PacTel offer shared transport in conjunction with unbundled local switching, and rejected Ameritech's objection that it was unable to measure and bill for shared transport.²⁶
- *Open architecture.* In commenting favorably on a DOJ consultant's report, the Commission observed that "reliance on benchmarking also improved the

²⁴ FCC 96-325, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, First Report and Order, CC Docket No. 96-98, adopted August 1, 1996, released August 8, 1996, para. 204 (henceforth Local Competition Order).

²⁵ Local Competition Order, para. 518-520.

²⁶ FCC 97-295, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Third Order on Reconsideration and Further Notice of Proposed Rulemaking, adopted August 18, 1997, released August 18, 1997, para. 26, fn 77.

Commission's regulation of interconnection and monitoring of network performance."²⁷ That report²⁸ cited a plan by Ameritech to introduce a new type of "Feature Node Service Interface" interconnection at local switches which led the Commission in its Third Computer Inquiry proceeding to require other RBOCs to submit open-architecture proposals.

- *Trunk-side interconnection.* The Commission received an extensive cellular industry report on cellular interconnection and requested public comments on that report. Based on the information collected, the Commission concluded that trunk-side Type 2 interconnection is the most efficient method of interconnecting a cellular carrier's network to an ILEC's wireline network. Finding that some LECs had made Type 2 interconnection facilities available to cellular carriers, the Commission concluded that Type 2 interconnection was feasible. The Commission also found that, even if delays were incurred to lay cable or obtain equipment, a carrier should require no more than six months to provide Type 2 interconnection.²⁹
- *Cageless collocation.* In the current Section 706 proceeding, the Commission observed that US West currently offers a cageless collocation arrangement. The Commission also noted that SBC permits CLECs to share collocation space instead of requiring each CLEC to occupy a dedicated cage. The Commission requested

²⁷ FCC 97-286, *In the Applications of Nynex Corporation Transferor and Bell Atlantic Corporation Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, Memorandum Opinion and Order, adopted August 14, 1997, released August 14, 1997, fn 175.

²⁸ Peter W. Huber, *The Geodesic Network: 1987 Report on Competition in the Telephone Industry*, 1987.

²⁹ 2 FCC Rcd 18, *In the Matter of The Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carrier Services*, Declaratory Ruling, adopted April 30, 1987, released May 18, 1987, 2914 (paras. 31-33).

comments to determine whether such arrangements should be presumed to be technically feasible at other LEC premises.³⁰

- *Operating expenses.* A Commission staff analysis of models submitted for use in estimating the costs of supplying universal service and unbundled network elements evaluated the input requirements of cost proxy models. The staff found that much of the variation in the models' estimates of the monthly cost of network elements is accounted for by differences in the treatment of operating expenses.³¹ One approach suggested by the staff for improving the cost estimates is to use, as a yardstick for operating expenses, the minimum actual costs achieved by a sample of companies that report annually to the Commission.³²
- *Line-of-business restrictions.* In support of its 1987 comments recommending elimination of the line-of-business restrictions, Ameritech provided an extensive summary of "the widespread and effective use of benchmark comparisons" since the divestiture established seven independent RBOCs.³³ It noted that in proceedings before the Department of Justice, the District Court, and the Commission, private-sector firms compared deployment and end-office conversion schedules, presubscription activities, ordering procedures, and rate levels for wholesale services,

³⁰ FCC 98-188, *In the Matters of Deployment of Wireline Services Offering Advanced Telecommunications Capability...Memorandum Opinion and Order, and Notice of Proposed Rulemaking*, adopted August 6, 1998, released August 7, 1998, para. 139.

³¹ J. Atkinson, C. Barnekov, D. Komuch, W. Sharkey, and B. Wimmer, *The Use of Computer Models for Estimating Forward-Looking Economic Costs: A Staff Analysis*, January 9, 1997, para. 64.

³² *Id.*, para. 68.

³³ A copy of Ameritech's summary is included as an attachment to this Declaration. Attachments to Ameritech's Comments on the Report and Recommendations of the United States Concerning the Line-of-Business Restrictions, March 13, 1987, Civil Action No. 82-0192.

among others. As one example, Ameritech observed that the Commission imposed on all RBOCs an allocation plan for routing of default traffic that was modeled after the practice proposed by a single company, Northwestern Bell, whereas all other RBOCs proposed routing the default traffic to AT&T.³⁴

- *Equal access.* In evaluating RBOCs' compliance with the divestiture decree, the Department of Justice has tended to define regional company equal access obligations based upon the highest level of performance achieved by *any* of the regional companies. The DOJ compared and contrasted the equal access progress of the RBOCs on issues including: (1) availability of equal access; (2) conversion of conforming end offices; (3) cellular radio equal access; (4) equal access for 800 and 900 services; and (5) equal access from public telephones. For each issue, the DOJ used the highest level of performance achieved by an RBOC as a benchmark in assessing the progress of the others.³⁵
- *Overhead costs.* The levels of overhead costs included in the rates for unbundled network elements, including collocation services, are of particular concern to carriers that must interconnect with ILECs. In a California Public Utilities Commission proceeding, Sprint recommended that a markup for overhead costs be limited to 15%. To reach this proposed standard, Sprint analyzed ARMIS data filed with the Commission and noted that two RBOCs consistently had markups less than 15%.³⁶

³⁴ Id., para. A-16.

³⁵ Report of the United States to the Court Concerning the Status of Equal Access (D.D.C.; Oct. 31, 1986).

³⁶ PUC of the State of California, R.93-04-003, I.93-04-002, Direct Testimony of David T. Rearden on Behalf of Sprint Communications Company L.P. on Pacific Bell UNE Pricing Issues, redacted version April 8, 1998, p. 10.

Best-Practice Benchmarking Abroad

Best-practice benchmark regulation is not limited to the United States. The European Commission has adopted a type of best-practice benchmark approach to assessing prices for access to public switched telecommunications networks and recommending maximum interconnection charges. The Commission established “best current practice” interconnection charges that are based on the three Member States with the lowest interconnection rates (the UK, France, and Denmark). The Commission’s methodology establishes a benchmark range, with the low rate set somewhat below the lowest access price available. Starting January 1, 1999, the best current practice rate for local interconnection, for example, is the range 0.5 – 1.0 Eurocent (0.6 to 1.2 US cents) per minute (at peak rate). The interconnection benchmark rate will establish an incentive for national regulators in a number of countries to reduce high interconnection rates. As of May 1998, eleven of the fifteen Member States had local interconnection rates that exceeded the upper end of the benchmark range and in five of those states the rates were more than 80% above the upper benchmark value.³⁷ In the context of antitrust cases brought under the European Union’s competition law, an interconnection price that is more than 100% above a best practice rate will be taken to signal a substantial likelihood of an abuse.

In the United Kingdom, the Director General of Water Services uses comparative information on water and sewerage companies in a variety of ways, but with particular emphasis on best practices.³⁸

³⁷ European Commission 98/511/EC, Recommendation Amending Recommendation 98/195/EC on Interconnection in a Liberalised Telecommunications Market (Part 1 – Interconnection Pricing), July 29, 1998.

³⁸ See the Monopolies and Mergers Commission’s discussion of the Director General’s comments, in its analysis of the proposed merger of Wessex Water Plc and South West Water Plc: Monopolies and Mergers Commission, *A report on the proposed merger*, October 1996, para. 2.70 (henceforth Monopolies and Mergers Commission).

C. "Heightened Scrutiny for Poor Performance" Benchmarking

A third form of benchmarking is the identification of problem cases. The Commission makes extensive use of comparative data that it collects from ILECs to assess the performance of individual companies in setting rates, delivering service of satisfactory quality, and enforcing existing regulatory standards. In its investigations, the Commission frequently relies on several years of data for each ILEC and buttresses preliminary findings concerning individual companies with comparisons across companies. In this way, the Commission is able to identify extremes of sub-standard performance. The Commission can require the poorly-performing ILEC to "catch up," impose regulatory sanctions or, at a minimum, instigate heightened regulatory scrutiny of the laggard ILEC. Not only does this potentially improve outcomes *ex post*, but the possibility that regulators may discipline sub-standard performance should improve ILECs' incentives *ex ante*. Again, absent multiple ILECs, the Commission would often lack the information to do any of these things with much confidence. Below we list the factors at issue.

- *Collocation.* The Commission has evaluated the reasonableness of LECs' charges for physical collocation services provided for interexchange access in terms of an industry-wide benchmark.³⁹ Collocation was a relatively new service for which little or no historical cost data and operating experience were available and for which LECs must make estimates of costs. For its statistical investigation, the Commission relied on direct cost estimates of 14 LECs⁴⁰ that offered collocation and had at least one

³⁹ FCC 97-208, *In the Matter of Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Physical Collocation for Special Access and Switched Transport*, Second Report and Order, CC Docket No. 93-162, released June 13, 1997.

⁴⁰ Pacific Bell, Nevada Bell, Southwestern Bell Telephone Company, Southwestern New England Telephone Company, Ameritech Operating Companies, New York Telephone and New England Telephone and Telegraph Company, BellSouth Telecommunications, Inc., US West Communications, Inc., GTE Telephone Operating

physical collocation customer. The Commission aggregated the LEC data for seven collocation functions: floor space, DC power, cross-connection and termination equipment, security installation, security escort, construction, and entrance facility. To minimize the impact of LEC estimation errors, it first excluded any cost estimate that exceeded the sample mean by more than two standard deviations (for that collocation function). The Commission then calculated the simple (unweighted) mean of the direct costs for each function and the sample standard deviation of the mean.

Deciding that it should recognize that some LECs may reasonably provide service somewhat less efficiently than other LECs, the Commission set the mean plus one estimated standard deviation as a maximum cost standard. Direct costs that exceed this value are disallowed, unless the LEC could justify the higher costs. The Commission used this methodology to ensure that the LECs' direct costs would fall within a "zone of reasonableness" and stated that the strict use of an average or median as the standard of reasonableness might not reflect the relative imprecision of the LECs' cost estimates for a new service.⁴¹ In doing so, the Commission rejected a more lenient standard, observing that "all LECs have ample incentive to inflate the direct cost of physical collocation because these are the rates that they are imposing on the interconnector-customers against which the LECs compete in the interstate access market."⁴² Thus, the Commission's procedure sets a benchmark for identifying poor

Companies, Cincinnati Bell Telephone Companies, Lincoln Telephone and Telegraph Company, Rochester Telephone Corporation, and Central Telephone Companies.

⁴¹ Id., para. 147.

⁴² Id., para. 148.

performance that is based on both the average and the variance of industry-wide experience.

- *Overhead costs.* ILECs recover their common costs and costs of overhead activities by marking-up the direct costs of services. The Commission observed that assigning high overheads to the LEC facilities upon which interconnectors rely to provide competitive services, while assigning low overheads to services against which interconnectors seek to compete, is anticompetitive and that actions to raise rivals' costs through this mechanism can be profitable.⁴³ In its review of tariffs for virtual collocation, the Commission issued a detailed request for overheads and cost support data. Using the data submitted by the ILECs, the Common Carrier Bureau selected point-to-point DS1 and DS3 services as a yardstick to evaluate the overhead loadings assigned to virtual collocation services.⁴⁴ The Commission found that the LECs' loadings for DS1 and DS3 services varied widely, and observed that three RBOCs that used some of the highest overhead loadings also impose the highest total charges for virtual collocation services.⁴⁵ On the basis of this investigation, the Commission concluded that most of those LECs' virtual collocation rates were likely to be unreasonably high, and prescribed maximum permissible overhead loadings for virtual collocation services equal to the loadings for the comparable DS1 and DS3 services. By collecting comparative data on ILEC practices, the Commission was better able to detect and remedy potentially exclusionary conduct.

⁴³ FCC DA-94-1421, Order, December 9, 1994, para. 23.

⁴⁴ *Id.*, para. 17.

⁴⁵ The LECs proposed to assign generally high loadings to collocation charges while assigning low loadings to comparable services.

- *Non-primary lines.* In its Access Charge Reform Order⁴⁶ the Commission modified the method for recovering common line costs and instituted a new flat, per-line charge (the Presubscribed Interexchange Carrier Charge – PICC) assessed on the customer’s presubscribed IXC. The new access charge regime requires LECs to distinguish between primary residential lines and non-primary residential lines. The rates for both the Subscriber Line Charge, which is paid by the end user, and the PICC are higher for non-primary residential lines. As a result, an ILEC with lower penetration of non-primary lines may be allowed to charge higher per-minute access fees.

The Commission investigated the penetration ratios for non-primary residential lines and found that several ILECs’ reported penetration ratios were increasing over time, but that the penetration ratios of SNET (now part of SBC) were much lower than expected. As “an initial test of reasonableness” the Commission calculated the average penetration of non-primary (second) residential lines for all price-capped LECs. The Commission tentatively concluded that SNET had under-represented the number of non-primary residential lines and ordered SNET to document in detail the procedures and data used to estimate non-primary residential lines and to present evidence to justify its low penetration ratio.⁴⁷ SNET has contended that it should not be required to undertake further measurements until the Commission formally establishes a definition of non-primary residential lines in a current proceeding.⁴⁸

⁴⁶ FCC 97-158, *In the Matter of Access Charge Reform*, First Report and Order, CC Docket No. 96-262, adopted May 7, 1997, released May 16, 1997.

⁴⁷ FCC 98-104, *In the Matter of 1998 Annual Access Tariff Filings, Southwestern Bell Telephone Company Revisions to Tariff FCC No. 73*. Memorandum Opinion and Order, Order Designating Issues for Investigation, and Order on Reconsideration, CC Docket 98-104, adopted July 29, 1998, released on July 29, 1998, paras. 15-19.

⁴⁸ CC Docket 98-104, Direct Case of the Southern New England Telephone Company, *In the Matter of 1998 Annual Access Tariff Filings*, August 31, 1998.

Surely, however, the availability of this kind of comparative information places the Commission in a much stronger position to defend consumers against the possibility that an ILEC understates the penetration of second lines.

Again, we note that U.S. telecommunications is not the only forum for such comparisons. For instance, the U.K.'s Director General of Water Services has promised stricter scrutiny for companies reporting relatively high costs.⁴⁹

III. Effects of Mergers on Benchmarking

In this section we use the analysis and discussion above to assess the effects of mergers among large ILECs on the efficacy of benchmarking. The Commission has recently clearly recognized that a merger of two RBOCs weakens its ability to use benchmarking to regulate effectively:

A reduction in the number of separately owned firms engaged in similar businesses will likely reduce this Commission's ability to identify, and therefore to contain, market power. One way that this can happen is by reducing the number of separately owned and operated carriers that can act as "benchmarks" for evaluating the conduct of other carriers or the industry as a whole.⁵⁰

In this section we discuss the effects of ILEC mergers on the forms of benchmarking we have discussed above. We confirm that mergers can harm benchmarking – both through reducing available information even if ILECs do not change their substantive behavior, and also by worsening their incentives under benchmarking.

⁴⁹ Office of Water Services (OFWAT), UK, *Setting Price Limits for Water and Sewerage Services: The Framework and Approach to the 1994 Periodic Review*. November 1993, p. 19.

⁵⁰ FCC 97-286, para. 147.

A. A Merger Reduces Information from Benchmarking Even When Behavior is Unchanged

Even ignoring incentive effects, if a merger leads to more aggregated reporting, valuable information is lost. In this sub-section we give a statistical formulation of this common-sense observation, intended to help analyze when it is likely to be important. After establishing the formulation, we discuss a rather stark best-practice example inspired by the number portability example above. Then we discuss effects on the use of average-practice benchmarking, both in terms of accuracy of the “average” as an estimate of an underlying parameter, and in terms of the effect of loss of observations on the confidence with which the Commission can wield this important tool. Finally, we note that these effects have been recognized elsewhere.

In many cases, after a phase-in period, the merged firm may adopt a common practice in such matters as pricing of services, availability of network components, and provisioning practices. Post-merger, only a single data point for these practices is then available for the two previously independent firms. In particular, useful financial information is likely to be reported at the firm level (aggregating across the merged operating companies). Even where the merged firm also reports company-by-company results, those values can be less useful than data from independent firms. Thus, the U.K.’s Monopolies and Mergers Commission (MMC), in considering the potential loss of independent observations through the merger of two water and sewerage companies, found that “the use of sub-company data is very much a second best ... first, that there are major cost allocation difficulties in the use of sub-company data and secondly, ... such data exhibit less variation and are hence less informative than they would be if they reflected the input of independent management.”⁵¹

⁵¹ Monopolies and Mergers Commission, para. 2.76.

Our setting is the following: Each of n ILECs (prior to a merger) reports a statistic x_i , where $i = 1, \dots, n$. Each x_i is drawn from a distribution with some parameter(s), say b , and thus contains information about b .⁵² The Commission wishes to learn something about b , perhaps in order to set a performance standard. We note that because different errors in establishing a benchmark (setting too stringent a performance standard versus too lax a standard) often have asymmetric costs, the Commission should care not only about a posterior mean of b but also about measures of posterior dispersion (such as variance). In other words, as we remarked above in the concrete context of “ideal” price caps, (warranted) confidence in the benchmark is important.

We then ask: How does a merger that effectively aggregates some of the x_i before they are reported affect the Commission’s ability to infer b from the information it receives? While there are cases in which such a merger has no effect (at this level of analysis), the conditions for such neutrality are stringent and unlikely to hold in many regulatory contexts.

A Best-Practice Example

Let us begin with an example in which one can see quite starkly how information can be lost in going to a single “merged” report based on what would otherwise have been independent observations x_1 and x_2 . Consider once again number portability as an illustration of best-practice benchmarking. Here, a model that captures our (and perhaps the Commission’s) thinking is that an unknown (to the Commission) parameter b is equal to 1 if LRN is reasonably implementable

⁵² The analysis is simplest if the x_i are independent and identically distributed, but that is not necessary for the basic insights.

in the near future, and is equal to 0 if it is not. For each firm i the observation x_i is, with probability p , equal to b (which may of course be 0 or 1), and, with probability $1 - p$, equal to 0.⁵³

Then, a sufficient statistic for b is the maximum of the x_i . An admissible (and sensible) decision rule is to require LRN implementation if and only if that maximum value is 1: this is best-practice benchmarking. If instead of independent reports, only a merged report $x_{1\&2}$ is available, the information on b is undamaged only in the special case where the merged report $x_{1\&2}$ is constructed so as to equal $\max[x_1, x_2]$.

However, that is an unlikely form of aggregation. When, in fact, LRN is practicable, but only one of the merging partners wishes to offer it, it would be remarkable if the joint decision were always to offer LRN. A more reasonable hypothesis would be that when the partners have differing preferences it is equally likely that the merged firm would offer LRN or not. In our notation, if (say) $x_1 = 0$ and $x_2 = 1$, then $x_{1\&2}$ is equally likely to be 0 or 1. In that case, as with almost any aggregation rule, observing $x_{1\&2}$ is strictly less informative than observing both x_1 and x_2 .

With this “equally-likely” aggregation rule, we can rather easily quantify the loss of useful information from such a merger. The key observation is that $x_{1\&2}$ has the same distribution as a single draw x_i . To see this, note that with the “equally likely” aggregation rule, the probability that $x_{1\&2} = 1$, conditional on $b = 1$, is given by $p^2 + 0.5[p(1-p) + (1-p)p] = p$.⁵⁴ Conveniently, in this formulation, from the point of view of best-practice benchmarking, the

⁵³ That is, with probability p firm i offers LRN, if indeed, it is practicable, and with probability $1-p$ it does not, even if it would be practicable.

⁵⁴ Pre-merger, the probability that at least one of these two firms would reveal the feasibility of LRN is $1 - (1-p)^2$.

merged firm is just like one of the original firms: mathematically, the merger then is equivalent (from this point of view) to a simple reduction in n .

For example, if pre-merger $n=8$ and $p=.125$ (perhaps a natural value to look at if we think in terms of the number portability experience, where one firm out of eight voluntarily implemented LRN), the probability that LRN is made available is given by $1 - (1 - p)^n$. Substituting for p and n , we see that this probability is 0.66. Now, suppose that two of the eight firms merge. Then, the probability falls to $1 - (1 - p)^7 = 0.61$. Similarly, if the eight original firms are reduced to four through four mergers, the probability falls from 0.66 to $1 - (1 - p)^4 = 0.41$. These are substantial effects.

Effects of Merger in the Use of Averages

Next, consider the reduction in information due to merger as it affects the use of average-practice benchmarking. We develop two points. First, the best point estimate of the underlying parameter b – loosely, an “average” – may in fact depend on more than a simple weighted average of firms’ reports, so that “the average” may be less accurately calculated after a merger. Second, losing information on variation among ILECs may rationally cause a loss of the confidence needed to use an average as a benchmark, and may make regulators or competitors more tentative in their use of such averages.

For a concrete example, we examine price-cap performance. We can view x_i as firm i ’s productivity performance, and model this performance as the sum of two terms – a “normally achievable” performance b , plus an idiosyncratic “error” e_i with mean zero. Thus, from the information point of view, the Commission is comfortable in applying the average-performance benchmark to firm i to the extent it believes that benchmark is a reasonably good estimate of what firm i is capable of achieving.

With standard assumptions, a consistent estimate of b is obtained simply by averaging the observations x_i . If the error terms are uncorrelated across firms and their variances are known and proportional to the squared sizes of the ILECs (where size is measured, say, by number of lines), then an efficient estimate of b is the size-weighted “sample mean” or average of the x_i .

In this special case, the “neutrality” result mentioned above holds: the estimate of b , and its statistical precision, are unaffected by a merger between firms 1 and 2 even if achieved productivity following a merger is reported only at the consolidated level. Intuitively, since the optimal use of all the x_i was merely to take the weighted average anyway, nothing has been lost if two observations were merged into a “within-group” weighted average before being reported.

But even modest changes in these assumptions bring us back to the fact that, in general, it is strictly more informative to observe all the diversity. For instance, consider the case where, as is the case for price caps, the covariance structure of the e_i cannot be taken as known and diagonal. Some unobserved effects in the error term may be common to several firms in a given year and other unobserved effects may persist for several years for a single firm. Because the covariance structure cannot be taken as known *a priori*, an efficient estimate of the performance *will not* use solely the weighted mean of the observations x_i .⁵⁵ The Commission’s inferences about b will then be predictably less accurate if it has reliable access only to the weighted mean of x_1 and x_2 rather than to both of these variables. In other words, a merger hurts the process.

More generally, the Commission often lacks strong *a priori* knowledge of the variance with which the observations x_i are distributed around the unknown b . This is particularly likely in a *sui generis* proceeding as compared with one designed to measure recent changes in

⁵⁵ For example, generalized least squares estimation uses the observations x_i to estimate a covariance structure and thus to construct a more efficient estimate of the unknown parameter b .

productivity. Specifically, consider the standard Bayesian model in which the x_i are independent draws from a normal distribution with unknown mean b and unknown standard deviation σ , and in which the prior distribution of b and of $\log(\sigma)$ is the improper uniform.⁵⁶ The observer's point (posterior mean) estimate of b is the average of the x_i . As above, this is unaffected by the reporting only of average information. But nevertheless the posterior distribution of b depends on the separate observations x_i . Observing only pre-averaged data increases the posterior variance of b , because the observer has less information and thus must be less confident.

For example, suppose we begin with $n=8$. Then the posterior variance is given by⁵⁷ $[(n-1)/(n(n-3))]s^2$, an expression that depends on the sample variance s^2 , but whose prior expectation is equal to $(7/40)\sigma^2$. Now if a series of mergers⁵⁸ reduces n to 4, we will have half as many observations, each of which is now normally distributed around the unknown b with (unknown) variance $\sigma^2/2$. The prior expectation of the posterior variance of b is now equal to $(3/4)\sigma^2/2 = (15/40)\sigma^2$. The result of this (semi-hypothetical) wave of ILEC mergers is that (in prior expectation) the posterior variance on b more than doubles. As a result, the Commission must be less confident in its estimate of industry performance and more circumspect in establishing any performance standard.

As this conclusion suggests, the Commission often wishes to make a rule but to be reasonably confident that it is not unduly harsh. In many problems, including price caps and

⁵⁶ See, for instance, George G. Judge, R. Carter Hill, William E. Griffiths, Helmut Lütkepohl, and Tsoung-Chao Lee, *Introduction to the Theory and Practice of Econometrics*, 2nd Edition, 1988, p. 150.

⁵⁷ See Judge et al., p. 152.

⁵⁸ We make this version of the comparison to avoid the analytical complexity of having just one pre-averaged (paired) observation. However, we note that if the SBC/Ameritech and Bell Atlantic/GTE mergers were to take place, since the passage of the Telecommunications Act, the eight largest ILECs would in fact have been reduced to four.

universal service support, this can be formulated as a desire to set a performance standard y as demanding (say, as low) as possible but such that the probability that y is less than the unknown b is acceptably low. Statistically, this amounts to finding a confidence interval.

In most instances, the degree of variability will not be known in advance, and the Commission must generally rely on experience reported by the ILECs to arrive at a suitable confidence interval (in estimation terms) or band of tolerance (in behavioral terms). In this way, the data will be used for more than a point estimate of b .

An example that comes close to explicitly formulating the problem as the choice of a confidence interval is the FCC's proceeding on physical collocation. In this proceeding, which began in 1993, the Commission analyzed the cost estimates of 14 ILECs. The Commission had available different numbers of observations for the different collocation functions, depending on the types of facilities used by the companies.⁵⁹ The number of observations ranged from 12, for DS1 cross-connection and termination equipment, to just 3 for one type of security installation.

Four of the companies (Pacific Bell, Nevada Bell, Southwestern Bell, and SNET) are today part of SBC, and two others (Bell Atlantic and NYNEX) are merged into Bell Atlantic. If Ameritech and SBC merge, what was 14 will become 9; if, in addition, Bell Atlantic and GTE merge, the number drops to 8. If the Commission's calculations were repeated beginning from just 9 ILECs, the number of observations would decline to 8 for DS1 cross-connection and termination, and remain at 3 for the security installation. A merger of Bell Atlantic and GTE would further reduce the range for some collocation functions.

⁵⁹ And after removing very high cost estimates (those that exceeded the sample mean plus two sample standard deviations).

The reduced number of direct cost estimates increases the variability of the Commission's cost standard for a zone of reasonableness – the sample mean plus one sample standard deviation.⁶⁰ In a framework of Bayesian estimation of a parameter b and its distribution, the Commission must have reduced confidence that its mean-plus-one-standard-deviation interval actually covers the range of costs of efficient ILECs. To achieve the same degree of confidence with fewer observations, the Commission would have to increase the size of the interval. However, the Commission rejected such a lax interval.

As the number of ILEC observations is reduced by mergers, the Commission's power to constrain excessive pricing by this kind of benchmarking is weakened and the tools for setting bands of reasonable costs ultimately become ineffective. To make this point most starkly, consider an industry with just two firms, and suppose that the Commission were to stick to the "mean plus one standard deviation" standard. Let the two observations be x_1 and $x_2 \geq x_1$, so that the sample mean is $(x_1 + x_2)/2$, and the sample standard deviation is $\sqrt{2} (x_2 - x_1)/2$. The Commission's zone of reasonableness, which allows everything up to one sample standard deviation above the sample mean, is now so large that even the maximum observation, x_2 , is *certain* to be judged reasonable! In other words, the technique now has no bite whatsoever. The standard would have to be even more lax, if that were imaginable, if the Commission took account of the lower probability that a one-standard-deviation allowance would truly cover sampling variation because of the low numbers.⁶¹

⁶⁰ We simulated the sample mean plus 1 sample standard deviation in repeated trials with 12 observations and then with 9 observations drawn from a normal population with mean and variance equal to the sample mean and sample variance for DS1 cross-connection and termination. We found that the reduced number of observations increased the standard deviation of the mean plus 1 standard deviation by 15.9%.

⁶¹ With $n=2$ and independent normal errors, the classical probability that the sample mean plus 1 sample standard deviation exceeds the population mean is only 0.75. (75% of the standard t distribution with one degree of freedom

Regulators Recognize the Problem

In summary, we have seen how mergers reduce the flow of information for benchmarking purposes, even if we assume away all incentive effects of the merger. Indeed, this effect has been recognized both by the Commission and by others. For instance, the Commission has noted, “[m]ergers between incumbent LECs will likely reduce experimentation and diversity of viewpoints in the process of opening markets to competition.”⁶² Similarly, in the U. K., benchmark comparisons are used to compare the efficiency of monopoly water and sewerage companies operating in different geographic districts and to set company-specific price caps. The essential value of having comparative data from independent firms is recognized in the statutory requirements. Under the 1989 Water Act, the Monopolies and Mergers Commission (MMC) is required to take account of the loss of comparative information that would result from a merger of water companies.⁶³ The MMC recently examined a proposed merger between two water and sewerage companies and applied this standard.

Two studies submitted to the MMC provided estimates of likely losses due to (1) loss of the observation of a best-practice firm at some stage in the future, and (2) setting of less stringent price benchmarks because of greater uncertainty. The MMC noted that many other dimensions in which comparators are used in the comparative process had not been valued, and it recognized that individual companies also make particular contributions in specific comparative exercises. In summary, the MMC found that, although it was unable to quantify exactly the loss from removal of one firm (South West Water) from the comparative process, “we are satisfied that it

lies below 1.) To define a zone of reasonableness that would have 90% probability of including the population mean one would have to allow variability of 3 standard deviations.

⁶² FCC 97-286, para. 152.

⁶³ Water Industry Act, 1991, Part II, 34 (3).

would be a substantial one.”⁶⁴ The MMC blocked the proposed merger that would have reduced the number of independent sewerage services companies from ten to nine. It found that “no remedy, even in the shape of very significant price reductions, would be sufficient to compensate for the loss of [South West Water Services] as a comparator.”⁶⁵

B. Unilateral Incentive Effects

A merger between firms with market power that compete in a product market has anticompetitive incentive effects that are well understood by competition authorities.⁶⁶ The “unilateral” effects stem from each merging party’s new incentive to help, or not hurt, its new partner.

When two firms compete in a product market, each has opportunities to engage in behaviors that (i) are socially desirable, (ii) are profitable for that firm, (iii) reduce the profits of the other firm, and (iv) therefore are less likely to take place after a merger between the firms. In the case of product-market competition, “lowering price towards marginal cost” is the paradigmatic example of such behavior, although quality improvements, innovation, and other effects are also (and in some⁶⁷ cases more) important. For this reason, antitrust authorities will challenge a merger between such firms if consumers lack adequate other alternatives, and if the change in incentives is likely to lead to significant worsenings of the firms’ offers to consumers.

When two regulated, geographically-separated ILECs face competition-by-comparison through benchmark regulation, similar economic forces are at work. The socially desirable actions

⁶⁴ Monopolies and Mergers Commission, para. 2.83, 2.85.

⁶⁵ Monopolies and Mergers Commission, para. 1.14; quoted in S.G.B. Cowan, “Competition in the Water Industry,” *Oxford Review of Economic Policy*, Vol. 13, No. 1, Spring 1997, p. 85.

⁶⁶ U. S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (revised April 8, 1997).

to consider now include: (a) lowering recorded access costs, (b) introducing new services that raise the average revenue per line, (c) cooperating more fully with regulation and with the introduction of local competition, and (d) once ILECs are offering in-region long-distance service, cooperating in difficult-to-enforce ways with rival IXCs. In each case, each ILEC may sometimes be willing to take such actions, but in general such actions would hurt other ILECs. After a merger, the merger partners internalize those cross-effects and become less likely to take such actions. In addition, as Katz and Salop argue, a merged firm may have stronger incentives to deny competitive accommodations and engage in exclusionary conduct toward rivals than has either merger partner separately.⁶⁷ When reflected in discriminatory conduct, these incentives worsen the comparative information available and impair average-practice, best-practice, and other forms of benchmarking.

1. Unilateral Incentive Effects of Merger under Average-Practice Benchmarking

Average-practice benchmarking sets firms into a form of competition with one another even if they do not compete in any conventional product market. As John Vickers has expressed it, if two agents face a similar incentive scheme in which each agent's rewards are based both on its own and another's performance, the agents "are in competition in the sense that the reward of each partly depends on performance relative to that of the other agent."⁶⁸ The establishment of benchmarks thus creates "competition-by-comparison" between firms that do not directly compete with each other in the same geographic markets.

As one might expect from this observation, mergers between firms whose performance is regularly compared under benchmarking can have adverse unilateral incentive effects that are

⁶⁷ Katz and Salop, Section VI.

⁶⁸ John Vickers, "Concepts of Competition," *Oxford Economic Papers*, January 1995, Vol. 47, No. 1, p. 10.

very similar to the corresponding anticompetitive effects of mergers among direct product-market competitors. Thus, consider the effect of a merger on the benchmark used for price-cap regulation. After the merger, each of the original firms will internalize the effect of its productivity improvements on its partner's profits. Compared to before the merger when the firms were competitors-by-comparison, this effect is a negative one.⁶⁹

If (say) SBC lowers its recorded access costs, it is likely that the X-factor(s) set at a subsequent price cap performance review will be greater as a result. The increased X-factor will make Ameritech (as well as other price-cap ILECs) less well off. Post-merger, the incentive for the merged firm to reduce its costs in the former SBC's area will therefore be lower than the incentives SBC faced pre-merger. Symmetrically, Ameritech's incentive to increase efficiency also declines.

To continue the example used earlier, after a merger of two ILECs, each of which has 20% of the total access lines, a larger ILEC, with 40% of the access lines, keeps only 60% (i.e., 100% - 40%) of the cost reduction after the readjustment has taken effect. Thus, this larger ILEC's gross private present-value return per line becomes

$$$(1 + .91 + .83 + .75) + .6*(.68 + .62 + .56 + \dots) = \$ 7.99$$

so that this larger ILEC faces a "tax" of 27% (i.e., $7.99/11 = .73 = 1 - .27$). The point is that a cost-reducing action by one of the original firms will reduce the access price that can be charged by its partner. The prospect that access charges will be adjusted in the light of the firm's own productivity experience creates a "tax" on the increased profits that each of the merged ILECs

⁶⁹ Although ILECs in different geographic areas are also suppliers of complements – each supplies originating access for calls terminating in the other's territory – this effect is surely small compared to the effects considered here.

realizes from investments that increase its productivity. As a result of the merger, the amount of "tax" increases because the effect on the merging partner is internalized.

We note that a simple comparison of these illustrative numbers – a 27% "tax" versus a 14% tax – may not fully convey to non-economists the difference in impacts. Economic logic tells us that the harm caused by a tax, or by a distortion of incentives away from the efficient level, is broadly proportional to the *square* of the distortion. Thus, a "tax" that is twice as large causes not twice as much, but approximately *four* times as much, economic loss.⁷⁰

Clearly these numbers are illustrative, rather than precise, calculations. However, we believe that they correctly suggest that an increase in the share of nationwide lines controlled by a single company, such as would occur under the proposed SBC/Ameritech merger, substantially worsens the ratchet effect created by periodic revision of the X-factor. Under a system of benchmarking that uses industry-wide averages of cost performance, the larger the ILEC, the worse the ratchet effect.

Studies of the effect of corporate tax rates and tax credits on research and development spending suggest that R&D expenditures are relatively price-elastic with respect to tax rates.⁷¹ This

⁷⁰ This observation is a staple of economic analysis. Roughly, it can be explained as follows, for the simple case in which projects' gross returns are approximately uniformly distributed (at least in expectation). In expectation, a tax that is twice as large will discourage about twice as many efficient projects, because it puts twice as large a range "below the threshold." In addition, the average discouraged project is approximately twice as valuable in pre-tax (i.e., efficiency) terms.

⁷¹ See, e.g., Bronwyn Hall, "R&D Tax Policy During the 1980s: Success or Failure?", *Tax Policy and the Economy* 7: 2-35, 1993; Philip Berger, "Tax Incentives for R&D: What Do the Data Tell Us?", *Council on Research and Technology*, Washington, photocopied, 1992; James Hines, "On the Sensitivity of R&D to Delicate Tax Changes: The Behavior of U.S. Multinationals in the 1980s," in Alberto Giovannini, Glenn Hubbard, and Joel Slemrod (eds.), *Studies in International Taxation* (University of Chicago Press: Chicago), 1993; Theofanis Mamuneas, and M. Ishaq Nadiri "Public R&D Policies and Cost Behavior of the U.S. Manufacturing Industries," *Journal of Public Economics* 63: 57-81, 1996.

effect makes it more likely that, as a result of a merger, the firms will allocate fewer resources to activities that would reduce costs but would also affect a benchmark.⁷²

Finally, while a merger between SBC and Ameritech does not affect the immediate incentives of "third" ILECs (such as Bell South) under an average-performance scheme, there is nevertheless a plausible effect on their actions. In particular, Bell South may be less likely to trim its own excess costs if SBC and Ameritech face weakened incentives to trim theirs.⁷³ The net result can be expected to be a slower rate of productivity improvement throughout the industry, and consequent harm to consumers, as competition-by-comparison is weakened through merger.

The merger of SBC and Ameritech would also impair the effectiveness of average-practice benchmarking in the universal service support program, and for very similar reasons. To illustrate, suppose that SBC introduces new services that are valued by consumers, and thereby raises its average revenue per line. In due course, this will be reflected in a higher revenue-per-line benchmark for calculating high-cost support. As a result, carriers collecting high-cost support funds based on the difference between their estimated costs of serving high-cost areas and the benchmark revenue per line will receive less support. If SBC's merger partner, Ameritech, is such a carrier, post-merger SBC will internalize this effect and it will have less incentive to introduce such new services. In the same fashion, Ameritech will have a reduced incentive to introduce new revenue-increasing services because it will take into account the potential for reduced support that could flow to SBC in its high-cost service areas.

⁷² This effect must be set against any merger-specific economies of scale in innovation. We note, however, that because licensing of innovations among ILECs faces no obvious barriers, one might be suspicious of claims that such economies of scale are merger-specific.

⁷³ Although there is no first-order effect on Bell South's incentives to cut its costs, if it becomes richer and "fatter" (as it will if merging ILECs cut back on their cost-reduction), it may nevertheless (perhaps because of managerial principal-agent problems) experience cost inflation itself. See Michael Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review*, 76:2 (May, 1986), pp. 323-329.

2. Unilateral Incentive Effects of Merger under Best-Practice Benchmarking

A merger will similarly weaken the effectiveness of best-practice benchmarking because of the adverse (unilateral) *incentive* effects of taking a merger partner's interests into account. In our analysis of this problem, we distinguish two cases: (a) the merged firm sets a common practice for both partners, and (b) formerly independent (now merged) firms maintain two different practices. Although the analysis is somewhat different, the key themes and qualitative result – a loss of effectiveness for best-practice benchmarking – are the same in both cases.

When the merged firm sets a common practice, if firms' practices can be represented numerically (as with collocation charges or overhead rates), the common practice value of the merged firm is likely to lie strictly between the practices that the parties would have set separately absent the merger. As noted above, under best-practice benchmarking, only the best observation among all firms ultimately counts. Thus, either the merger makes no difference (because neither merging party would have provided that best observation), or the merger moves the firm with the best practice toward the other partner's preferences (because the best-practice firm now internalizes the effect on its partner). In the latter case the merger produces an undesirable change.

For example, suppose that Ameritech as a stand-alone RBOC would offer collocation charges of \$X, an offer that turns out to be "best practice" among the ILECs, while SBC as a stand-alone entity would offer higher charges of \$Y. In the absence of a merger, Ameritech's offer would be imposed as the benchmark, and SBC would be limited to charges of \$X. Post-merger, decisionmakers for the merged company select a common charge for both partners that maximizes their total net benefit. As we noted above, one would expect this single policy to be set somewhere between the two pre-merger policies, \$X and \$Y, which implies that it would be higher than \$X.

Consequently, post-merger the observed best practice is inferior to the best practice absent the merger.

In some cases, the merged firm will maintain different practices. In this case, too, there is an incentive to “shade” the previously independent choice in the direction of the less cooperative merger partner’s preference. To illustrate this incentive, suppose that the Commission were to use a best-practice standard to establish maximum rates for collocation services and that each ILEC recognizes in advance that best-practice benchmarking is likely to be applied to collocation charges. Acting independently, each ILEC would offer collocation charges reflecting its own cost conditions and strategic goals, as well as other factors such as the intensity of state regulatory scrutiny.

However, if the firms merge, Ameritech's decision-makers would take into account that SBC's preferred charges are \$Y and that the practice that Ameritech sets, \$X, may be selected by the regulator as best-practice and applied to SBC as well. The decision-makers who maximize the joint profits of the merged companies, or even take SBC's preferences into account more weakly, would shade the offer of \$X towards \$Y – that is, the offered collocation rate would be higher. As a result, the benchmark charges would end up higher: either the shaded offer remains best practice, or another ILEC's offer, (by assumption higher than \$X), is now best practice.

It is important to note that even if (in this example) Ameritech's influence brings SBC's preferred charge down from \$Y towards \$X, under best-practice benchmarking this reduction does not matter.⁷⁴ While a merger between an ILEC that (in a particular matter) is cooperative with new competitors and one that is intransigent may moderate the behavior of both, under best-

⁷⁴ Assuming, that is, that Y is not so “moderated” as to fall below X.

practice benchmarking it is only the merger's effect on the cooperative ILEC that affects the final result.

In summary, then, there is an adverse incentive effect of a merger when the merging firms' practices are compared by regulators and best practices are promoted. This is distinct from, although analogous to, the adverse incentive effect of the merger under average-practice benchmarking.

C. Coordinated Effects and Risk of Collusion

Recall from our discussion above that, under competition-by-comparison (as under product-market competition), each ILEC can undertake actions that are socially desirable and profitable but that harm the interests of other ILECs. A merger can increase the threat that a common understanding will develop (explicitly or implicitly) not to engage in such behavior. We believe that a substantial decrease in the number of relevant independent firms (and for some purposes only large ILECs may be relevant firms) can significantly increase this threat.

This, too, is not a novel point. Indeed, the Commission has observed that, although ILECs have a common interest in minimizing their cooperation with regulators and competitors who are seeking to open their local markets to competition, "On any particular issue, however, one incumbent LEC may have an incentive to cooperate with its competitors, contrary to the interests of other LECs," an incentive that may arise from regional differences between the ILECs.⁷⁵ The Commission rightly observed that if two major ILECs merge, the incentive for an individual ILEC to "break ranks" and cooperate with pro-competitive processes may be reduced. The number-portability example that we described earlier strikingly illustrates such a possibility.

⁷⁵ FCC 97-286, para. 154.

As in the product-market case, such parallelism is more likely the smaller the number of large ILECs. In large part, this is because of the diversity discussed above in the context of best-practice benchmarking. That is, with many ILECs, it is more likely that there will be one or two mavericks on any complex issue. With a large number of players, an ILEC contemplating aggressively cutting costs or boldly innovating will be less inclined to worry about offending the others by breaking an otherwise united front. By contrast, as the number of ILECs is reduced by merger, they become more likely to be able to coordinate their behavior and refrain from socially desirable actions. In this sub-section, we expand on this point.

As above, suppose first that each of n independent ILECs will, with probability p , take the socially desirable action. We next investigate the tradeoff between unilateral incentives to do so and coordinated incentives to maintain a united front. Suppose that an ILEC may, for its own reasons, prefer to take the socially desirable action in a matter at hand, but would also derive future value if a united position is maintained that would provide benefits in future regulatory matters. By hypothesis, if this ILEC goes along with the putative united front, it incurs some private cost c . This private cost, and even the fact that it is positive, are likely to be difficult for others to observe.

An ILEC in this position trades off c against the possibility that its action determines whether the united front – which it values at B – is maintained. (It may value this because of the prospect of preferring the united front on future matters, for instance.) Then this ILEC will reflect that, apart from its own action, with probability $q_n = (1 - p)^{n-1}$ the front is united, so that its own action determines whether the united front is maintained. As a result, it will cooperate with the united front if, and only if, $q_n B > c$.

Observe now that the probability q_n is decreasing in n for a given value of p , so that q_n increases with a merger. Also recall that (under a reasonable symmetric model of how conflicts between merger partners are resolved) a merger can be modeled simply as a reduction in n . So, a merger will make it more likely that a united front is maintained, conditional on each ILEC's choice of p . This effect, which we discussed above in subsection III.A, has nothing to do with incentives (it holds p constant), but is purely a statistical (information) effect.

There is *also* an incentive effect, however. This is best seen in a Bayesian equilibrium of an incomplete-information game among the ILECs. Suppose for instance (plausibly enough) that each ILEC's value of maintaining a united front, B , and/or its value of c for a particular matter, are private information. Then this ILEC will maintain the united front if and only if, for its particular values, c/B is less than the perceived probability q_n that all others will maintain the united front. As a result, the probability that it chooses, instead, to be a maverick is $p(q_n)$, a decreasing best-response function.

Taking as given other ILECs' choices of p , any one individual ILEC's incentive to maintain the united front is increased by a merger. Because there is no point in playing on the team if others fail to do so, an increase in the perceived probability q_n that all others will do so – such as follows from a reduction in n holding p constant – therefore also makes each individual ILEC more inclined to go along with the (perhaps) united front and less inclined to be a maverick. Thus, the merger causes each ILEC's optimized p to fall, even if it takes others' values of p to be fixed (unaffected by the merger). Furthermore, if the ILEC recognizes this effect, it will know that others' values of p have, in fact, fallen, so that q is now even higher, further reinforcing its own incentive to reduce its p .

This analysis illustrates how a reduction in n can make maintenance of a united front more likely, both statistically, given each ILEC's p (as analyzed above), and also behaviorally, through the effect on p . Thus, a decrease in the number of firms through merger can increase the likelihood that the ILECs will achieve a united front inimical to cooperation with regulators and competitors.

D. Effects of Merger on "Purified" Benchmarks.

Yardstick competition can in principle eliminate the ratchet effect in average-performance benchmarking by setting a separate firm-specific benchmark for each firm. The Commission appears generally to have avoided this practice, possibly because of the difficulty of arguing persuasively that a common standard is being applied to all firms. Another problem is that, to the extent there are durable firm-specific effects or modest numbers of firms, as an estimate of what an individual firm is capable of achieving, a purified benchmark is statistically inefficient – although efficient in incentive terms.

Whatever the merits and defects of purified benchmarks, our goal here is to understand the effects of a merger among large ILECs. The primary effect of such a merger on purified benchmarking is that each merging ILEC's "target" or performance standard must become "noisier," because purified benchmarks impose the constraint that (for instance) Ameritech's performance receive zero weight in setting a target for SBC, and vice versa. Since it would be very unlikely absent the merger that no weight would be given to Ameritech's performance in setting an efficient purified benchmark for SBC, this is a loss.

This analysis applies when the regulator sets a very simple "average" purified benchmark. A related effect, however, applies to non-merging parties as well. That is, the ability to adjust a benchmark for firm-specific effects is impaired. "Where econometric analysis is needed before

comparisons can be drawn between companies with diverse operating environments, it is important that the number of separate observations relative to the number of explanatory variables that should be included in any model is sufficient.”⁷⁶

IV. Conclusion

Our discussion of the use of comparative and benchmark techniques by telecommunications regulators illustrates one of the important losses from mergers among large ILECs. We note again that not only regulators but also customers and suppliers of complements (such as IXCs), as well as nascent competitors, can and do compare ILECs against one another. The loss of one of a relative handful of large ILECs would substantially damage efficient regulation, including the interconnection regulation necessary for the growth of competition in local exchange and exchange access markets.

⁷⁶ Monopolies and Mergers Commission, para. 2.43.

THE BENEFITS OF BENCHMARKING AS RECOGNIZED IN MFJ PROCEEDINGS

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The Benefits Of Benchmarking As Recognized In MFJ Proceedings

The Federal Communications Commission has observed that the ability to make benchmark comparisons arising from the Bell System's formation of seven autonomous regional local exchange companies, in place of the monolithic pre-divestiture Bell System operating company structure, constitutes an "important regulatory tool" whose benefits have been recognized on numerous occasions since the MFJ was proposed and implemented.¹ During the course of various MFJ-related proceedings, the Commission, the Justice Department, and the Courts all acknowledged and relied upon the ability of regulators to employ benchmarking in a variety of contexts. In addition, the RBOCs themselves, in their own court filings, repeatedly emphasized the importance of the benchmarks created by the AT&T divestiture in enhancing the ability of the Commission and other regulatory authorities to detect and deter anticompetitive conduct.²

Even before the MFJ was approved and implemented, the Justice Department, in its Competitive Impact Statement, implicitly recognized the value of the ability to utilize a benchmark approach to enhance the effectiveness of regulation, noting that while the proposed consent decree did not mandate

¹ See In the Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, for Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, Order, FCC 97-286, 12 FCC Rcd 19985 at ¶¶ 148-149 (1997).

² Id. at ¶ 149.

consolidation of the BOCs into any particular number of entities, AT&T affiliates had indicated that there would be multiple entities, and further stating that "the Department will take into account, as appropriate, the potential impact of the proposed configuration of BOCs on the likelihood that the [MFJ's] non-discrimination requirements will, in fact, be achieved."³

While the District Court did not explicitly address the issue of benchmarking in its 1982 opinion approving the proposed AT&T consent decree, with certain modifications,⁴ the Court specifically cited the ability to make such comparisons in rejecting the Justice Department's proposal to alter one of the Court's proposed modifications, i.e., the provision allowing the RBOCs to "provide, but not manufacture" all types of customer

³ United States v. Western Elec. Co., 47 Fed. Reg. 7170, 7174-75 (Feb. 17, 1982) (United States Department of Justice, Competitive Impact Statement). Subsequently, in urging approval of the proposed GTE consent decree, the Department specifically cited the ability of regulators to utilize the divested BOCs as benchmarks against which to evaluate the conduct of the GTE operating companies ("GTOCs"), to ensure the GTOCs' compliance with the equal access standards included in the proposed decree. United States v. GTE Corp., 48 Fed. Reg. 46634, 46657 (October 13, 1983) (United States Department of Justice, Competitive Impact Statement).

⁴ United States v. AT&T, 552 F.Supp. 131 (D.D.C. 1982). In contrast, in his 1984 order approving the proposed GTE Consent Decree, Judge Greene noted that "GTE's implementation of equal access will be judged not only against the requirements of the decree, but also against two objective benchmarks: (1) the Bell Operating Companies' provision of equal access; and (2) the provision of equal access by the [GTOCs] in the cities not served by Sprint." United States v. GTE, 603 F.Supp. 730, 735 (D.D.C. 1984).

premises equipment.⁵ In explaining its refusal to grant the Department's request to limit the BOCs to the provision of residential and single-line business CPE, the Court noted inter alia that concerns with regard to the potential for BOC discrimination in the installation and maintenance of CPE were alleviated by the fact that "claims of one Operating Company that it had particular difficulties or problems with the equipment of manufacturers it did not sell could be readily undermined by a comparison with the practices of the other six companies."⁶ In a subsequent order, the District Court itself utilized the other six RBOCs as benchmarks in concluding that Pacific Bell's refusal to provide access to its lines for services originating from AT&T's coinless public telephones constituted a violation of the MFJ's equal access requirement, noting in its opinion that "[a]ll the Operating Companies except Pacific Bell appear to be providing the required access."⁷

In its 1987 Report to the District Court concerning the line of business restrictions imposed on the RBOCs under the MFJ, the Justice Department gave considerable weight to the

⁵ United States v. AT&T Co., 1982-2 Trade Cas. (CCH) ¶ 64,980 at 73,150-73,151 (filed August 23, 1982) (D.D.C.).

⁶ Id. at n.8.

⁷ United States v. Western Elec., Inc., 583 F.Supp. 1257, 1258, n.4 (D.D.C. 1984). Elsewhere in its opinion, the Court observed that "Pacific Bell seems to be the only Operating Company to have taken the position that it need not grant access to AT&T unless and until ordered to do so by its state regulatory body." Id. at 1259, n.11.

conclusions reached by the Department's consultant, Dr. Peter Huber, concerning the value of benchmarks, specifically noting that "[Dr. Huber] believes that the existence of seven BOCs provides benchmarks that are likely to be useful to the regulators in identifying attempted abuses of the remaining bottleneck monopolies."⁸ In his report, Dr. Huber found that reliance on benchmarking had improved the effectiveness of the Commission's regulation in the area of interconnection in particular, observing that:

Benchmarking one LEC's performance against another in the post-divestiture marketplace has proved an effective regulatory tool. Laggard or eccentric LEC performance stands out when eight large holding companies [i.e., the seven RBOCs and GTE] line up for periodic regulatory inspection. . . .⁹

⁸ Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment ("DOJ Report and Recommendations") (filed February 2, 1987) at 44.

⁹ Peter W. Huber, The Geodesic Network: 1987 Report on Competition in the Telephone Industry, at 3.24 (1987). Elsewhere in his report, Dr. Huber observes that:

. . . the FCC's ability to use one RHC's performance to benchmark another's makes regulatory oversight considerably easier than it once was . . . [I]f regulators themselves sometimes fail to spot network idiosyncrasies, adversely affected parties generally do not. . . .

Id. at 5.17.

Dr. Huber also cited the positive impact of benchmarks in other areas of regulation (e.g., cost allocation) as well.¹⁰ In recommending elimination of the RBOC manufacturing prohibition, the Department cited "the emergence of multiple independent benchmarks for regulatory comparison of cost allocation and equipment purchase decisions" as one of two "major changes" which served to significantly reduce the potential for anticompetitive cross-subsidization.¹¹

In its own filings with the Court in the MFJ Triennial Review proceedings, the Commission itself described the positive impact of the new benchmarks created by divestiture on its ability to constrain anticompetitive conduct by the BOCs. In its response to the Justice Department's Report and Recommendations, the Commission observed that:

The divestiture itself makes it easier for the Commission to protect the competitive process. The creation of seven regional companies effectively established independent benchmarks for comparing BOC performance.¹²

¹⁰ Id. at 3.54-3.55 and 6.39 (noting that "benchmark regulation can be used quite effectively to weed out idiosyncratic LEC tariffs and cost allocations -- which might otherwise be tailored to advantage the LEC-affiliated ISP.")

¹¹ DOJ Report and Recommendation at 165.

¹² Comments of the Federal Communications Commission as Amicus Curiae on the Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment ("DOJ Report and Recommendations") (filed March 13, 1987) at 10.

The Commission went on to report that it had "been able to take advantage" of the benchmark approach to determine "minimum standards or maximum rates."¹³ In a separate filing, the Commission again noted that "[a] critical difference between regulating a monolithic Bell System and overseeing independent, competitive BOCs is the ability to compare or 'benchmark' the actions of the separate companies."¹⁴

The RBOCs themselves -- including the parties to the transaction which is the subject of this application and other already completed and proposed mergers -- were particularly vociferous in emphasizing the benefits arising from their creation as seven independent entities, each of them available for regulators to use as "benchmarks" in their efforts to identify and constrain anticompetitive discrimination and cross-subsidy. Indeed, the comments filed by one of the parties to the instant application, Ameritech, in response to the Justice Department's Report and Recommendations, included a lengthy attachment cataloguing the "widespread and effective use of benchmark comparisons since 1982" by the FCC, the Justice Department, the Court, and the private sector "in ways that would

¹³ Id.

¹⁴ Responsive Comments of the Federal Communications Commission As Amicus Curiae on the Report and Recommendations of the United States Concerning the Line of Business Restrictions Imposed on the Bell Operating Companies by the Modification of Final Judgment ("DOJ Report and Recommendations") (filed April 27, 1987) at 5.

have been inconceivable prior to divestiture."¹⁵ In its comments to the Court, Ameritech asserted that the "division of the local exchange networks among seven independent companies has greatly enhanced the delectability of any monopoly abuse and the effectiveness of regulation," adding that "[t]he utility and effectiveness of such 'benchmark comparisons' among the regional companies is demonstrated by the extensive record of their actual use."¹⁶ In a subsequent filing, Ameritech went on to argue that "[n]o amount of sophistry can suppress the importance of benchmarks," citing "overwhelming evidence that divestiture-created benchmarks are being used effectively by regulators, the

¹⁵ Ameritech Comments on the Report and Recommendations of the United States Concerning the Line-of-Business Restrictions (filed March 13, 1987), Attachment A at A-2.

¹⁶ Id. at 10-11. Similarly, in the introduction to its extended description of the post-divestiture use of benchmark comparisons, Ameritech observed that:

Today the seven regional companies and GTE operate local exchange networks of approximately the same size. The actions and decisions of any of these eight independent firms establish 'benchmarks' by which the actions and decisions of the other seven can be evaluated.

The presence of benchmark comparisons makes competition more effective because customers can make more informed decisions. Equally important, the presence of benchmark comparisons permits regulators and others to evaluate the merits of an operating company's actions or decisions even in circumstances where direct competition is absent.

Ameritech Comments, Attachment A, at A-1.

Department and the industry as safeguards against any potential anticompetitive conduct or regulatory abuse."¹⁷

The other party to the merger which is the subject of this application, SBC, in its response to the DOJ's Report and Recommendations, also emphasized the importance of benchmarks, observing that:

Perhaps the most profound change in the telecommunications industry since the announcement of the settlement that resulted in the MFJ is the existence of the seven RHCs as independent, publicly held companies. . . . The integrated Bell System was literally beyond comparison. Neither regulators, financial markets, nor the public had a benchmark against which the practices of AT&T could be measured.

The creation of the seven RHCs completely changed those circumstances. The FCC can now monitor the rates, performances, and business practices of the seven RHCs to detect potential anticompetitive activities."¹⁸

In its comments to the Court, SBC further asserted that the existence of the seven RBOCs as benchmarks provides "an effective deterrent against even subtle attempts to abuse any advantages

¹⁷ Ameritech's Response to Comments on the Report and Recommendations of the United States Concerning the Line-of-Business Restrictions (filed April 24, 1987) at 23; also see Ameritech's Reply to Responses to Comments on the Report and Recommendations of the United States Concerning the Line-of-Business Restrictions (filed May 22, 1987) at 3-7.

¹⁸ Comments of Southwestern Bell Corporation on the "Report and Recommendations of the United States Concerning Line of Business Restrictions (filed March 13, 1987) at i, 9-10.

that might arise from the ownership of local exchange telecommunications facilities."¹⁹

Comments submitted by another RBOC, Pacific Telesis (PacTel), which has since been merged into SBC, echoed the same theme, citing the "division of the Bell System into eight parts and the new ability of regulators to measure the BOCs against each other" as factors which have resulted in "an increased ability of regulatory agencies to identify and safeguard against improper discrimination and improper cross-subsidies."²⁰ Subsequent filings and expert testimony submitted by PacTel to the Court emphasized the ability of regulators to "use the other BOCs and GTE as benchmarks" in specific areas such as interconnection and procurement.²¹

The comments filed by other RBOCs which are not parties to the pending application included similar statements highlighting the benefits of having seven independent entities available to utilize as benchmarks. NYNEX, which is now subsumed within Bell Atlantic, noted in its comments to the Court that prior to divestiture "courts and regulators had practically no opportunity to develop 'benchmarks'" and observed that

¹⁹ Id. at ii.

²⁰ Comments of the Pacific Telesis Group in Support of the Recommendations of the United States (filed March 13, 1987) at 9-10.

²¹ Further Comments of Pacific Telesis Group, Pacific Bell, and Nevada Bell (filed April 27, 1987) at 75, 89, 95; also see Affidavit of Jerry A. Hausman at ¶¶ 26, 56, 60.

"[d]ivestiture changed all this" by establishing seven independent companies, thereby providing "[a] firm, constant and readily available basis . . . for comparing the actions of any one against the actions of another."²² Similarly, BellSouth's response to comments on the DOJ Report and Recommendations noted that the existence of seven RBOCs will "facilitate the detection of questionable competitive practices by allowing each BOC to serve as a benchmark for the others."²³ In its comments to the Court, U S WEST asserted that concerns with regard to the potential for anticompetitive cross-subsidies and discrimination in favor of RBOC-affiliated interexchange operations were unfounded, noting that "each of the other RHCs would provide a check or benchmark for the conduct of any one of them."²⁴ In this respect, U S WEST observed, "the effectiveness of federal

²² Response of NYNEX Corporation to the Comments filed on the Report and Recommendations of the Department of Justice (filed April 27, 1987) at 22-23.

²³ BellSouth Response to Comments on the Justice Department Recommendations and Memorandum in Support of Motion for Relief from Section II(D) of the Modification of Final Judgment (filed April 27, 1987) at 16; also see Comments of BellSouth Corporation on the Justice Department Recommendations Concerning Section II(D) of the Modification of Final Judgment (filed March 13, 1987) at 22, noting that "[s]ince there are now seven Regional Holding Companies, regulators can and do compare the activities of all so that the practices of any BOC manufacturing affiliate can be used as a benchmark to detect undesirable conduct by other BOCs."

²⁴ Memorandum for U S WEST, Inc. Presenting Points and Authorities in Support of Its Motion for Relief from Line of Business Restrictions Imposed by Section II(D) of the Modification of Final Judgment and Responding to Comments, (filed April 27, 1987) at 147.

and state regulatory agencies has been significantly enhanced by divestiture."²⁵

Affidavits submitted by the RBOCs in connection with their joint request for removal of the MFJ information services restriction, filed in the proceedings which followed the 1990 Court of Appeals' decision remanding this issue to the District Court, also emphasized the importance and effectiveness of the benchmarks created as a result of the AT&T divestiture. In one such Affidavit, for example, Professors Kenneth J. Arrow and Andrew M. Rosenfield observed that "[d]ivestiture also has made effective regulation easier by helping regulators evaluate and control the conduct of the RBOCs through the use of 'benchmarks,'" and noted that "the use of such benchmarks has already become standard practice at the Antitrust Division, the FCC and state public utility commissions."²⁶ In their affidavit, Messrs. Arrow and Rosenfield went on to assert that "[t]he availability of benchmarks greatly increases the probability that any attempt to discriminate in the provision of regulated service

25 Id.

26 Reply Memorandum of the Bell Companies in Support of Section VII Motions for Removal of the Section II(D)(1) Restriction on the Provision of Information Services, Reply Affidavit of Kenneth J. Arrow and Andrew M. Rosenfield, ¶ 43, citing the use of benchmarks by regulators "in evaluating compliance with equal access requirements and in comparing installation and maintenance practices for CPE."

to information service competitors would be detected and defeated quickly."²⁷

In its initial 1987 ruling in the MFJ Triennial Review proceeding, the District Court acknowledged the RBOCs' argument that, in contrast to the situation that existed prior to divestiture, "now . . . benchmarks exist by which the performance of one of them can be measured against that of the six others."²⁸ However, the Court rejected the notion that this fact constituted a sufficient "changed circumstance" to justify modification of the MFJ line of business restrictions, observing that "the possibility of the existence of benchmarks was necessarily included in the decree assumption which imposed the restrictions upon the several successors of the Bell System."²⁹ The Court also found that the RBOCs could take individual and collective

²⁷ Id.; also see Affidavit of Sanford J. Grossman, ¶ 28 ("divestiture has also increased the likelihood of detection by allowing regulators and competitors of the BOCs to compare one BOC to the other," and accordingly it is "very unlikely, as an institutional matter, that a BOC or its managers would undertake anticompetitive actions now"), and Reply Affidavit of Dennis W. Carlton and George J. Stigler, ¶¶ 44-45 (citing the AT&T divestiture and the existence of seven RBOCs as having "improved significantly the ability of regulators, antitrust authorities and rivals to detect and defeat attempts to behave anticompetitively").

²⁸ United States v. Western Elec. Co., 673 F.Supp. 525, 547 (D.D.C. 1987).

²⁹ Id.

action of various sorts to prevent the successful use of a benchmarking approach.³⁰

The D.C. Circuit, in its 1990 Order resolving RBOC appeals of the District Court's ruling, agreed that "as the District Court noted, the mere existence of seven BOCs in place of the prior unified Bell System is not by itself a significant factor" sufficient to justify a modification of the decree.³¹ The Court of Appeals concluded, however, that it was appropriate to consider "the asserted existence of 'benchmarks' for comparing BOC performance" in determining whether the standard for removal of the line of business restrictions established in Section VIII(C) was met.³² In its opinion, the Court of Appeals noted that "[a]ccording to appellants and the FCC, these benchmarks would make it far easier to regulate the BOCs than the old Bell System if the BOCs were permitted to enter other markets," but found that "the district court still legitimately

³⁰ In its opinion, the Court noted that "the Regional Companies are free, by virtue of the regulations proposed by the FCC, to adopt entirely dissimilar accounting and other procedures, making impossible intelligent benchmark comparisons between and among them." Id. at 547-548. In addition, the Court observed, "the Regional Companies are, of course, quite capable of cooperating with each other, if necessary, to defeat any benchmark-type comparison scheme." Id. at 548, n. 97.

³¹ United States v. Western Elec. Co., 900 F.2d 283, 299 (D.C. Cir. 1990).

³² Id.

imposes on the petitioning BOCs the burden of making the requisite showing."³³

In considering whether the District Court's refusal to lift the MFJ manufacturing restriction was justified, the Court of Appeals observed that "while the risk of cross-subsidization cannot be eliminated completely, FCC regulation -- especially the availability of benchmarks to enforce effective accounting rules -- would 'significantly mitigate' it."³⁴ Ultimately, of course, the Court of Appeals affirmed Judge Greene's decision maintaining the MFJ interexchange and manufacturing restrictions, but reversed and remanded the District Court's determination that the information services restriction should be modified, but not eliminated.³⁵

Subsequently, in its 1993 opinion affirming the District Court's decision on remand removing the information services restriction, the D.C. Circuit found that the existence of the seven RBOCs and the resulting use of benchmark comparisons had in fact materially enhanced the effectiveness of regulators, concluding that:

There is a lot of evidence that the break-up and other recent developments have enhanced regulatory capability. . . . [T]he existence of seven [R]BOCs increases the number of

33 Id.

34 Id. at 302.

35 Id. at 311.

benchmarks that can be used by regulators to detect discriminatory pricing. . . . Indeed, federal and state regulators have in fact used such benchmarks in evaluating compliance with equal access requirements . . . and in comparing installation and maintenance practices for customer premises equipment.³⁶

On the basis of its finding that the availability and use of benchmarks had enhanced the ability of regulators to constrain anticompetitive conduct by the RBOCs and other factors, the Court of Appeals determined that removal of the MFJ information services restriction was appropriate.³⁷

Following the Court of Appeals' ruling, the RBOCs renewed their efforts to secure removal of the remaining MFJ line of business restrictions, and in July 1994, four of the RBOCs, including SBC, filed a Motion to Vacate the Decree.³⁸ In their supporting memorandum, the RBOCs again cited their existence as seven independent entities, available for regulators to use as benchmarks, as a significant factor supporting removal of the MFJ interLATA and manufacturing line of business restrictions, stating that:

The story is quite different today. To some extent, the Decree itself is responsible for

³⁶ United States v. Western Elec. Co., 993 F.2d 1572, 1580 (D.C. Cir. 1993), cert. denied 126 L.Ed. 2d 438 (1993), citing the Arrow/Rosenfield, Grossman, and Carlton/Stigler affidavits described above, supra n.26-27.

³⁷ Id. at 1582.

³⁸ Motion of Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation and Southwestern Bell Corporation to Vacate the Decree (filed July 6, 1994).

making regulation effective. As the Court of Appeals has explained, '[t]he seven independent BOCs are not the old AT&T'. . . . Each BOC serves as a benchmark against which the Commission can measure the performance and behavior of the next; such comparisons were quite impossible before divestiture.³⁹

The RBOC's memorandum went on to note that "[t]he FCC also uses an automated system known as ARMIS to track BOC accounts over time and to compare the accounts of different BOCs, giving it 'unprecedented capability' to exploit the 'benchmarking' possibilities created by divestiture."⁴⁰

In addition, a number of the affidavits submitted in conjunction with the RBOCs' motion emphasized the enhanced ability of regulators to utilize benchmark comparisons between and among the seven RBOCs and GTE to more effectively constrain the potential for discrimination and cross-subsidization in various areas, e.g., interconnection/access, procurement. The joint affidavit submitted by former Commissioner Henry Rivera and two former FCC Common Carrier Bureau Chiefs, for example, asserted that:

Detection of interconnection problems today is easier than in the past as the result of two related developments. First, the break-up of the Bell System has produced numerous,

³⁹ Memorandum of Bell Atlantic Corporation, BellSouth Corporation, NYNEX Corporation, and Southwestern Bell Corporation in Support of Their Motion to Vacate the Decree (filed July 6, 1994) at 29-30.

⁴⁰ Id. at 35, citing Affidavit of James E. Farmer at ¶¶ 29, 31 and Affidavit of Henry Rivera, Richard Firestone, and Albert Halprin at ¶¶ 80-81.

similarly situated regional companies. Each of these companies' performance can be used as a benchmark for the rest. Although these comparisons alone cannot conclusively resolve whether discrimination has occurred -- each region is different because each has different network configurations and a different mix of equipment -- the Commission has used these benchmarks with great success, comparing BOC ONA plans and CEI proposals for such services as audiotex, protocol conversion, voice mail, electronic mail, remote monitoring, and computer storage. This is precisely the opposite of the situation confronted by the Commission before the Decree, when the Bell Companies were all part of a single integrated entity.

Second, the creation of numerous competing telecommunications companies has created a whole new class of sophisticated and aggressive whistleblowers. . . . [L]ike the FCC itself, these companies often will deal with several BOCs; as a result, they are able to detect discrimination by comparing the behavior and performance of each of the companies with which they deal.⁴¹

The affidavit submitted by Professor Gary S. Becker in conjunction with the RBOCs' motion also emphasized the value of benchmarking, in the areas of access and procurement, observing that:

Even provision of interLATA services to within-region customers raises fewer risks of discrimination against competitors than it did a decade ago. Whether local exchange companies provide equal access is now routinely monitored by regulators. Also, service providers that require local exchange access, such as those offering long distance and information services, can readily compare the quality and price of access provided by

⁴¹ Affidavit of Henry Rivera, Richard Firestone, and Albert Halprin, at ¶¶ 58-60.

other LECs in determining whether they are subjected to discrimination. . . .

Even RBOC manufacture of equipment that does or can interconnect with its local network raises fewer competitive concerns than at the time the decree was entered. If the prohibition on manufacturing were eliminated, regulators would be helped in detecting discrimination against unaffiliated equipment providers by analyzing equipment purchasing patterns of the integrated RBOCs (and customers in their regions) against a variety of other benchmarks including the other RBOCs and other large LECs such as GTE.⁴²

Similarly, the affidavit submitted by Professors Arrow and Carlton noted that "[i]f the equipment manufacturing ban is removed, regulators would still be able to compare the purchasing practices of any of the RBOCs against those of the six other RBOC benchmarks as well as GTE and other large local exchange providers," and asserted that "[t]his environment facilitates detection of attempts to discriminate against unaffiliated suppliers."⁴³

On April 11, 1996, the District Court issued an order terminating the MFJ effective as of February 8, 1996, the date on which the Telecommunications Act of 1996 was signed into law.⁴⁴ Pursuant to the Court's Order, all pending motions were dismissed as moot.⁴⁵ Accordingly, there was no judicial determination as

42 Affidavit of Gary S. Becker, ¶¶ 15, 17.

43 Affidavit of Kenneth J. Arrow and Dennis W. Carlton, ¶ 26.

44 United States v. Western Elec. Co., 1996-1 Trade Cas. (CCH) ¶ 71,364 at 76,837 (April 11, 1996) (D.D.C.).

45 Id.

to the merits of the arguments advanced in support of the RBOCs'
Motion to Vacate the Decree.

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA,)
)
 Plaintiff,)
)
 v.) Civil Action No. 82-0192
)
 WESTERN ELECTRIC COMPANY, INC.)
 and AMERICAN TELEPHONE AND)
 TELEGRAPH COMPANY,)
)
 Defendants.)

ATTACHMENTS
TO
AMERITECH'S COMMENTS ON THE REPORT AND
RECOMMENDATIONS OF THE UNITED STATES
CONCERNING THE LINE-OF-BUSINESS RESTRICTIONS

March 13, 1987

Attachment A

BENCHMARK COMPARISONS

Divestiture has created the conditions for effective monitoring of the nation's telephone operating companies by customers, competitors, the Department of Justice, the Court and others and for effective regulation by the Federal Communications Commission. Today, the seven regional companies and GTE operate local exchange networks of approximately the same size. The actions and decisions of any of these eight independent firms establish "benchmarks" by which the actions and decisions of the other seven can be evaluated.

The presence of benchmark comparisons makes competition more effective because customers can make more informed decisions. Equally important, the presence of benchmark comparisons permits regulators and others to evaluate the merits of an operating company's actions or decisions even in circumstances where direct competition is absent. Since divestiture, the regional companies have faced both burgeoning competition and a proliferation of benchmarks affecting nearly everything they do. The upshot is that the regional companies live under a spotlight that may be unique in the business community.

The use of benchmark comparisons has become a standard practice of the regional companies' customers and competitors, as well as the FCC and the Department of Justice. Benchmark comparisons are used on large items and small items. They are used on

questions ranging from costs and profits, to network scheduling, to technical feasibility -- in short, wherever a regional company's decisions materially affect a competing economic interest group. This Attachment illustrates the widespread and effective use of benchmark comparisons since 1982. in ways that would have been inconceivable prior to divestiture.

I. USE OF BENCHMARK COMPARISONS BY THE PRIVATE SECTOR

The private sector -- including carriers, customers and others -- has often used benchmark comparisons in proceedings before the Department of Justice, the Court, and the Federal Communications Commission:

A. Use of Benchmark Comparisons before the Department of Justice and the Court.

o In its August 6, 1984 Comments on the regional companies' equal access compliance plans, AT&T made the following comparative assessments of those plans:

- Contrasting the NYNEX, Ameritech, Southwestern Bell and Northwestern Bell plans for terminating equal access with the silence of the other regional companies. (AT&T Comments at 6).
- Comparing equal access conversion schedules. (Id. at A-2).
- Contrasting the BellSouth, U.S. West and NYNEX plans to provide customer presubscription lists with the silence of the other regional companies. (Id. at A-6).
- Contrasting the willingness of Ameritech, Pacific Bell and Southwestern Bell to provide Maintenance Limit data with the silence of the other regional companies. (Id. at A-9).

o In its August 21, 1984 Comments on the regional companies' compliance plans, MCI made the following comparative assessments:

- Comparing access tandem deployment schedules. (MCI Comments at 3-5).
- Comparing end office conversion schedules. (Id. at 5-9).
- Comparing access ordering requirements. (Id. at 10).
- Comparing availability of toll usage data. (Id. at 14).
- Comparing the Bell Atlantic, Pacific Telesis and Pacific Northwest Bell plans for allocation of access capacity. (Id. at 16-19).
- Comparing presubscription procedures and reports. (Id. at 23-31).
- Comparing plans for calling card services and directory assistance. (Id. at 35).
- Comparing plans for switched access from public telephones. (Id. at 36).
- Contrasting Ameritech's inclusion of various equal access information in its compliance plans with the omission of that information by the other regional companies. (Id., Exhibit 4).

o In its August 17, 1984 Comments on the regional companies' compliance plans, Satellite Business Systems made the following comparative assessments:

- Contrasting Ameritech's commitment to deploy access tandems rapidly with other companies' plans for direct trunking. (SBS Comments at 7).
- "Southwestern Bell appears to have responded most completely of all the BOCs to the [transmission quality] information requests

presented by the Department . . ." (Id. at 16).

- Comparing presubscription procedures and reports. (Id. at 27-42).
 - Contrasting the plans of NYNEX, Southwestern Bell and Pacific Bell for calling card services with the silence of the other regional companies). (Id. at 44).
- o In its August 6, 1984 Comments on the regional companies' compliance plans, GTE Sprint made the following comparative assessments:

- Contrasting Northwest Bell's plans to allocate undesignated traffic with other companies' default of that traffic to AT&T. (GTE Sprint Comments at 6).
- Comparing availability of customer lists. (Id. at 7-9).
- Comparing plans for access tandem deployment. (Id. at 24).

- o In its May 10, 1985 letter from Michael Salsbury to Kevin Sullivan at the Department, MCI compared the presubscription activities of each of the regional companies with respect to four issues:

- 1) Presubscription order confirmation;
- 2) Conflict resolution;
- 3) Notification of new customers; and
- 4) Notification of installation timeliness.

For example, MCI contrasted the presubscription conflict procedures (which have since been standardized through FCC directives) of Ameritech, NYNEX, and Pacific Bell. Letter at 8 n.8.

- o In its Report To The Department of Justice on RBOC Compliance With Equal Access (Aug. 16, 1985), MCI made numerous comparisons among the regional companies' presubscription procedures and reports, including:
 - Comparing regional company presubscription confirmations, customer information, billing practices and report formats. (Report Sec. II at 4-5).
 - Comparing automated versus manual input of presubscription orders into switches. (Id. at 6).
 - Comparing schedules for presubscription implementation. (Id., Sec. III at 2 n.2).
 - Comparing presubscription report formats. (Id. at 3 n.3, 5 n.5).
 - Comparing methods of resolving presubscription conflicts. (Id. at 10 n.20).
 - Comparing charges for certain presubscription reports. (Id. at 11 n.20, 21).
 - Comparing Bell Atlantic and Ameritech positions on verification of presubscription orders. (Id. at 15 n.31).

- o In arguing its position concerning its February, 1986 requests for equal access at approximately 1400 regional company end offices, MCI made extensive comparisons with respect to those companies' equal access conversion schedules, procedures, and responses to the February, 1986 MCI requests. MCI's Objections To The RBOCs' August 1 Filings Concerning Bona Fide Requests For Equal Access Conversions (D.D.C.; Aug. 15, 1986).

B. Use Of Benchmarks Comparisons Before
The Federal Communications Commission

Allocation Plan

- o MCI compared Ameritech's proposed Allocation Order conflict resolution plan to BellSouth's plan. MCI concluded and argued to the Commission that Ameritech's proposal should be allowed, while BellSouth's proposal should be denied. Reply of MCI to Petition of Ameritech and BellSouth, Investigation of Access and Divestiture Related Tariffs, CC Docket No. 83-1145; Phase I (filed Sept. 26, 1985).

Bidirectional WATS

- o MCI Telecommunications Corp. commented that "[i]n contrast to the behavior of the other LECs," Ameritech promptly provided MCI with unblocked, unscreened, two-way WATS access lines. MCI commended Ameritech's efforts, particularly in light of the fact that other LECs have the same switching equipment as Ameritech. "Ameritech's efforts lay in stark contrast to the promised slow deliveries of the other LECs." Reply of MCI Telecommunications Corp., Mid-Year 1986 Access Tariff Filings at 2-3 n.4 (filed July 25, 1986).

Equal Access

- o In its reply comments, Lexitel Corp. presented a chart comparing all operating companies' order verification

reports. Lexitel analyzed the operating companies' performance data and concluded that some operating companies performed better than others. Accordingly, Lexitel argued that the Commission needed to define equal access and establish availability requirements. Establishment of a Comprehensive Definition of "Equal Access" to Local Exchange Facilities to Ensure Equal Opportunities for Competitive Provision of InterLATA Telecommunications Services, RM No. 5196 (filed Dec. 5, 1985).

Generic Rate of Return Formula

o In its July 3, 1986 reply brief in Authorized Rates of Return for the Interstate Services of AT&T Communications and Exchange Telephone Carriers, CC Docket No. 84-800, Phase III, GTE argued its position on interstate access rate of return methodologies by presenting data to the Commission that compared the following:

- The regional companies' capital structure components. (Exhibit 3).
- The regional companies' rates of return on common equity and rate base. (Exhibit 4).
- The regional companies' adjusted Commission quarterly DCF calculations. (Exhibit 5).

Rate Levels

- o MCI made numerous comparisons of operating companies in its January 7, 1985 Comments And Petition To Reject, Or, In The Alternative, To Suspend And Investigate, Investigation Of Access And Divestiture Related Tariffs, CC Docket No. 83-1145, Phase I and Phase II, Part I, Trans. No. 31. MCI's comments included comparative charts on the following:
 - Intrastate private line rates for NECA and Non-NECA BOCs. (Tables 2 and 3).
 - Special access rates for Digital Data Service. (Table 5).
 - Special access rates between carriers for voice grade service. (Table 4).
 - Special access investment per circuit. (Table 6).
 - Special access demand data. (Table 7).
 - Forecast number of access connections and special access lines. (Table 8).
 - Major unit investments used to allocate revenue requirements to rate elements. (Table 9).
- o In its November 22, 1983 comments on the Investigation of Access and Divestiture Related Tariffs, Phase I, CC Docket No. 83-1145, Western Union Telegraph Co. presented tables to demonstrate local carriers' rate increases. Specifically, the tables compared rates for identical two-wire voice-grade facilities within various mileage, transport and exchange/wire center categories. (Tables 12 to 15). Western Union also compared the 1978 Bell System rates to the 1982 separate

rates and the proposed special access rates. (Tables 16 to 23).

- o AT&T used an operating company comparison to demonstrate three rate alternatives to the Commission. AT&T's Application for Review, Investigation of Access and Divestiture Related Tariffs, Phase I, CC Docket No. 83-1145 at 21 (filed June 26, 1984).
- o AT&T included a comparison of various operating companies' special access monthly charges for three-mile voice-grade facilities in its discussion of interim special access tariff arrangements as opposed to Docket 20099 tariff arrangements. Brief of Intervenor AT&T, The Western Union Telegraph Co. v. FCC, Nos. 84-1177, 84-1641, 84-1642, 85-1115, 85-1124, 85-1148, 85-1151, 85-1183, 85-1204, 85-1300 at 12 n.24 (filed June 27, 1986).^{1/}

II. USE OF BENCHMARK COMPARISONS BY THE DEPARTMENT OF JUSTICE

The Department has made extensive use of benchmark comparisons in defining decree obligations and in monitoring compliance with those obligations. With respect to equal access, the Department has compared each regional company's practices,

^{1/} See also AT&T's Application for Review, Investigation of Access and Divestiture Related Tariffs, Phase I, CC Docket No. 83-1145 at 3 (filed June 26, 1984).

procedures, schedules and positions with those of the other regional companies. The Department has tended to define regional company equal access obligations based upon the highest level of performance achieved by any of the regional companies. For example:

- o The Department reviewed the revised conversion schedules and other responsive materials from each of the regional companies concerning MCI's February, 1986 requests for equal access at approximately 1400 end offices.^{2/} Based upon the schedules of some of the regional companies, the Department concluded that a 24-month interval between receipt of a bona fide request and conversion is prima facie reasonable for conversion of nonconforming offices. In comparing the different regional companies' conversion schedules, the Department observed that the regional companies "that propose substantially to complete their conversions within 24 months from the request . . . provide a 'yardstick' to which the more extended schedules must be compared to

^{2/} See, e.g., Memorandum of Ameritech On Its Equal Access Performance and the accompanying Affidavits of Gerald I. Malik and Joseph F. Luby (July 31, 1986), and Ameritech's Reply To The MCI, AT&T And Sprint Responses To Its Revised Equal Access Schedule, which was supported by the Supplemental Affidavits of William B. Wells, Harry N. Stephenson, and James R. Nette (Aug. 22, 1986).

determine whether they satisfy the decree standards."

Memorandum Of The United States Regarding BOC Schedules
For Equal Access at 15, (D.D.C.;

Nov. 21, 1986).

- o As part of its review of regional company responses to MCI's February, 1986 access requests, the Department noted that several companies were exploring the use of adjunct devices to provide equal access at nonconforming offices and requested detailed information from each of the regional companies concerning their experience with and plans for such devices. This information was requested so that the Department could evaluate the reasonableness of office conversions scheduled beyond a 24 month interval and report to the Court its conclusions regarding use of such adjunct devices. See, e.g., January 9, 1987 Letter from Nancy C. Garrison of the Department to Kenneth E. Millard of Ameritech.
- o Based upon its review of information from each of the regional companies, the Department compared and contrasted the equal access progress of the regional companies on a wide range of issues, including:
 - Availability of equal access;
 - Conversion of conforming end offices;
 - Cellular radio equal access;
 - Equal access for 800 and 900 Services; and
 - Equal access from public telephones.

With respect to each of these issues, the Department used the highest level of performance achieved among the regional companies as a benchmark in assessing the progress of the others. Report Of The United States To The Court Concerning The Status Of Equal Access (D.D.C.; Oct. 31, 1986).

- o The Department has made extensive use of benchmark comparisons among the regional companies' presubscription procedures and reports. Based on those comparisons, the Department has defined specific information that should be reported promptly to carriers as part of the presubscription ordering and conversion process, including:

- Notice of receipt and disposition of presubscription orders;
- Notice of conflicts among presubscription orders;
- Notice that a presubscription order has been superseded by a subsequent order; and
- Verification of presubscription order implementation.

Report Of The United States To The Court Concerning Equal Access Implementation at 9-10, 11-52 (D.D.C.; Feb. 7, 1986).

- o In comments in the FCC's Third Computer Inquiry, the Department noted that the existence of seven regional companies, separate from AT&T and from each other, should increase the regulatory abilities of the FCC:

[I]nstead of being faced with a single accounting proposal from an integrated AT&T, the Commission will have the benefit of different accounting proposals from the BOCs and AT&T, each of which will have the incentive to devise a facially effective set of accounting rules. The multiplicity of accounting approaches offered the Commission may increase its ability in the future to establish the types of regulatory tool necessary to prevent discrimination and improper cost shifting.

Comments Of The United States Department Of Justice, CC Docket No. 85-229 at 41-42 (Nov. 13, 1985).

- o As part of its review of the regional companies' decree compliance plans, the Department solicited additional comments on those plans from all interested parties. Appended to that Notice was the Department's list of more than 41 benchmark comparisons that the Department compiled through its review of those plans. Notice Of Comment Period Regarding The BOCs' Compliance Plans (D.D.C.; June 29, 1984).
- o In the DOJ Response To Public Comments On The GTE Consent Decree, the Department also concluded that GTE's equal access performance "can be tested against the objective benchmarks of the practices of the divested BOCs" 48 Fed. Reg. 46,655 at 46,657-68 (Oct. 13, 1983). See also GTE Competitive Impact Statement, 48 Fed. Reg. 22,026 at 22,033-4 (May 16, 1983) (any discrimination by GTE against interexchange

carriers can be detected by comparison with the regional companies).

III. USE OF BENCHMARK COMPARISONS BY THE COURT

Coinless Public Telephones

- o In ordering Pacific Bell to provide access lines for AT&T's coinless public telephones, the Court rejected various regulatory and public interest arguments by Pacific Bell and noted that "[a]ll the Operating Companies except Pacific Bell appear to be providing the required access." United States v. AT&T, 583 F. Supp. 1257, 1258 n. 4, 1259 n. 11 (D.D.C. 1984).

800 Service

- o The Court compared the reluctance of two regional companies to absorb the cost of a new billing system for intraLATA 800 Service with the willingness of the other regional companies to do so. United States v. AT&T, Mem. Opinion at 4 n.4 (D.D.C.; May 4, 1984).

Sale of CPE

- o The Court compared Bell Atlantic's attempt to sell embedded CPE to the General Services Administration with the behavior of the other regional companies, which had not attempted such sales. United States v. AT&T, 578 F. Supp. 680, 684 n.13 (D.D.C. 1983).

Installation and Maintenance of CPE

- o The Court stated that "with seven different Operating Companies involved in installation and maintenance, claims of one Operating Company that it had particular difficulties or problems with the equipment of manufacturers it did not sell could be readily undermined by a comparison with the practices of the other six companies." "Given the high probability of disclosure," the Court considered it "quite improbable that the Operating Companies would run this risk for relatively little gain." United States v. AT&T, 1982-2 Trade Cas. (CCH) ¶ 64,980 at 73,151 n.8 (Aug. 23, 1982).

Equal Access by GTE

- o The Court recognized that "GTE's implementation of equal access will be judged not only against the requirements of the decree, but also against two objective benchmarks: (1) the Bell operating companies' provision of equal access; and (2) the provision of equal access by the GTE Operating Companies in the cities not served by Sprint." Any violation would be "relatively easy to detect." United States v. GTE Corp., 603 F. Supp. 730, 735 (D.D.C. 1984).

IV. USE OF BENCHMARK COMPARISONS BY THE FEDERAL COMMUNICATIONS COMMISSION

The Commission not only compares one regional company to another but also compares GTE to the regional companies and vice versa. In discussing "equal access," for example, the Commission recently observed:

Because of inherent differences in equipment and size of carriers providing access facilities, the Commission adopted requirements for the larger exchange carriers, i.e., the Bell Operating Companies and General Telephone Operating Companies, which differ from those applicable to the generally smaller ITCs [Independent telephone companies].

Indiana Switch Access Division, File No. W-P-C 5671, Mimeo No. 3652 at 8 ¶ 16 (rel. Apr. 10, 1986) ("Indiana Switch Access Division").

Default Traffic

- o All operating companies except Northwestern Bell proposed routing to AT&T all interLATA calls originated by any customer who did not presubscribe to another interexchange carrier. Northwestern Bell proposed allocating non-presubscribing customers pro rata. The Commission imposed an allocation plan on all the regional companies modeled after the Northwestern Bell plan, encouraged other regional companies to use Northwestern Bell's customer material format, and required the GTE operating companies to adopt a Northwestern Bell-type plan. Investigation of Access and

Divestiture Related Tariffs, 50 Fed. Reg. 25982, 25987 ¶ 32 & n.44 (June 24, 1985) ("Default Traffic Plan Order").

Sales Agency Plans

- o Ameritech, NYNEX, BellSouth and U.S. West submitted new or modified sales agency proposals to the Commission. The Commission compared the plans and accepted only the BellSouth and U.S. West plans as being in compliance with the Sales Agency Order. Sales Agency Plans for the Furnishing of Intrastate Basic Service and Customer Premises Equipment, 59 Rad. Reg. (P&F) 309, 311 ¶ 3 (1985) ("Reconsideration Order").
- o NYNEX and Ameritech submitted modified sales agency plans for approval. The Commission accepted both, commenting that Ameritech's amended plan conformed "essentially to the plan submitted by BellSouth and accepted by the Commission in the Reconsideration Order." Amended Sales Agency Plans of American Information Technologies Corp. and Operating Companies and NYNEX Operating Companies, ENF 84-49 and 84-51 at ¶¶ 1, 6 (rel. Oct. 20, 1986).

Cellular Interconnection

- o Noting that some telephone companies had offered cellular carriers trunk-side connections (Type 2) as

well as standard line-side connections (Type 1), the Commission in effect, required all telephone companies, including GTE and the regional companies, to make available Type 2 interconnection. The Need to Promote Competition and Efficient Use of Spectrum for Radio Common Carrier Services, 59 Rad. Reg. 2d (P&F) 1275, 1284 ¶ 3 (rel. Mar. 5, 1986) ("Cellular Interconnection").

Comparably Efficient Interconnection

- o The Commission in its Third Computer Inquiry proceedings reviewed proposals and comments from each regional company regarding nondiscriminatory access for information services. Ameritech's proposal to introduce a new network architecture, Feature Node/Service Interface, triggered the Commission's broader initiative to require similar proposals from the other regional companies.^{3/} "Because it is in the carrier's competitive self-interest to utilize efficient interconnections, we view Ameritech's proposal as an indication that an architecture with highly efficient interconnections can be designed." Amendment of Section 64.702 of the Commission's Rules and Regulations (Third Computer

^{3/} Third Computer Inquiry, 50 Fed. Reg. 33,581, 33,600 ¶¶ 125-129 (Aug. 20, 1985).

Inquiry), 104 FCC 2d 958, 1063-1064 ¶ 212 (1986)
("Computer III Decision").

Equal Access

- o The Commission granted waivers for recovery of equal access costs to NYNEX and Bell Atlantic. The Commission compared other waiver requests to these and granted them if they were "consistent." The Commission also based its rulemaking proceeding to establish permanent procedures for equal access cost recovery on NYNEX's and Bell Atlantic's approaches. MTS and WATS Market Structure Amendment of Part 69 of the Commission's Rules for Recovery of Equal Access Costs, CC Docket No. 78-72, FCC No. 86-595 at ¶¶ 8 & n.20, 11 (rel. Jan. 15, 1987).
- o The Commission modeled a proposal requiring all operating companies to provide certain information to the IXCs serving their operating areas after a program implemented by Northwestern Bell. After reviewing comments in opposition to the Northwestern Bell plan from other operating companies, the Commission decided not to impose the requirements. GTE Sprint Communications Corp., US Telecom, Inc., Allnet Communications Services, Inc., and United States Transmission Systems, Inc. Joint Petition for Expedited Rulemaking, 60 Rad. Reg. 2d (P&F) 763, 768-769, 770 ¶¶ 12, 13, 17 (1986).

- o The Commission established an equal access implementation schedule that distinguished the non-GTE independent telephone companies from GTE and the regional companies.^{4/} "[A]ccess requirements adopted for the BOCs and GTOCs are different from those approved for the ITCs." MTS and WATS Market Structure Phase III, 100 F.C.C. 2d 860, 874 ¶ 47 (1985).^{5/}

Billing Information

- o The Commission granted Ameritech's waiver request from certain Feature Group A (FGA) usage surrogate requirements. "Because we have concluded that Ameritech's proposal is a reasonable method for developing usage surrogates, we believe its use by other carriers could be appropriate for purposes of the filing required by the Surrogate Order. Accordingly, we will entertain petitions for waiver from other carriers who may wish to use the same method for calculating their usage surrogates." Petition of Ameritech Operating Companies

^{4/} Indiana Switch Access Division at 9 ¶ 16; Petitions of MCI Telecommunications and GTE Sprint Communications Corp. Regarding the Validity of Connecticut Statute and Decisions of the Connecticut Dep't of Public Utility Control Relating to Unauthorized Intrastate Traffic, FCC 86-450 at 9 ¶ 37 (rel. Oct. 27, 1986).

^{5/} Indiana Switch Access Division at 1 ¶ 3.

for Waiver of Feature Group A Usage Surrogate Requirements, Mimeo No. 2788 (rel. Feb. 24, 1986).

Spread Spectrum Waivers

- o The Commission granted Northwestern Bell a waiver to collocate enhanced technology in its central offices. The waiver was granted subject to numerous conditions. These conditions set the standard for waiver requests by other operating companies. The Commission promised prompt action if the other operating companies filed waiver requests consistent with the Commission's directives to Northwestern Bell. Applied Spectrum Technologies, Inc., 58 Rad. Reg. 2d (P&F) 881, 888-90 & n.28 (1985).^{6/}

Generic Rate of Return Formula

- o The Commission proposed assigning each exchange carrier to one of several "rate of return groups." Some operating companies argued that each Bell region should be treated as a separate rate of return group. In reply comments, Ameritech observed that sufficient similarities existed among the regions to justify grouping all regional companies together during the

^{6/} See, e.g., The Mountain States Tel. & Tel. Co., AAD 6-1104, Mimeo No. 3515 at ¶ 1 (rel. Apr. 2, 1986).

first two-year return period. Specifically noting Ameritech's position, the Commission adopted a single rate of return group for all exchange carriers -- the regional companies, GTE and other independent telephone companies -- over the continuing objections of the other regions. Interstate Services of AT&T Communications and Exchange Telephone Carriers, 51 Fed. Reg. 1795, 1797 ¶ 10 (Jan. 15, 1986).

Rate Levels

- o The Commission contrasted with other regional companies' practices Southwestern Bell's (SWB) requirement that MCI's seven-digit FGA numbers be associated with WATS line usage. The commission decided to reject SWB's tariff. "In regard to the proposal that Other Common Carriers (OCCs) supply seven-digit numbers in conjunction with terminating WATS access line service, it remains unclear why SWB does not use its own records, as have other regions." Southwestern Bell Telephone Co., Trans. Nos. 1505, 46, 1249, 817, 853, 135, Mimeo No. 2199 at ¶ 6 (rel. March 6, 1987).
- o In developing its Annual 1985 Access Tariff Filings, Phase II, FCC 87-50 (rel. March 9, 1987), the Commission made the following comparisons from information submitted by GTE and Bell operating companies:

- The Commission contrasted operating companies' methods of calculating cancellation charges. (Id. at ¶¶ 94-100).
 - The Commission compared operating companies' expedited order charge calculation methodologies to the NYNEX methodology. (Id. at ¶¶ 112, 116-123).
 - The Commission compared operating companies' data on minimum monthly usage charges to review the reasonableness of those charges. (Id. at ¶¶ 39, 42, 22).
 - The Commission chose BellSouth's proposed language as "an example of the clarity necessary to inform customers," after examining the operating companies' service interruption credit allowances. (Id. at ¶ 56).
 - The Commission decided that it "would accept as reasonable a notice period of up to two days, as suggested by BellSouth" for service discontinuation. (Id. at ¶ 182).
- o Over an eighteen month investigation of individual access tariff rates, the Commission compared the rates proposed by each operating company for individual access rate elements as one basis for determining whether the other operating companies' rates might be outside the zone of reasonableness and would, thus, require further investigation. The Commission also compared the regional companies' and GTE's proposed rate structures in arriving at a reasonable structure for various access rate elements. Investigation of Access and Divestiture Related Tariffs, 97 F.C.C.2d 1082, 1098-99, 1100-1101, 1104 ¶¶ 39, 44-45, 52 (Feb. 17, 1984).

- o With the benefit of AT&T's analysis of those methodologies, the Commission compared the regional companies' various cost development methodologies. Investigation of Access and Divestiture Related Tariffs, 49 Fed. Reg. 23924, 23927-928 ¶¶ 21-27 (June 8, 1984).
- o After comparing and contrasting other regional companies' interim 800 service tariffs, the Commission granted Bell Atlantic's requested waiver of Part 69 of the rules because the Commission had "previously granted similar petitions filed by US WEST, NYNEX and Ameritech for reasons that apply equally to Bell Atlantic." Interim 800 Exchange Access Tariffs, CC Docket No. 86-279, Mimeo No. 5586, at ¶¶ 2, 10 (rel. July 3, 1986).
- o Various regional companies filed petitions requesting waiver, clarification or reconsideration of an order requiring the removal of all direct and indirect restrictions on the use of WATS access lines. After comparing all the petitions, the Commission concluded "that Ameritech's request for a waiver of the current standard ordering interval is justified." While rejecting other regional companies' waiver requests, the Commission granted Ameritech's waiver "for all carriers." Midyear 1986 Access Tariff Filings, 60 Rad. Reg. 484, 489, 490 ¶¶ 18, 22 (1986).

- o The Commission cited the troubles that one regional company had in developing an accurate cost ratio between 2-wire and 4-wire service as a reason to impose a ratio on all regional companies that differed significantly from the ratios reflected by the regional companies who did not profess to have problems. The Commission then placed the burden on carriers that believed that a different ratio was appropriate to "make such a showing as the basis for a request for waiver" Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket No. 85-166 at 51-52 & n.152 ¶¶ 105-106 (rel. May 24, 1985) ("Special Access Cost Order").

Protocol Waivers - Accounting Plan

- o The Commission used New Jersey Bell's protocol waiver request to establish standards for reviewing similar Computer II waiver requests by the other operating companies after directing certain revisions in New Jersey Bell's cost accounting plan. New Jersey Bell Tel. Co., ENF 84-22, Transmittal No. 474, Mimeo No. 0426 at 14-15 ¶ 32 (rel. Oct. 24, 1985).^{7/}

^{7/} See, e.g., Pacific Bell Petition for Waiver of Section 64.702 of the Commission's Rules and Regulations to Authorize Protocol Conversion Offerings, AAD 6-1326 at 2 (Footnote Continued)

Protocol Conversion - Marketing Plan

- o The Commission accepted various operating companies' proposals to market customer proprietary information because their procedures "are patterned after those [the Commission] approved for New Jersey Bell and the other Bell Atlantic companies" and "are also similar to those which the Commission approved when it relieved AT&T of the separate subsidiary requirement for the provision of CPE."^{8/} In addition, the Commission compared each operating company's protocol conversion offering with the conditions established for other operating companies in the Protocol Waiver Order.^{9/}

(Footnote Continued)

¶ 13 (rel. Dec. 3, 1986) ("Pacific Bell Petition"); Southwestern Bell Telephone Co. Petition for Waiver of Section 64.702 of the Commission's Rules to Provide and Market Asynchronous Protocol Conversion on an Unseparated Basis, AAD 6-1473 at 2 ¶ 13 (rel. Jan. 5, 1987) ("Southwestern Bell Petition"); Ameritech Operating Companies' Petition for Waiver of Section 64.702 of the Commission's Rules (Computer II) to Provide Protocol Conversion as an Adjunct to a Basic Packet Switched Network, AAD 6-1424 at 2 ¶ 13 (rel. Oct. 20, 1986) ("Ameritech Petition"); The Bell Atlantic Telephone Cos. Petition for Waiver of Section 64.702 of the Commission's Rules to Provide Certain Types of Protocol Conversion, AAD 5-1296 at 337 ¶ 47 (rel. May 19, 1986) ("Bell Atlantic Petition").

^{8/} See also Ameritech Petition at 6 ¶ 55; Pacific Bell Petition Bell Atlantic Petition at 338 ¶ 49.

^{9/} Petitions for Waiver of Section 64.702 of the Commission's Rules and Regulations, 100 FCC 2d 1057 (1985) ("Protocol Waiver Order").

Southwestern Bell Telephone Co. Petition for Waiver of Section 64.702 of the Commission's Rules to Provide and Market Asynchronous Protocol Conversion on an Unseparated Basis, AAD 6-1473 at 7 ¶¶ 18-21, 52 (rel. Jan. 5, 1987).^{10/}

Non-Traffic Sensitive Cost Recovery Plans

- o Five regions filed petitions seeking access charge waivers. Four regions proposed a fixed (non-usage sensitive) charge. New England Telephone proposed a usage sensitive scheme. Although the Commission rejected all petitions, it invited the operating companies to file waiver petitions requesting permission to implement plans similar to New England Telephone's proposal. Petitions for Waiver of Various Sectors of Part 69 of the Commission's Rules, 60 Rad. Reg. (P&F) 142, 193, & ¶ 144 (1986).

^{10/} See Ameritech Petition at 3 ¶ 20; Pacific Bell Petition at 3 ¶ 24; Bell Atlantic Petition at 333 ¶¶ 23-26.

DECLARATION OF JOHN B. HAYES

**MARKET POWER AND THE BELL ATLANTIC-
GTE MERGER**

**The Tilden Group, LLC.
23 November 1998**

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I. INTRODUCTION AND QUALIFICATIONS

1. My name is John B. Hayes. I am a Senior Economist employed by The Tilden Group, a consulting firm that applies economic analysis to issues of antitrust and regulatory policy. My work as an economist has been in the area of microeconomics, with a specialization in the study of antitrust and regulatory policies. In the course of my professional career I have had numerous opportunities to consider questions of market definition in the context of mergers and acquisitions generally.
2. I was previously employed by the U. S. Department of Justice for five years. Most recently, I assisted in the Department's evaluations of the Ameritech and SBC applications to provide in-region long-distance services. I have also taught courses at Georgetown University and advised government officials in the United States and other countries on antitrust and telecommunications policy.
3. I earned a Ph.D. in Economics from the University of Wisconsin, where my major field of study was Industrial Organization. A copy of my curriculum vitae is attached to this declaration as Appendix A.
4. I have been asked by counsel for Sprint to determine the markets relevant to an analysis of the competitive effects arising from the proposed merger of Bell Atlantic and GTE; to identify the participants, together with their shares, in those markets; and to assess the competitive significance of these market participants. In reaching my conclusions I have relied upon the Bell Atlantic-GTE *Merger Application*¹ and affidavits offered in this proceeding, evidence submitted in state

¹ *Application For Transfer of Control*, , CC Docket. No. 98-184, filed October 2, 1998 ("Merger Application").

and federal section 271 proceedings, industry reports, previous Tilden Group analyses of telecommunications markets, and the relevant economic literature. Drawing on my training and experience as an economist, and my review of the relevant facts available to me, I find that the proposed merger raises significant public interest concerns.

II. OVERVIEW

5. I previously filed a declaration with the Federal Communications Commission ("the Commission") describing the markets relevant to an analysis of the SBC-Ameritech merger, a matter that currently is pending before the Commission. The economic issues relevant to properly defined markets that were identified and evaluated in my prior declaration are in all significant respects unchanged in the current application. Because of these similarities, I have attached the relevant section from my prior declaration as Appendix B and will rely generally on the conclusions with respect to market definition described therein.² Specifically, the product markets relevant to an analysis of the competitive effects of the proposed merger are local exchange and access markets, and the geographic markets relevant to an analysis of the merger are the local service areas of Bell Atlantic and GTE. In addition, there are three customer segments with distinct demand characteristics: large business customers, medium-sized business customers, and small business and residential customers. The demand characteristics of these segments are sufficiently different that the competitive effects of the proposed merger should be separately studied in each of these segments.

² Appendix B was previously filed with the Commission on 14 October 1998 as section III of the Declaration of John B. Hayes, "Market Power and the SBC-Ameritech Merger."

6. In this declaration, I provide evidence on market shares in local exchange and access markets in the regions served by Bell Atlantic and GTE and assess the competitive significance of market participants in those service areas. My review of the evidence leads to the following principal results and conclusions:

- While the market share data are incomplete, there is persuasive evidence that local exchange and access markets are highly concentrated for all customer segments and in virtually all geographic markets. Large business customers located in major metropolitan areas are more likely than others to have viable competitive alternatives for service, but even for these large customers choices are limited. Small business and residential customers, with few exceptions, have no alternative service providers available. Aggregating across customer segments and geographic markets, the market share served by competitors to Bell Atlantic and GTE never exceeds two percent in any state, and in most states the CLEC share is less than one percent.
- Bell Atlantic and GTE possess substantial market power in many local exchange and access markets, and they will continue to possess market power for years to come. Further, competitors and providers of complementary services, such as long distance and mobile wireless services, will continue to require cooperation from the incumbent, both for existing services and for new and innovative forms of telecommunications.
- The out-of-region entry strategy proposed by Bell Atlantic and GTE is unlikely to benefit residential and small business customers in the near term. The proposed entry initially targets large and medium-sized business customers where competition is already developing.
- The merger of Bell Atlantic and GTE does not meet the Commission's public interest standard that the merger will enhance competition.³

³ *In the Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries, Memorandum Opinion and Order, FCC 97-286, released August 14, 1997 ("Bell Atlantic-Nynex Order") at ¶¶2-3.*

7. In the remainder of this declaration, I explain in detail the economic logic, factual analyses, and supporting data that have led me to the findings summarized above.

III. BELL ATLANTIC AND GTE POSSESS *DE FACTO* MONOPOLIES IN LOCAL EXCHANGE AND ACCESS MARKETS

A. Methodology for Assessing Market Power

8. The courts have long recognized that market share is an important predictor of an ability to exercise market power. In addition to market share, however, one must also consider other measures of structural characteristics of the relevant markets, indicators of market performance, and entry conditions.

B. Bell Atlantic and GTE Dominate Their Local Exchange and Access Markets

9. While the data available to assess market structure in the relevant markets are limited, they provide persuasive evidence that Bell Atlantic and GTE have dominant shares of local exchange and access markets in each customer segment.⁴

⁴ See also *Petition of Bell Atlantic-Pennsylvania, Inc. For a Determination of Whether the Provision of Business Telecommunications Services Is Competitive Under Chapter 30 of the Public Utility Code*, "Recommended Decision," Docket No. P-00971307, July 24, 1998 ("*Bell Atlantic-Pennsylvania Business Services Petition*") at 4-5 ("...I conclude that BA-PA has not come close to establishing...that there is effective competition for business services throughout BA-PA's service territory such that BA-PA would be unable to sustain price increases for its services. BA-PA's presentation on the issue of competitive presence does not withstand even the most cursory review."), and *In the Matter of the Board's Investigation Regarding the Status of Local Exchange Competition*, "Report and Action Plan," Docket No. TX98010010, July 1998 ("*Status of Local Exchange Competition*") at 1-2 ("...the Board finds that there has not been any significant statewide 'resale based' or 'facilities based' local land line residential or small business telephone offerings to or switching of customers to CLECs from ILECs in New Jersey or the nation.").

Moreover, because CLECs must interconnect with the incumbent carrier, their ability to discipline efforts to exercise market power is to a considerable extent controlled by the incumbent. As there are no viable substitutes for local exchange and access services, Bell Atlantic and GTE could substantially raise prices or degrade the service they provide to competitors, unless they are prevented from doing so by regulation.

10. That the ILECs possess substantial market power is hardly news. The Commission previously has found this to be true on numerous occasions.⁵ Both the Commission and state regulators cap access charges for precisely this reason.⁶ Moreover, the interconnection and structural separation provisions of the Telecommunications Act of 1996⁷ also are based on recognition of ILEC market power.⁸ In this declaration, I provide some evidence on the extent of the market power possessed by Bell Atlantic and GTE. Several alternative measures of market structure are examined, including:

⁵ See, for example, *In the Matter of Interconnection Between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, Notice of Proposed Rulemaking, CC Docket No. 95-185, released January 11, 1996 (“*LEC-CMRS Interconnection Proceeding*”) at ¶2 (“ILECs unquestionably still possess substantial market power in the provision of local telecommunications services.”).

⁶ See *In the Matter of Access Charge Reform*, First Report and Order, released May 16, 1997 at ¶¶258-284.

⁷ Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996). The 1996 Act amends the Communications Act of 1934, 47 U.S.C. §§ 151 et. seq.

⁸ See *In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as Amended and Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, Notice of Proposed Rulemaking, CC Docket No. 96-149, released July 18, 1996 at ¶3 and *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, Notice of Proposed Rulemaking, CC Docket No. 96-98, released April 19, 1996 at ¶¶6-10.

- shares of switched access lines;
- shares of switched minutes of use; and
- the existence of local service facilities, including collocation facilities and fiber facilities.

11. My analysis concentrates on switched facilities because switched lines provide both local exchange and access services. Shares of switched lines are therefore a useful indicator of market structure in both local exchange and access markets.⁹ As the Commission has observed, “[B]ecause interstate switched access is generally provided over the same ‘bottleneck’ facilities and by the same providers as provide local exchange and exchange access service, failure to create competition among local service providers necessarily means a lack of competition to provide interstate switched access.”¹⁰

12. The publicly available data are limited in several respects. Most importantly, the data are not available by customer segment or local service area. My conclusions are therefore based on an examination of state-level data reported separately for business and residential customers.

⁹ Shares of switched access lines may not provide a useful measure of market structure for exchange access services provided to certain high-volume customers. Some high-volume customers, such as large businesses, can purchase dedicated, special access lines. There is evidence that CLECs have a greater share of special access lines than switched access lines. This is the case both because CLECs have been selling special access longer than switched access, and more importantly, because special access lines are installed at locations that have sufficient traffic volumes to support profitably multiple high-capacity access lines. Consequently, customers who purchase special access are precisely the customers that are most readily served by CLECs. Special access lines account for 16 percent of total access lines and 19 percent of total interstate access revenues. *1997 Preliminary SOCC*, Tables 2.5 and 2.9.

¹⁰ *Bell Atlantic-Nynex Order* at ¶31.

i. *Switched Access Lines*

13. Table 1 reports market shares of switched access lines within the Bell Atlantic states. Bell Atlantic's share of switched access lines ranges from 98 percent in Massachusetts and New York to 100 percent in West Virginia. Aggregating across all in-region states, Bell Atlantic's market share is nearly 99 percent.

TABLE 1. BELL ATLANTIC MARKET SHARE OF LOCAL EXCHANGE LINES

<i>Bell Atlantic Market Share</i>			
State	Business	Residential	Combined
DC	99.41%	99.84%	99.25%
DE	99.66%	98.93%	98.59%
MA	98.26%	99.74%	98.00%
MD	99.79%	99.85%	99.64%
ME	99.74%	99.99%	99.73%
NH	98.91%	99.96%	98.86%
NJ	99.83%	99.74%	99.56%
NY	98.42%	99.59%	98.01%
PA	99.18%	99.37%	98.55%
RI	99.29%	99.86%	99.16%
VA	99.78%	99.92%	99.70%
VT	99.77%	100.00%	99.77%
WV	100.00%	100.00%	100.00%
Bell Atlantic Market Share (weighted by lines in service)	99.11%	99.67%	98.78%

Source: Second Local Competition Survey.

14. Table 2 reports market shares of switched access lines within the GTE local service regions. GTE's share of switched access lines exceeds 99 percent in all of its regions except Florida, where its market share is 98.73 percent. In 12 of the 15

states reported in Table 2, GTE serves virtually all of the switched lines in its local service area.¹¹

TABLE 2. GTE MARKET SHARE OF LOCAL EXCHANGE LINES

<i>GTE Market Share</i>			
State	Business	Residential	Combined
CA	99.93%	99.17%	99.09%
FL	99.47%	99.26%	98.73%
HI	99.99%	99.99%	99.98%
IL	100.00%	100.00%	100.00%
IN	100.00%	100.00%	100.00%
KY	99.80%	99.98%	99.78%
MI	100.00%	100.00%	100.00%
NC	99.85%	99.98%	99.84%
OH	100.00%	100.00%	100.00%
OR	99.99%	99.99%	99.97%
PA	99.99%	100.00%	99.99%
TX	99.53%	99.36%	98.89%
VA	99.99%	99.99%	99.98%
WA	99.99%	99.99%	99.98%
WI	99.94%	100.00%	99.94%
GTE Market Share (weighted by lines in service)	99.84%	99.60%	99.44%

Source: *Second Local Competition Survey*.

15. The market share estimates reported in Tables 1 and 2 are based on data from the *Second Local Competition Survey*.¹² The figures include CLEC customers served through resale and UNE loops in the CLEC share. These are two of the three methods that CLECs use to provide service. The publicly

¹¹ GTE reported data for 15 of its 28 states in the *Second Local Competition Survey*.

¹² *Second CCB Survey on the State of Local Competition*, available at www.fcc.gov (data as of June 30, 1998) ("*Second Local Competition Survey*").

available data from the *Second Local Competition Survey* do not include information on customers served over facilities owned by CLECs, the third method that CLECs use to provide service. Tables 1 and 2 therefore do not include CLEC on-net customers. Because there are few CLEC on-net customers in most states, including them in the calculations would reduce the ILEC share by an insignificant amount.¹³

ii. *Minutes of Use*

16. There are publicly available data for the states directly affected by the merger from which to estimate the share of switched local service minutes carried by CLECs operating in BOC service areas.¹⁴ Table 3 and 4 contain market shares of switched local service minutes for the Bell Atlantic and GTE states.¹⁵ Table 3

¹³ For example, Bell Atlantic's combined share of residential and business customers, including CLEC on-net customers, in Delaware and Virginia are: Delaware - 98.52 percent, as compared to the 98.59 percent reported in Table 1; Virginia - 99.47 percent, as compared to 99.70 percent reported in Table 1.

¹⁴ By definition, the CLEC share of minutes is equal to the number of minutes that originate or terminate on CLEC networks divided by the total number of minutes that originate or terminate in the ILEC service area. I have estimated the CLEC share by dividing the number of minutes CLECs exchange with the ILEC by the total number of minutes that originate or terminate on the ILEC's network. This estimate necessarily understates actual CLEC shares of total local exchange and access minutes of use because it does not include, in either the numerator or the denominator, minutes for calls that travel entirely on CLEC networks. As these calls are unquestionably a tiny fraction of the total, this source of bias is small. For example, if customers have balanced calling patterns, *i.e.*, customers make the same number of incoming and outgoing calls, and CLECs have a 5 percent share of customers, then the estimation method that I use would exclude one quarter of one percent (5 percent squared) of the total number of calls.

¹⁵ The data are from the *First CCB Survey on the State of Local Competition*, available at www.fcc.gov (data as of December 31, 1997) ("*First Local Competition Survey*"). The *First Local Competition Survey* data includes local, intrastate and interstate switched minutes. As the BOCs are prohibited from carrying interLATA minutes, the latter two categories are largely switched access minutes.

shows that Bell Atlantic's share of switched minutes ranges from 97.3 percent, in New York, to 100 percent, in New Hampshire. Bell Atlantic's share of switched minutes, averaged across its entire service region, is 98.7%. Table 4 shows that GTE's share of switched minutes ranges from 96.9 percent in Florida to 100 percent in several states.¹⁶ GTE's share of switched minutes, averaged across its entire service region, is 98.7%.

TABLE 3. BELL ATLANTIC MARKET SHARE OF NETWORK MINUTES OF USE

State	Bell Atlantic Minutes	Minutes Exchanged with CLECs	Distribution of Interconnection Minutes		Bell Atlantic Market Share
			Originating On ILEC	Terminating on ILEC	
DC	3,914,094,573	72,654,342	88.9%	11.1%	98.18%
DE	2,844,179,229	N/A	N/A	N/A	N/A
MD	20,664,044,746	193,764,052	94.4%	5.6%	99.07%
NH	3,701,159,999	0	0.0%	0.0%	100.00%
NJ	30,055,911,001	75,548,950	89.4%	10.6%	99.75%
NY	58,044,431,350	1,437,357,889	89.2%	10.8%	97.30%
PA	32,864,097,911	603,349,556	91.5%	8.5%	98.20%
RI	3,354,495,953	N/A	N/A	N/A	N/A
VA	20,255,539,401	10,800,806	93.9%	6.1%	99.95%
VT	1,596,841,523	N/A	N/A	N/A	N/A
Bell Atlantic Market Share (weighted by minutes)					98.67%

Source: First Local Competition Survey.

¹⁶

GTE reported identical numbers of minutes exchanged with CLECs in Missouri and North Carolina. Because one or both of these data points is likely an error, I did not report the data for these two states.

TABLE 4. GTE MARKET SHARE OF NETWORK MINUTES OF USE

State	GTE Minutes	Minutes Exchanged with CLECs	Distribution of Interconnection Minutes		GTE Market Share
			Originating On ILEC	Terminating on ILEC	
AL	410,721,150	0	0.0%	0.0%	100.00%
AZ	9,732,311	0	0.0%	0.0%	100.00%
AR	311,361,901	0	0.0%	0.0%	100.00%
CA	12,124,276,432	276,759,025	98.3%	1.7%	97.77%
FL	3,178,304,137	101,636,823	87.6%	12.4%	96.90%
HI	590,631,897	116,974	37.3%	62.7%	99.98%
IA	397,812,411	0	0.0%	0.0%	100.00%
ID	175,582,015	0	0.0%	0.0%	100.00%
IL	3,244,329,489	0	0.0%	0.0%	100.00%
IN	1,235,723,135	0	0.0%	0.0%	100.00%
KY	646,109,698	0	0.0%	0.0%	100.00%
MI	1,653,842,334	4,369,134	100.0%	0.0%	99.74%
MN	163,867,338	0	0.0%	0.0%	100.00%
MO	586,132,786	N/A	0.0%	100.0%	N/A
NC	607,862,367	N/A	0.0%	100.0%	N/A
NE	74,446,748	0	0.0%	0.0%	100.00%
NM	145,055,551	0	0.0%	0.0%	100.00%
NV	50,421,448	0	0.0%	0.0%	100.00%
OH	1,215,088,961	0	0.0%	0.0%	100.00%
OK	134,538,990	0	0.0%	0.0%	100.00%
PA	1,102,851,966	0	0.0%	0.0%	100.00%
SC	329,222,945	0	0.0%	0.0%	100.00%
TX	2,162,994,022	1,469,545	0.0%	100.0%	99.93%
VA	1,115,095,097	0	0.0%	0.0%	100.00%
WA	1,148,567,463	49,178,907	73.0%	27.0%	95.89%
WI	1,011,203,479	0	0.0%	0.0%	100.00%
GTE Market Share (weighted by minutes)					98.70%

Source: First Local Competition Survey.

17. Tables 3 and 4 also contain data on the distribution of minutes exchanged over trunks connecting CLEC and BOC networks. Inspection of these interconnection data reveals that the minutes exchanged across BOC and CLEC networks are notably unbalanced.¹⁷ Tables 3 and 4 show that CLECs originate far

¹⁷ Hawaii stands out as an exception to this pattern.

fewer minutes to BOC networks than they terminate from the incumbent's network. If CLEC customers were equally likely to originate and terminate calls, these distribution data would show equal percentages of minutes originating and terminating on the ILEC's network. The unbalanced distribution data in Table 5 suggest that CLECs have been most successful at selling service to customers, such as Internet service providers, that terminate far more calls than they originate.¹⁸

18. The unbalanced origination and termination minutes exchanged between ILEC and CLEC networks suggest that CLEC sales are concentrated in a limited market segment, an inference that provides a reason to be cautious about predicting CLEC success in a broader local service market. Additional analysis is needed to understand why CLECs have been especially successful in this market segment. Specifically, it is unclear whether the competitive advantages that CLECs possess in this segment are sustainable over time and will prove valuable in the broader market.

19. For example, CLEC success with Internet service providers may be partly explained by reciprocal transport and termination rates that are in excess of cost. If these rates are set above cost, then CLECs have an incentive to seek customers that terminate more calls than they originate. CLECs could offer such customers unusually attractive service rates because, net of reciprocal compensation payments to the BOC, they earn rents on call termination services sold to the ILEC. This type of competitive advantage would not extend to customers with

¹⁸ Bell Atlantic recently argued that Internet service providers operating on CLEC networks are driving the traffic imbalance. Letter from Edward D. Young, III, Senior Vice President and Deputy General Counsel, and Thomas J. Tauke, Senior Vice President for Government Relations, on behalf of Bell Atlantic, to William E. Kennard, Chairman, Federal Communications Commission, dated July 1, 1998.

balanced calling patterns because these customers would not provide transport and termination rents to the CLEC. Moreover, this type of advantage is not sustainable because it is not based on an inherent cost or other advantage possessed by CLECs.¹⁹

iii. *Local Exchange Facilities*

20. Because it is doubtful that resale will create sufficient competitive pressure to significantly discipline BOC market power, it is useful to separately assess the shares of CLECs that are providing facilities-based local service. While offering valuable competition over some aspects of service, such as marketing, billing, and customer service, resale is of inherently limited competitive significance and is therefore less meaningful as a constraint upon the exercise of market power than facilities-based service.²⁰ Facilities-based CLECs can offer additional competition along a number of dimensions, such as service innovation and network quality, where the capabilities of resellers are limited. Because resale rates are not based on the underlying costs of the facilities, resale competition can do relatively little

¹⁹ It is ironic that the BOCs are now working to limit their transport and termination payments to CLECs, after they opposed Bill and Keep arrangements in the CMRS interconnection proceeding. *LEC-CMRS Interconnection Proceeding* at 38. Wireless carriers tend to originate more calls than they terminate. Thus interconnection with wireless carriers at transport and termination rates set above cost would tend to generate net rents for the BOCs.

²⁰ See *Bell Atlantic-Pennsylvania Business Services Petition* at 21-24 (“A [resale] ‘competitor’ is unable to differentiate its offering from BA-PA’s on quality, is unable to introduce innovative services, and cannot assert price pressure on BA-PA, since BA-PA dominates the reseller’s cost structure.” [citation omitted]) and *Status of Local Exchange Competition* at 7 (“Although the ‘resale strategy permits CLECs to enter the market quickly, this strategy suffers from certain constraints in pricing and innovation for CLECs.”).

to drive retail rates down towards cost.²¹ Facilities-based competitors also represent alternative sources of access services, while resellers do not serve this function.

21. Facilities-based competition also is superior to resale competition because it represents far greater competitor independence of the ILEC. For the purposes of competitive assessment, a key issue is whether one firm is dependent upon its *competitors* for key inputs. Clearly, CLECs who are reselling BOC service remain heavily dependent upon the BOC to provide service, contractual and regulatory protections notwithstanding. In its merger analyses, the U.S. Department of Justice routinely recognizes in merger analysis that firms dependent upon rivals for key inputs (*e.g.*, through a supply agreement designed to fix an anticompetitive outcome associated with an acquisition) typically are not as strong a competitive force as those that operate independently. Competition from firms that rely upon a rival for a key input, and whose basic ability to offer services is dependent upon contractual rights unwillingly imposed on a direct rival, are generally not “economically equivalent” to fully independent rivals. Of course, all CLECs, including facilities-based CLECs, are dependent on ILECs for interconnection services.

22. Looking only at facilities-based service, the data show that CLECs serve a tiny fraction of total switched access lines.²² Table 5 details the CLEC share of

²¹ Harris and Teece, in an affidavit on behalf of Ameritech Michigan, appear to agree with this, stating that “for purposes of competitive assessment, self-supplied facilities and leased unbundled network elements...are clearly distinct from resale of services over the incumbent’s facilities.” *Harris-Teece Michigan Affidavit* at 15.

²² The New Jersey Board of Public Utilities has collected data on CLEC facilities nationwide. They report that CLECs provide facilities-based service to approximately 2,500 of the 108 million local residential lines (or significantly less than 1/10 of 1 percent)

facilities-based lines to business and residential customers in a number of Bell Atlantic states where there are sufficient publicly available data to calculate market shares of facilities-based lines. These data include access lines purchased as unbundled loops from the BOC and facilities owned by CLECs. Resold lines are counted as part of the Bell Atlantic share. Bell Atlantic's share of facilities-based service to business customers ranges from about 98 percent in Pennsylvania to nearly 100 percent in the District of Columbia. In comparison, facilities-based service to residential customers is *de minimus*. The CLEC share of facilities-based service to residential customers does not exceed one-half of one percent for any of the states shown in Table 5.

TABLE 5. CLEC FACILITIES-BASED MARKET SHARE OF LINES

<i>ILEC Facilities-Based Market Share</i>			
State	Residential	Business	Combined
DC	99.98%	99.95%	99.96%
DE	99.89%	99.77%	99.84%
MD	99.92%	99.66%	99.82%
NJ	99.93%	99.82%	99.89%
PA	99.88%	98.05%	99.22%
VA	99.84%	99.56%	99.74%
Market Share (weighted by total lines)	99.90%	99.25%	99.65%

Source: See Appendix C.

and to approximately 400,000 of the 52 million local business lines (or approximately 7/10 of 1 percent). See *Status of Local Exchange Competition* at 10.

C. The Competitive Landscape for Business and Residential Customers

23. Residential customers are far less likely to have competitive alternatives to Bell Atlantic and GTE than are business customers.²³ In large part, this reflects the relative attractiveness to CLECs of the various market segments. Bernie Ebbers, WorldCom's Chairman and CEO, has stated that "Not AT&T, not MFS or anyone else, is going to build local telephone facilities to residential customers. Nobody ever will in my opinion."²⁴ The evidence on CLEC business plans and facilities locations examined in this section confirms that while competition for business customers is developing, there are limited prospects for competition to provide local service to residential customers. In a subsequent section I evaluate the likely impact of the out-of-region entry strategy announced by Bell Atlantic and GTE on competitive conditions in local exchange and access markets.

i. Residential and Small Business Customers Lack Competitive Alternatives

24. The announced business plans and actual marketing efforts of CLECs indicate that most entrants into local exchange and access services markets principally are interested in attracting business, as opposed to residential, customers.²⁵ CLEC strategies largely concentrate on service to high-volume business customers located in major urban centers. My analysis of the evidence shows that, consistent with national trends, CLEC facilities in Bell Atlantic and

²³ See *Status of Local Exchange Competition* at 14 ("To date, virtually no land line 'facilities based competition' in the residential market has occurred in Pennsylvania and New York...").

²⁴ Mike Mills, "Hanging Up on Competition?," *Washington Post*, June 1, 1997 at H1.

²⁵ See *Status of Local Exchange Competition* at 5 ("The Board finds that a vast majority of the CLECs that are pursuing the land line facilities based entry strategy have only targeted business customers, at this time.").

GTE service areas generally are concentrated in major urban areas. With few exceptions, most CLECs have no plans to offer residential service in the near term.²⁶

25. At the present time, there is only a limited potential for profitable entry into the residential and small business segment of local exchange and access markets. The major long-distance companies have scaled back or frozen their initially-ambitious plans to enter local markets, citing poor profitability.²⁷ Sprint, MCI, and AT&T, for example, have each testified that competitive entry through resale into the State of New Jersey's local service markets would not provide a reasonable return on their investment, and Bell Atlantic's own expert testified that CLECs would lose \$3 per customer per month reselling Bell Atlantic-New Jersey's

²⁶ See "CLEC Officials, Wall Street Predict Continued Growth, But Not in Local Residential Market," *Communications Today*, November 4, 1997. Brooks Fiber/Worldcom has entered the residential local exchange and access services market on a facilities basis in Michigan, but it has not expanded its residential service outside that state. *Communications Today*, *op. cit.* See also *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in Michigan*, Memorandum Opinion and Order, FCC 97-298, released August 19, 1997 ("Ameritech Michigan Order") at ¶65. It is too early to tell whether WorldCom will continue to pursue this strategy.

²⁷ In January of this year, MCI President Timothy Price announced that "as long as the current regulatory environment continues, MCI will not offer resale service to any new residential customers." See January 22, 1998 MCI Press release, available at <http://www.mci.com>. This was soon followed by an announcement from AT&T's chairman Michael Armstrong that "the company has halted its efforts on the total services resale (TSR) method of local service entry but will continue to support its current local customers.... TSR discounts are not big enough to make it an economically viable way for AT&T to provide local service." See AT&T Press release, January 26, 1998, available at <http://www.att.com>. AT&T claims to be losing \$3 a month per local telephone customer. "AT&T Says It Loses Money on Local Telephone Service," *St. Louis Post-Dispatch*, February 11, 1998. AT&T apparently is still working on its wireless local service plans.

service.²⁸ GTE evidently agrees with this assessment of the prospects for resale, as it has “concluded that a resale strategy alone cannot succeed.”²⁹ Cable companies have also pulled back on their highly-touted plans,³⁰ although a few cable companies, such as Cox, Cablevision and MediaOne, have recently begun offering telephony services over cable plant to limited numbers of customers.³¹ It is too early to tell whether the proposed AT&T-TCI merger will reinvigorate efforts to offer telephony over cable TV plant.³² Dan Miller, chairman of the Illinois Commerce Commission, explains the current limited competition for residential customers by observing: “What nitwit is going to go in and start competing where the prices don’t cover the cost?”³³

26. Mobile wireless service also is not currently a practical economic alternative to wireline local exchange and access service for the vast majority of customers. Mobile wireless service generally is not priced competitively with

²⁸ *In the Matter of the Board's Investigation Regarding the Status of Local Exchange Competition*, “Comments of the Division of the Ratepayer Advocate,” Docket No. TX98010010, May 1, 1998 (available at www.njin.net/rpa/pos-pape.htm).

²⁹ Declaration of Jeffrey C. Kissell (“Kissell Declaration”) at 3.

³⁰ TCI, for example, dropped its cable telephony plans. See Mark Robichaux, “Bad Call: Malone Says TCI Push into Phones, Internet Isn’t Working for Now,” *Wall Street Journal*, January 2, 1997 at A1. Time Warner also suspended its cable telephony plans. See Stephan Somogyi, “Sages or Stooges?,” *Upside*, June 1997 9(6) at 62-68.

³¹ See *En Banc Presentation on the Status of Local Telephone Competition*, “Testimony of Alex Netchvolodoff,” January 29, 1998 (available at www.fcc.gov); and Carl Weinschenk, “Double Your Money—Or at Least Give It Your Best Shot,” *Tele.com*, November 1, 1998 (available at www.teledotcom.com).

³² See Leslie Cauley, “TCI, AT&T Look to Enter Partnerships With Cable-TV Firms on Phone Service,” *Wall Street Journal*, September 24, 1998 at B14.

³³ As quoted by Jerri Stroud in “Competition is Key to Phone Deal’s Approval,” *St. Louis Post-Dispatch*, May 17, 1998.

basic wireline service for a consumer with a high volume of calling from a fixed site to nearby end users.³⁴ To date, mobile wireless service has been further limited in its ability to substitute for basic telephone service by its relatively low data transmission rates, lower voice quality, and the fact that wireless customers pay for both incoming and outgoing calls. I am optimistic that wireless service will eventually compete with wireline service for a significant number of local exchange customers. The steadily decreasing prices, rapid network build-outs, and increasing penetration rates all speak to that possibility. But the fact remains that wireless service does not provide meaningful competition to wireline local exchange and access services at this time.

D. Entry is Unlikely to Diminish BOC Market Power or Eliminate the Need for On-Going Regulation in the Near Future

i. Local Telephone Markets are Not Yet Open to Competition

27. Despite their claims to the contrary, Bell Atlantic and GTE have not yet sufficiently opened their local telephone markets to competition. State authorities in Michigan, New York, New Jersey and Pennsylvania each have found that Bell Atlantic and GTE have not met their obligations under the Telecommunications Act to open their local service markets to competition.

- The Michigan Public Service Commission (“MPSC”) ruled that GTE’s “conduct to date does not give the Commission reason to believe that the company will permit competition...”³⁵ The MPSC went on to note that it

³⁴ See *In the Matter of Second Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana*, Declaration of Carl Shapiro and John Hayes on Behalf of Sprint, CC Docket No. 98-121, filed August 4, 1998.

³⁵ *In the Matter of the Application of GTE Communications Corporation for the Issuance of a License to Provide and Resell Basic Local Exchange Service in Ameritech*

issued final orders requiring GTE to act on its interconnection agreements with AT&T and Sprint in December 1996 and that GTE has failed to comply with those orders.³⁶

- The New Jersey Board of Public Utilities issued a report finding that there are “two major barriers to local land line telephone competition in New Jersey....the most significant barrier to competition is the lack of standardized Operations Support Systems.... The Board finds the second ‘major barrier’ to competition is access to ‘unbundled network elements’.”³⁷
- An administrative law judge in New York ruled that “This record indicates unequivocally that Bell Atlantic-New York’s options alone...are unacceptable to support combination of elements to serve residential and business customers on any scale that could be considered mass market entry. Given this record, at this time, absent the provision of the element platform pursuant to the Pre-filing, Bell Atlantic-New York would be in compliance neither with 251(c)(3) nor, consequently, 271(c)(2)(B)(ii).”³⁸
- An administrative law judge in Pennsylvania ruled that “The credible evidence of record demonstrates that the collocation constraints described here have, in fact, acted to inhibit the growth of facilities based competition in BA-PA’s service territory.”³⁹ (emphasis in original)

28. It is significant that state commissions have found that Bell Atlantic does not currently satisfy the section 271 standard. Section 271 does not require that BOCs face effective competition before interLATA authority is granted. It instead requires only that local service markets be opened to competition. Successful 271

Michigan’s and GTE North Incorporated’s Exchanges in the State of Michigan and Related Approvals, “Opinion and Order,” Case No. U-11440, December 12, 1997 at 4.

³⁶

Id.

³⁷

Status of Local Exchange Competition at 11, 15.

³⁸

Proceeding on Motion of the Commission to Examine Methods by which Competitive Local Exchange Carriers Can Obtain and Combine Unbundled Network Elements, Case 98-C-0690, “Proposed Findings of Administrative Law Judge Eleanor Stein,” released August 4, 1998.

³⁹

Bell Atlantic-Pennsylvania Business Services Petition at 36.

applicants can, and they almost certainly will, retain substantial market power in local exchange and access markets even when interLATA authority is granted. These state commission rulings show that local exchange and access markets in Bell Atlantic's territories have not yet been sufficiently opened to enable competition to significantly diminish the incumbents' market power.

ii. CLECs Will Continue to Rely Upon ILEC Cooperation to Interconnect with ILEC Networks

29. Even if local service markets were fully opened to competition, the need for on-going regulation would not soon end. Because interconnection is required whenever multiple carriers provide service over disparate networks, entrants will continue to require high-quality and timely interconnection to the incumbent's public switched network. Adequate interconnection is vital to successful competition in telecommunications markets because acceptable telephone service presumes an ability to reach any subscriber on the public switched network.

30. In addition, because ILECs have clear incentives to deny competitors access, assuring adequate interconnection requires effective regulation. ILECs' incentives to deny access arise because telecommunications markets exhibit powerful network effects that can, if regulation is ineffective, be used to preserve a dominant provider's market position. Because the incumbent supplies access to virtually all existing network customers, it is not dependent upon interconnection with CLECs to complete calls. In contrast, it is unavoidable that entrants will initially have fewer subscribers than the incumbent and will therefore depend upon interconnection with the incumbent to complete most calls. If networks are not adequately interconnected customers will prefer the incumbent's service—even if it is otherwise inferior to the entrant's—because they benefit from readily being able to make and receive calls on the public switched network. As the Commission has previously stated, absent enforceable interconnection rules,

incumbents could use their existing control over access to the subscriber base to suppress entry.⁴⁰

31. While CLECs have no realistic alternatives to interconnection, they could potentially limit their dependence on the incumbent by investing in duplicate network facilities. But building network facilities is costly, time-consuming and, from the public interest or cost-minimizing perspective, potentially wasteful. In addition, network facilities are largely sunk costs that increase the risk of entry for CLECs, raising an additional entry barrier. And because facilities represent fixed costs, they increase the market penetration needed to achieve profitability. For these reasons, investments in network facilities are unlikely to diminish significantly CLECs' dependence on interconnection in the near future.

E. The Proposed Out-of-Region Entry Strategy Will Not Expand the Competitive Alternatives Available to Residential Customers in the Near Future

32. The *Merger Application* describes an out-of-region entry strategy that calls for Bell Atlantic and GTE to expand into 21 urban centers outside the combined company's service area.⁴¹ The merged company intends to leverage Bell Atlantic's existing customer relationships with large businesses to build a presence in out-of-region markets. Once the merged company has successfully attracted enough large

⁴⁰ "We are concerned that existing interconnection policies may not do enough to encourage the development of CMRS, especially in competition with LEC-provided wireline service. ... [I]t is important that the prices, terms, and conditions of interconnection arrangements not serve to buttress LEC market power against erosion by competition." *LEC-CMRS Interconnection Proceeding* at ¶2.

⁴¹ Public Interest Statement at 6.

business customers to recover its largely fixed investments in facilities, it will target consumer and small business customers.⁴²

33. If, through pursuing the proposed out-of-region entry strategy, Bell Atlantic and GTE aggressively entered residential local exchange and access markets, the benefits to consumers could be substantial. There is little reason, however, to suppose that this upbeat outcome is likely in the near term. Bell Atlantic and GTE have not explained how, after establishing service to the Fortune 500 companies that are the plan's initial service target, they will be able to profitably serve residential and small business customers. Indeed, the strategy that Bell Atlantic and GTE have presented in this proceeding bears considerable resemblance to the strategies followed by facilities-based CLECs like MFS, TCG and MCI Metro, and none of these carriers have found it profitable to enter residential markets on a significant scale. Bell Atlantic and GTE have not provided evidence to demonstrate why the out-of-region entry strategy would allow them to succeed where others have foundered. It is widely accepted that the customer service needs and marketing methods employed in the large business market segment differ in important ways from those in the small business and residential market segment.⁴³ For example, an important asset for successful mass market entry is an established brand name.⁴⁴ Bell Atlantic and GTE have not explained how their out-of-region service experience with Fortune 500 companies will aid

⁴² Kissell Declaration at 4-5.

⁴³ See Appendix B for a more detailed discussion of the different demand patterns in the large business and residential and small business market segments.

⁴⁴ See *Bell Atlantic-Nynex Order* at ¶70 ("The remaining four most significant market participants distinguish themselves from the universes of actual and precluded competitors and of other market participants by their experience and strong brand reputation in the provision of telephone service to the mass market.").

development of the marketing skills and brand name needed to successfully compete in the mass market.

IV. CONCLUSION

34. Bell Atlantic and GTE possess substantial market power in local exchange and access services markets. That market power largely stems from control of access to customers: SBC and Ameritech each serve dominant shares of switched access lines in their service regions, and local service competitors require their cooperation to complete calls on SBC's and Ameritech's local networks. Absent high-quality and timely interconnection, competitors will be unable to offer a viable service alternative.

35. In addition, entry is unlikely to significantly diminish the market power possessed by Bell Atlantic and GTE for years to come. First, the proposed merger eliminates a significant potential entrant into each service region. Second, as several state commissions have consistently found, local markets in the states served by Bell Atlantic and GTE are not yet sufficiently open to enable competition to thrive. Furthermore, Bell Atlantic and GTE control the pace at which their markets are opened to competitors because they control access to those customers.

36. Even if markets were fully opened to competition, the need for regulatory oversight of Bell Atlantic and GTE would not soon end. Interconnection is required whenever multiple carriers provide service over disparate networks. Because incumbent local exchange carriers have clear incentives to deny competitors access, assuring adequate interconnection requires effective regulation.

37. This merger does not satisfy the Commission's public interest standard because it preserves the dominant market positions of Bell Atlantic and GTE and it fails to materially improve the prospects for competition in any relevant market.⁴⁵

⁴⁵ *Bell Atlantic-Nynex Order* at ¶36.

APPENDIX A: Curriculum Vita for Dr. John B. Hayes

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Education **University of Wisconsin, Madison, WI**
Doctor of Philosophy in Economics, 1994

University of Denver, Denver, CO
Master of Arts in Economics, 1986

Stanford University, Palo Alto, CA
Bachelor of Arts in Economics, Stanford University, 1983

Awards 1992 Federal Reserve System Board of Governors Dissertation Fellowship
1986 University of Denver Fellowship

Current Position Senior Economist, **The Tilden Group, Oakland CA**
September 1997 - present
Economic analysis to support antitrust litigation in high technology and communications industries.

Professional Experience Economist, **U.S. Department of Justice, Antitrust Division, Washington, D.C.**
1993 - 1997
Economic analysis to support antitrust litigation and Federal competition policy. Advised and trained foreign competition agency personnel. Extensive telecommunications experience includes comments filed with the Federal Communications Commission and analysis of the AT&T-McCaw and Bell Atlantic-Nynex cellular mergers.

Adjunct Professor of Economics, Georgetown University, Washington D.C.
1995 - 1996
Taught an undergraduate course in industrial organization.

Research Assistant, Wisconsin Vocational, Technical and Adult Education System, Madison, WI
1989 - 1991
Economic analysis of labor market trends affecting enrollment in the VTAE system.

Project Manager, **US WEST, Strategic Marketing Division, Denver, CO**
1987 - 1988
Identified new business opportunities. Compared the performance of business units to industry benchmarks. Trained staff in the use of data resources for business performance analysis.

Research Assistant, **Medical Group Management Association, Center for Research and Ambulatory Health Care, Denver, CO**
1986 - 1987
Survey design, implementation, analysis, and presentation of results. Authored articles for the association newsletter and journal. Maintained research databases. Prepared research proposals.

**Research
Papers**

- 1994 Hayes, John B. "Do Firms Play Exit Games? Theory and Evidence on the Strategic Role of Size in an Exit Game." Ph.D. dissertation, Department of Economics, University of Wisconsin-Madison.
- 1994 Hayes, John B. "An Exit Game with Continuously Adjustable Output and Efficiency Differences." Working paper, Department of Economics, University of Wisconsin-Madison.
- 1993 Hayes, John B. "Do Firms Play Exit Games? Some Evidence on the Strategic Liability of Size." Working paper, Department of Economics, University of Wisconsin-Madison.
- 1992 Eisner, James and John B. Hayes. "Labor Market Information for the Trade and Industry Occupations." Wisconsin Board of Vocational, Technical and Adult Education, Madison, WI.
- 1990 Hayes, John B., Catherine M. Cotter, and Ronald J. Hustedde. "Labor Market Information for Business and Marketing Occupations." Wisconsin Board of Vocational, Technical and Adult Education, Madison, WI.
- 1990 Hayes, John B. "Optimal Exit Strategy in a Stochastically Declining Market." Applied Microeconomics Workshop, Department of Economics, University of Wisconsin-Madison.

APPENDIX B: Relevant Markets for Public Interest Analysis

A. Principles of Market Definition

1. In assessing whether a carrier has market power, and whether a merger is likely to harm competition, it is helpful to define relevant markets. Economists generally define market power as the ability to maintain prices above competitive levels for a sustained period of time.⁴⁶ Properly defined markets are a useful tool for assessing the competitive effects of mergers and other business practices.
2. Relevant markets are usefully defined along two dimensions: (1) the collection of products or services to be included in the market; and (2) the geographic scope of the market. Within each dimension, economists determine the scope of a relevant market by the existence of demand substitutes.⁴⁷ Those products that consumers view as good substitutes are properly included within the market. Products that consumers perceive as poor substitutes are excluded from the market. The Commission adopted this approach in the *LEC In-Region Interexchange Order* and the *Bell Atlantic-Nynex Order*.⁴⁸ In a correctly defined market, a hypothetical monopoly producer of all of the products or services included in the market could profitably raise price(s) above competitive levels for a sustained period of time. In contrast, any market in which a monopoly producer

⁴⁶ Alternatively, one could define market power as the ability to maintain quantity or quality below competitive levels for a sustained period of time.

⁴⁷ U.S. Department of Justice and the Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992 (revised April 8, 1997).

⁴⁸ *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area*, Second Report and Order, FCC 97-142, released April 18, 1997 ("*LEC In-Region Interexchange Order* ") at ¶27 and *Bell Atlantic Nynex Order* at 50.

could not sustain a price increase would not be a useful tool for assessing the possible exercise of market power following a merger.

B. Relevant Product and Geographic Markets

3. SBC and Ameritech provide a diverse and expanding array of telecommunications products and services. These products and services are usefully grouped into two categories. Retail services, such as Centrex and basic local service, are provided in downstream markets to end users. Wholesale services, such as access and the provision of unbundled network elements, are provided in upstream product markets to other network providers. At both the wholesale and retail levels, many of these services could potentially be considered distinct relevant markets.⁴⁹ In this declaration I focus on the provision of two core services—basic local exchange service and access—that are fundamental to many, if not most, of the network services provided by the merging parties. Competitive conditions in these markets are likely to be similar to those in other markets relevant to an analysis of the competitive effects of the merger.

4. An ability to complete calls ubiquitously over the public switched network is an essential characteristic of telecommunications. Access services provided by ILECs are fundamental to this ability, as they allow carriers to complete calls on distant and disparate networks. Access services can take many forms.⁵⁰ Horizontal access arrangements allow competitors to interconnect their network

⁴⁹ Long distance services may be an additional relevant market. As SBC and Ameritech are new and comparatively small participants in long distance services, I have not addressed long distance services in this declaration. For similar reasons, I have not addressed bundled long distance and local services.

⁵⁰ See Ingo Vogelsang and Bridger M. Mitchell, *Telecommunications Competition: The Last Ten Miles*, MIT Press, 1997 at 12-17.

with the incumbent's local exchange network. Vertical access arrangements permit providers of complementary services, such as long distance or wireless services, to originate and terminate calls on the local network. In this declaration I will use the term access expansively to refer to all forms of access to the local exchange network in a specific local service area.⁵¹ As there are no viable substitutes to access, this service is a relevant market.⁵²

5. Local telephone service, broadly defined, is a collection of services that includes the capabilities (1) to originate calls from a specific location and terminate them anywhere on the public switched telephone network, and (2) to receive calls from any point on the public network. As a practical matter, there are no viable substitutes for local service, and therefore this product constitutes a relevant market.

6. There are many specific locations to originate calls within local telephone networks and consequently, there are many distinct relevant product markets within a local service region. It is also true, however, that within any particular geographic region there is a limited set of carriers that have facilities in place to provide local telephone service. Within this region, the range of competitive alternatives and, more importantly, the nature of competition between the alternative suppliers, may be very similar. It can be useful in such circumstances to aggregate these similar product markets and assess competition in the aggregate

⁵¹ It is worth noting that this definition does not encompass special access arrangements that provide access to interexchange networks but do not directly provide access to a local exchange network.

⁵² More narrowly defined access markets may also exist. The competitive effects of the merger in more narrowly defined markets are unlikely to differ substantially from those identified in this broadly defined market.

market as a whole. Because consumers face the same set of choices within this area, the competitive effects of the merger can be accurately analyzed within the aggregate market.⁵³

7. For many telecommunications markets, such aggregation may be more than a convenient way to simplify the analysis. When competition takes place simultaneously over multiple markets, it is often useful to gauge the competitive significance of market participants in an aggregate market that encompasses the full set of markets where firms simultaneously compete. Residential and small business telecommunications services in particular are marketed through mass media outlets which reach potential customers spanning large areas. The economies of scale inherent in this kind of marketing compel competitors to provide service to the entire area addressed by their marketing efforts. As a consequence supply conditions, especially those in the residential and small business customer segment, provide an additional reason to assess competition within aggregate local service markets.

8. SBC and Ameritech provide local telephone service to customers in certain well-defined geographic areas. The competitive alternatives for service available to customers in these local service areas are generally sufficiently similar to treat each local service area as a separate relevant market.

9. An alternative approach to defining a local service market begins with the observation that telephone calls are point-to-point (or in some cases point-to-multipoint) connections, so one could potentially think about each call from a

⁵³ See the *Bell Atlantic-Nynex Order* at ¶51 and the *LEC In-Region Interexchange Order* at ¶5.

specific origination point to a specific termination point as a unique product.⁵⁴ As there are no viable substitutes for specific point-to-point telephone connections—a call from the office to home cannot substitute for a call from the office to a client—each point-to-point connection constitutes a distinct relevant market.⁵⁵

10. Taking point-to-point calls as a product therefore leads once again to the conclusion that there are many distinct relevant product markets. For the same reasons described above, however, it is both convenient and analytically useful to aggregate those markets where the competitive alternatives are similar. Such an aggregation leads to the same set of local service areas identified above.

11. The two alternative approaches to market definition for local exchange services described in this section lead to an identical collection of relevant markets for an assessment of the competitive effects of the merger: the local service areas in SBC's and Ameritech's service regions. Economic analysis of the merger is unaffected by a decision to adopt one approach to market definition over the other.

C. Market Segments

12. It is widely accepted that the patterns of demand for some customer groups are sufficiently distinct that they require separate analysis. The Commission has previously determined that within local exchange and access services markets it is possible to identify three customer groups with distinct patterns of demand: (1)

⁵⁴ The Commission has taken this approach in several recent decisions. See the *Bell Atlantic-Nynex Order* at ¶51 and ¶54 and the *LEC In-Region Interexchange Order* at ¶5.

⁵⁵ Defining local service markets around point-to-point calls suffers from the defect that local service is not typically sold on a point-to-point basis. Instead, local service is sold in a bundle that includes a general ability to terminate calls to any point on the local network. This fact indicates that it may not be economically viable to offer local service on a point-to-point basis.

residential and small business customers, (2) medium-sized business customers, and (3) large business and government customers.⁵⁶ These groups are distinguished by the different characteristics of their demands for local exchange and access services.

13. The large business and government customer segment consists of customers who typically:

- generate traffic volumes that require multiple high-capacity lines (*e.g.*, DS1s and DS3s) for their local exchange and access services;
- purchase a wide array of complex telecommunications services such as ISDN, frame relay and Centrex;
- negotiate firm-specific contracts;
- have dedicated, professional telecommunications services managers on staff; and
- require a premises visit to initiate service.

In contrast, residential and small business customers typically:

- generate traffic volumes that can be supported by one or two voice grade lines;
- purchase local service together with vertical features such as call waiting or caller ID; and
- rarely require a premises visit to initiate service.

The demand patterns for medium-sized business customers are intermediate between those of large business customers and residential and small business customers. Medium-sized business customers typically generate traffic volumes that require multiple voice-grade lines but not multiple high-capacity lines.

14. Reflecting the complexity and scale of their purchases, local telephone service for large business and government customers is generally marketed through

⁵⁶ *Bell Atlantic-Nynex Order* at ¶53.

dedicated account representatives who visit the customer's premises to describe service offerings. In contrast, service is marketed to residential and small business through mass media and to medium-sized business customers by specialized firms.

15. Consistent with their high traffic volumes and demand for complex telecommunications services, local service revenues are concentrated in large business customers. The largest one percent of local service customers account for roughly 30 percent of revenues.⁵⁷ Business customers of all types utilize 32 percent of switched access lines nationwide; residential customers account for 67 percent of all access lines; and pay telephones account for one percent.⁵⁸

16. These three customer segments exhibit sufficiently different demand patterns that the competitive effects of the merger should be separately assessed for each market segment. Large, and to a lesser extent medium-sized, business

⁵⁷ Vogelsang and Mitchell *op. cit.* at 29, citing *Bypass of the Public Switched Network*, Third Report and Order, released May 26, 1987 at 32.

⁵⁸ *1997 Preliminary Statistics of Common Carriers*, Federal Communications Commission, ("1997 Preliminary SOCC") Table 2.5.

customers are most readily served by CLECs because their traffic volumes profitably support the provision of multiple access lines.⁵⁹ As a result the competitive effects of the merger could differ significantly across the three customer segments.

⁵⁹

The competitive effects for small business customers may, in fact, differ sufficiently from residential customers that it also would be useful to separately assess effects in this customer segment. Residential service generally is priced at lower rate than business service. This pricing difference could potentially support greater entry opportunities for CLECs in the small business segment than in the residential segment, even if traffic volumes for these two customer groups are comparable.

APPENDIX C: Data Sources for Table 5

1. **CLEC On-Net Lines.** An estimate of fully facilities-based (on-network) CLEC lines was reported in the Atlantic • ACM survey,⁶⁰ which contains data as of December 31, 1997. In order to maintain consistency in the table, I chose to obtain other data from this same time period where possible.

2. **Unbundled Network Element (UNE) Loops.** CLEC purchases of unbundled loops were derived from the following sources:

- *First Local Competition Survey*, data as of December 31, 1997. These data were used for the DC, Maryland and Pennsylvania estimates.
- *Second Local Competition Survey*, data as of June 30, 1998. These data were used for the Delaware and Virginia estimates.

New Jersey Board of Public Utilities reported that CLECs in New Jersey provided no residential lines and 6700 business lines.⁶¹ Given the Atlantic • ACM survey estimate of 875 CLEC on-net lines in New Jersey, I estimated business UNE loops to be 5,825.

3. Apart from the New Jersey data, the available data on UNE loop counts did not distinguish between residential and business loops. Using Brooks Fiber's experience in Michigan, as reported in the *Harris-Teece Michigan Affidavit*,⁶² as

⁶⁰ *An Analysis of Local Switched Services Market Share in the Bell Atlantic-Delaware Region*, provided by Atlantic • ACM. This survey was sponsored by various corporations, including Sprint Telecommunications.

⁶¹ *In the Matter of the Board's Investigation Regarding the Status of Local Exchange Competition*, "Report and Action Plan," Docket No. TX98010010, July 1998 at 10.

⁶² *In the Matter of Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as amended, to Provide In-Region, InterLATA Services in*

well as Brooks Fiber's report to the Michigan PSC that 90 percent of its residential customers are on unbundled loops and 10 percent of its residential customers are on fully facilities-based lines, I estimated that 46.25 percent of the unbundled loops reported for Bell Atlantic and GTE in the *Local Competition Survey* serve residential customers. This estimate probably overstates the fraction of unbundled loops serving residential customers, as Brooks Fiber targeted residential customers in Michigan more aggressively than did CLECs in other locations.

4. **Total ILEC Lines.** Total ILEC lines, including lines sold directly to end users and those sold to competing local exchange carriers for resale, was provided by Bell Atlantic and GTE in the *First Local Competition Survey*.

Michigan, Joint Affidavit of Robert G. Harris and David J. Teece On Behalf of Ameritech Michigan, CC Docket 97-137 ("Harris-Teece Michigan Affidavit").

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

Applications of GTE Corporation,)

Transferor,
and Bell Atlantic Corporation,

for Consent to Transfer of Control

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CC Docket No. 98-184

AFFIDAVIT OF KEVIN E. BRAUER

I. Introduction.

Bell Atlantic's (BA) proposed merger with GTE Corporation (GTE) is a significant threat to Sprint's and other companies' ability to compete for telecommunications business in the home areas of BA and GTE and thus a threat to the welfare of telecommunications customer in their areas. If these companies combine, they will control vital last mile facilities to 58 million access lines across thirty-two states. This is more than one-third of the access lines in the United States. My affidavit will describe many of the blatantly anticompetitive actions of both BA and GTE, and why a merger of these two companies neither bodes well for the advancement of the Federal Communication Commission's ("FCC's") pro-competitive goals nor brings benefits to consumers. While GTE is not technically a Regional Bell Operating Company ("RBOC"), it is currently larger in terms of access lines and revenues than any of the original seven RBOCs. For purposes of this

affidavit, I will refer to the RBOCs and GTE collectively as the Incumbent Local Exchange Carriers ("ILECs").

I will explain the plans Sprint has to compete with the ILECs and detail some of the significant problems that the ILECs potentially cause Sprint. BA combined with GTE, has the power to harm local competition by providing poor access to their last mile and collocation space facilities as well as by refusing to cooperate with competitors' requests for new ways of providing essential inputs (new or existing) that may be needed for the provision of new services. The large scope of the combined company increases the opportunity for one company to negatively affect a very large part of the market. Based upon the serious roadblocks that Sprint has faced reselling BA's local exchange service post-BA/NYNEX merger, I am deeply concerned that the BA/GTE merger will exacerbate the problems by compounding each companies' anticompetitive tactics across a wider region.

Before providing this detail, I will briefly set forth my relevant experience in the telecommunications field. I am the President of Sprint's National Integrated Services organization. As President of this organization, I am responsible for implementing Sprint's new, innovative, state-of-the art technology platform and service. Sprint recently announced this new platform and service - Sprint ION, Sprint's Integrated On-demand Network.

I have held my current position for the last year. Before that, I was the President of Sprint Business, the group responsible for serving Sprint's larger business customers. I have also served as a Sprint senior vice president responsible for developing and

implementing strategies related to Sprint emerging growth opportunities and held various vice presidential level marketing assignments.

II. Sprint ION Deployment

The Telecommunications Act of 1996 encourages both the development of competition in local exchange markets and the deployment of advanced services to consumers residing in the United States. Sprint ION assists in meeting both goals: it brings competitive communications offerings to current local exchange carrier (LEC) monopoly customers and it does this through the use of advanced technologies created for the data age rather than the technologies used in the provision of yesterday's plain old telephone service.

The networks and technology deployed by traditional telephone companies, both local and long distance, rely upon circuit switches to route both local and long distance voice traffic using a time division multiplexing (TDM) technology. While voice comprises the bulk of the communications traffic today, data traffic is increasing rapidly. We are experiencing a rapid growth in use of the Internet and the developing capability of converting voice TDM traffic to a data format that can be carried on more modern data networks. Data traffic is growing at a much more rapid pace than traditional voice traffic and is expected to be the bulk of the communications traffic in the near future.

Sprint's new ION service integrates traditional voice TDM traffic, Internet traffic, Frame Relay traffic, and other data traffic on one customer access facility and carries all of this traffic in the asynchronous transfer mode (ATM) data format through the Sprint network. The initial conversion of these various formats takes place at the customer

premises where all of the traffic is converted to ATM and transported to Sprint's network for delivery to the terminating point.

Sprint ION service will be capable of carrying the traffic of Sprint ION customers over any distance, whether the communication is delivered within a city, across a state, or across the nation, without regard to artificial regulatory boundaries. For communications terminating to end users that are not Sprint ION customers, Sprint will convert the Sprint ION format to the format needed to communicate with the off-net non-Sprint ION customer.

As Sprint deploys Sprint ION, it will focus customers on the efficiency gained by integrating all services on one access facility, increased functionality provided to customers through increases in bandwidth, and innovations in customer control by providing the customer with easy-to-use service configuration functionality. For example, a smaller customer will have the capability to create up to six voice communications channels where only one existed before and greatly increase the data throughput speed of its access to the Internet and other data applications. Configuration choices will be available to the customer through an easily used computer-based program.

For businesses large and small, the Sprint ION technology will enable networked multimedia applications that efficiently link employees, customers, and external partners by providing virtually unlimited bandwidth to all work locations. This will facilitate E-Commerce to help reach new markets; interactive distance learning for employees at all locations; management of a telecommuting and/or geographically dispersed workforce; and real-time video desktop collaboration, connecting both internal and external participants at multiple locations.

Sprint intends to offer Sprint ION service to large businesses using dedicated access and to smaller businesses and residential customers initially via Digital Subscriber Loop ("xDSL") access solutions. Sprint has plans to provide Sprint ION service in metropolitan areas containing over 65 percent of the population of the United States.

Initially, in late 1998, Sprint will offer Sprint ION service to a select group of customers in seven cities. In early 1999, the number of customers to whom and the number of cities where Sprint ION service is offered will increase dramatically.

Later in 1999, Sprint will begin offering Sprint ION service to smaller customers as alternatives to dedicated access service become available. One method of supplying the additional communications bandwidth required for Sprint ION service to these smaller customers is xDSL technology. Sprint will collocate xDSL equipment in selected ILEC central offices to gain access to ILEC unbundled network element (UNE) loops. A data-capable loop, one free of problems that degrade its potential performance, when connected to xDSL technology at the customer premises and in the central office, provides the bandwidth necessary for Sprint to offer Sprint ION service. Sprint's collocation program will extend into the year 2000.

In the latter half of 1999, Sprint expects to increase the functionality of Sprint ION service to include the ability to combine what had previously been local voice calling with other communications on the all-distance Sprint ION platform. The addition of this capability will allow a customer to integrate its local service with other services through a single Sprint ION service using a single access facility to the customer premises. At this point, Sprint will be providing facilities-based competition for the business of the local customer.

Sprint anticipates that ION service will not only appeal to many of its current voice and data customers, but also to additional customers seeking innovative communications solutions to both local and long distance communications needs. The typical consumer profile that is likely to be interested in Sprint ION services uses two or more local lines, an Internet service provider, custom calling features or packaged services, and has long distance usage. If the RBOCs gain authority to provide long distance service within their current operating areas, Sprint ION service will compete with the RBOCs for local and intraLATA toll services as well as in-region, interLATA service previously offered only by interexchange companies.

xDSL Availability

Sprint has considered using xDSL services offered by the ILECs. However, the issue of whether the ILECs need to offer this service to competitive telecommunications carriers is the subject of on-going proceedings at the Federal Communications Commission. Several of the ILECs have asserted that xDSL services should not be available to competing carriers for either resale or UNE use.¹ While GTE filed and recently received acceptance of an interstate ADSL tariff offering, by GTE's own admission, the offering was developed with its retail operation in mind, and does not meet the needs of Sprint ION with respect to broadband service availability. In fact, GTE's tariff would effectively prohibit direct connection to Sprint as a network service provider in that it is limited solely to those instances where the data-only service is directly connected to an Internet service provider

¹ See the petitions of Bell Atlantic, US WEST, and Ameritech that were addressed in the FCC's August 7, 1998 memorandum opinion and Order in CC Docket No. 98-147, et al. (FCC 98-188). Bell Atlantic and SBC have sought reconsideration of the portion of that order requiring ILECs to provide conditioned loops that are capable of use for xDSL service, and US WEST has sought judicial review of the order in the D.C. Circuit (Case No. 98-1410).

("ISP"). The ISP to which the service terminates must be specified in order for GTE to provide the service. Sprint ION service will not terminate directly to an ISP. Rather, the service purchased by Sprint is required to terminate directly to the Sprint network, with any and all successive terminations handled by Sprint from that point forward.

GTE's stated plans in its interstate tariff description and justification (GTOC Transmittal No. 1148 dated May 15, 1998) to offer ADSL service in 30 markets exclude numerous states where GTE has local exchange operations, including Alabama, Alaska, Arkansas, Arizona, Idaho, Iowa, Kansas, Nebraska, Nevada, New Mexico, Oklahoma, South Carolina, and West Virginia. The lack of ADSL in GTE's operating territories in many of these states could degrade the value and deployment of Sprint's ION service.

Even where ILEC xDSL service may be arguably available to Sprint, the deployment of xDSL by ILECs, as offered, does not meet the needs of Sprint for use in providing Sprint ION service. Sprint ION is an integrated, all-distance service that combines local and long distance, voice and data. The ILEC deployment of xDSL is a data only service that places additional equipment at the central office and the customer premises (via a POTS splitter) to strip off plain old telephone service (POTS) voice traffic (both local and long distance) to the ILECs circuit switched local exchange and exchange access network. This stripping of voice traffic defeats one of the primary benefits of Sprint ION – integration of voice and data using Sprint's ATM based network. In fact, GTE's ADSL tariff requires, as an essential component to the purchase of its ADSL service, that a companion local service offering be in place. As I stated earlier, Sprint ION will not require a separate POTS voice line, but will integrate all forms of end user traffic for transport over a single xDSL circuit in an ATM data format. Thus, GTE's requirement is

inefficient from a network standpoint and makes resale of GTE cost prohibitive as the essential intermediate supplier of last mile xDSL services.

Sprint desires to use the xDSL facilities and equipment of the ILECs, particularly in smaller offices where Sprint's collocation of its own xDSL equipment is not as economical because the number of potential customers is low. In these offices, sharing the xDSL equipment makes sense from a cost standpoint for all parties. Unfortunately, it appears that competitive obstructionism by the ILECs may well overcome the merits of cost sharing.

III. ILEC Roadblocks to Competition

General

Competition has been slow in coming to telecommunications markets. Long distance markets began truly opening to competition upon the divestiture of the RBOCs from AT&T. In the landmark antitrust litigation that brought about the RBOC divestiture, evidence convincingly indicated that the RBOCs had used their market power to impede the entry of competitors into the long distance marketplace. The remedy for this anti-competitive activity was separating the potentially competitive long distance market from the local exchange monopoly market. When this occurred, and the RBOCs no longer had an incentive to block long distance competition, actual competition in the long distance market blossomed and resulted in the highly competitive long distance marketplace the American consumer enjoys today. In addition, due to the potential for anti-competitive activity, GTE agreed to a consent decree placing certain restraints on it and its long distance operations.

Before the divestiture, evidence indicated that the RBOCs used their monopoly position to disadvantage competitors as they attempted to enter the long distance market.

It was shown that the RBOCs provided better terms and conditions to their own long distance affiliate than to competitors, that the RBOCs provided higher levels of service to their long distance affiliate than to competitors, that the RBOCs flatly refused to provide needed facilities to competitors, and that the RBOCs disparaged competitors. Given the fact that the RBOCs had, and continue to have, a near monopoly on the facilities needed to serve end users, these actions precluded effective competition in the long distance market.

Operational Support Systems

The ILECs retain the capability to harm potential competition in local markets and they have the incentive to exercise that power in a negative manner to delay meaningful local exchange competition. The ILECs' near monopoly in access to local customers is the key to their continuing ability to impact local competition by failing to provide quality access to those monopoly facilities to companies such as Sprint. While the Telecommunications Act of 1996 requires major ILECs to open their local markets to competition and to treat competitors at parity with itself in terms of Operational Support System (OSS) capabilities and access to facilities, the difference between words and action is clearly evident in the behavior of the ILECs. GTE has been defiant of many of the Act's requirements since its inception. For example, the Act and many Sprint/GTE interconnection agreements require automated access to the customer service record (CSR), and access to the unbundled network elements platform (UNE-P) that greatly facilitates the use of UNEs. GTE remains in violation of these agreements, borne of state PUC rulings, and has simply refused to provide an automated interface to CSR data. Repeated requests for automation of this access by Sprint have been rebuffed by GTE, which first stated that it was still not required to automate this interface, then stated that

such access was unavailable due to system limitations, and then stated that future system enhancements would allow this functionality to be provided by the fourth quarter of 1998. As we stand now in the fourth quarter 1998, GTE's current position is that, due to budget cuts, all automation and development and implementation activities related to automated access to the CSR would cease until the third quarter of 1999. Thus, if Sprint requests access to a CSR today (nearly two years after the execution of interconnection agreements requiring such automation), it must provide a written request to GTE, and GTE commits to provide the information via fax within 24 hours of the request – a far cry from the virtually instantaneous access that GTE's own customer service and sales personnel have to this information on an existing customer.

In the case of BA, over the past six months Sprint has dedicated significant resources towards the development of application-to-applications interfaces with BA. To date, Sprint has not achieved parity with the BA pre-order, order or trouble/maintenance OSS Systems. For pre-order systems, in mid-October 1998, Sprint at long last received the final documentation necessary to initiate mapping of BA pre-order systems. This final baseline document was received after several interim, incomplete versions had been distributed. Sprint has only begun the process to evaluate this final baseline documentation and proceed with computer programming. Therefore, parity with BA's pre-ordering systems has not been achieved.

For ordering systems, Sprint received the final EDI Issue 8 documentation in mid-July 1998 and initiated a large work effort to map the EDI transactions and validate business rules. Following clarification of BA's specifications, Sprint initiated software programming efforts. In early September, BA issued an emergency release of the ordering

specifications requiring business rule changes. Sprint is coding to the current EDI specifications but has not completed those efforts. Therefore, parity with BA's internal ordering systems has not been achieved.

For trouble/maintenance systems, BA's only option is the graphical user interface (GUI). The GUI has inherent flaws that ensure that parity will never be achieved. Specifically, CLECs must enter trouble information into their own individual trouble/maintenance systems. Then, the CLEC must reenter much of this same information into the GUI. This dual entry is not at parity with BA's own single entry system. Thus, the basic design of the GUI does not allow for parity.

Sprint is active in setting industry standards for pre-order, order and trouble/maintenance systems. During Sprint's evaluation of BA North systems (those used in the old NYNEX areas), Sprint identified twenty-nine proprietary data elements that were non-industry standard. Any one of these elements, standing alone, does not create an interface development requirement that is overly burdensome. However, this large number of proprietary fields does create a large work effort to customize Sprint's OSS systems to accommodate BA's non-standard system elements. Further, many of these unique non-standard data elements are not utilized by BA South, (the area served by the original Bell Atlantic), which may have its own set of non-standard data elements. Globally, Sprint is forced to develop several iterations of code for these ILEC-specific proprietary data elements. Such multiple development unnecessarily increases Sprint's costs and delays Sprint's ability to achieve parity with BA's retail operations.

In the situations where Sprint has used the GUI for service order and repair, Sprint has had numerous connection problems. Sprint's GUI users are required to obtain authorization from BA to log-on to the GUI system and BA has delayed that authorization for many weeks. During this delay our new customer service agents were unable to log-on to BA's systems. Further, the dial-

up log-on process has been fraught with problems where when connecting to the GUI, Sprint encountered hours of busy signals, ring-no-answer, and disconnections. This has all be complicated by the fact that BA has changed log-on procedures and its help desk rarely answers telephone calls.

State Commission Competition Rulings

Both BA and GTE have claimed that they have met their obligations under the 1996 Act.² However, in several cases examined by state public utility commissions, both companies have been found to have failed to meet the OSS, access and Section 271 competitive checklist requirements of the Act. For example, Sprint actively participated in the New York Public Service Commission's proceedings regarding BA's compliance with the Act's checklist requirements. Bell Atlantic has been unable to demonstrate that it has satisfied the check list and other requirements such as OSS parity, access to UNEs, and collocation on reasonable terms and conditions in New York or any other state. BA has not even attempted to gain FCC approval of its 271 obligations. Recently, the New Jersey Board issued a report finding that there is no significant residential or small business local telephone competition in New Jersey, and it identified BA's lack of standardized OSS and access to UNE combinations to be two major barriers to entry.

GTE has been one of the leaders in challenging the Act's provisions before state regulators and the courts. In fact, GTE vigorously opposed Sprint's 252(i) election of the AT&T/GTE interconnection agreements in each instance where Sprint sought such an

² See, e.g. testimony of Dan Whelan, President of Bell Atlantic-Pennsylvania, where he went through each item of the 14 point competitive checklist and proclaimed them to be "done." At the beginning of his testimony, he told the Commission that Bell Atlantic's "goal here today is to convince you that we have complied totally and fully with the 14-point checklist and that the public interest demands our entry." Implementation of the Telecommunications Act of 1996; Bell Atlantic-Pennsylvania's Entry into In-Region IntraLATA Services Under Section 271, Docket No. M-960840, April 3, 1997 Hearing Transcript at 8-18 (PA. P.U.C.) The Commission did not find that the checklist had been met.

election, claiming that Sprint had no right to elect under this provision of the Act because it had already entered the arbitration process with GTE directly. None of these states upheld GTE's claim and Sprint has elected the AT&T/GTE interconnection agreement in each instance where that agreement was ripe for election. The only tangible result of GTE's litigious approach to Sprint's market entry initiatives is to add to Sprint's legal costs and extend the time that Sprint is required to spend securing an effective interconnection agreement with GTE. Even when it was made abundantly clear by the PUC or federal district court that Sprint was entitled to the 252(i) election it sought, GTE executed the agreement, but footnoted the signature, stating that GTE does not consent to the agreement and that it was executed under the duress of a state PUC order requiring such a signature.

Similar contractual problems have occurred with BA. Sprint has twice signed interconnection agreements prepared by BA only to have BA fail to sign and file the contracts in a timely manner. The first instance occurred when Sprint signed and then delivered a New Jersey interconnection agreement on May 19, 1998 while BA signed on June 2, 1998 (a two week delay) and then filed the document with state regulators until July 31, 1998 (an additional two month delay). The same scenario is reoccurring with the Pennsylvania Sprint/BA interconnection agreement. In the Pennsylvania situation, Sprint signed the Bell Atlantic prepared contract and then returned it to Bell Atlantic on November 4, 1998. As of the preparation of this affidavit, it is Sprint's understanding that Bell Atlantic will not sign the contract and that it will not be filed with state regulators. BA's bad faith negotiating practices and delay places Sprint's Pennsylvania market entry in jeopardy. BA's unilateral action to withhold finalizing good faith negotiations in

Pennsylvania also places Sprint's market entry plans in Washington, D. C., Maryland, Virginia, West Virginia and Delaware in jeopardy. Sprint and BA had agreed to use the New Jersey contract as the template for Pennsylvania and these other states. BA's ability to refuse to enter into contracts that, at its whim, it chooses to reject after thorough negotiations with Sprint underscores its ability to hamper competitive entry in its markets.

The conclusion to be drawn from these failures is that neither BA nor GTE have embraced competition and relaxed their hold on local markets.

Today, all long distance carriers remain largely dependent upon the ILECs for access to their customers. In this regard, Sprint is like other interexchange carriers. As Sprint expands from its long distance customer base to serve all-distance Sprint ION customers, Sprint is dependent upon both BA and GTE for last mile wire line access to end users. As I explained previously, Sprint ION service will reach customers through either a dedicated access line purchased by Sprint from an ILEC (in most instances), through an xDSL loop and collocation space leased from an ILEC or, potentially through a resold ILEC xDSL service if a compatible service becomes available at a reasonable price. In all of these cases, the ILEC owns the last mile of access (although CAP alternatives may be available for dedicated access to some degree). In the case of xDSL collocation, the ILEC also controls the central office space where xDSL equipment must be located to connect with the copper loops of the ILEC in order to function. In the case of xDSL service provided by the ILEC, the ILEC controls the total xDSL access facility.

Performance Measurements

The ILECs have many ways to exercise their ability to harm Sprint in its drive to compete in the local market with the ILECs. In order to compete in the local market Sprint needs efficient, standardized OSS that allow productive and timely pre-ordering information and ordering of facilities and services from the ILEC. These systems should provide parity performance with the systems used by the ILEC itself in its retail operation. As has been found by many state commissions and the FCC, these standardized systems do not exist today. Even when measurements are established by an industry work group including BA, as in New York's Carrier-to-Carrier measurements work group, BA has not complied with its agreement to provide such measurements as Design Record Layout Timeliness, OSS Repair Response Time, and the entire category of percentage of orders completed within a presubscribed period.

Automated flow-through without manual intervention is another critical issue associated with OSS. CLEC orders must flow-through the ILEC system at parity with the ILEC orders. To date, neither BA nor GTE have provided any empirical, verifiable data regarding the flow-through of their own orders. Without such measurement, Sprint has concluded that CLEC orders are not processed with the same speed and precision as BA or GTE retail orders.

Further, Sprint installation and maintenance orders must be worked in the same time frame as ILEC end user orders and both sets of customers should receive parity treatment. Parity service does not exist today, and ILECs resist creating measurements to quantify the disparity. The FCC has a proceeding proposing model measurements, but it has not suggested it will require use of these measures. Further, many states lack reasonable

measures that identify and quantify the disparity. In New York, where the Commission is working toward meaningful measurements, it was noted in a BA proceeding that installation of CLEC UNE loops takes three times longer than BA's provision of its own retail service.

In a facilities-based environment, the ILEC must also provide quality and timely interconnection, reasonable collocation conditions, and reasonable, cost-based pricing. In Sprint's view, these conditions have not yet been met and there are significant questions concerning the ground rules for meeting these needs. Take interconnection as an example. Sprint ION service is an integrated all distance, local and long distance, voice and data product. Sprint's efficiency depends on aggregating all of the customers' traffic over a single access network and Sprint's efficiency is improved through a single interconnection with the ILEC. It remains unclear whether ILECs will allow Sprint to operate in this manner.

Costing Issues

The ILEC has control over each of the elements that relate to its monopoly control over last-mile facilities. The failure to provide any one of these functions on a reasonable, timely, and cost effective basis has great impact upon Sprint's ability to succeed in the local exchange market. As discussed, the terms and conditions under which these elements are offered (if they are offered at all) do not allow for viable access for competitors.

GTE's position in the interconnection arbitrations was that, in the face of TELRIC costing requirements, it was entitled to recovery of the monopoly embedded investment in the derivation of interconnection and unbundled network element prices. GTE did not prevail on this point but it is my understanding is continuing to press this issue by litigating

what it claims are constitutional rights to embedded cost recovery. If successful, these efforts would saddle new market entrants with a full allocation of the firm's total embedded investment. But even if unsuccessful, GTE will still have succeeded in creating additional uncertainty and risk for new entrants.

Parity

In general, the ILECs have failed to provide sound and capable OSS for CLEC use in ordering services and facilities from the ILECs. This failure results in a better level of service for ILEC end users than for the customers of competitors. The ILECs have also failed to provide parity service regarding installation and maintenance of their facilities used to serve customers of their competitors as compared to that provided their own end users.

These two problem areas create both a real and customer perceived quality gap between the ILECs' service and the services of their competitors. In addition, these problems greatly and needlessly inflate the operational and customer service costs of competitors because time is spent manually processing orders and following up with customers and the ILEC concerning ordering, installation, and maintenance. This inefficient customer service activity significantly raises the cost of customer acquisition and keeps competitors from being successful in the market. Further, the OSS and related problems with the ILECs result in a significant loss of revenue to Sprint due to delayed cut-over of service, loss of customers, and damage to Sprint's reputation as a quality telecommunications provider. Sprint continues to face actual unresolved problems in this area.

There are numerous issues of operational parity that Sprint continues to fight with GTE on a daily basis and that GTE has still not resolved. I will highlight only three of the

problems to illustrate the anticompetitive stance that GTE takes in its approach to opening its local markets to competition.

First, and perhaps most serious, is GTE's continued billing of its own retail intraLATA toll to Sprint's California local end user subscribers. At the time Sprint chose to enter the California market as a competitive local service provider, it chose to resell GTE's intraLATA long distance product. However, Sprint discovered that its local subscribers were continuing to receive GTE intraLATA toll bills. In July, 1997, GTE was made aware of the problem, and the issue was formally logged for resolution. After many months of analysis and claims that the problem was "fixed", it was finally determined that system limitations prevented the recognition of a Sprint local subscriber account on the GTE system as being a Sprint account. Specifically, indicators in the GTE system that are supposed to identify the customer record as a Sprint account were not present, causing GTE's system to recognize the account as still being an active GTE retail account. While this caused Sprint subscribers to receive GTE intraLATA bills, many of these Sprint customers were being disconnected by GTE for nonpayment of the GTE bill – a bill that, by GTE's own admission, never should have been issued in the first place.

In one instance in particular, an end-user brought Court action against Sprint, the California PUC, and GTE. In ruling on the case, the presiding magistrate found all culpability resting with GTE, thereby exonerating both Sprint and the CPUC from any wrongdoings. After numerous missed commitments by GTE, Sprint issued an ultimatum to GTE in July, 1998 (a full year after the problem was identified) – either fix the problem permanently and systematically, or face formal legal action. In response, GTE took steps (that are still in place today) to manually examine each Sprint account for the missing

indicator and edit the customer record if it is in error, pending a systematic solution. Each attempt at a systematic solution has failed, and Sprint's customers are still receiving GTE bills. Even GTE's band-aid solutions have failed and have only served to exacerbate the problem.

Second, GTE charges Sprint three times the amount that it charges its own end users for a change of the primary interexchange carrier (PIC). In response to Sprint's claim of anticompetitive and disparate treatment, GTE contends that it must process a local service request (LSR) to make the PIC change triggering a separate "service order charge", while GTE's retail operation does not charge their end users this "service order charge" because they are able to input the order directly into their system without the need for a service order. However, their input of the order is equal to the input of Sprint's LSR. Additionally, GTE has established procedures such that Sprint will never be able to input its orders directly into the GTE retail system – all changes to Sprint customer accounts must be made via the LSR. Thus, Sprint will effectively never be able to avoid this charge, causing significant cost disparity, not to mention the numerous failure points introduced in the LSR process.

Finally, due to GTE's manual processing of Sprint's LSRs, Sprint is experiencing a high number of LSRs that are, by GTE's own admission, rejected back to Sprint in error. All of Sprint's LSRs require manual intervention by GTE, which leaves them open to human interpretation and error. Rejects cause undue delay in the provision of service. GTE's erroneous rejections of Sprint's LSRs only serve to exacerbate this problem because Sprint must then engage in extensive dialogue with its customers and problem solving, causing expense on the Sprint side and ultimately resulting in poor quality service to

Sprint's end users. To place GTE's actions in perspective, GTE defined parity as being parity between new entrants, not the common definition which is parity between the ILEC and new entrants. It is easy to see that, from this ideological position taken as a baseline assumption for implementation of the Act, that anticompetitive behaviors day-to-day are not unexpected.

xDSL Facilities

In situations where new facility installation is required, the ILEC routinely fails to provide timely notification of facilities availability issues, which often prevents Sprint from meeting its due date commitments to customers. This forces the re-scheduling of work activity, causing not only increased cost to Sprint, but also inconvenience to customers and vendors. At best, this puts Sprint in the position of appearing inept and unresponsive to its customers, and at worst results in loss of the customer.

These problems may well be worse when Sprint begins to provide Sprint ION through xDSL and unbundled loops. xDSL technology provides the ability to carry high-speed digital signals over the existing twisted-pair copper local loops. The performance of the xDSL equipped local loop will largely depend on the condition of the individual copper pairs and the presence of other digital signals. Many existing local loops will require individual treatment in terms of conditioning in order to carry the high-speed digital signals directly to the customers' premises. As I detailed above, the standard to which these loops must be conditioned has not been established in many states. Further, an inventory of xDSL capable loops is unavailable.

Another problem is the assessment of the addressable market for xDSL services in BA and GTE territories. In its requests for physical collocation with GTE and BA, Sprint

asked for information on the scope of the market that was addressable for a broadband solution. Specifically, Sprint asked that BA and GTE provide, in conjunction with its estimate of physical collocation costs, the average loop length, the percentage of customers that reside within 18,000 feet of the central office, and the percentage of customers that reside behind digital line concentrators – each measure being a minimal but illustrative measure of the number of customers that can realistically be offered broadband services. To date, BA has not offered this market assessment data, and GTE has explicitly refused to provide the requested information.

Additionally, the ongoing performance of the conditioned loops depends largely upon whether other digital signals are carried within the same cable sheath or binder, thus raising the concern of interference from these other signals. Because the ILEC exclusively controls access to the monopoly loop, the conditioning of the loops, and the placement of digital signals within a binder group of loops, Sprint is at risk from ILEC discriminatory treatment. The fact is that standards for these binder groups have not yet been established in most states and only a few states currently have proceedings underway related to this significant problem. The fact remains that the ILEC can refuse to provide loops to Sprint, or simply provide poor quality loops that can affect Sprint's ability to either deliver service or to deliver quality service in a timely fashion.

xDSL NRCs

Even if the ILEC performs loop conditioning, it may not actually perform the required conditioning at a reasonable charge. Where the xDSL capable loop has not been identified as a UNE, the cost of conditioning has not been established. Excessive charges for either UNE loop provisioning or for loop conditioning result in a situation where the

provision of competitive local service is not economical. Indeed, not all of the ILECs have agreed to perform the necessary conditioning work or will only do so only at excessive rates.

xDSL DLC

In addition to these problems affecting UNE loop availability, many ILEC loops are behind Digital Loop Carrier (DLC) equipment that prevents the provision of xDSL service on these loops. At this point, availability of UNE loops behind a DLC is a very contentious and unresolved issue at both the FCC and the states. While there are potential solutions to this problem, the ILECs as a rule have refused to entertain requests to collocate CLEC equipment at ILEC DLC locations and to perform sub-loop unbundling for the twisted-pair copper from the DLC to the end user premises. Since many new residential and business developments are served by ILEC DLC equipment, the ILECs are denying CLECs access to these upscale customers by refusing to perform sub-loop unbundling and collocation at DLC equipment locations.

xDSL OSS

There are additional loop-related potential problems for local service competitors. Generally, the ILECs have not committed to provide timely information about which loops can be, or are already, conditioned for xDSL. This lack of efficient OSS pre-ordering systems causes competitors significant problems qualifying potential customers for service and further frustrates their ability to meet customer expectations and provide firm orders for service when contacted by a customer.

Collocation

Sprint ION initiatives can also be impaired by unreasonable collocation practices. An increasingly troublesome problem is the publicly documented ILEC claim of lack of space in ILEC central offices for physical collocation of the equipment of competitors. The ILECs have tended to make claims of space unavailability even when such space is reasonably available. Public complaints indicate the ILECs have generally been unwilling to provide detailed floor plans or allow walk throughs so that CLECs can independently verify that ILEC claims of lack of space are reasonable. This very conflict is an issue against BA in a current docketed Massachusetts complaint proceeding. Moreover, in New York, an administrative law judge found BA-NY's collocation methods to be unacceptable to support mass local market entry.

Collocation - Warehousing

In many instances where ILEC central offices appear to be full, there is unused equipment that has not been removed or administrative personnel that are not essential for the performance of network functions. This takes up space that could otherwise be reasonably used for collocation purposes. In most of these instances, the unused equipment could be removed and personnel not essential to the operation of the network could be economically relocated, thus freeing space for collocation.

Additional lack of space claims are due to unreasonable warehousing of space for potential use by the ILEC, including for the ILEC's own deployment of competing advanced services. An ILEC reserving a reasonable amount of space for its own use (not that of an affiliate) for one year for actual, planned activities should be permissible. Unfortunately, it appears that current ILEC warehousing goes far beyond this reasonable

standard and has resulted in unfounded claims of collocation space unavailability. For example, GTE took the position in an arbitration related to the development of an interconnection agreement with Sprint that it should be able to reserve central office space for the placement of its equipment for a full five years. Undoubtedly, when central office space is becoming increasingly scarce, an ILEC's ability to "lock up" space for its own exclusive use for an extended period would serve to limit the availability of space to entrants. Without collocation, there can be no competitive xDSL-based competitive services using the ILEC UNE loops.

Collocation - DSLAM

Competitors may be further hampered in their collocation activities by unreasonable ILEC refusals to allow collocation of essential equipment, including DSLAMs (digital subscriber line access multiplexers—the central office end of xDSL technology) which they claim provide too much functionality to be eligible for collocation.

For example, prior to allowing the placement of equipment in its collocation space, GTE is requiring Sprint to execute an Equipment Limitation Agreement containing the following limitation language: "Sprint agrees that their collocation equipment installed at all GTE collocation sites will be utilized for OAM&P (Operations, Administration, Maintenance, and Provision) purposes only. Also, Sprint agrees that their equipment, including, but not limited to, DSLAM and other similar equipment, will contain no intelligent router function, thereby limiting its use to that of transmission equipment or multiplexer/ integrated line concentration functions only." The bottom line is clear – unless Sprint signs the agreement restricting the use of its equipment, it will be prohibited from placing Sprint ION equipment in the collocation space.

Collocation - Timeframes

Another collocation problem that has arisen involves excessive delays in delivery of physical collocation quotes and finished space. Competitive DSL providers have reported delays in excess of one year in some cases. These delays are unreasonable and preclude competitors from bringing their services to market. They may in some instances discourage entry by some competitors entirely. Further, in a recent New York proceeding, facilities-based CLECs were nearly unanimous about BA's inability to meet the commission imposed timelines for collocation construction. This inability to meet collocation timeline commitments directly impacts CLECs' ability to enter markets and provide competitive services.

ILECs have also reportedly imposed other artificial and unreasonable barriers, including unjustified minimum space requirements, unjustified certification requirements, and excessive collocation charges that appear to have no relation to cost. Some DSL companies have reported instances where the ILEC has refused collocation absent state CLEC certification, even though the FCC ruled in its Interconnection Order that ILECs could not refuse to negotiate interconnection with CLECs based on whether state certification had been obtained.

For example, Sprint recently requested 100 sqft. of collocation from BA in four central offices. Bell Atlantic was willing to provide collocation as requested in only one of the four locations. One office was rejected because BA stated that no space was available. Sprint requested the central office floor diagrams to confirm the validity of this denial, but this request was also rejected. In another central office, Sprint was informed that space was not available today but may be available in the future. This order is still on hold. In a

third central office, BA quoted a price of nearly \$100,000 for 100 sqft. of space. These are all examples of the roadblocks to competition that CLECs face when attempting to collocate and bring competition to the BA market.

Collocation - Alternatives

A further complication is the lack of ILEC-offered alternatives to physical, caged collocation when space truly is limited. Virtual collocation arrangements typically require the CLEC to relinquish control over the installation and maintenance of its own equipment, and thus are offered only on a basis that is substantially inferior to physical collocation. Similarly, only a small number of the ILECs have offered cageless collocation, but even then, BA's cageless offering is at the artificially inflated prices they charge for physical collocation. Sprint estimates that the same floor space can accommodate twice as much equipment using cageless collocation versus the traditional physical collocation arrangement. However, BA has priced cageless collocation at the same or higher level as physical collocation even though logic suggests cageless should be less than half the cost of physical collocation. The absence of economically viable alternatives to physical collocation where space is a genuine limitation is another potential impediment to Sprint ION in particular and true competition in general.

As indicated above, Sprint intends to serve large customers via dedicated special access facilities acquired from the ILECs. While the ILECs currently have an adequate system for ordering these access circuits, Sprint is also concerned that the ILECs will begin to degrade this capability when it is used for Sprint ION service that will facilitate competition with the ILEC on a local level. Degradation of this capability could seriously harm not only Sprint ION deployment, but could also harm ongoing Sprint long distance

operations. Not counting trouble reports, Sprint's long distance arm sends thousands of new access orders per month to ILEC (many if not most of which are special access) and thus remains highly dependent upon the ILECs' congenial provisioning of access.

Collocation – Pricing

When it comes to the prices that Sprint must pay to secure the physical space in ILEC central offices, Sprint is by and large at the mercy of the ILEC. Absent state action that required TELRIC based pricing for physical collocation (of which there are very few), prices for physical collocation are established pursuant to the antiquated fully distributed cost methodologies once endorsed by the FCC prior to the Act. Even when the ILEC's physical collocation prices are established at the state level, tariff application can be very suspect. For example, GTE is attempting to charge Sprint double for the placement of power. In the instance where Sprint has ordered A& B feeds of power to its collocation space, GTE is charging Sprint for the A feed and the B feed separately, when technically, these feeds are inseparable. GTE is the only ILEC that is interpreting the application of prices for power in this manner.

Complex Services

Further, in the early phases of Sprint ION deployment, competitive local service will be provided through resale of ILEC local services to Sprint customers. The ILECs currently do not have adequate OSS systems in place to serve the larger, more complex customers that are the initial target market for Sprint ION. The OSS systems that do exist are largely dedicated to simple orders.

Sprint has experienced first hand in GTE's area the multitude of problems that arise from ILEC manual processing of orders - they get lost, delayed, changed in ILEC data

entry, and/or erroneously rejected. This leads to a poor level of service to Sprint and its customers. There are many examples of GTE improperly processing Sprint's orders resulting in erroneous order rejection. One blatant example is GTE's processing of Sprint's directory listing orders. Since GTE processes all directory listing orders manually, all of Sprint's listing orders are open to human misinterpretation which has resulted in multiple erroneous rejects. Just in the past six months, over 95 % of all directory listing orders have been rejected for invalid reasons or for reasons undeterminable by Sprint. There have been numerous joint planning and problem resolution meetings with GTE and performance by GTE has not markedly improved. Sprint is concerned that history will repeat itself and that the ILEC will harm Sprint's market entry by poor manual performance on these complex resale orders and xDSL capable UNE loop orders.

CLECs are often frustrated by the lack of properly documented ILEC product information and OSS ordering codes. Even when Sprint understands an ILEC product, pricing information is needed to make a rational business decision. Sprint has formally requested such information from BA. However, to date such product, pricing and ordering information has not been provided. As in any vendor/customer relationship, the vendor must supply a simple easy-to-use price list with ordering codes. Such price lists with ordering codes are common supplier marketing information in American industry today. Wholesalers often refer to these price list ordering codes as stock numbers, item numbers, or part numbers. BA, as a wholesale provider of services, must supply an easy to use price list for customers to make a purchase decision and order BA services. BA has committed to handle product inquiries on a case-by-case basis, however, such a resolution is slow and inadequate in a competitive market and is a significant hurdle to competition.

Many of the problems I have discussed have been fully documented in state regulatory proceedings, 706 petitions and proceedings, and FCC dockets. Some may well be on the way to being fixed through the complaint process or rulemakings. But as a provider of a technically new and dynamic service such as Sprint ION, Sprint is concerned not only with repairing each known misstep but with the problems that will inevitably arise in the future. Stated another way, the problems identified to date by Sprint and others do not define a closed set of discrimination opportunities. Especially with the dynamically changing technological environment that characterizes telecommunications, each future modification, no matter how marginal, presents the ILECs with another opportunity to delay or deny access.

We are too often told by ILECs “we don’t provide that” or “there’s no provision in the tariff for that.” This intransigence may sometimes just reflect a monopoly supplier attitude, but where there is an additional competitive incentive to delay or deny an input, companies like Sprint are especially at risk. I also fear that, if incentives to discriminate worsen (as they would with this merger), it would be virtually impossible to gain full cooperation from the ILECs, even with vigorous regulatory enforcement. As soon as watchful regulators insist that ILECs provide one particular arrangement based on a specific complaint, the ILECs will simply turn to yet another vulnerability to exploit.

In addition, even if regulators were able to rectify each instance of obstructionism as it occurred, the time required to resolve the complaints would inevitably impede our ability to deploy Sprint ION in a timely way in the combined BA/GTE territories in particular. By reducing the number of Sprint ION subscribers in the BA/GTE service areas, the attractiveness of Sprint ION to consumers in other parts of the country will also

be reduced. As a result, the ability of Sprint ION to provide competition to ILECs in general and BA and GTE in particular will be diminished until, if ever, BA and GTE provide Sprint with all of the arrangements required for Sprint ION to be fully competitive.

Because of their last mile bottleneck, the ILECs are the gatekeepers to large blocks of geography in the United States. Negative action by any one ILEC relative to Sprint ION last mile access and collocation impacts the geographic scope of Sprint ION. A reduction in the geographic scope of Sprint ION significantly reduces the attractiveness of the service to customers as the "on-net" benefits are curtailed.

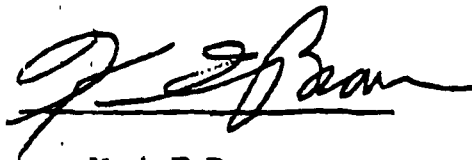
While one ILEC causing deployment problems for Sprint ION is very troublesome, the creation of an entity capable of impacting 58 million access lines across 32 states is an even larger concern because of the larger scope of the geography one supplier can affect and thus impact the deployment plans and potential success of Sprint ION. As larger and larger geographic regions of the nation become problem areas for Sprint ION deployment due to the activity of a single supplier, the potential for Sprint ION meeting its full competitive promise is significantly compromised.

IV. Summary and Conclusions

To summarize, because BA and GTE have monopoly control of last-mile facilities essential for access to end users, and central office space essential to deploy xDSL technology, they have the ability to adversely impact local service competition and the introduction of new services by denying access to these facilities or degrading performance associated with these facilities. Because these ILEC last-mile facilities will be used to compete on a local basis, the ILEC has an incentive to discriminate against Sprint and other potential competitors and provide poor OSS performance,

installation and maintenance performance, and access to facilities. The control these carriers enjoy over essential inputs can be used to damage competition in the markets for local, long distance and new services. These problems will only be exacerbated if BA and GTE are allowed to merge.

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.



Kevin E. Brauer

Subscribed and sworn before me this ____ day of November, 1998.

Notary Public

My commission expires:

**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

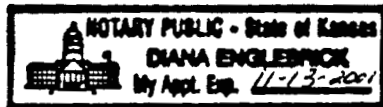
In the Matter of)
GTE CORPORATION,)
Transferor,)
and) CC Dkt. 98-184
BELL ATLANTIC CORPORATION,)
Transferee,)
For Consent to Transfer of Control.)

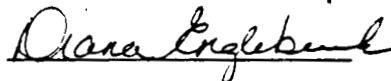
AFFIDAVIT OF GENE AGEE

I hereby swear, under penalty of perjury, that I have personal knowledge of the statements and allegations of facts contained in the attached affidavit, originally filed in CC Dkt. No. 98-141, and that it is true and correct, to the best of my knowledge and belief.


Gene Agee

Subscribed and sworn before me this 16th day of November, 1998.




Notary Public

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In re of Applications of)
)
AMERITECH CORP.,)
Transferor,)
)
and)
)
SBC COMMUNICATIONS, INC.,) CC Docket No. 98-141
Transferee)
)
for Consent to Transfer Control)
of Corporations Holding Commission)
Licenses and Authorizations)
Pursuant to Sections 214 and 310(d)))
of the Communications Act and)
Parts 5, 22, 24, 25, 63, 90,)
95 and 101 of the Commission)
Rules)

AFFIDAVIT OF GENE AGEE

I. Introduction

In this affidavit I discuss the economies of scale and scope inherent in the traditional public switched telephone network ("PSTN") and Sprint's ION network. My affidavit will also discuss the technological and financial imperatives, which are the drivers of a national deployment strategy.

My name is Gene Agee and I am employed by Sprint as a Director of Finance at Sprint National Integrated Services ("NIS"). I received a Bachelor of Science degree in

Accounting from Southern Illinois University, Carbondale, Illinois in 1979 and a Masters in Business Administration from the University of Missouri at Kansas City, in 1998. As a Certified Public Accountant, I have experience in public accounting with Peat, Marwick, Mitchell and Company from 1979-1982 and private accounting as a manager of internal audit at Pizza Hut and director of internal audit for Interstate Bakeries Corporation from 1982-1987 and 1987-1989, respectively. I joined Sprint Corporation, then known as United Telecommunications, in October 1989 working in the Local Telephone Division as Manager of Regulatory Accounting for Missouri and was promoted in 1994 to Revenue Director for Minnesota, Nebraska and Wyoming. In 1996, I became Director of Decision Support for the National Integrated Services organization of Sprint. In that capacity I direct a financial analysis team assessing the economic value of Sprint's entry into emerging local telephone markets.

My group analyzes the financial impact of products and packages of services offerings including local exchange, long distance, Internet, wireless, data and customer premises equipment for all market segments. As part of my responsibilities, I must understand the economies of scale and scope inherent in technology deployment, the role of increased geographical deployment in recovering fixed costs, and the difference between fixed and variable cost. I have been deeply involved with the financial analysis that supports Sprint ION and understand the various cost components required to deliver the Sprint ION platform.

II Definition of Terms

The discussion of economies of scale and scope must begin with a clear understanding of the concepts and terms used. By economies of scale, I refer to an entity's ability to benefit from lower unit costs as volume increases. By economies of scope, I refer to an entity's ability to benefit from a national service offering. Fixed costs are those costs that are constant regardless of the actual number of customers served or units produced. Examples of fixed costs include all costs of research and development, software licensing, billing systems, operating support systems, communications databases, and control systems. Variable costs are those that vary directly with the actual number of customers served or units produced. An example of variable cost would be access charges incurred by inter-exchange carriers to originate or terminate calls over the PSTN. Finally, semi-fixed costs are those costs that remain fixed for a given level of activity, but then increase at critical points by some given amount. An example of semi-fixed costs would be costs associated with expansion of service into a new geographic area.

III Economies of Scale and Scope for the PSTN

All telephone service providers incur many costs that are largely fixed and do not vary markedly based on the number of customers. The costs of providing the PSTN using today's software intensive technologies involve both high fixed and semi-fixed costs. Semi-fixed costs arise in the form of equipment deployment that must occur in a geographical area in order to provide service. Much of the hardware used on a local basis in telecommunications, such as individual switches or copper wire to a new subdivision, may be added in a semi-fixed fashion. Much of the technological infrastructure

of a telecommunications firm, however, is either software related, and is thus a fixed cost (as discussed below), or represents core network hardware and is available in minimum sizes or definite ranges of sizes. Where this is the case, the telecommunication firms can benefit from increased utilization, so that these fixed and semi-fixed costs are spread across more users.

Examples of costs that are largely fixed include the costs of: (a) software that drives the services offered in the network; (b) back office systems that maintain customer and facility records; and (c) billing systems. Switching systems, whether they are traditional circuit switches such as a DMS 100 or 250, a Lucent 5ESS, or new generation ATM switches are in reality sophisticated computers that rely on extensive software programs to work. Interoperability between the core network switching systems and other network components also requires extensive software. In some instances, an equipment supplier develops this software on a speculative basis. In other instances, the software is custom built at the expense of the user. To the extent that the software is custom built or that licensing of the software requires a significant up-front payment that does not depend upon the volume of machines in use, significant fixed costs exist.

The costs of billing systems are another example of fixed costs to the service provider. The largest component of a billing system is software that contains the instructions on how to read and rate individual transactions, integrate multiple services, and provide a bill to the customer. This software is complex, significant in size, very expensive, and the size of the software program is independent of the size of the user. Thus, after investing in billing software development, a telecommunications company has a fixed investment that results in a lower unit cost for each additional customer billed

through the software. The billing systems used by long distance providers are not adequate for the provision of local service, and so long distance companies looking to provide local services must invest in new systems (or modify existing ones) as an incremental cost to local market entry.

Voice and data telephony providers use other complex and costly software programs to run their businesses in addition to those used in billing. For example, these systems known in the industry as operational support systems ("OSS") are used to keep records of the facilities used by each customer, the services that each customer subscribes to, the facility/service routing tables, customer history, and historical service performance. The programming of each of these OSS is complex, expensive, and the cost is basically independent of the size of the user.

Increasingly, centralized databases play a role in the provisioning of telecommunications services. Examples include 800 number databases, local number portability databases, calling party name databases, line information databases ("LIDB"), and other advanced intelligent network ("AIN") databases that are used to create new services through the manipulation of software triggers. A single pair of these databases, paired for redundancy purposes, is all that a company requires.

Much of the design and control of the network can be handled from a centralized point. The use of paired, redundant network control facilities brings economies of scale and scope as additional networks to be monitored and controlled are added at the centralized network monitoring point. Further, network designers, using standardized computer programs and network components, can design network deployments for all of the nation from a centralized point using common software. As additional engineering

work is performed using a common software platform, economies of scale and scope are realized.

What is occurring in the industry is the creation of large and complex software platforms, centralized databases, and centralized network engineering and monitoring facilities whose cost is largely independent of the size of the company deploying this technology. As a result of the largely fixed investment, great economies of scale and scope are created and available in the telecommunications industry.

The result is that any provider of a new service must consider the largely fixed costs of the offering, as well as its ability to recover these costs. Any provider of a new service will have to incur some or all of the types of fixed costs described above before it can offer that service. In addition, providers typically incur additional fixed costs over time as they improve and add functionality to their service. A company that has relatively small scale and scope has much higher per-unit costs for these functions than a company with larger scale and scope. The differences in the scale and scope of companies using these platforms and facilities translates into real marketplace differences in pricing as a smaller scale company struggles to compete with a larger company that can allocate recovery of its high fixed costs over a much larger customer base.

IV. Sprint ION Costs

Earlier this year, Sprint announced its new Sprint ION strategy which seeks to create and extend a single data network to the customer's premise to provide integrated, all-distance, voice, data and video services. Sprint owns national long distance networks today which provide voice and data services to both businesses and consumers over distinct and separate networks. The existing all digital, fiber optic long distance network

will become the backbone for the transmission of all traffic types. Sprint's previous investment in the digital, fiber optic network allows it to quickly migrate to an end-to-end high speed, high bandwidth data network.

Although Sprint ION leverages the existing long distance fiber optic network, Sprint must expend substantial additional capital to develop and implement Sprint ION in order to extend our network to the customer premise and offer a new service to customers. This new investment will have primarily fixed and semi-fixed cost characteristics. During the keynote address at Internet World, Sprint Chairman and CEO, Bill Esrey, disclosed that "we've already invested more than \$2 billion in building the network, and we have another \$400 million in investments lined up."¹ The remaining development investment, as outlined by Mr. Esrey, is smaller than the facilities investment required to deploy ION.

Sprint will need to deploy Sprint Service Nodes ("SSN"). The SSNs are physical assets deployed in target markets to run Sprint ION enabling software. The incremental cost for deploying an SSN includes acquiring the physical facilities and hardware as well as establishing physical connections to Sprint's long-distance network and the incumbent's local exchange facilities. These deployment costs are driven by both markets selection as well as the location of Sprint ION customers within the market, and, once installed are relatively insensitive to volume.

In addition to the SSNs, Sprint ION service to many business and consumer locations require the integration of all customer traffic over a common access facility through the use of a digital subscriber line access multiplexer (DSLAM), located at the

¹ CEO Chairman, Bill Esrey, Internet World Keynote Address, Chicago IL., July 15, 1998.

central office. Total estimated initial investment that will be required for the physical asset deployment of SSNs and DSLAMs is in excess of \$400 million.

Sprint ION must also develop the SSN software. Software defines how traffic negotiates the network and provides premium functionality to differentiate Sprint ION from other communication offerings. Software costs are driven by software feature specifications. Key software in the SSN includes the previously unavailable capability to offer quality voice service over packet-switched networks and the capability to dynamically allocate bandwidth by the customer. The Sprint ION Service Node will also provide what is known in the industry as "class 5 features". These include software capabilities such as call-forwarding, caller ID, call waiting, and speed dialing that have previously been available in the network only through circuit switches.

Software development is a significant fixed cost that is insensitive to volume, and once developed, software has significant economies of scope through deployment in service nodes across a national footprint. The software to run the SSN is standardized and is being developed for Sprint at an estimated cost of \$100 million.

Sprint is also undertaking significant modifications to existing systems and the construction of many new systems to support its Sprint ION service. For example, Sprint's existing long distance billing system is not capable of performing local billing or billing products like Sprint ION. Modification of this system and other support systems required to meet the needs of Sprint ION will cost \$320 million.

Sprint must incur each of the costs noted above to offer its Sprint ION service to customers. The estimates of development and initial deployment cost exceed \$800 million. All of these costs are either fixed or semi-fixed costs.

V. Additional Fixed Cost Activities

There are additional economies of scale and scope available to telecommunications companies. A prime example is mass advertising economies. The development of a mass advertising campaign is very expensive from a production standpoint. Examples of such advertising media include national television, national magazines, and national newspapers such as the Wall Street Journal and USA Today. Economic efficiency is gained as the geographic scope of the target market is increased. It is much more economic per customer to use national television to reach a market which include all of the United States than to use it to reach only potential customers in the State of Texas. As the size and scope of the target market increases, the cost per presentation to potential customers via national advertising campaigns is reduced.

Sprint has already begun national advertising of Sprint ION service using the television medium. Through television, business customers nationwide are being told that they will be able to subscribe to Sprint ION. At the Sprint ION announcement, Sprint presented information to the national press and received nationwide newspaper, television and other print media coverage. Sprint is using nationwide mass media to deliver its Sprint ION message to potential business and residential customers. Sprint spent \$290 million promoting its nationwide products in 1997 and anticipates a similar campaign for its suite of products that now includes Sprint ION.

Today, Sprint serves over 16 million businesses and consumers in the United States. A national customer base lowers acquisition costs, accelerates acquisition time, and, as described above, provides the opportunity to spread national marketing costs.

The national scope of Sprint ION can also leverage the existing national distribution and affinity programs such as AARP and Radio Shack used to sell current Sprint services.

VI Sprint ION's Value to Customers

Sprint ION has value to customers by offering cost savings and increased functionality and features. Sprint ION allows customers access to multiple services over a single, broadband access facility with managed bandwidth capabilities. These features enable users to make more efficient use of telecommunications services and networks than they are able to do today under the PSTN platform. Customers' access costs are lower than when they must use multiple, separate access facilities, one for each type of service. As a result, customers can be expected to have greater access capacity and capability, which in turn means the ability to exchange communications they otherwise could not. In other words, ION effectively will allow customers to utilize services they would not choose to utilize (or utilize to the same degree) at prevailing prices.

Thus, Sprint ION provides additional features and functions. At the consumer level, an access circuit that today provides only one plain old telephone service ("POTS") line would be capable of providing up to six POTS-like lines, or a combination of narrowband and broadband services managed by the customer on a dynamic, as-needed basis. The need for and costs of multiple physical access lines in order to make or receive calls (and avoid busy signals) while another member of the household is on the Internet, for example, is eliminated. As another example, the Internet access that blocked calls today over the analog loop can occur over the digital loop not only simultaneously with a voice call but also at much greater speeds. For business users, network use also becomes more efficient. Today, for example, an ordinary private line customer with a

dedicated access link is able to pass traffic at given speeds or below subscribed for in advance. If the private line service is integrated on Sprint ION, however, the customer's data traffic could use the much larger integrated access link to pass the traffic at much higher speeds, again on a dynamic, as-needed basis. With Sprint ION, business customers no longer will be forced to choose between leasing an expensive, fixed high-bandwidth pipe which sits underutilized much of the time or forgoing the greater bandwidth.

Customers realize savings as multiple, stand-alone services (e.g. local voice, frame relay, Internet traffic, ATM, and long distance voice) are moved from separate, inefficient access facilities to a single, more efficient, integrated access facility. The integrated facility also will facilitate increased functionality and flexibility for communications between locations served by Sprint ION.

In telecommunications, the value of the increased functions and features at the originating end of the transmission is, of course, constrained by the capabilities at the terminating end. The full functionality of ION will be available to ION subscribers only. For example, video conferencing and other broadband applications between and among households will be possible if those households are Sprint ION subscribers. In the private line example, the off-net location would restrict the transmission to a subscribed maximum speed rather than higher speeds available on a managed bandwidth basis over the Sprint ION integrated access link.

Clearly, new products and services like Sprint ION are most beneficial if they are widely distributed and connected via a reliable network. For example, the first

fax machine had little value as a single machine. As more fax machines were purchased and utilized, the value of all fax machines increased. The same will be true of Sprint's ION network. The more customers utilizing a single broad band pipe to their premise and complete on-net Sprint ION traffic, the greater the value of the Sprint ION network to all users. Video telephony has little value if only a handful of people have the capability. However, much like the Internet, the value of the Sprint ION network is enhanced once many customers are networked together. Thus Sprint's ION envisions multiple ION Service Nodes and users all connected over a broadband network to provide new and innovative products and services through Sprint ION.

In addition, Sprint ION customers will realize savings over off-net calling prices as traffic is transported on-net. Sprint's costs for carrying traffic that only either originates or terminates on the Sprint ION platform are different from the costs that Sprint incurs for Sprint ION on-net traffic where both the origination and termination point subscribe to Sprint ION service. Sprint confronts different and lower costs for carrying on-net calls than carrying off-net calls. For on-net calls, Sprint can carry the entire call between customer premises without needing to translate the transmission from or to the traditional circuit-switched platform. For switched voice services (traditional long distance) involving off-net facilities, Sprint will incur additional costs to perform the necessary translation from ATM protocol at a Sprint Service Node before receiving/delivering the call from or to an off-net, circuit-switched environment. Of course, these calls involving off-net transactions also incur per minute access charges that are assessed by the incumbent local exchange carriers. Thus, for traffic that either originates or terminates to locations that are not served by Sprint ION, additional costs

are incurred above those required to carry a call connected via Sprint ION at both ends. Sprint plans to recover these higher costs through applying traditional Sprint product pricing, or some form of higher pricing that reflects the difference in costs, for service to off-net locations.

When both ends of a call are on-net, all of the cost benefits described above are realized. The greater the penetration of Sprint ION in the marketplace, whether within multiple locations of a single customer, or across diverse customers, the greater the savings that a Sprint ION customer may achieve. If Sprint ION does not reach some level of critical mass by being available across the nation to a large portion of a customer's locations or if only a small portion of a customer's call complete on-net, there may not be sufficient savings related to Sprint ION to justify movement from the status quo.

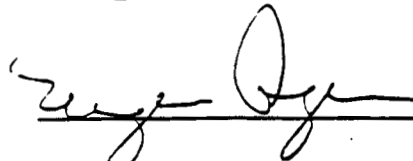
Market realities and the cost profile of Sprint ION to the customer lead to the conclusion that a customer that can maximize its on-net Sprint ION traffic is most attracted to Sprint ION service. This means that the unavailability of Sprint ION service in one region of the country has a chilling impact upon the ability of Sprint to market Sprint ION service in other areas of the country because it is more difficult for the customer to achieve the benefits promised from Sprint ION on-net transactions. Without these cost savings and increased functionality generated through contacts with other locations that can receive Sprint ION traffic on-net, many customers will choose to remain with their current service configuration because of customer inertia – a customer without a compelling reason to change carriers or services will not do so.

VIII Conclusion

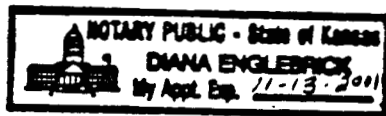
Many of the costs of firms providing voice and data telephony are largely fixed or sunk costs that are independent of the size of the firm providing the service. As the scale and scope of the firm increases, the sunk or fixed costs become a smaller portion of the total costs of the firm. Sprint will have to incur such fixed and semi-fixed costs to offer its new Sprint ION service customers. Other carriers also will have to incur such costs in order to develop and offer new local or combined local and long distance services.

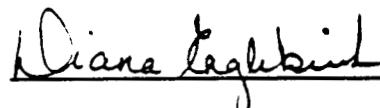
The value of the Sprint ION service to customers increases as the number of customers and geographic scope of Sprint ION service increases. Customer savings and the value to customers of Sprint ION service are maximized as more Sprint ION customers come on-net. The lack of availability of Sprint ION in a region will cause significant harm to the Sprint ION value proposition and harm the value of Sprint ION to customers.

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.


Gene Agee

Subscribed and sworn before me this 12th day of October, 1998.




Notary Public

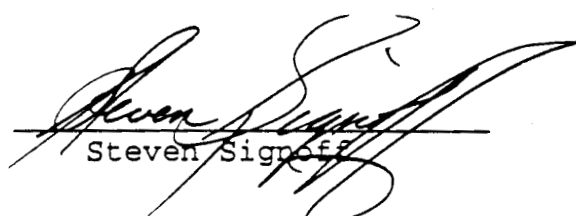
My commission expires:

**BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554**

In the Matter of)	
GTE CORPORATION,)	
Transferor,)	
and)	CC Dkt. 98-184
BELL ATLANTIC CORPORATION,)	
Transferee,)	
For Consent to Transfer of Control)	

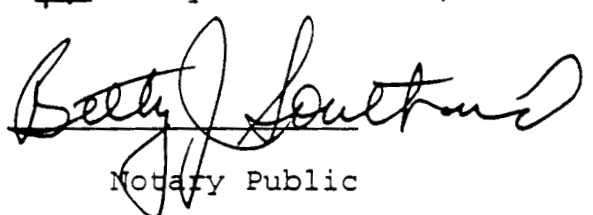
AFFIDAVIT OF STEVEN SIGNOFF

I hereby swear, under penalty of perjury, that I have personal knowledge of the statements and allegations of facts contained in the attached affidavit, originally filed in CC Dkt. No. 98-141, and that it is true and correct, to the best of my knowledge and belief.


Steven Signoff

Subscribed and sworn before me this 18th day of November, 1998.

BETTY J. SOUTHARD
Notary Public - State of Kansas
My Appt. Exp. 5/29/99


Notary Public

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In re of Applications of)
)
AMERITECH CORP.,)
Transferor,)
)
and)
)
SBC COMMUNICATIONS, INC.,) CC Docket No. 98-141
Transferee)
)
for Consent to Transfer Control)
of Corporations Holding Commission)
Licenses and Authorizations)
Pursuant to Sections 214 and 310(d))
of the Communications Act and)
Parts 5, 22, 24, 25, 63, 90,)
95 and 101 of the Commission's)
Rules)

AFFIDAVIT OF STEVEN SIGNOFF

1. My name is Steven Signoff. I am Vice President of Strategic Business Development for the Sprint Business unit of the long distance division of Sprint. I began my professional career at Sprint in 1989 in the finance organization. Since then, I have served as executive assistant to the president of the National Markets Group and the president of the Small and Medium Business Marketing Group. Other positions have included director level assignments to lead Sprint Quality efforts and Strategic Planning. In 1996, I served as an executive on assignment to France Telecom in Paris, France for eighteen months. I returned to the United States in June of 1998 and was

appointed Vice President of Strategic Business Development, leading the functions of strategic planning, business development, global alliance management, business transformation, program management, market research and competitive analysis.

2. I have been asked to provide this affidavit in connection with Sprint's participation in the FCC's proceeding to review SBC's proposed acquisition of Ameritech. More specifically, I have been asked to evaluate the claim made in the Application that the merger is necessary for SBC and Ameritech to provide local services outside their regions, particularly through the proposed "National-local" strategy. I have reviewed both the public interest section of the Application and an affidavit submitted by James Kahan. SBC and Ameritech argue that the merger is necessary to allow them first to accumulate 20 in-region incumbent markets and then launch service in 30 other domestic markets (as well a number of foreign markets) all in an effort to 'follow the [in-region] customer.' The outcome of not doing this, they claim, is to risk losing their in-region customers to competition.

3. I address and respond to a number of assertions and assumptions in this "National-Local-Global" strategy. The strategy assumes that SBC and Ameritech must 'follow the customer.' The Application states that the parties believe that they must position themselves to serve at least 70%- 80% of the telecommunications requirements of the largest customers. This is characterized as one of their "most fundamental assumptions." Kahan at ¶ 48. While no specific basis for the 70-80% figure is

given or explained, the Application assumes that the largest users want sole source supply arrangements: "Customers now see an opportunity to obtain what they want -- the option of having one principal source of service, one source of contact and consolidated lines across the nation and across the world". Kahan Aff. at page 10, also page 12. Another fundamental assertion is that SBC and Ameritech cannot adequately enter out-of-region markets unless they have a secured customer base in each local market they enter: "In the absence of the merger, SBC does not believe these strategies are viable and does not contemplate out-of-region entry into local exchange markets." Kahan Aff. at p.31.

4. As described in greater detail below, these assertions bear little resemblance to Sprint's marketing experience. Large users frequently and quite deliberately divide their telecommunications requirements among different providers, and so there is no particular reason to believe that only those suppliers geographically positioned to serve a set percentage of any one customer's needs will be considered. Also, competitive entry into local markets will most often require marketing to target customers without any pre-existing relationships. Because the largest purchasers of telecommunications services are sophisticated purchasers, and because SBC and Ameritech each are independently recognized by this group of customers as established, experienced providers of telecommunications services, I believe Mr. Kahan has placed too much emphasis on prior business relationships and brand recognition in this

context. I discuss these issues in more detail below.

5. It may be helpful to begin by recognizing that the National-local strategy comprises competition in three distinct marketplaces: long distance , in-region local services, and out-of-region local services. I assume here that interLATA authority has been granted, since otherwise this strategy appears to make no sense at all. As a businessman, I believe these markets present very different sorts of challenges, particularly for local monopolists such as SBC and Ameritech. The long distance market is very competitive, especially so in the market for the largest users. Local markets, on the other hand, each are dominated by a monopoly provider only just beginning to see a very small and fragile amount of competition. Here, the incumbent advantages are substantial, especially until the rules for opening these markets are fully set and implemented.

6. I have set forth this set of differences because it seems to me that the strategy described in the Application seems to confuse them. For example, the need for national coverage is one I would agree with for the provision of long distance services to large users, but it is merely a wish in the context of local services, given the very limited opportunities for competition here. Also, the description of out-of-region local entry does not appear to account for the competitive problems that exist in these markets. I think it is important to consider these very different stages of competition in any discussion of a strategy to package them all together.

Follow the Customer

7. The strategy described in the Application is contingent upon two assumptions. First, it assumes that the successful deployment of the strategy requires that a very large number of large business customers are headquartered in, and can be "followed" from, SBC's service territories. Second, it assumes that, in order to sell services to these customers, a supplier must serve everywhere (or almost everywhere) the customers' operations are located. As an initial matter, I would note that if SBC and Ameritech were correct that in fact the largest customers demand sole source supply, then 70-80% coverage wouldn't suffice; only 100% coverage would meet the stated requirement. Of course, not even the pre-divestiture Bell System had this coverage.

8. The Application insists that SBC or Ameritech will be at risk of losing their existing, in-region local customer base simply because they could not 'follow the customer' for all purposes in all locations. There are two key assumption here. First, Kahan assumes that SBC's competitors will be able to offer 100% coverage, and so SBC must position itself to match them. Secondly, he assumes that large buyers will want to purchase all of their telecommunications requirements from one source. The problems with these assumptions are explained below.

9. Suppliers will generally not be able to offer sole

source arrangements for the largest users for some time to come, at least not where local services across several geographic regions are needed. Given the limited amount of local competition that has developed to date, it will be a long time before anyone will be so situated. In Sprint's experience, the RBOCs, including SBC and Ameritech, have vigorously resisted cooperating in the effort to lower barriers to entry into local markets. I have no reason to believe that this resistance will subside to any material degree in the near future. While it is true that legal changes should make it eventually easier for one company to offer local services in more and more markets, this has not yet occurred and is unlikely to occur for some time.

10. Thus, while partnering is described in Mr. Kahan's testimony as a poor alternate, it is Sprint's experience that multiple sourcing is necessary and will remain so for a long time until competitive local services are more readily available.

11. As discussed, Mr. Kahan's need to 'follow the customer' also assumes that most or all large users desire single source supply arrangements. This is not Sprint's experience, even if one were to consider only long distance services contracts. Many large buyers deliberately do not purchase all their telecommunications needs from a single source. In Sprint's experience, large users often divide up their requirements in numerous ways, e.g., purchasing voice and data lines from distinct providers, splitting their requirements among competing providers by volume or by geography, purchasing services primarily from one carrier and using another as redundant or

backup source, etc.

12. Buying patterns also vary with the locus of decisionmaking for these users, and these too can vary widely. While one would expect to see some centralization of the decisionmaking, the degree of centralization can vary materially. A large multinational business with multiple subsidiaries across the country and abroad may purchase its telecommunications needs by groups of subsidiaries in accordance with its corporate organization, by region of the country, national versus foreign, etc. Some of these differences are due to variations in the telecommunications needs of specific companies. Where local communications with the public is a priority, such as with retail businesses, localized (or decentralized) decisionmaking may be more common. In contrast, where the greatest telecommunications needs are internal to the company between and among a number of geographic areas, more centralized decisionmaking may occur. Other differences can be due to managerial preferences and such other factors independent of the underlying telecommunications needs. The point is that no one pattern captures the majority of cases.

13. Just by way of example, Sprint is one of a number of suppliers to a Fortune 100 multinational conglomerate whose corporate policies expressly prescribe the use of multiple vendors for purposes of redundancy and price leverage in negotiations. Another example is Sprint's wholesale contract to supply a large telecommunications company for only voice purposes; the same buyer has separately purchased its data transmission

requirements. Of course, the most public example is the federal government's procurement of telecommunications services, which is also divided among multiple carriers.

14. Of course, some buyers do want sole source contracts. But in our experience, no one particular pattern fairly characterizes these largest users as a group.

15. I would note my agreement with Mr. Kahan in his general observation that the legal changes of the past several years can and likely will lead to changes in the marketplace. Mr. Kahan is of course correct that, over the time period in which local telecommunications services were provided on a legal monopoly basis, buyers had no choice but to purchase local services in different regions from distinct local monopoly vendors. Once local markets are actually opened up to competition, carriers will be in a position to sell more services to customers. I disagree, however, with Mr. Kahan's assumption that where we are inevitably headed is a market where all buyers purchase all their needs exclusively from one vendor. Although local service is no longer provided as a legal monopoly, its provision has not thus far been integrated to any great extent with the provision of long distance service.

16. Nevertheless, I agree with Mr. Kahan that one-stop shopping will in the future become more important to customers. My view is that such a trend is likely because it is most efficient from an engineering standpoint to provide all services - voice and data, local and long distance - over a single packet-switched, broadband network. This is the reason for the

introduction of Sprint ION service. To my knowledge, neither SBC nor Ameritech has a similar vision of the future, however. Both apparently intend to continue to provide voice service, as they traditionally have, over circuit switched networks, and to separate the provision of data service onto packet switches. If voice and data continue to be provided separately, there would appear no overriding reason for buyers to utilize a single vendor. On the contrary, under such circumstances, the ever-increasing importance of data may lead to an increase in buyers driven by quality consideration for this set of services, leaving their voice requirements to other suppliers. In fact, Mr. Kahan's affidavit sets data (IP) apart from other telecommunications services, notwithstanding his emphasis on the importance of serving all customers with all services.

17. The 'follow the customer' assertion also assumes that large users are heavily influenced by existing business relationships. While the existence of standing business relationships can be helpful in obtaining additional business from a customer, it is not sufficient by itself and is far behind other factors in terms of importance, especially for large users who are sophisticated purchasers of telecommunications services. This is especially true where the large user is setting out to contract for some substantial set of telecommunications needs (such as when an existing contract is near expiration), as compared with a buyer looking only to add incrementally to its existing services already under contract.

18. The telecommunications services industry is made up of

many companies. Among the hundreds (if not thousands) of competitors, there is a smaller group of well-established firms with recognized expertise and experience in this field. These firms are in some cases household names, as with the major long distance carriers. SBC and Ameritech seem to assume that they enjoy this recognition only in-region, but among large telecommunications users, that employ full time telecommunications managers, their names are known throughout the country and globally. Thus, the value of brand recognition, described as a hurdle in the application, is one already achieved by SBC and Ameritech.

19. It is helpful to consider in this context how large business users make their telecommunications purchasing decision when they have competitive alternatives to consider. Large users purchase telecommunications based on a variety of factors. The two factors that are unequivocally most important are price and quality. The managers responsible for their companies' telecommunications needs are typically under substantial pressures to obtain the best services at the lowest cost. Thus, in a typical procurement effort, large users will not merely extend existing service arrangements but will open up the contract opportunity to the industry at large. Again, while managers may be reluctant to put too much of their business at risk with 'newcomer' suppliers, SBC and Ameritech are recognized and established suppliers and would not be considered risky choices on the basis of name recognition.

20. The follow the customer strategy places heavy emphasis

on existing in-region relationships. It is not clear to me exactly what is meant by this. If all SBC and Ameritech are saying by this is that, as the incumbent monopoly, they have substantial advantages in securing additional business from their customers, no one could really disagree with that statement. To the extent they believe that they will win all of a customer's business simply because they serve that customer in-region, more specifically, because that customer's headquarters is located in-region, I disagree. If nothing else, they will have to compete out-of-region for business now held by another monopoly incumbent.

21. It is important to consider the logical conclusion of the assertion that carriers will enjoy overwhelming advantages in gaining the business of large customers headquartered in their region. It would require the conclusion that carriers would not really compete for the large users but rather "divide" them based on the location of their headquarters. Moreover, if one accepts the story, it would mean that a carrier that lacks an in-region monopoly base to work from could not survive in this market environment for services to large users.

22. SBC and Ameritech seem to be arguing that they need to merge not so much in order to compete but rather to expand the size of their incumbent base so they can better leverage their monopoly outside the bounds of their current area. Thus, their story predicts a decrease in competition -- in both local and long distance services -- as customers are divided up based on the location of their headquarters. Note also, then, their story

would seem to require the conclusion that SBC and Ameritech are likely to lose the business of those large users which have branch operations in their regions but are headquartered in another region, something I doubt that either company would want to concede.

23. The underlying assumption that this will simply be a battle of a few giants is something else I question. The history of telecommunications shows that size and reputation alone won't guarantee market success. We have witnessed the success of new entrants into both local and long distance services; many of these firms were initially start-up companies. While of course buyers may seek assurances of quality and reliability in dealing with new suppliers (as well as with experienced providers), some large sophisticated purchasers are willing to take risks and may test new entrants with at least some portion of their business and expand the relationship if they're satisfied.. If this were not the case, then we would not be witnessing the tremendous growth for resellers and smaller facilities-based firms.

24. The Application provides a rather complicated set of figures to explain why the merged entity would have to reach 50 markets to succeed. It suggests a detailed analysis has been undertaken of the telecommunications requirements (by volume and location) of each Fortune 500 company headquartered in either SBC's or Ameritech's region. It is really not possible to comment on these assertions without additional information as to how these numbers were derived. Sprint is not aware of any specific, publicly available data source that would accurately

and comprehensively report this sort of data. Without the underlying basis for the assertion, however, there is no particular reason to think that any particular number of markets must be entered simultaneously for the National-local strategy to succeed.

25. Further, it is not at all clear how one can accurately divide telecommunications requirements across geographic markets without specific customer information. Certainly some assumptions would have to be made about the percentage of dollars spent on local versus toll services, and on voice versus data services. These patterns could variably considerably across the Fortune 500 companies. Because the 70-80% figure is so crucial to the stated need to enter 50 markets, its underlying rationale should be examined carefully. And because the means by which the conclusion that 50 markets must be reached is also hidden, that too should be subject to rigorous scrutiny.

Global presence

26. The Application also claims that the merger is necessary to this strategy because it will allow for the combination of the international assets of the two firms. But the merger would not materially improve either firm's international presence given the secondary nature of most of the markets in which each holds interests. For example, such major areas of international commerce as Japan, Germany and Brazil are missing from the even the combined foreign assets. The new combined firm would have to enter these locations on its own or,

far more likely will have to partner in order to serve customers with coverage of the major foreign markets.

Secured entry

27. Mr. Kahan states that it would not be prudent for either SBC or Ameritech to enter out-of-region markets alone because neither company alone would have sufficient base of secured business flowing from in-region customers. This too is inconsistent with Sprint's experience. It is in fact rare in local telecommunications services that serving the customer in one locale is a necessary prerequisite to obtaining that customer's business in another location. Obviously existing customer relationships may help, but they are not essential. As I have discussed above, SBC's name would be widely recognized in Ameritech's region (and elsewhere) among the large telecommunications users.

28. Mr. Kahan does not specify what advantages they seek to gain from this broader customer base; if he is describing an ability to exploit incumbent advantages, then all he is saying is that they want a larger monopoly base from which to capture additional service requirements. But it is my understanding that at least some of the more apparent leverage opportunities may be foreclosed by law. For example, it may be helpful to market to a potential customer if one has available proprietary information about the customer's telecommunications usage, but I understand the new law and FCC regulations substantially inhibit SBC or Ameritech from sharing this information with their competitive

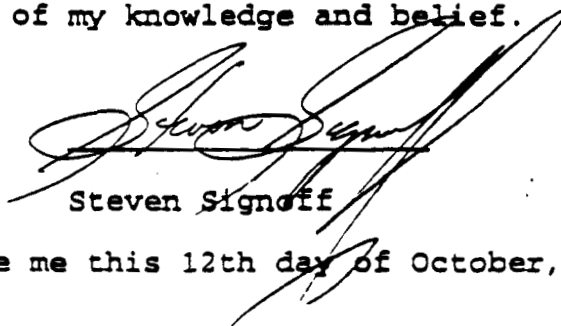
affiliates.

29. It is in fact the unusual case that a telecommunications supplier can enter a new geographic area through an existing customer base. Competition will require each new entrant to prove itself in the new marketplace. Again, the success to date of new entrants that target only certain geographic areas of the country proves the assumption wrong.

30. There are of course scale economies in providing local telecommunications services in a particular market. However, the minimum scale required has been substantially reduced from earlier days, due to a variety of factors. In part, this is due to the availability of and reduced costs of smaller sized switches as well as regulatory requirements allowing for resale or leasing of unbundled elements (where the incumbent has made these meaningful opportunities). As I understand it, the purpose of the 1996 Act's requirements for resale and unbundled network elements access was precisely to allow for graduated entry into local markets.

31. In sum, a number of assertions and assumptions underlying the 30 market strategy are contrary to market experience.

I hereby swear, under penalty of perjury, that the foregoing is true and correct to the best of my knowledge and belief.



Steven Signoff

Subscribed and sworn before me this 12th day of October,

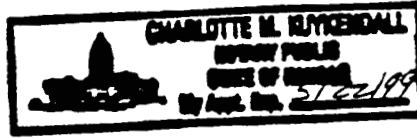
1998.

Charlotte M. Remondall

Notary Public

My Commission expires:

5/22/99



Bell Atlantic and GTE Appeals
Under the Telecommunications Act of 1996

Bell Atlantic

Circuit Court Appeals of FCC Orders

Bell Atl. Tel. Cos. v. FCC, 131 F.3d 1044 (D.C. Cir. 1997) (provision of interLATA services under Section 272(e)(4)).

U S W. v. FCC, Case No. 97-9518 (10th Cir.) (number portability appeal).

Texas Office of Pub. Util. Counsel v. FCC, Case No. 97-60421 (5th Cir.) (universal service appeal).

SBC Communications, Inc. v. FCC, 138 F.3d 410 (D.C. Cir. 1998) (Section 271 Oklahoma appeal).

BellSouth Corporation, et al. v. FCC, Case No. 98-1087 (D.C. Cir.) (Section 271 Louisiana appeal) (case since dismissed pursuant to BellSouth stipulation).

USTA v. FCC, Case No. 97-1469 (D.C. Cir.) (price caps appeal).

Southwestern Bell v. FCC, Case No. 97-2618 (8th Cir.) (access charges appeal).

Southwestern Bell v. FCC, Case Nos. 97-3389, 97-3576, 97-3663, 97-4106, 1998 U.S. Dist. LEXIS 18352 (8th Cir. Aug. 10, 1998) (appeal of third order on reconsideration of common/shared transport).

Iowa Utils. Bd. v. FCC, 120 F.3d 753 (8th Cir. 1997), cert. granted, 118 S. Ct. 879 (1998) (local competition/interconnection order appeal).

District Court Appeals

MCI v. Bell Atl., No. 97-3076 (D.D.C.).

Bell Atl.-Del. v. McMahon, AT&T, No. 1:97cv00312 (D. Del.) (appeal of SGAT).

Bell Atl.-Del. v. Delaware Pub. Serv. Comm'n, AT&T, No. 1:97cv00511 (D. Del.).

MCI v. Bell Atl., No. 2:98cv00109 (D.N.J.).

MCI v. Bell Atl.-Pa., No. 1:CV-97-1857 (M.D. Pa.).

MCI v. Bell Atl.-Va., No. 3:97CV629, 1998 U.S. Dist. LEXIS 17558 (E.D. Va. July 1, 1998).

GTE

Circuit Court Appeals of FCC Orders

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District Court Appeals

GTE v. Conlon, AT&T, No. C 97-1756, 1998 U.S. Dist. LEXIS 17556 (N.D. Cal. Sept. 29, 1998).

GTE v. Conlon, MCI, No. C 97-1757, 1998 U.S. Dist. LEXIS 17556 (N.D. Cal. Sept. 29, 1998).

GTE v. Clark, MCI, No. 4:97cv211 (N.D. Fla.).

GTE v. Johnson, Sprint, No. 4:97cv234 (N.D. Fla.) (dismissed for lack of case or controversy based on Sprint's election of AT&T/GTE interconnection agreement).

AT&T v. GTE, No. 4:97CV300-RH (N.D. Fla.).

GTE v. Naito, AT&T, No. 1:97cv00739 (D. Haw.).

AT&T v. Contel of Minn. d/b/a GTE, No. 97-901 (D. Minn.).

GTE v. Johnson, Western Wireless, No. 4:97cv03224 (D. Neb.).

GTE v. Johnson, AT&T, No. 4:97cv03218 (D. Neb.) (consolidated).

AT&T, GTE v. City of Dallas, Case No. 3:98-CV-0003, 1998 U.S. Dist. LEXIS 8932 (N.D. Tex. June 8, 1998) (preemption of municipal ordinance).

GTE v. Wood, MCI, No. M-97-078 (S.D. Tex.).

GTE v. Wood, Sprint, ACSI, No. M-97-115 (S.D. Tex.).

GTE v. Wood, AT&T, No. M-97-138 (S.D. Tex.).

GTE v. Morrison, AT&T, Cox Fibernet, MCI, Case No. 3:97CV493, 1998 U.S. Dist. LEXIS 7881 (E.D. Va. May 19, 1998).

Sprint v. GTE, No. C97-699 (W.D. Wash.).

MCI v. GTE, Nos. C97-742, C97-905, C97-928, 1998 U.S. Dist. LEXIS 11335 (W.D. Wash. July 7, 1998).

GTE v. Washington Utils. & Transp. Comm'n, AT&T, No. C98-491 (W.D. Wash.).

COPY

CONSUMER PERSPECTIVES ON ILEC MERGERS

Presentation by
Susan M. Baldwin
Senior Vice President
Economics and Technology, Inc.
Boston, Massachusetts 02108

“The Effect of Lions and Tigers and Bears on Human Society!
Mergers, Acquisitions and Customers”

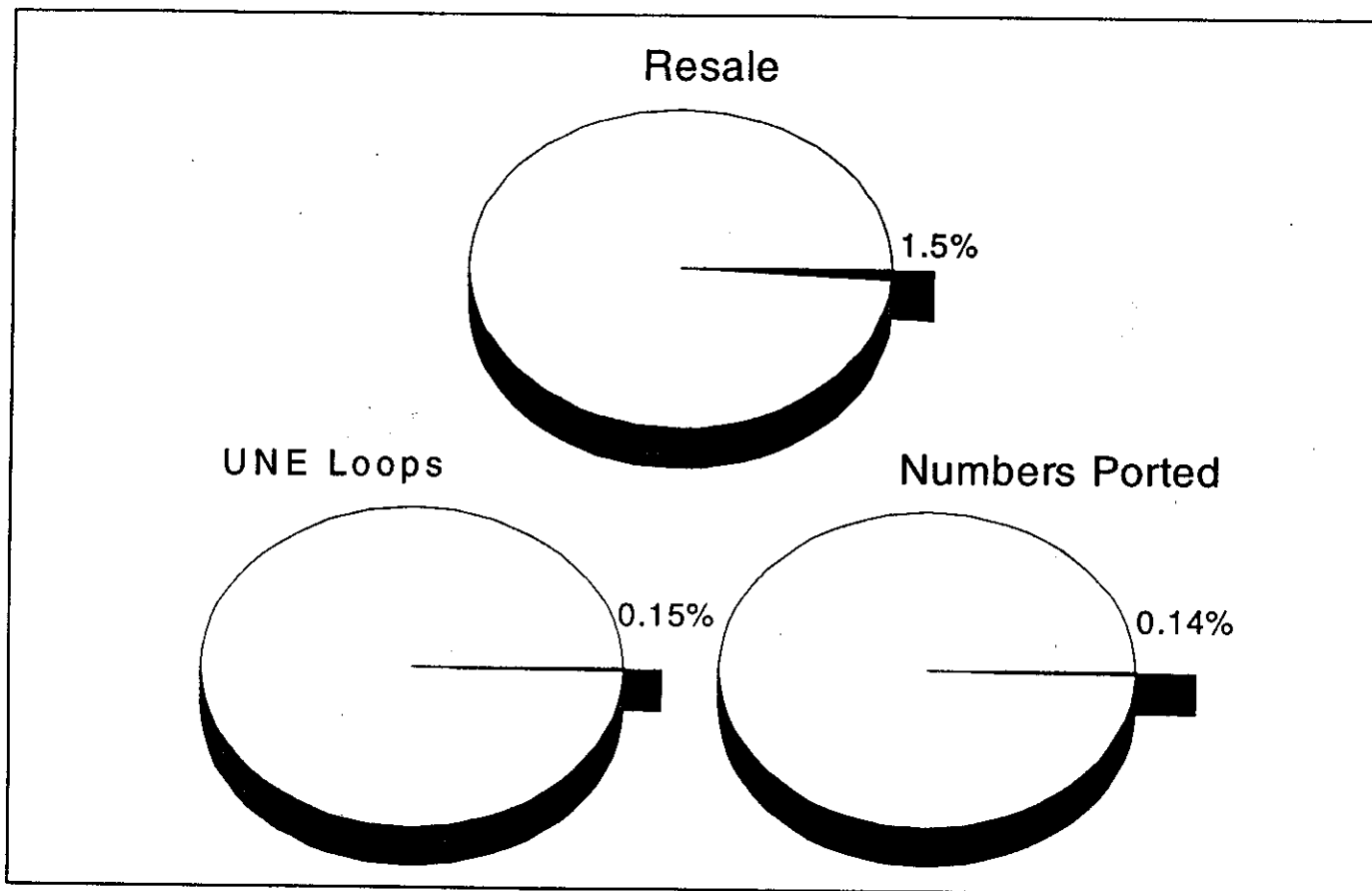
NARUC 110TH Annual Convention in Orlando, Florida

November 11, 1998

Since the passage of the Telecommunications Act of 1996, ILECs have been busier merging with each other than with opening their markets to local competition

<u>Merger</u>	<u>Date of Merger Announcement</u>	<u>FCC Status</u>
SBC/Pacific Telesis	April 1, 1996	January 31, 1997 - approved
Bell Atlantic/NYNEX	April 22, 1996	August 14, 1997 - approved
SBC/SNET	January 5, 1998	October 23, 1998 - approved
SBC/Ameritech	May 10, 1998	Pending
Bell Atlantic/GTE	July 28, 1998	Pending

Competitive Entry into the Local Market, Nationwide



Source: Common Carrier Bureau Second Survey of Local Competition, October 28, 1998,
(Numbers Ported Data from First Survey, March 27, 1998)
www.fcc.gov/ccb/local_competition/survey/responses.

The FCC Has Raised Specific Concerns about Further ILEC Consolidation

The Federal Communications Commission gave ample notice that approval of the Bell Atlantic/NYNEX merger should not be construed as a guarantee that the FCC would approve all future mergers:

Further reductions ... become more and more problematic as the potential for coordinated behavior increases and the impact of individual company actions on our aggregate measures of the industry's performance grows. ...[thus] further reductions in the number of Bell Companies or comparable incumbent LECs would present serious public interest concerns. *In the Application of NYNEX Corporation, Transferor, and Bell Atlantic Corporation, Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, File No. NSD-L-96-10, Memorandum Opinion and Order, released August 14, 1997, at para. 156.

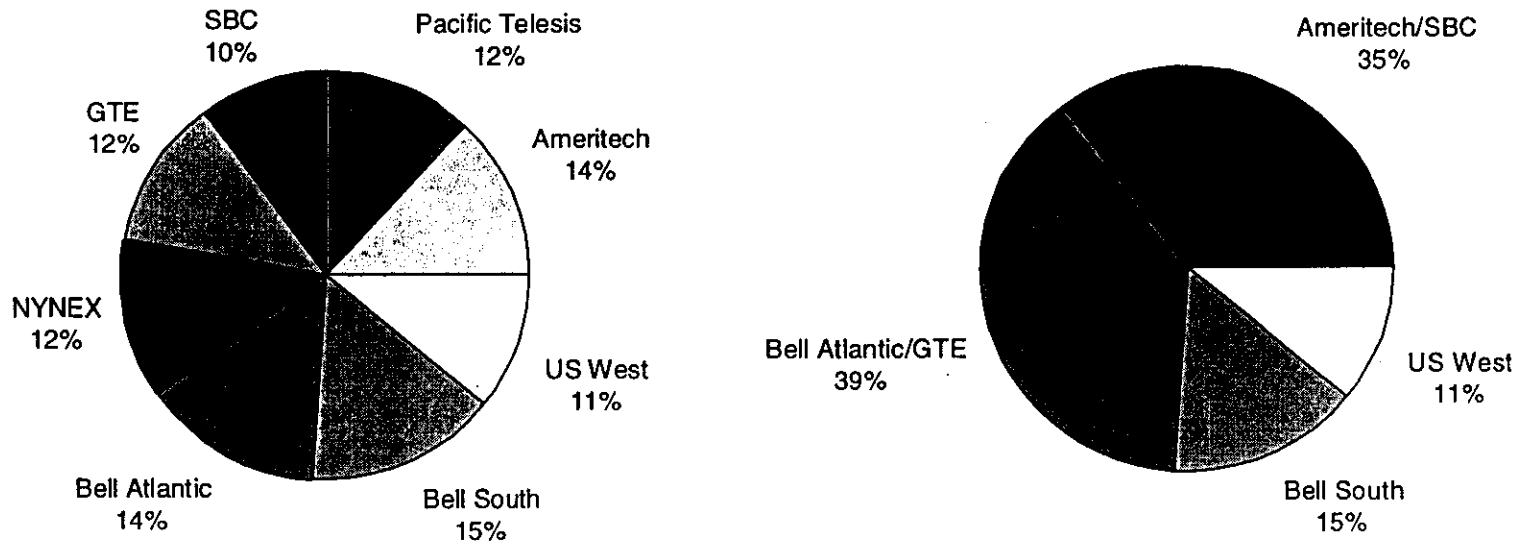
The FCC Has Raised Specific Concerns about Further ILEC Consolidation (cont'd)

The FCC also alerted the industry that:

It is quite plausible that there will be some mergers of actual or precluded competitors that will present such significant potential harms to competition that there will be no means to conclude that the transaction serves the public interest, convenience and necessity. The elimination of an even more significant market participant than Bell Atlantic would raise even greater competitive concerns. *BA/NYNEX Merger Order*, at para. 179.

Convergence in the Local Telecommunications Market

Approval of all pending mergers would reduce the number of large ILECs from eight in 1996 to four in 1999



Source: Statistics of Common Carriers, Table 2.10, 1996 (access lines).
Preliminary Statistics of Common Carriers, Table 2.10, 1997 (access lines).

Mergers May Jeopardize Local Competition, Reasonable Rates, and Service Quality

- SBC candidly states its intention to divert ILEC resources to support competitive ventures
- Mega-ILEC presence may discourage competitive entry in the local market
- Mergers result in the loss of potential competitors: ILECs bring unique advantages to the local market

Mergers May Jeopardize Local Competition, Reasonable Rates, and Service Quality (cont'd)

- Mergers create pressure to increase revenues and lower costs, thus jeopardizing service quality
- Mergers could result in selective disinvestment, particularly in areas not likely to experience significant competition
- There is no compelling evidence that mergers result in more new services or in more rapid innovation

Proposed SBC/Ameritech Merger Poses Numerous Risks to Consumers

- SBC would raid home-region assets: SBC intends to “rely to a significant extent on managers from SBC and Ameritech to staff the 30-city venture” (Carlton Affidavit, at para. 32).
- SBC asserts that its National/Local Strategy will “jumpstart” competition
 - In fact, the merger would reduce the number of actual potential entrants
 - The merger would eliminate SBC as an actual potential competitor in the five-state Ameritech region

Proposed SBC/Ameritech Merger Poses Numerous Risks to Consumers (cont'd)

- SBC would confront strong financial pressure to recover the \$13-billion premium it proposes to pay for Ameritech through price increases in noncompetitive or minimally competitive services throughout its expanded 13-state home region
- Since acquiring Pacific Bell in 1997, SBC has asked the California PUC to approve numerous rate increases and upward pricing flexibility for services over which Pacific continues to maintain substantial market power

Proposed SBC/Ameritech Merger Poses Numerous Risks to Consumers (cont'd)

- SBC would rely on customers of noncompetitive services to finance out-of-region entry
- SBC and Ameritech acknowledge that “[a] substantial base of current customers and revenues is necessary to maintain earnings growth and spread risk while following customers into out-of-region local markets” Schmalensee/Taylor Affidavit, at para. 16

Contradictory View of Competition in the SBC/Ameritech Merger Application

What the Applicants say:

“...absent the merger SBC does not believe it could undertake the task of competing out-of-region in all the key domestic and international local exchange markets...[b]y implementing the National-Local Strategy, SBC believes that its actions will accelerate the development of competition in all market segments.”
Kahan Affidavit, at paras. 27 and 86.

Contradictory View of Competition in the SBC/Ameritech Merger Application (cont'd)

What the Applicants don't say:

Under this view, the only way to increase competition is to increase concentration.

The Trend Toward ILEC Consolidation Is Not in the Public Interest

- A larger SBC will simply precipitate interest in mergers by other large ILECs — now is the time to put on the brakes.
- Neither competition nor existing price regulation schemes (unless modified) would constrain the merging ILECs to flow through merger benefits to customers of their noncompetitive services.
 - Quantitative measures show little progress toward breaking ILEC dominance of the local exchange market.
 - Five mergers of Tier 1 ILECs have been proposed or completed since the end point (1995) of the FCC's study period used for establishing the current X factor.

It is possible that the risks posed by some mergers are so great that there is simply no set of conditions that can remedy the probability of harm to the public interest.

- The decision to allow two ILECs to merge is irreversible
- Conditions may be difficult to enforce
- Benefits that ILECs promise may be difficult to enforce
- None of the proposed or approved mergers to date have provided consumers with substantive benefits

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true and exact copy of the foregoing Comments of Sprint Communications Company Limited Partnership as well as Attachments A and B, by United States First Class Mail and Federal Express (*), postage prepaid upon the following:

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This 11TH day of JANUARY, 1999.



Monica M. Barone
Sprint Communications Company Limited
Partnership