

EX PARTE OR LATE FILED



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March 16, 1995

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Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

RE: Ex Parte Presentation ✓
CC Docket Nos. 79-252, 93-197 80-286

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Dear Mr. Caton:

On Wednesday March 15, Neil Briskman, David Kasserman, Al Lewis, John Mayo, Gerard Salemme and I met with Anna Gomez, Michael Katz, Kathleen Levitz, Richard Metzger, John Morabito, John Muleta, Donald Stockdale, Mark Uretsky and Kathleen Wallman to discuss the above-captioned dockets and the attached materials.

Because the meeting was held late in the day, two copies of this Notice are being submitted on the following business day to the Secretary of the FCC in accordance with Section 1.1206(a)(1) of the Commission's rules.

Sincerely,

Attachments

cc: Ms. Anna Gomez
Mr. Michael Katz
Ms. Kathleen Levitz
Mr. Richard Metzger
Mr. John Morabito
Mr. John Muleta
Mr. Donald Stockdale
Mr. Mark Uretsky
Ms. Kathleen Wallman

SHOULD AT&T BE CLASSIFIED AS NON-DOMINANT?

OUTLINE

- I. Introduction
- II. The Economic Criteria for Dominance
- III. Application of Economic Criteria: The Descriptive Evidence
- IV. Other Empirical Evidence Concerning Dominance
- V. Responses to Residual Regulatory Issues
- VI. Other Competitive Issues

II. The Economic Criteria for Dominance

A. Elasticity of fringe supply

1. barriers to expansion
2. barriers to entry

B. Market share

1. level
2. trend
3. stability

C Market demand conditions

1. elasticity
2. distribution
3. willingness to switch
4. growth

DOMINANT AND NONDOMINANT FIRMS – THE BASICS

To determine whether a firm is properly classified as "dominant" or "nondominant" it is essential to have an accepted definition of these terms.

The Economic Definition:

- ▶ Dominant Firm – A firm with significant monopoly power (i.e., significant control over market price).**
- ▶ Nondominant firm – A firm that faces effective competition.**

The Regulatory Definition:

(FCC, First Report and Order, CC Docket No. 79-252)

- ▶ Dominant firm – A firm with "substantial opportunity and incentive to subsidize the rates for more competitive services with revenues obtained from its monopoly or near-monopoly services."**
- ▶ Nondominant firm – A firm without sufficient market power to "sustain prices either unreasonably above or below costs."**

MARKET DEFINITION

- What is a market?
- Criteria for defining a market
- Importance of market definition

III. Application of Economic Criteria: The Descriptive Evidence

- A. Market definition**
- B. Elasticity of fringe supply**
 - 1. number of firms**
 - 2. growth of output of other carriers**
 - 3. capacity**
- C. Market share of AT&T**
- D. Market demand conditions**

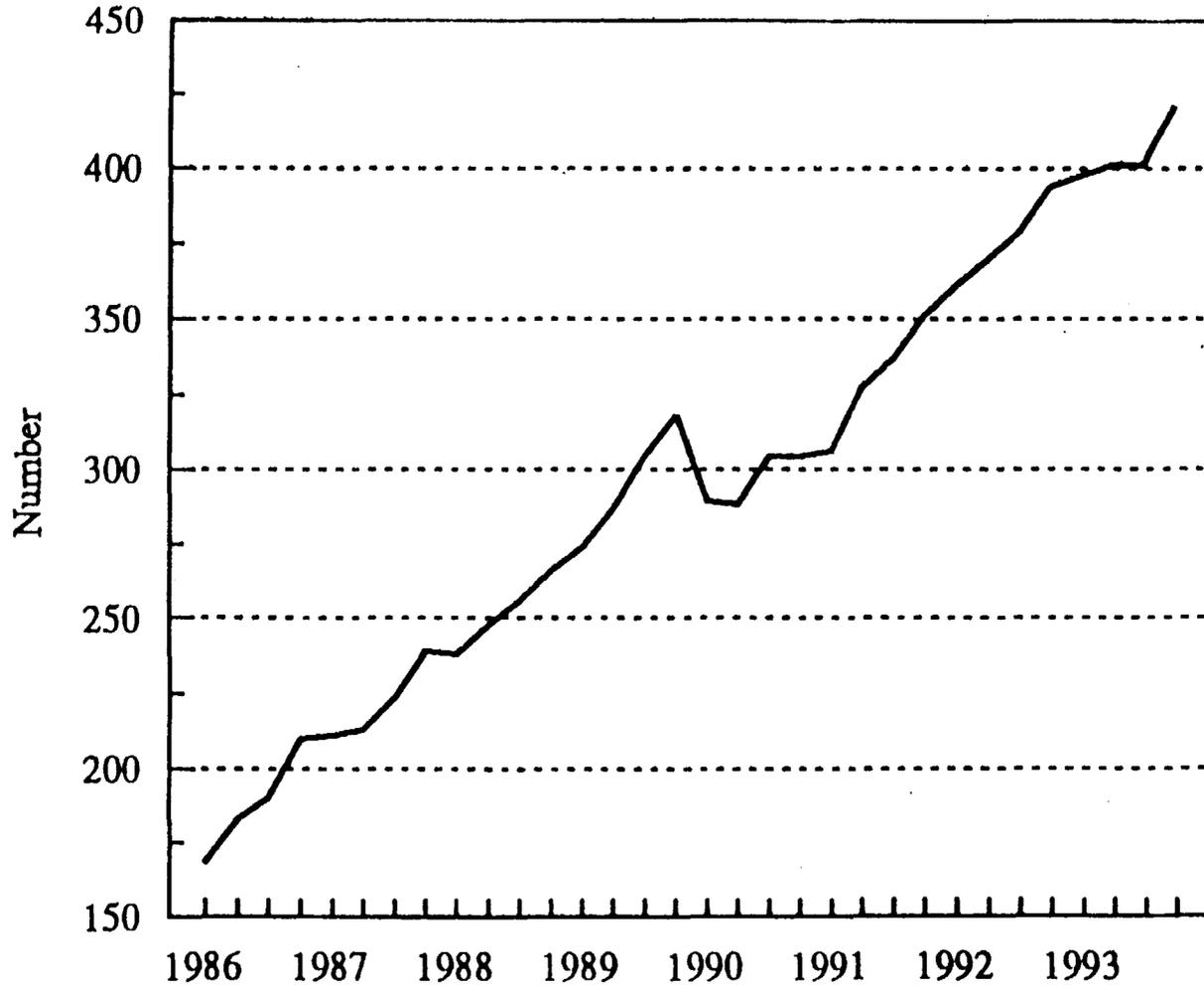
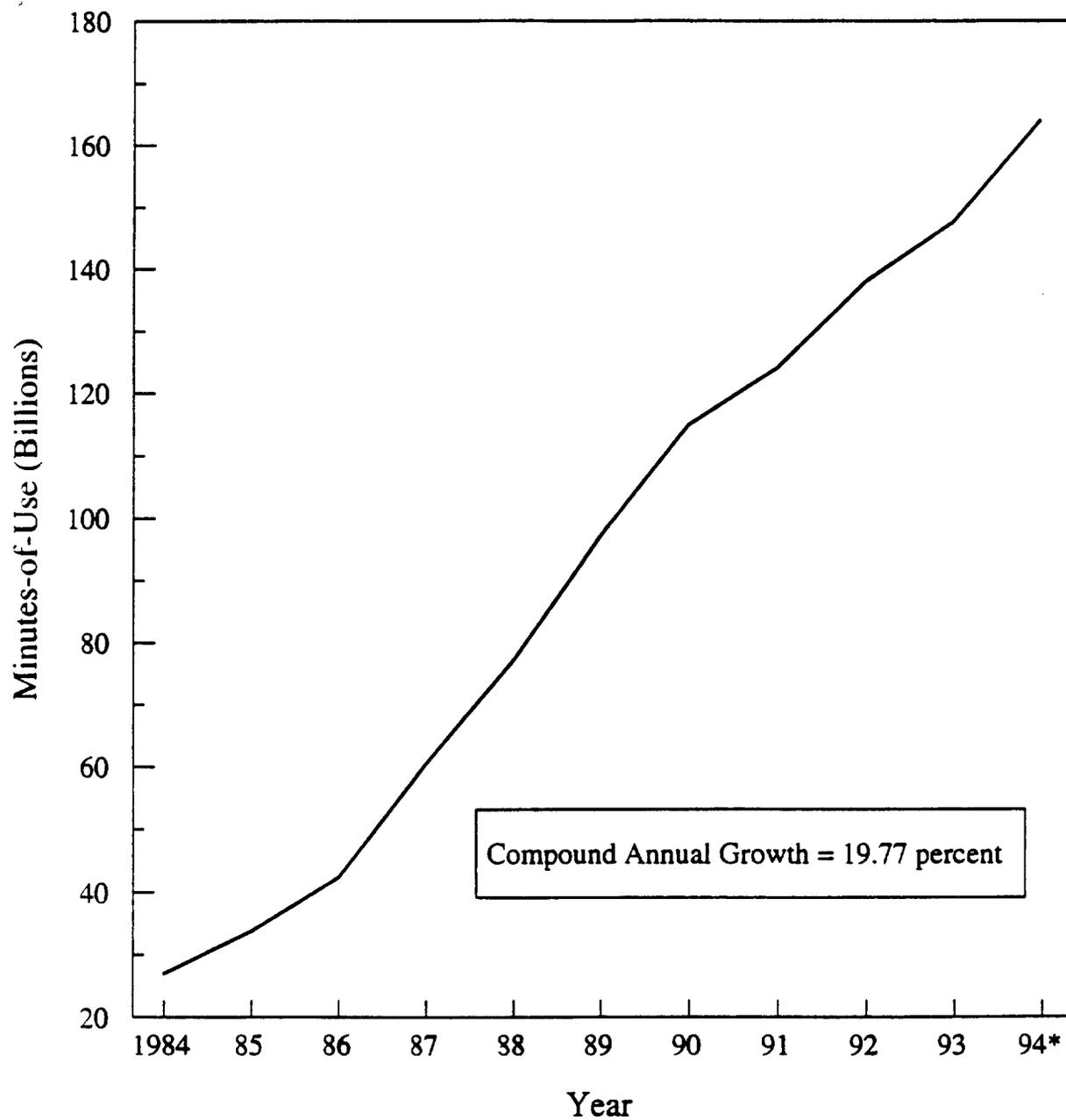


Figure 1. Long-Distance Firms Purchasing Equal Access

Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

OUTPUT OF AT&T'S COMPETITORS



*Estimate based on annualized rate of output for first three quarters.

Source: Long Distance Market Shares, Third Quarter 1994, Industry Analysis Division, Common Carrier Bureau, January 1995.

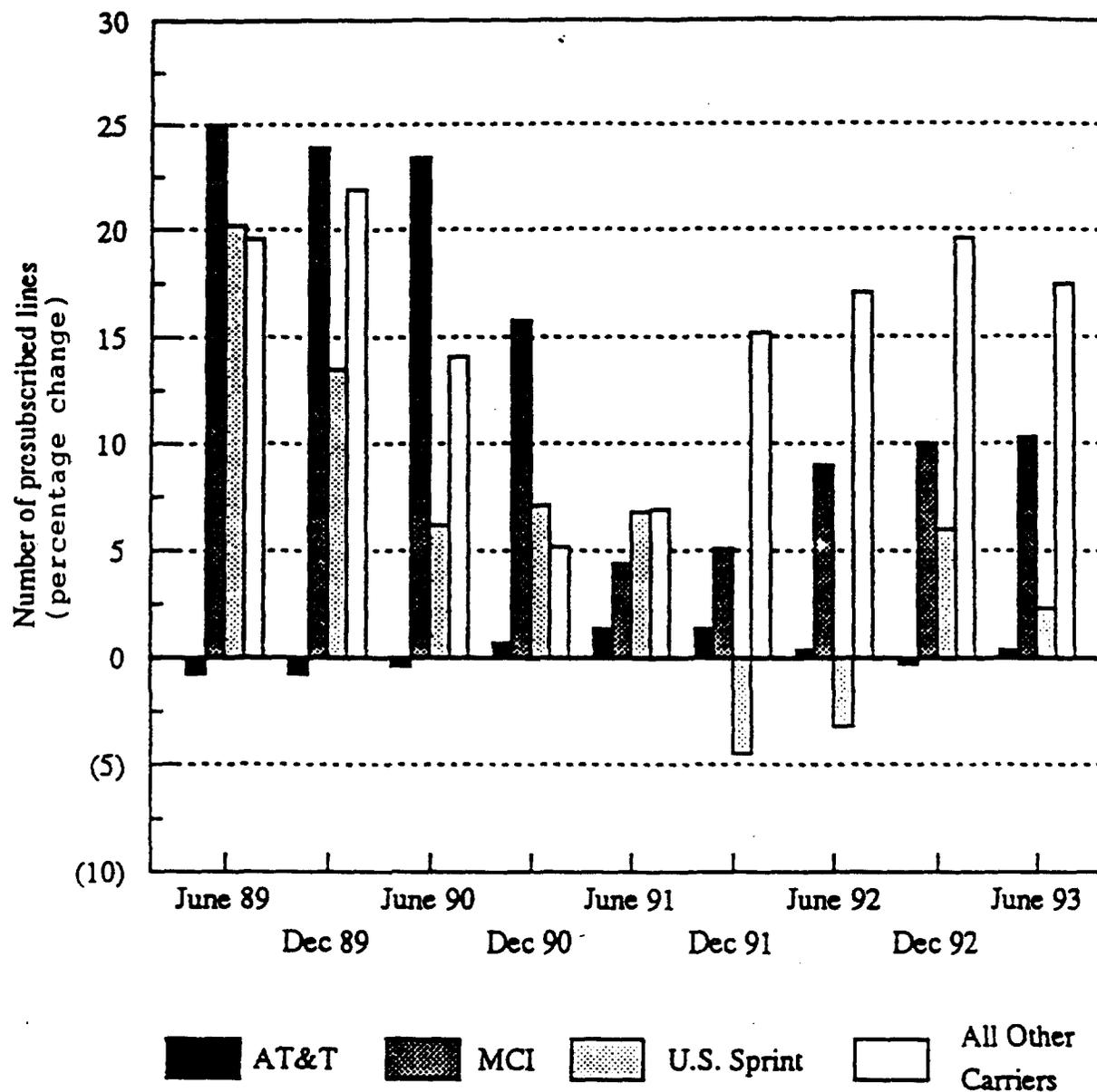
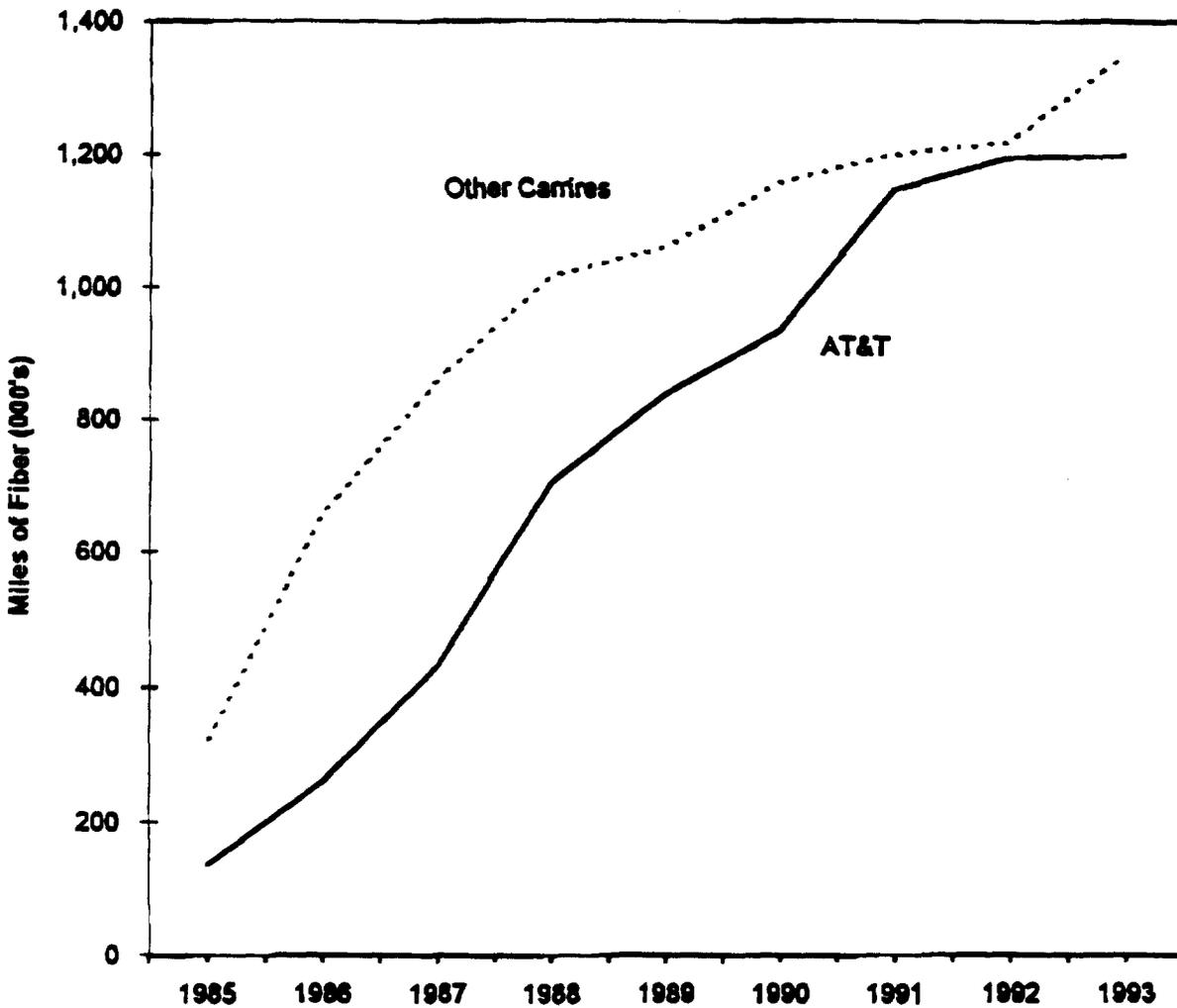


Figure 2. Growth Rate of Presubscribed Customers

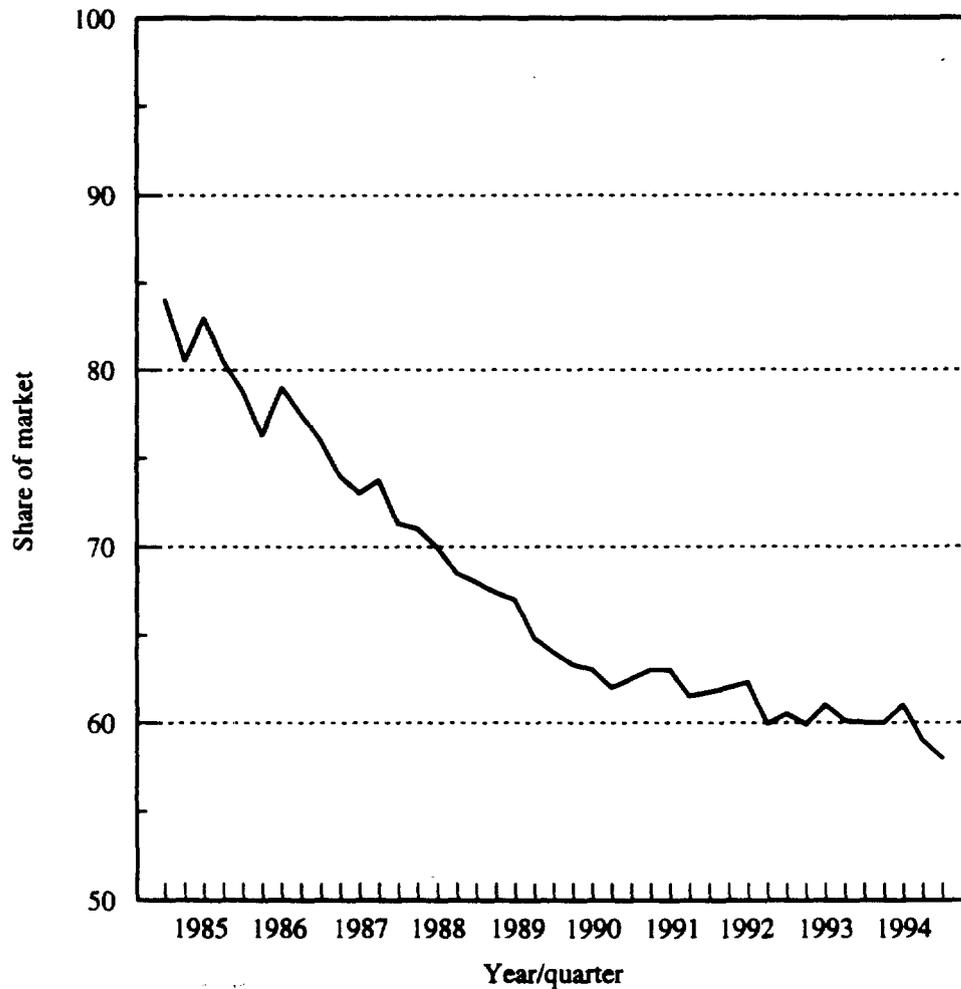
Source: Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994.

Deployment of Interexchange Company Fiber - Miles



Source: Jonathan Kraushaar, "Fiber Deployment Update. End of Year 1993." Industry Analysis Division. Federal Communications Commission, May 1994.

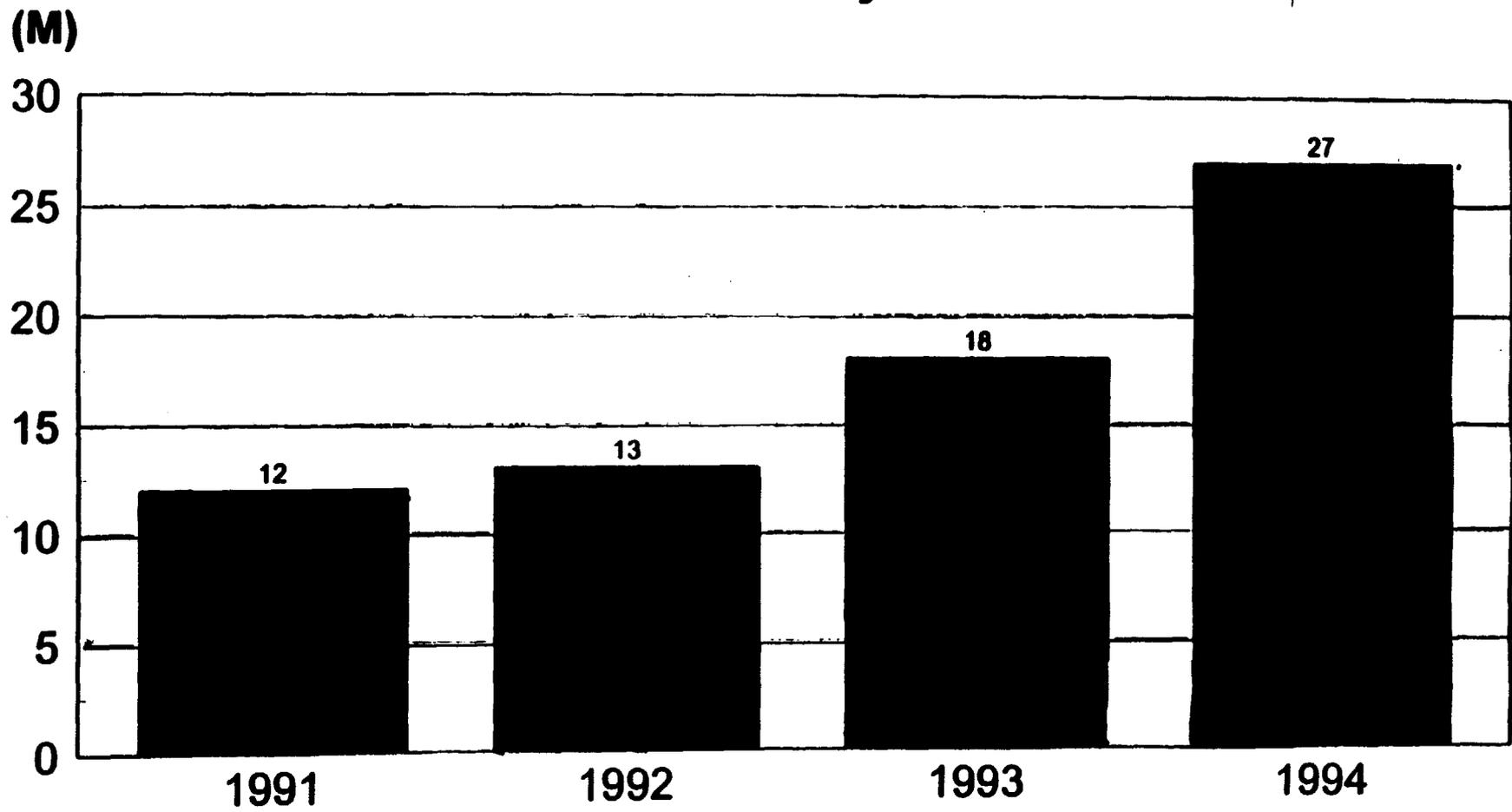
AT&T's Minutes-of-Use-Based Market Share



Source: Trends in Telephone Service, Industry Analysis Division,
Federal Communications Commission, May 1994.

About 30M customers change carriers annually - indicating a market of free choice.

Total Industry Churn



IV. Other Empirical Evidence Concerning Dominance

- A. Evidence on the effects of reduced regulation — the states' experience
 - 1. Mathios and Rogers
 - 2. Kaestner and Kahn

- B. Direct estimates of the Lerner index for AT&T
 - 1. Ward
 - 2. Kahai, Kaserman, and Mayo

Lerner Index Estimates

	Ward	K K, & M
Fringe Supply Elasticity	8.95	4.38
Lerner Index	0.085 - 0.186	0.13 - 0.29

TABLE 5

Bresnahan's Survey of Prior Empirical Estimates of Lerner Indices

Author	Industry	λ
Lopez (1984)	Food Processing	0.504
Roberts (1984)	Coffee roasting	0.055/0.025 ^a
Appelbaum (1982)	Rubber	0.049
Appelbaum (1982)	Textile	0.072 ^c
Appelbaum (1982)	Electrical machinery	0.198 ^c
Appelbaum (1982)	Tabacco	0.648 ^c
Porter (1983)	Railroads	0.40 ^b
Slade (1987)	Retail gasoline	0.10
Bresnahan (1981)	Automobiles (1970s)	0.1/0.34 ^d
Suslow (1986)	Aluminum (interwar)	0.59
Spiller-Favaro (1984)	Banks "before" ^e	0.88/0.21 ^f
Spiller-Favaro (1984)	Banks "after" ^e	0.40/0.16 ^f

^a Largest and second largest firm, respectively.

^b When cartel was succeeding: 0 in reversionary periods.

^c At sample midpoint.

^d Varies by type of car; larger in standard, luxury segment.

^e Uruguayan banks before and after entry deregulation.

^f Large firms/small firms (see their table 2).

V. Responses to Residual Regulatory Issues

- A. Oligopoly/Tacit Collusion/Price Leadership**
- B. Low Volume User/Rural Customers/Captive Customers**
- C. Predatory Pricing/Strategic Pricing**
- D. Market Definition**

A. Oligopoly/Tacit Collusion

- It is an oligopoly?
- If it is an oligopoly, is tacit collusion likely?
 - Industry structure
 - Industry performance
- BOCs' incentive
- Not a sound basis for continued asymmetric regulation

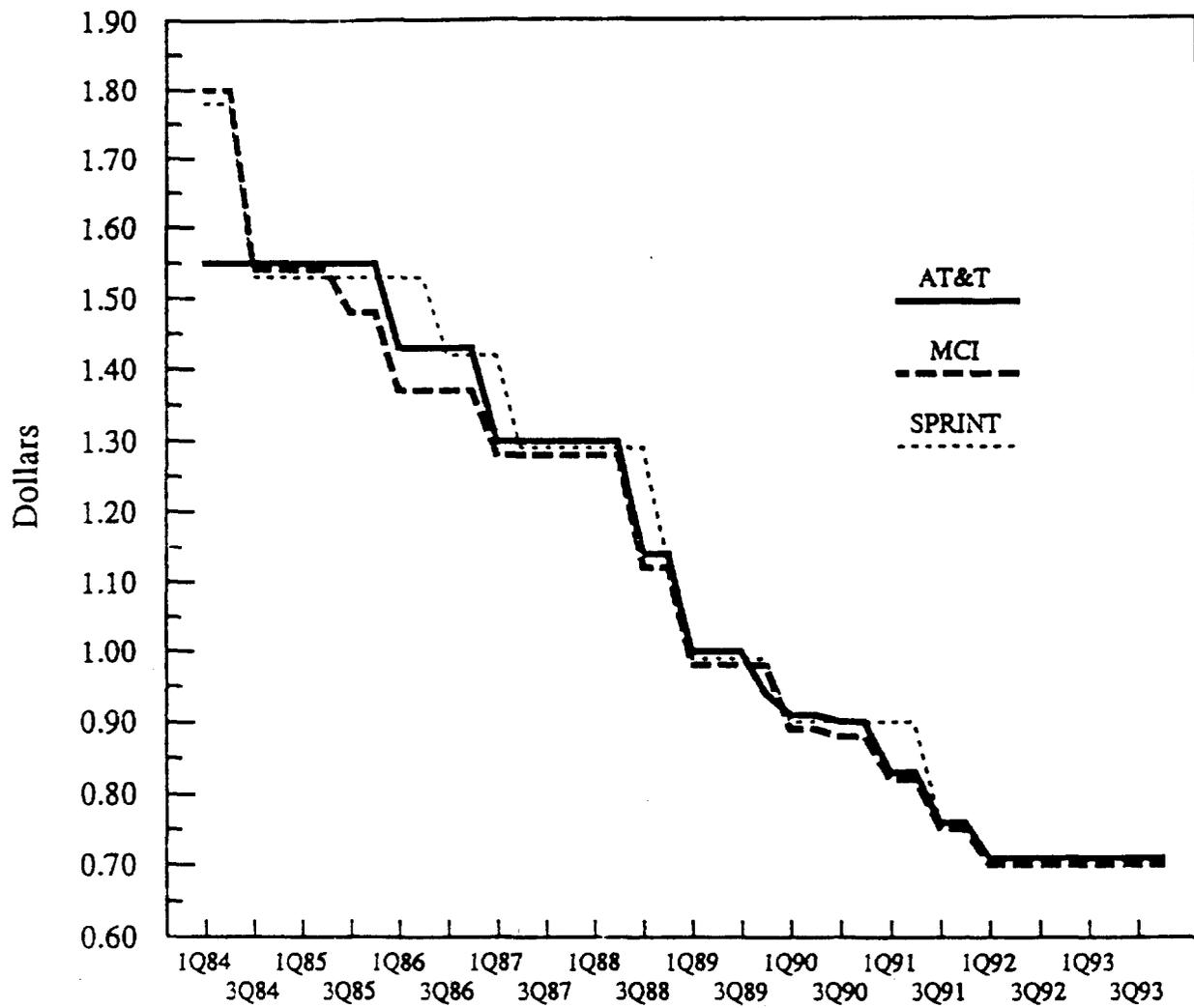


Figure 4. California Intrastate Rate Comparison (5-Minute, 100-Mile Day Call)

Source: Tariff filings, California Public Utility Commission

B. Low Volume User/Rural Customers

- Competitive choices are available to all customers, regardless of location or volume
- Economic theory - shoppers versus non-shoppers
- Price discrimination
 - Rural - geographically uniform rates
 - Low volume - arbitrage
 - Common in many relatively competitive markets
- Churn numbers
- Empirical results apply to basic schedule rates

Table 1. Number of Long Distance Carriers in Various Cities and Towns		
Major Metropolitan Areas	Population^{1,2}	Long Distance Firms³
Baltimore	2,382,000	30
Denver	1,623,000	23
New York City	8,547,000	32
San Francisco	1,604,000	25
Milwaukee	1,432,000	22 ⁴
Salt Lake City	1,072,000	26
Smaller Communities		
Helena, Montana	24,569	14
Moose, Wyoming	100	18
Carthage, Tennessee	2,386	37
Hope, Arkansas	9,643	11
¹ U.S. Bureau of the Census. <i>Statistical Abstract of the United States: 1991</i> (111th edition), Washington, D.C., 1991.		
² U.S. Bureau of the Census. <i>1990 Census of the Population: General Population Characteristics</i> , Washington D.C., May 1992.		
³ These are the firms given by the local exchange company business office as offering long distance telephone service on a "1+" basis.		
⁴ The local exchange company representative indicated that there were 11 "primary" long distance companies chosen by residential subscribers, but that all 22 carriers were available for subscription on a "1+" basis for Milwaukee customers.		

C. **Predatory Pricing**

- **How predatory pricing works in theory**
- **What would have to occur**
- **Structural conditions are inconsistent with predatory pricing**
- **Investment strategy of entrants**
- **Empirical results (paper)**

Public utilities

FORTNIGHTLY

Long-distance Telecommunications Policy — Rationality on Hold

By DAVID L. KASERMAN and JOHN W. MAYO

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Long-distance Telecommunications Policy — Rationality on Hold

By DAVID L. KASERMAN and JOHN W. MAYO

The following article examines the justifications that have been advanced for continuing regulation of long-distance rates and services. The authors conclude that while the question of whether long-distance telecommunications is a natural monopoly may not yet be determined, partial regulation of the industry prevents the realization of the benefits of either competition or regulation. The best policy would be to try complete deregulation, which would make a resolution of the natural monopoly question possible. If natural monopoly prevails, complete regulation could then be reimposed.

"Competition is finally forcing us to confront the vexing question of how to manage a system that is part regulated, part free. My own experience with airlines convinced me that, at least in that industry, there was no acceptable halfway house — that my own conscientious efforts to manage the process, to deregulate gradually in order to avoid abrupt shocks to a system that had been cartelized for forty years, created more distortions and intolerable pressures than letting go all at once. The lesson there, I believe, was that one either regulated comprehensively or got out of the way quickly."

— Alfred Kahn

Long-distance telecommunications companies and the customers they serve have been placed on hold by regulators and public policy officials who have failed to adapt regulatory rules to the rapidly changing environ-



David L. Kaserman is a professor of economics at Auburn University. Prior to his appointment at Auburn, he served on the faculties of the University of Tennessee and the University of Florida. In addition, he has been employed as a research economist at Oak Ridge National Laboratory, the Federal Trade Commission, and the Department of Housing and Urban Development, and has testified in a number of regulatory hearings and antitrust cases. **Dr. Kaserman** received a BS degree from the University of Tennessee and a PhD degree from the University of Florida.

ment in this industry. The January 1984 divestiture of American Telephone and Telegraph Company from the Bell operating companies restructured the industry in order to accommodate and complement the growth of active competition in the long-distance market. The basic purpose of the divestiture order was to separate the competitive from the monopolistic portions of the overall telecommunications business so that unnecessary regulations could be removed from that segment of the industry that is now effectively controlled by market forces.¹

Despite divestiture and the advice of Professor Kahn quoted above, the litigative Muzak emanating from hearing rooms in Washington, D. C., and state capitals across the country drones on while the pricing and investment decisions of the firms in this industry continue to be made in an atmosphere of extreme policy uncertainty. While a number of more enlightened states have implemented various forms of reduced regulation, the widespread deregulation that was envisioned at the time of divestiture simply has not materialized.² At the present time, approximately half of the states as well as the Federal Communications Commission have failed to implement significant regulatory reforms. As a result, the harvest that was supposed to arise from the seeds of divestiture (consisting of lower prices, reduced administrative costs, and the possibility of more rapid technological advance) has failed to bear fruit.

In this article we provide a critical evaluation of public policy in the long-distance telecommunications industry since divestiture.³ We first describe the current situation that exists in those jurisdictions that have man-

aged to avoid any significant regulatory changes to date. The policy that remains in effect in these jurisdictions is referred to as asymmetric regulation. We then explain why this policy is undesirable under any conceivable market environment. Next, we analyze a number of potential reasons for the observed reluctance to adopt more efficient regulatory policies. Our purpose here is to explain the economic incentives that have contributed to the observed policy lethargy. Finally, we conclude with a call for additional judicial and legislative action designed to break the current policy stalemate and initiate further regulatory reform.

Where We Are Now

Regulatory policy in the long-distance telecommunications industry, both in the pre- and postdivestiture eras, has been more the result of historical accident than conscious design.⁴ Since the opening of toll markets to competition, regulators have allowed (or, more accurately, merely witnessed) the entry of a substantial number of firms into the long-distance market. This opening of entry has eroded the market share of the traditional provider of long-distance telecommunications services. The extent of this loss, however, has not been uniform across geographic areas. AT&T's market share has declined rapidly in urban areas while its share has remained relatively high in many rural areas.⁵

At the same time, for a variety of technical, legal, and economic reasons, the companies providing local service to these rural areas have not converted their switching equipment to provide equal access to all long-distance carriers as rapidly as the companies providing local service to urban areas. The combination of the absence of ubiquitous entry and the failure of some local companies to convert to equal access has created concerns that AT&T still retains some residual market power in certain geographic regions.⁶

The instinctive reaction to these concerns has been the implementation by default of a policy of asymmetric regulation. That is, AT&T has continued to be subjected to traditional rate-of-return regulation (with constraints on pricing, new service offerings, and so forth), while the newer firms have been subjected only to minimal reporting requirements and have been allowed to enter and exit freely whatever market segments they choose. This unequal treatment of firms that are in direct competition in the marketplace ostensibly has been adopted to protect consumers; but, for reasons we discuss below, it has likely had precisely the opposite effect. Instead, it has served to protect potentially inefficient firms from the vigors of open and active competition. It is consumers, of course, who must ultimately pay the price of such protection.

The degree of asymmetry of the regulatory treatment provided the firms in this industry varies substantially

from one jurisdiction to another. In some locations, AT&T continues to be subjected to traditional rate-of-return constraints with full administrative hearings required to change rates. This extreme form of asymmetric regulation persists in almost half of the states and at the federal (interstate) level. In other jurisdictions, rate bands have been established, and AT&T is allowed some pricing flexibility within prescribed limits. This somewhat less severe form of asymmetric regulation has been adopted in, perhaps, a dozen or so states.⁷ In still other jurisdictions, the firm is allowed complete pricing flexibility subject to the constraint that rate schedules remain geographically uniform; i.e., a call of a given duration over a given distance at a given time of day must be priced the same regardless of the point of origination.

This last policy represents the least restrictive form of regulation. Elsewhere, we have called this policy market-based regulation, because it allows prices in the rural areas to be driven by the more intensely competitive market forces that exist in the cities.⁸ Thus, we shall differentiate this last policy from the others and refer to the first two collectively as asymmetric regulation.⁹

Why We Shouldn't Be There

At first blush, it might appear that, by handicapping only one competitor, asymmetric regulation would impair the profit opportunities of the affected firm but have little or no impact on the overall long-distance market. That is, the policy may seem to have implications for the profitability of AT&T without having any detrimental effects on consumers or the competitive process. A closer examination, however, indicates that this, in fact, is not the case. Myriad adverse effects stem from the economically perverse incentives created by a policy of asymmetric regulation.

First, where rate-of-return controls are applied in conjunction with a policy of uniform prices that are based on average embedded (as opposed to marginal) cost, there is a distinct possibility that inefficient entry and investment patterns will be fostered. Where the regulatory system involves cross-subsidization, some markets will be attractive targets for entry while others will not.

John W. Mayo is associate professor of economics at the University of Tennessee. He has served as the chief economist for the U. S. Senate Small Business Committee, Democratic Staff, and has also served as a consultant and expert witness in regulatory and antitrust matters. **Dr. Mayo** received his BA degree from Hendrix College in Arkansas, and MA and PhD degrees from Washington University in St. Louis.



If unregulated firms are allowed to enter selectively those markets where profits exist, then observed entry may represent nothing more than cream skimming.¹⁰

Now, from an economic point of view, there is nothing inherently evil about cream skimming. It is merely a private market response to a regulatorily imposed system of price discrimination. From a public policy point of view, however, a serious problem arises. Namely, it is generally not possible to distinguish with confidence entry that is due entirely to cream-skimming opportunities from entry by firms that are at least as efficient as market incumbents. If what we are observing is the former, then the total costs of providing service will be increased as a result of encouraging and then allowing entry by relatively high-cost producers. Moreover, in this case, the new entrants may not prove to be viable competitors in the long run in the absence of regulatorily induced market distortions. But if what we are observing is the latter, then industry costs may well be lowered by the infusion of competitive rivalry in an industry that was formerly closed to competition. As long as a policy of asymmetric regulation remains in effect, however, it will be impossible to distinguish between these competing hypotheses regarding the genealogy of observed entry, and the risk that regulation is spawning an inefficient industry structure will persist.

The second major problem with a policy of asymmetric regulation is that while it is in effect, consumers will not reap the myriad benefits of competition that were promised to emerge from a policy of open entry and divestiture. Where the competitive energies of a major producer remain hamstrung by a regulatory system inherited from an earlier era of natural monopoly, the salutary impacts of interfirm rivalry are simply less likely to materialize. For example, in order to reduce rates, AT&T must first convince regulators that the proposed changes are cost justified. This task is difficult enough in the presence of common costs and regulatory rules pertaining to verification standards. But when predictable claims of predatory pricing are added to the process by the alternative carriers (who are free to participate as intervenors in the rate hearing), the prospects for significant rate reductions quickly fade. Thus, the anticipated price changes are not forthcoming, and consumers' expectations are frustrated under this atavistic policy.

The introduction of new service offerings that competition is supposed to foster is also hampered by asymmetric regulation. As with rate changes, AT&T's proposals for new services or pricing options must be approved by the regulatory commission. Strong opposition and claims of predation are likely to be encountered here as well. In addition, the approval process itself consumes a significant amount of time during which the firm's competitors are informed of the new offering, so that important marketing advantages are

lost. Consequently, incentives to experiment with innovative pricing or service packages are dampened.

In a related vein, the continuation of rate-base regulation of only one competitor substantially reduces the incentive for this firm to invest in research and development efforts. The truncated distribution of financial returns to innovative activity that is created by rate-of-return controls attenuates the profit incentive for this firm to seek out lower cost methods of production. As a result, the potentially beneficial effects of competition on industry costs are much less likely to emerge under asymmetric regulation.

This is not to say that there is no incentive for technological advancement to occur under the current system. Indeed, if AT&T were granted greater pricing flexibility, it is theoretically possible that its incentive to upgrade existing equipment to counteract competitive intrusions could actually be reduced. Nor do we mean to imply that either economic theory or empirical evidence unambiguously predicts a significant increase in the rate of technological change under a deregulated environment. The precise causal relationship between market structure and research and development activities remains an uncertain one in economics.¹¹ Thus, our statements regarding the effect of deregulation on technological change must be couched in probabilistic terms. The issue is simply too complex to withstand definitive proclamations. Nonetheless, for the reasons discussed above, it appears likely that deregulation would tend to foster an intensification of research and development activities.

Next, by providing an open forum for discussion (and, all too often, obfuscation) by the parties whose profits are directly affected by the policies and decisions of the regulatory authority, the current system forces substantial and unnecessary expenditures of both private and public funds on the hearing process.¹² No party significantly affected by the outcome of this process is free to abstain from participation in order to reduce its costs, because a failure to present one's case is likely to result in an unfavorable decision.¹³ Protracted and contested hearings on rates, new services, new rules, and policy changes are expensive to stockholders, ratepayers, and taxpayers alike. Moreover, much (most?) of this litigative activity is undertaken merely to offset the strategic actions of competitors in the regulatory arena and, therefore, represents a socially wasteful expenditure of resources.¹⁴ The net result is an inflation of industrywide costs and administrative agency workload with no discernible benefits flowing to the consuming public.

Finally, since the policy of asymmetric regulation also maintains geographically uniform average cost pricing in order to alleviate the fear of residual monopoly power in rural areas, it may well represent a self-fulfilling prophecy. If the costs of providing service (including network costs, access charges, and billing expenses) are