not limited and certainly present a price-constraining influence on LECs. MCI, for example, has committed billions of dollars "to construct local networks in most major U.S. cities" with the 20 largest expected to be installed within the next two years. WSJ, "MCI is Planning Local Networks in Major Cities," p. 3, Dec. 30, 1993.[20] Meanwhile, AT&T's pending purchase of McCaw Cellular positions it to control an end-to-end network through which it can bypass LECs entirely (see Wireless Services section, below). Most recently, AT&T has filed in Illinois the first petition "of many it plans to file across the country" to conduct market tests "in which one or more newcomers could provide everything from local dial tone to transmission services by interconnecting..." with the existing LEC network. WSJ, "AT&T Moves to Open Market on Local Service," p. A3, April 13, 1994. Expanded Interconnection benefits IXCs' competitive position as it does CAPs. Finally, IXCs are motivated to support alternative entry by CAPs and others, because they ultimately must view LECs as competitors in their own long distance market. Kraemer, p. 1-2. IXCs increasingly will compete with LECs both in interstate access services and local exchange services.

Cable Television Firms ("CATV") -- CATVs already have in place wired networks, virtually ubiquitous in residential areas, and are readily capable of providing local telephone service. Indeed, CATV's presently are readying their networks to offer residential telephone services. SPR, p. 7. Further, CATVs are pursuing aggressive upgrades to fiber networks, which expand their capacity immeasurably. A network architecture developed by CableLabs supports CATV entry into telephony in competition with LECs (and a "network of networks" future industry structure) by facilitating interconnection of CATV systems with CAPs, wireless technologies, IXCs and LECs. Kraemer, p. 6. Already in the United Kingdom, CATV's furnish local telephone service in competition with the incumbent British Telecom. Huber, pp. 23-24. Closer to home, Time Warner's "Full Service Network" now under construction in Orlando, Florida, is slated to provide telephone service by year end. Absent exclusionary regulation, CATV represents a classic and formidable "uncommitted entrant" included in the market under Guideline analysis, because CATVs promptly can use in-place production facilities to include service offerings in competition with LECs. The British experience supports the fact that this wide-scale entry can occur within one year. U S WEST, in partnership with TCI, owns TeleWest, a principal CATV threat to British Telecom.

CATV and CAP networks, with coverage of the former focused on residential users and the latter on businesses, enjoy rich synergies that invite industry alliances. Together these two sources present an even more formidable competitive threat to incumbent LECs. Significant CAPs (Teleport, Jones Lightwave, Fibernet, Hyperion) maintain financial ties to CATVs. SPR, p. 8, fn. 22. The CATV interests that control Teleport offer a prime

---

[20] Significantly, MCI already possesses rights of way to facilitate placement of its local network through its earlier purchase of Western Union assets. PR Newswire, "MCI Acquires Assets of Western Union's ATS Division," March 8, 1990.

example of their competitive posture, having formed a joint venture among Time Warner, TCI, Comcast Corp., Cox Enterprises, Inc. and Continental Cablevision, Inc. to collaborate using Teleport as a platform to "organize local cable operators in large markets to compete with regional telephone companies." WSJ, "Cable Firms to Form Venture to Take on Phone Companies," p. B2, Dec. 2, 1993. CATVs thus pose an ominous presence on the competitive landscape for LECs.

Out of Region LECs -- The flurry of announced telecommunications business combinations during the recent past demonstrates the reality of head-to-head competition among LECs. Southwestern Bell's acquisition of Hauser set the stage. U S WEST's $2.5 billion investment in Time Warner exhibits a firm commitment to out-of-region LEC rivalry. As summarized in one industry analysis, "[b]y buying into cable television out-of-region, Southwestern Bell and U S WEST moved LEC vs. LEC competition from the category of remote possibility to one of high probability in the mid-1990's time frame." Kraemer, p. 10. BellSouth has subsequently announced purchase of a 22.5% stake in Prime Management. Finally, the proposed TCI/Bell Atlantic merger, and Southwestern Bell partnership with Cox, while both ultimately unsuccessful, likewise portend further industry realignment that will intensify the level of LEC to LEC competition.[21]

Electric Utilities -- New technology promises to permit telecommunications transmission over electrical lines. This innovation creates yet another wired network to compete against the LECs. While electrical utilities might not meet the Guidelines' two year competitive entry test at present, they may sit poised at the edge of a relevant market and exert some degree of pressure from there. As technology develops, their relative position in the competitive roll call may change rapidly, exemplifying just the sort of market-metamorphosis to which the Commission will need to be prepared to respond, as it impacts on regulated LECs.

Wireless Services -- The range of wireless technologies that present competitive challenges to LECs extends from the existing Specialized Mobile Radio Spectrum ("SMR") and cellular businesses, to the anticipated Personal Communications Systems ("PCS") with the Commission's allocation of new spectrum later this year. Wireless providers enable the bypass of LEC networks and direct connection with IXCs. Cellular providers alone have over 14 million subscribers and continue to shatter expected subscriber growth rates. WSJ Reports, "Telecommunications: Look! No Wires!," p. R5, Feb. 11, 1994. The perceived capacity constraints and quality concerns of past cellular services are largely eliminated by the ongoing transition from analog to new digital technologies. SPR, p. 10. While cellular service was once considered a complement to wired local service, now "one in three business

---

[21] Both sets of parties to these transactions cited "increasingly stringent" regulatory constraints as the primary basis for their decisions to call off the deals. See WSJ, "Southwestern Bell and Cox Cancel Venture," p A3. April 6, 1994.

users expects to spend less on wireline as they increasingly deploy wireless services." Kraemer, p. 8. The upshot is that "increasing penetration by wireless means less direct revenues for LECs from end users." Id. "Wireless service providers will increasingly be competitors in all core business lines of a LEC, including access, toll, and local service,... with substantial wireless-based competition by the late 1990's." Id. at 8 and 9.

The synergies between wireless local service providers and IXCs are made obvious by the IXCs' current pursuit of substantial investment in wireless systems. AT&T's $18 billion merger with McCaw sums up the situation. MCI's $1.3 billion dollar investment in Nextel's SMR spectrum further demonstrates the point. Sprint has acquired the Centel cellular interests. Additionally, these companies have announced plans for considerable PCS deployment as spectrum becomes available. See Huber, p. 32 - 40.

The competitive significance of PCS for LECs cannot be overstated. First, the transmission quality of PCS is considered equivalent to wire-based LEC systems. Kraemer, p. 9. Second, PCS spectrum allocation will markedly boost wireless capacity. Overall, "[w]ithin the next few years, radio based services will possess spectrum licenses sufficient to offer as much local carrying capacity as is currently being used by all landline customers." Huber, p. 35.[22] Additional capacity will lower prices of wireless offerings, and, as prices drop, those offerings become more cross-elastic with LEC wireline service. If a LEC overcharges for services, then users can switch to wireless providers (they may pay a premium for wireless portability). See, SPR, p 10.

The development of new satellite link system ventures presents even more competition from wireless sources. Motorola has underway "Iridium," its worldwide system designed for portable phones and hand-held computers, while industry giants Microsoft and McCaw have teamed up to offer "Teledesic," for use in office locations. Time, "Is Bill Gates Getting Too Powerful?," p. 67, April 4, 1994 ("Both ventures will compete with the U.S. phone companies, which are busily laying cable for a fiber-optic system costing at least $100 billion that will carry video signals and data as well as voice communications."). Obviously, these sorts of major players have the financial wherewithal and technical savvy to sustain robust competition against LECs.

As time proceeds, the present degree of cross-elasticity that now exists between LEC services and those of CAPs, IXCs, CATV, PCS, SMR, cellular, and others will increase. The Commission would do well to recognize now the inevitable future enhancement in interchangeability of these offerings, rather than to attempt to modify the regulatory scheme with every technological advancement. Such a task will not be doable here, where market conditions are changing with such frenetic pace.

---

[22] The Commission previously has made clear that the ability to absorb all incumbent business far exceeds the amount of capacity necessary to constrain an incumbent's market behavior. Business Services Order, 6 FCC Rcd. 21 at 5888 ¶¶44-46. See supra fn. 5, p. 6.

To the extent that the Commission accepts that each of the above sources of competitive pressure do and will continue with even greater force to present substitutes for LEC services (as the industry realigns and technology continues to facilitate integrated wired and wireless offerings of voice, video, and data) then market concentration decreases, and market power exercise is unlikely to be anything more than a near term concern. Even if, for whatever reason, the Commission ultimately excludes one or more of the above-listed competitive sources from today's relevant market, the Commission's assessment of whether a LEC can exercise market power in the emerging market of the future must include careful consideration of these applicable commercial realities. The needed transitional regulatory framework that offers a road map to the operation of competitive markets must take account of the fact that these various sources are becoming closer and closer substitutes for LEC services now subject to price caps.

VI. USTA Access Reform Proposal is Conservative Under Antitrust Principles

The United States Telephone Association ("USTA") has proposed a near term alternative regulatory plan to enable LECs to qualify to operate with less pricing restriction in those geographic areas and for those services for which LECs confront actual competition. See RM-8356, USTA Petition For Rulemaking, Reform of the Interstate Access Charge Rules, filed Sept. 17, 1993. The USTA proposal turns on the concept of "addressability," which essentially questions whether LEC customers have alternative suppliers. USTA starts with the Commission's zone price plan, and designates zones as "Initial Market Areas" ("IMA"). IMA's would operate under the price caps structure much as it exists today. USTA then suggests a focus on LEC wire center serving areas to evaluate competitive circumstances. If an alternate supplier of access services is present (in close enough proximity to readily extend service to LEC customers), then a wire center is eligible to be contained in a redefined area known as a "Transitional Market Area" ("TMA"). An Expanded Interconnection arrangement with a competitor under the Commission's rules, of course, would create the existence of an alternate supplier. In a TMA, the LEC would receive modest enhanced flexibility: to lower prices (15%); to respond to customer RFP's on a custom contract basis (like AT&T Tariff 12); to notice tariffs in a somewhat abbreviated period; and to introduce new services under a net revenue test. Finally, if the alternative supplier has the ability to serve a significant amount of the market (25% of a LEC wire center interstate access demand), and significant customers show willingness to accept the alternative (by soliciting bids, using private networks, etc.), then the wire center (or services offered within that wire center) could be reslotted into a Competitive Market Area ("CMA"), and moved out of price caps regulation. Services in CMA's would come under Title II, regulated as tariffed services.

Given the economic realities of this industry, under antitrust principles, the USTA access reform proposal is uncontroversial and relatively moderate. Antitrust law instructs that the existence of potential competitors in a market with growing demand and accessible entry is sufficient to constrain market power, rendering the existence of actual competitors unnecessary to the analysis. E.g., Metro Mobile, 892 F.2d at 63; Brunswick, 6 F.3d at

1422. USTA's plan, on the other hand, triggers streamlined regulation only after the appearance of actual competitors. While the concept of "addressability" resembles the antitrust notion of substitutability, because it asks whether customers have alternative supply sources available, it actually is narrower than antitrust's supply substitution inquiry, which takes account of "uncommitted entrants," among other things. USTA's plan does not take account of implemented private bypass or IXC self-supply. Geographically, USTA's proposal does not scope markets to account for the breadth of potential sources of supply substitution for LEC services. See, e.g., Ball Memorial Hospital, 784 F.2d at 1336. Conventional antitrust market analysis, then, would result in the identification of broader markets than the USTA approach implies.[23] In TMA's in particular, USTA's plan does not relax regulation as far as antitrust principles would suggest, given the abundant capacity of the alternative supply (assuming a fiber network as the alternative), and given that interstate access customers are sophisticated and not wedded to an incumbent. Nevertheless, by using the Commission's existing zone structure as a starting point for IMA's, and focusing on the competitive situation of individual wire centers, USTA's approach has the administrative benefit of streamlining the sometimes cumbersome, market-by-market, definitional process that strict antitrust analysis would require. With its built in conservatism, USTA's pre-scoped market approximations thus present a workable mechanism for the Commission to achieve the underlying goals of price caps without undertaking consuming case-by-case market definition.

The USTA model would enhance LECs' incentives to operate efficiently in TMA's and CMA's beyond the recognized incentives of existing price cap regulations. The more LECs can reduce costs, the better able they will be to price competitively. At the same time, LECs will be unable to "cross subsidize," because not-yet-competitive services would remain subject to existing price cap restraints. See, NPRM ¶14.[24] See also, R. Schmalensee & W.

---

[23] USTA's proposal could approximate an effort to identify discrete submarkets within a larger economic market. Antitrust law counsels that "within [a] broad product [or geographic] market, ... submarkets may exist which, in themselves, constitute product [or geographic] markets for antitrust purposes." Brown Shoe, 370 U.S. at 325. One of the recognized "practical indicia" of submarkets is "unique production facilities." Id. Wire centers may approximate the sort of facility considered to indicate submarkets. The ability to price discriminate among groups of customers is another factor that may point toward distinct submarkets. See F.T.C. v. Owens-Illinois, Inc., 681 F.Supp. 27, 47 (D.D.C.), vacated as moot, 850 F.2d 694 (D.C.Cir. 1988). To the extent that LECs may be able to price discriminate among groups of customers for different services or in different wire centers, the USTA approach scopes relevant submarkets consistent with antitrust theory.

[24] The NPRM notes: "[C]onsumers are protected from cross-subsidization by the grouping of similar services in price cap baskets, which prevents a carrier from raising rates in one basket and lowering them in another to the detriment of customers taking service in the first basket...". NPRM, ¶14. The same principle applies if the Commission removes competitive services from price cap regulation. Not-yet-competitive services remain within

Taylor, Comments on the USTA Pricing Flexibility Proposal, May 9, 1994, §III.C.2, filed in CC Docket 94-1, with USTA's Comments. Likewise, under the USTA plan, predatory pricing of LEC interstate access services is unworkable, because a prerequisite to converting into a TMA or a CMA is the actual presence of a competitive provider. Given the durable, immobile nature of such networks, the competing operator would continue to operate the network providing non-interstate services. As soon as the LEC attempted to raise access prices to supracompetitive levels to recoup short term losses, the competitor would simply resume offering the subject services, thereby defeating the LEC's ability to recoup.[25] Id. at §III.C.1. As a practical matter, the rivals whom LECs could attempt to eliminate through predatory tactics may well be financially secure enough to sustain such tactics without exiting the market. Id. at p. 15, n. 21. The overall benefit of the competition afforded by USTA's proposed streamlined regulation of selected market segments (by geography and by services within geography) will accrue entirely to consumers.

While USTA's approach provides a useable fix, the Transition Issues of the NPRM suggest that the Commission may want to consider more comprehensively the scope of economically meaningful markets for present and future regulatory purposes. The changing nature of these markets likewise calls out for the Commission to go further and set a regulatory course that the industry can follow to reduced regulation as the various sources of

---

the price caps structure, and a LEC cannot increase those rates to offset losses it may sustain from low prices in competitive services. Stated differently, shifting costs from competitive to not-yet-competitive services that remain under price caps will avail the LEC no benefit.

[25] The Supreme Court recently confirmed that the ultimate recoupment of profits lost from below-cost pricing is an essential prerequisite to a successful predatory pricing scheme. Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 113 S.Ct. 2578, 2588 (1993)("Recoupment is the ultimate object of an unlawful predatory pricing scheme; it is the means by which a predator profits from predation. Without it, predatory pricing produces lower aggregate prices in the market, and consumer welfare is enhanced."). If a firm does not have a reasonable likelihood of regaining lost profits, and achieving some additional gain, by subsequently charging monopoly prices for a sustained period once it has driven competitors from the market, then the firm has no economic motive to forego present profits. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 590-91, 597 (1986)(no economic motive to engage in predatory scheme unless firm can "maintain[ ] monopoly power for long enough both to recoup ... losses and to harvest some additional gain."). The unlikely prospect of achieving such recoupment has led the Court to observe that, in practice, "predatory pricing schemes are rarely tried, and even more rarely successful." Brooke, 113 S.Ct. at 2589, citing, Matsushita, 475 U.S. at 589. Given that price predation requires future increase in prices to a supracompetitive level for recoupment purposes, evaluation of its likelihood in a market is parallel to the analysis of market power that enables a firm to price supracompetitively in the first instance. For that reason, this paper subsumes analysis of predatory pricing conduct in its analysis of market power that permits anticompetitive price increases overall.

alternative technology impose more and more competitive pressure on LECs. Only in this way can the Commission adequately navigate through the maelstrom that is sure to result from the hectic pace of change in this industry. Only in this way can the Commission ensure that it will not obstruct the competitive process by failing to adjust regulation as needed, thereby causing LECs unwarranted economic injury and retarding economic progress.

As a basic premise, significant differences exist in the competitive profile between urban areas and rural areas. In general, when a CAP enters into a metro-area (perhaps scoped as an MSA) competition has arrived. Of course, the CAP builds out its network first to the highest profit opportunities, "cream skimming" off of the LECs' inability to meet price competition for high-volume customers. But, the fact that the CAP's network is not co-extensive with the LEC's network does not in any way minimize the significance of the CAP's competitive impact city-wide. Once the CAP has invested its start-up costs and has a presence in a metro area, it is committed there, and its ability to constrain LEC anticompetitive pricing throughout the area is real. As soon as the LEC attempts to boost prices unwarrantedly, the CAP can quickly take advantage of that profit opportunity and defeat the LEC's increase. This ability is particularly true given the LECs' Expanded Interconnection obligations. In view of that reality, some level of relaxation in regulation may be appropriate on a city-wide basis, once a CAP is on the scene. Such an approach more aptly reflects the breadth of competitive influence that CAPs present. See e.g., Ball Memorial Hospital, 784 F. 2d at 1336; see also Guidelines at §1.2 and §1.3. This idea could dovetail with the USTA approach, with the former applying to lesser modifications of the regulatory regime over a broader area and the latter (USTA) applying to more substantial modifications, like removal from price caps altogether.

VII. Conclusions

U S WEST urges the Commission, in addressing the NPRM Transition Issues, to follow the antitrust principles set forth above (and in Attachments 2 and 3 to U S WEST's Comments) and map out a migratory path to streamlined regulation. That path should be sufficiently flexible to account for the competitive effects of the ongoing industry convergence. Specifically, the transitional structure first should avoid undue reliance on faulty market share data and should recognize that an historically large market share in a regulated industry is no indication of future market power. Second, the structure should foster the competitive process, not distort it by shielding one set of competitors from another through artificial protections (i.e., requisite market share loss before LECs can compete on the merits). Third, the framework should consider structural features that effect the potential exercise of market power. One such feature is the substantial leverage that predominant access purchasers wield over LECs. Another is the barrier to effective competition presented by existing regulatory constraints, including geographic rate averaging and LEC tariff obligations. Other key features are the market trends of expanding demand and rapid technological change, which reduce the likelihood of durable market power and must be factored in. Fourth, and perhaps most importantly, the structure should define the market through examination of demand and supply substitution, with particular attention to the

tremendous impact of potential competition in this high technology innovative market. By so applying antitrust precepts that have worked throughout the last century to promote competition in this country, the Commission can lead this industry into an era of robust competition with the consequent economic growth and technological advancement.

Attachment 2

A Facility is "Essential" Only When Alternatives are Not Feasible

This paper responds to the NPRM's request, in Transition Issue 1c, for comment on the propriety of classifying LEC services as "essential facilities." The essential facilities antitrust doctrine is a limited exception to the general rule that a firm may decide unilaterally whether to deal with others. The doctrine applies only when a firm with monopoly power controls a particular asset, or scarce resource, access to which is imperative to the viability of would-be competitors. In such circumstances, antitrust law imposes a duty to grant reasonable access to competitors, where feasible.

Obviously, a firm's resource is not vital to competition if an alternative is available to rivals from other sources. E.g., Flip Side Productions, Inc. v. Jam Productions, Ltd., 843 F.2d 1024, 1034 (7th Cir. 1988), cert. denied, 488 U.S. 909 (1988). Nor is a resource essential if competitors can operate effectively without it. To be essential, the desired resource must be, not just helpful, but vital to competitive survival. P. Areeda & H. Hovenkamp, Antitrust Law ¶736.2 at p. 723 (1989 Supp.)(citing cases). Thus, to establish existence of an essential facility, the would-be rival must show more than inconvenience, or even some economic loss; it must show that an alternative to the desired facility is not feasible. E.g., Twin Laboratories, Inc. v. Weider Health & Fitness, 900 F.2d 566, 570 (2d Cir. 1990). This means the rival must show, not only that no alternatives presently exist, but also that such alternative facilities cannot practically or reasonably be duplicated. E.g., Burris v. Panhandle E. Pipe Line Co., 935 F.2d 1469 (7th Cir. 1991)(access to defendant's pipeline not essential because economically feasible for competitors to duplicate much of system).

An alternative is not necessarily infeasible because it is more expensive. Although expensive in absolute terms, the cost of duplication may be reasonable in light of transactions and profits that would be facilitated. Florida Fuels, Inc. v. Belcher Oil Co., 717 F.Supp. 1528, 1533 (S.D. Fla. 1989) (Facility not essential where "... construction of [the upstream market's fuel] storage tanks and pipelines is expensive. But, as both parties note, the [downstream South Florida bunker fuel] market is burgeoning and potentially lucrative.... The potential economic gains to be reaped from an investment are substantial.").[1] A showing that access to a facility is merely 'more economical' than other alternatives is insufficient to demonstrate essentiality. Florida Cities v. Florida Power & Light, 525 F.Supp. 1000, 1007 (S.D.Fla. 1981). Similarly, the fact that a competitor could achieve savings at the expense of the monopolist and its other customers is not enough to make a facility essential. City of Anaheim v. Southern California Edison Co., 955 F.2d 1373, 1380

---

[1] The court in Florida Fuels traced its reasoning to MCI v. AT&T, 708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983), where "[t]he court's ruling ... that AT&T's private long distance circuits were not an essential facility, contemplated that plaintiff should be willing to expend hundreds of millions of dollars to compete with AT&T to duplicate its long distance telephone service [given potential profits to be gained]." Id. at 1532.

(9th Cir. 1992). Simply put, if a LEC facility can be duplicated without overwhelming expense, it is not "essential."

The most extensive recent circuit court decision that describes the limits of the essential facilities theory in the single-firm context makes clear that, to be "essential", control of the facility must enable the owner to eliminate, not merely impede, competition. Alaska Airlines, et al. v. United Airlines, et al., 948 F.2d 536 (9th Cir. 1991), cert. denied, 112 S.Ct. 1603 (1992)(reviewing and unifying significant single-firm essential facilities cases (including MCI v. AT&T) to determine that "[a] facility that is controlled by a single firm will be considered "essential" only if control of the facility carries with it the power to eliminate competition in the downstream market."). Control of a facility that merely enables the owner to gain a monetary profit at its rival's expense is not actionable under the antitrust laws as causing injury to competition. Id. at 546. Thus, where a LEC cannot eliminate competition by denying access, its service should not be deemed an "essential facility."

Alaska Airlines also makes clear that, for a facility to be essential, the elimination of competition caused by denial of access to the facility must be "relatively permanent." Id. at 544, fn. 11. ("... a second condition that must be satisfied for a facility to be considered 'essential' ... [is that] the power to eliminate competition must not be momentary, but must be at least relatively permanent.").[2] In an industry like telecommunications, with such rapidly developing technology, a facility that was previously considered "essential" can become non-essential relatively quickly. The Commission properly should consider, given market conditions, whether denial of access from a LEC facility truly would stall competition for a sufficient duration to deem the facility "essential."

The antitrust laws do not require that an essential facility be shared if such sharing would be impractical or would inhibit the owner's ability to serve its customers adequately." Hecht v. Pro-Football, Inc., 570 F.2d 982, 992-3 (D.C. Cir. 1977), cert. denied, 436 U.S. 956 (1978). For that reason, a monopolist need not deny its own use of its facility to grant access to competitors. Kellogg, Thorne, & Huber, Federal Telecommunications Law, §3.2.1, citing, Almeda Mall, Inc. v. Houston Lighting and Power Co., 615 F.2d 343 (5th Cir. 1980), cert. denied, 449 U.S. 870 (1980); see also City of Anaheim, 955 F.2d at 1381. The facility holder's offer of a reasonable alternative type of access than that requested may defeat a claim that access was denied to an essential facility. E.g., Laurel Sand v. CSX Trans., 924 F.2d 539, 544-5 (4th Cir.), cert. denied, 112 S.Ct. 64 (1991). While a prohibitively high rate charge, or unreasonable change in services provided, may constitute constructive denial of access, the firm seeking access is not assured a profit. Rather, courts

---

[2] Alaska Airlines here relied in part on MCI's discussion of the then-existing "virtual impossibility of duplicating AT&T's local distribution facilities" to uphold the finding of AT&T's local exchange network as an essential facility. Today, of course, technological innovation has negated fully that "virtual impossibility." See Attachment 1 to U S WEST's Comments at Section V.

analyze the reasonableness of rates in the overall context of competition, not from the claimant firm's perspective. Id. In determining whether competition should have access to LEC "essential" services, the Commission properly should consider whether that access will impair a LECs own use of the facility or ability to serve its customers.

The question of whether access is feasible essentially introduces into the analysis the "business justification" concept found in other monopolization contexts. City of Anaheim, 955 F.2d at 1380 ("[feasibility] ...basically raises the familiar question of whether there is a legitimate business justification for the refusal to provide the facility ...".). In short, a facility owner's legitimate business concerns can excuse its refusal to provide access. Burris, 935 F.2d at 1469 (refusals to provide access can be justified by the owner's legitimate business concerns). Efficiency enhancing measures that produce superior service, lower costs, or otherwise improve operations can serve as reasonable business justifications, and measures designed to avoid higher costs are tantamount to measures designed to lower costs. Id. at 1483. Thus, two recent, concurrently-decided cases (both citing Alaska Airlines) confirmed that a regulated utility has a valid business justification to refuse to provide access to an essential facility where such access would increase its own costs and, consequently, result in higher rates to the detriment of both its customers and the public interest in keeping utility rates as low as possible. City of Vernon v. Southern California Edison Co., 955 F.2d 1361, 1365 (9th Cir. 1992), cert. denied, 113 S.Ct. 305 (1992); City of Anaheim, 955 F.2d at 1379. Efficiency considerations, then, are also important to the Commission's identification of circumstances in which competitors' access to LEC facilities may or may not be appropriate.

The major interconnection antitrust cases of the last decade uniformly accepted local exchange networks as essential facilities, most without significant analysis on the point.[3] Nevertheless, as the above discussion makes clear, "essential facility" status is largely fact-dependent, and the same asset may be essential under one set of facts and not another. Indeed, these interconnection cases expressly recognized the technologically dynamic nature of the telecommunications industry and predicted future contrary rulings on the essentiality of the local exchange network. For example, in 1984 the court in Southern Pacific explained

---

[3] U.S. v. AT&T, 524 F.Supp. 1336, 1353 (D.D.C. 1981)(Greene, J.)(denying AT&T's motion to dismiss: "[I]t is clear that the local facilities controlled by Bell are "essential facilities" within the meaning of [the listed] decisions...".); Southern Pacific Comm. Co. v. AT&T, 740 F.2d 980, 1008 (D.C. Cir. 1984), cert. denied, 470 U.S. 1005 (1985)("By using its control over access to these essential facilities [local distribution network], AT&T had the ability to extend its natural monopoly power in the market for local public switched telephone service to the competitive market for intercity private line service." AT&T's refusal to interconnect excused by legitimate business justification based on regulatory policy); Litton Systems, Inc. v. AT&T, 700 F.2d 785, 811 (2d Cir. 1983), cert. denied, 464 U.S. 1073 (1984)(noting, in passing reference, that AT&T's control over local telephone network is "a textbook example of a monopolist in control of an essential facility.").

that, in the foreseeable future, duplication of the local network by alternate technology would become economically feasible, as follows:

> "The local facilities can be duplicated by AT&T competitors, but it would not be economically feasible **at this time**. Moreover, there is increasing concern... that the **new "bypass" technology would obviate the need for the intercity carriers to interconnect with the local exchanges."** 556 F.Supp. at 882, fn. 56 (emphasis added).

Likewise, the Seventh Circuit in MCI expressly qualified the monopoly status of local exchange service as follows: **Given present technology,** local telephone service is generally regarded as a natural monopoly and is regulated as such." MCI, 708 F.2d at 1133 (emphasis added). This language expressly anticipates a different conclusion at such time as technological advances warrant. With the emergence of alternative wireline networks and multiple wireless networks through new technology, that time now may have arrived. The advent of fiber optic technology opened the competitive floodgates in the access services segment, while radio services and new coaxial cable technology are doing the same for local loop service. See Meltzer, et al., Federal Perspectives on Access Charge Reform, FCC Staff Analysis, p. 17 - 18, April 30, 1993. CAPs and IXCs continue to deploy their own switching and transport facilities. Dark fiber exists in abundance. In view of these and other industry developments, the "essential facility" characterization of LEC network elements should be narrowed appropriately.[4]

Not surprisingly, antitrust law tends to lag behind commercial reality. Elasticities among goods and supply sources change and markets converge often long before reported decisions reflect these differences. In addressing the NPRM Transition Issues, the Commission can and should be in the forefront of delineating the breadth of these newly emerging markets.

---

[4] To the extent that competitors now have access to LEC facilities by regulatory fiat (e.g., Expanded Interconnection), they do not need to create their own facilities in order to compete effectively. See NPRM, ¶95, Transition Issue 1b(3), regarding the extent to which competitors "have the facilities" to serve LEC customers.

Attachment 3

LECs Cannot Improperly Leverage Market Power into Other Markets

Transition Issue 1e seeks comment on the impact of LEC entry into "related industries," such as cable TV, and RBOC entry into inter-LATA telecommunications. From a market power standpoint, this raises the question of whether LECs could "leverage" their existing market positions to advantage themselves against other competitors in these adjacent markets.

Traditionally, of course, LECs have been regulated as natural monopolies (but see Attachment 1 to U S WEST's Comments, p. 15, fn. 13 and accompanying text). Even if, for the sake of this argument, LECs' networks are assumed to give LECs monopoly power, that condition in no way means that LECs should be precluded from competing freely with others in new markets. See Olympia Equipment Leasing v. Western Union Telephone Co., 797 F.2d 370, 375-76 (7th Cir. 1986), cert. denied, 480 U.S. 934 (1987)("The lawful monopolist should be free to compete like everyone else..."). See also Foremost Pro Color, Inc. v. Eastman Kodak Co., 703 F.2d 534, 543-44 (9th Cir. 1983), cert. denied, 465 U.S. 1038 (1984)("A monopolist, no less than any other competitor, is permitted and indeed encouraged to compete aggressively on the merits.").

As recent antitrust decisions have explained, even if a firm can exploit its monopoly position in one market to gain some advantage in adjacent markets, that conduct does not necessarily result in injury to competition, as recognized by the Sherman Act. Specifically, recent cases make clear that such "leveraging" is unlawful only if the competitive advantage that the LEC gains would lead to a monopoly or "dangerous probability" of monopoly in that adjacent market:

> The anticompetitive dangers that implicate the Sherman Act are not present when a monopolist has a lawful monopoly in one market and uses its power to gain a competitive advantage in the second market. By definition, the monopolist has failed to gain, or attempt to gain, a monopoly in the second market. Thus, such activity fails to ... establish a violation .... Unless the monopolist uses its power in the first market to acquire and maintain a monopoly in the second market, or to attempts to do so [i.e., creates a "dangerous probability" of doing so], there is no Section 2 violation. Alaska Airlines, et al. v. United Airlines, et al., 948 F.2d 536, 548 (9th Cir. 1991), cert. denied, 112 S.Ct. 1603 (1992).

In view of the existing structure of the cable TV and inter-LATA telecommunications industries, it is difficult to imagine an advantage that a LEC could leverage that would create a dangerous probability that it would monopolize either of those markets (to the extent that they remain discrete markets). The interexchange business has three nationally strong, established competitors. In the cable business, likewise, LECs would combat solid, entrenched incumbents.

ATTACHMENT 3

Even if LECs could, as an economic matter, leverage their position, the existing regulatory regime effectively precludes any such practice. As explained in Attachment 1 to U S WEST's Comments, (p. 27, fn. 24 and accompanying test), the price caps structure itself removes motives to shift costs of unregulated operations to the regulated side, because increased costs result, not in higher caps, but in lower profits. So too, price caps stifle the ability and incentive of LECs to leverage from not-yet-competitive services by instituting price increases for those services to fund predatory pricing tactics in unregulated markets. Additionally, the complete set of "equal access" obligations on LECs protects IXCs and others from the possibility that LECs could diminish, for instance, interconnection quality.

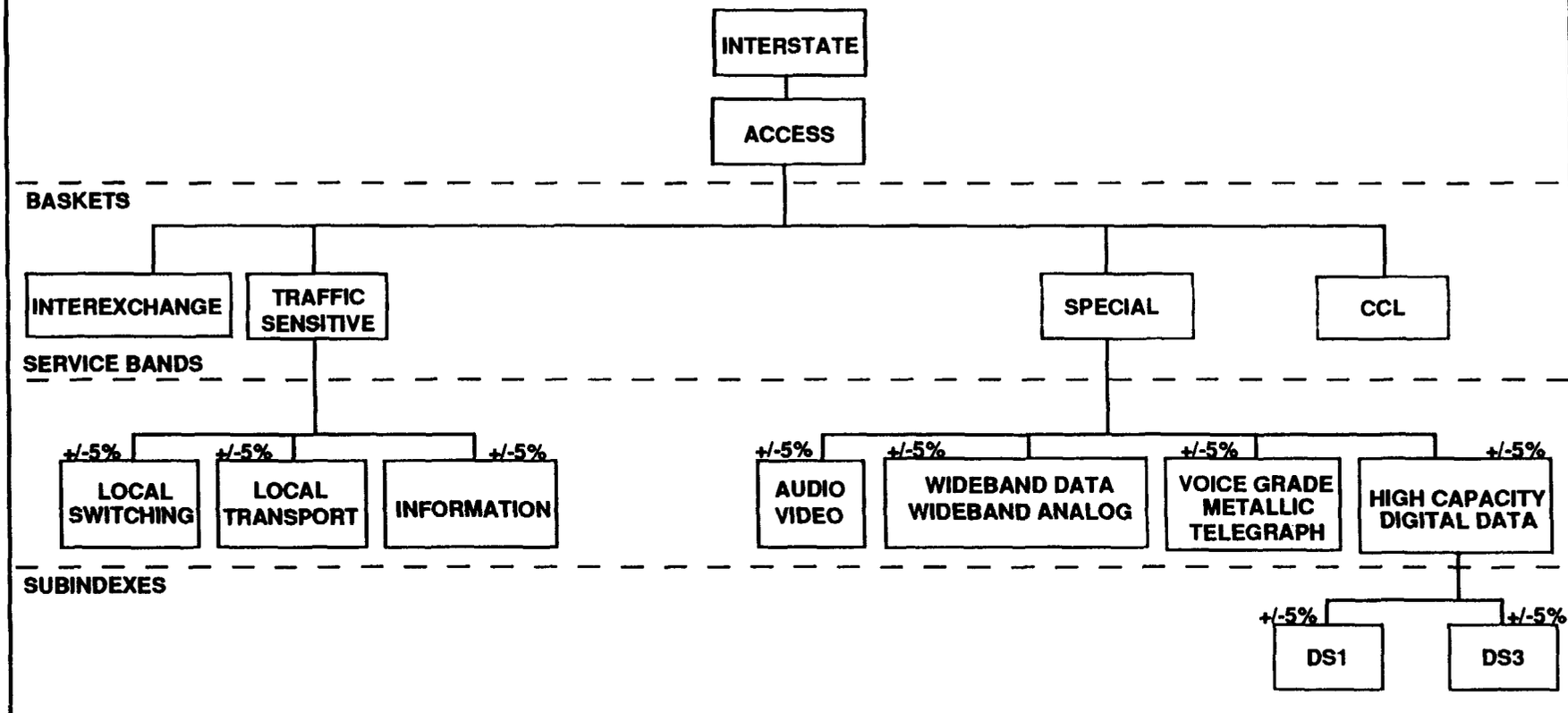
In any event, as a real-world matter, LECs do not appear to have the ability to extend any monopoly power from their local networks into neighboring industries that they may enter. The best evidence that LECs cannot so leverage their position comes from past and present operation of actual markets. The historical absence of leveraging activity by LECs in practice is well documented and presented in the recently released report by Dr. Peter W. Huber, The Enduring Myth of the Local Bottleneck, pp. 63-76, March 14, 1994. There, Huber details, market by market, concrete experience of LECs competing against other firms, in adjacent markets, including: interexchange services (corridors between New York/New Jersey and Philadelphia/Camden); information services; PBX; cellular service; and public pay phones. In each instance, the evidence shows that the market has operated without LECs gaining any anticompetitive advantage by leveraging their local network market position. Id. at Exec. Sum., p. vii ("In all of these markets, prices have dropped, output has increased and competition is flourishing."). If LECs had the ability to leverage market power, surely, as profit maximizing actors, they would have done so, and by now would dominate at least some of these markets. Thus, the Huber evidence tends to confirm that LECs lack the ability to leverage market power into any other markets.

For that reason, to the extent that LECs enter markets that are competitive in and of themselves, the Commission need not impose any selected regulation on LECs in particular. In mature existing markets, like cable or inter-LATA services, LECs would serve as the upstart entrant working to intensify competition. In newly emerging markets, all entrants including LECs, would start with a clean slate and should receive like regulatory treatment. Reduced regulation for LECs in competitive markets is workable for the added reason that the Commission serves as a vigilant watchdog in the event that something goes awry in the operation of market forces. Non-LEC competitors would have no hesitation to make the Commission aware of any suspected market irregularities. Finally, those non-LEC competitors always have available as a legal backstop a private right of action under the antitrust laws. 15 U.S.C. §15.

"[F]ostering an environment where businesses fight it out using the weapon of efficiency and consumer goodwill is what the antitrust laws are meant to champion." U.S. v. Syufy Enterprises, 903 F.2d 659, 669 (9th Cir. 1990). To the extent that the Commission strives for like goals, it should not dampen the competitive spirit that may push LECs to enter new markets by restricting their operations. In the absence of any evidence that LECs can extend market power into adjacent businesses, the Commission should treat LECs no differently than other contenders in those markets.

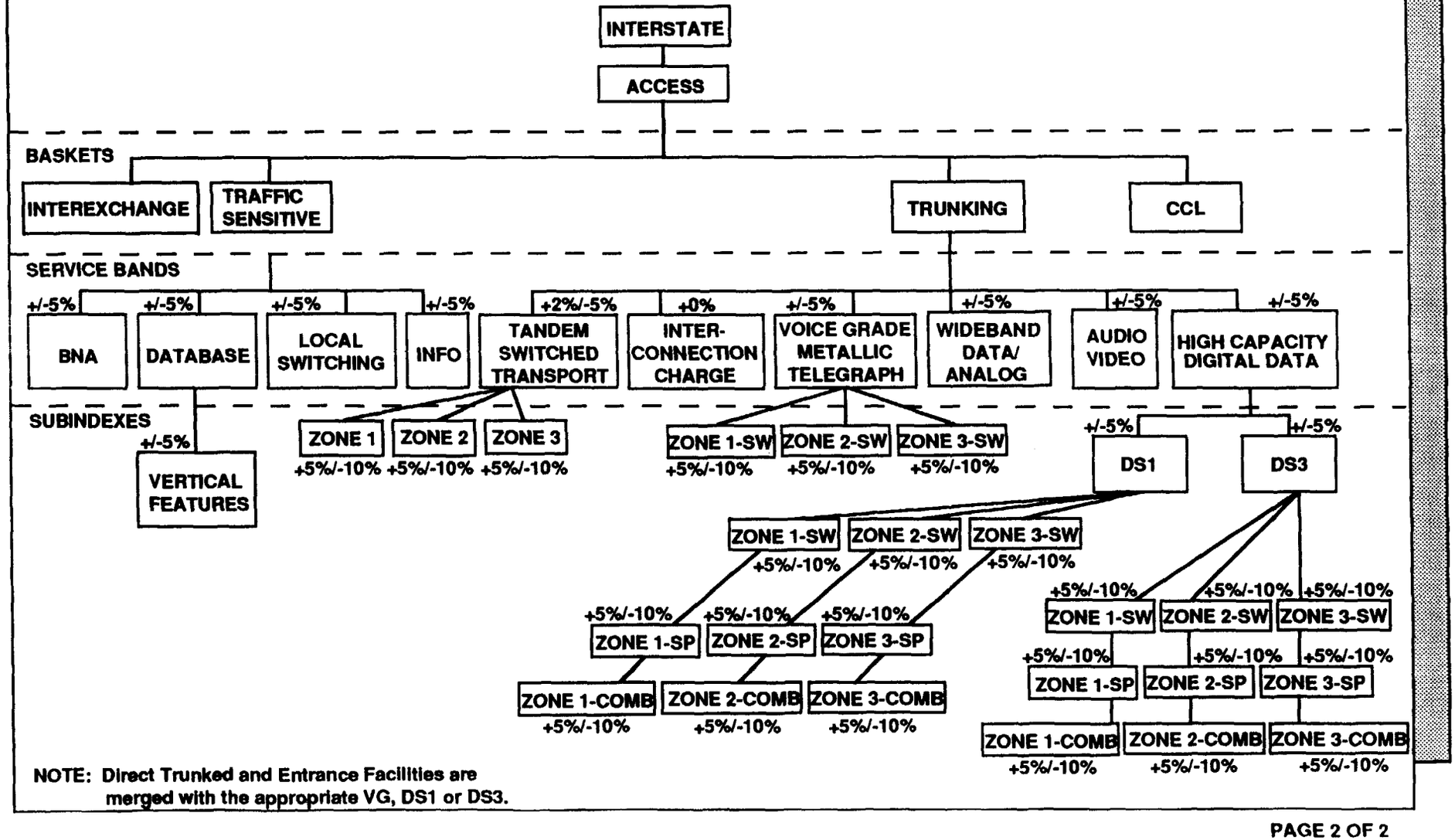
Attachment 4

PRICE CAP SERVICE STRUCTURE
(EFFECTIVE 1/1/91)



PRICE CAP SERVICE STRUCTURE

(EFFECTIVE 4/1/94)



NOTE: Direct Trunked and Entrance Facilities are merged with the appropriate VG, DS1 or DS3.

Attachment 5

STRATEGIC
POLICY
RESEARCH

STRATEGIC
POLICY
RESEARCH

REGULATORY REFORM FOR THE INFORMATION AGE

EXECUTIVE SUMMARY

JANUARY 11, 1994

In recent years, many regulators have realized that rate-of-return regulation is wholly inappropriate for the telecommunications industry. A different approach is needed, as the industry enters the Information Age. The FCC and state regulators have tried many different versions of regulatory reform. Results have generally been successful. Incentive regulation has been an appropriate step in the right direction. Further steps in the same direction could yield much larger public benefits. To reap those benefits, regulators must avoid resting on their laurels by simply fine-tuning existing plans. What is called for are bold *new* steps to further regulatory reform.

This paper presents a vision of where regulation should be 5 years from now. Because of inevitable procedural delays, progress must begin immediately if this goal is to be achieved. The vision provides a compass for evaluating shorter-run reforms. We also suggest some specific short-run reforms that would significantly move regulation in the direction of our long-run vision.

GROWTH IN COMPETITION

Any plan for regulatory reform should anticipate and facilitate changes in the market by providing appropriate regulatory flexibility. Local telecommunications is currently undergoing profound changes that will revolutionize the industry structure. Removal of state and federal regulatory barriers to entry is fueling growth in competition. Technological and policy developments will strengthen the array of competing services. Competing access providers (CAPs), cable and wireless services industries are already thriving and hold excellent prospects for the future.

7500 Old Georgetown Rd., Suite 810 Bethesda, MD 20814 (301) 718-0111 (301) 215-4033 fax

REGULATORY REFORM FOR THE INFORMATION AGE

CAPs have for some time succeeded in bypassing local exchange carriers (LECs) by directly connecting private facilities to long-distance carriers. Now, by taking advantage of new interconnection opportunities, they can offer switched access and local services as well. With their established presence in most major markets and their substantial financial resources, CAPs are poised for large-scale, head-on competition with LECs.

Competition from the cable industry will also intensify in the near future. The number of homes passed and number of homes served by the cable industry have both grown rapidly. Cable now has a large presence in residential areas. Increased use of fiber in cable networks positions the cable industry to provide local exchange services at low incremental cost. The recent spate of proposed mergers and other joint arrangements between LECs and cable companies portends an acceleration of competition jointly by cable companies and out-of-region LECs.

The wireless industry will soon bring a vast new universe of competition to local services. The rapid growth of cellular telephony demonstrates the popularity of mobile communication. Advances in digital technology will allow additional capacity for increased traffic. The FCC has adopted a policy of expediting Personal Communication Service (PCS) deployment, and recently decided to increase the spectrum available for wireless technology by four-fold. These and other developments (*e.g.*, Motorola's sale of spectrum to Nextel) will drive down the price of wireless service and equipment. We expect that within 10 years, wireless services will provide reasonably-priced alternatives to LEC landline services. The entire landscape of the telecommunications industry will be transformed as a result.

In sum, LECs will face increasingly potent competition. Growth of local-services competition is likely to far outpace the early growth of long-distance competition.

EFFICIENCY INCENTIVES

Effective plans for reform also must take into account the incentives for efficiency under different regulatory scenarios. Under traditional rate of return regulation, the company is allowed an opportunity to earn a "fair" return on operations. While providing some benefits, this method of regulation significantly dilutes the firm's incentives to be efficient. Increased efficiency often requires difficult changes in established business and personnel patterns. Without a sufficient financial incentive, such changes are unlikely to be made. Our measurements indicate that rate-of-return regulation (with a one-year lag) affords only a small percentage (about 14 percent) of the efficiency incentives that exist in unregulated competitive markets. Greater incentives can be provided through alternative regulatory approaches.

Price Regulation

Current Price Caps. Direct price regulation is one alternative approach to rate-of-return regulation. Price regulation plans currently in operation typically last only 3 to 5 years. The aggregate price level (for services not subject to streamlined regulation) is limited by a price freeze or a predetermined formula. The allowable price level changes each year, in accordance with the formula. However, the formula itself does not change during the term of the plan. Price-regulation plans benefit customers through lower rates during the plan's term (*i.e.*, the consumer dividend). However, renegotiations at the end of the plan term substantially dilute efficiency incentives. Moreover, the shorter the term of the plan, the more are incentives diluted. In addition, some current price-cap plans incorporate a sharing mechanism whereby prices are adjusted on the basis of the firm's earnings. Such plans are hybrids between "pure" price caps and rate-of-return regulation. Such mechanisms further dilute incentives and are counterproductive. We estimate that the current FCC hybrid price-cap plan for LECs provides *less than* 35 percent of the efficiency incentives that exist under unregulated competition. Marginal efficiency incentives in the hybrid plan are only about 18 percent for a LEC whose earnings are in the sharing zone each year.

Potential Improvements. While current price-cap and hybrid plans are somewhat better than rate-of-return regulation, substantial further improvement is possible and desirable. There should be no earnings sharing mechanisms, and the term of the plan should be lengthened to 8 to 10 years. Such a term optimizes the trade-off between the higher risk of a long-term plan and the diluted incentives of a short-term plan. Significantly more incentives for efficiency could be preserved with these improvements than under current plans.

Streamlined Regulation in Selected Markets

Streamlined regulation in selected markets is another alternative approach to regulation. Under streamlined regulation, the firm must file tariffs. However, regulators do not (in practice) regulate the firm's prices or earnings. Streamlined regulation provides the full efficiency incentives of competition. Competitive and market pressures are relied upon to limit market power of any firm.

The standard for streamlining regulation in a market should be whether customers who constitute a sizable fraction of demand have reasonable alternatives. This standard is superior to a test of market share, which has limited value as an index of market power, and may create perverse incentives for providers.

Efficiency benefits are maximized when regulation in all appropriate markets is streamlined. To that end, LECs should be allowed to disaggregate services to create additional candidates for streamlining. Discretionary services, including new services that supplement existing services, should be under streamlined regulation. Consumers can check abuse of market power by cutting back purchases of discretionary services if prices are raised