

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

In the Matter of)

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)
) Computer III Further Remand
) Proceedings: Bell Operating
) Company Provision of Enhanced
) Services)

CC Docket No. 95-20

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REPLY COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY

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SUMMARY*

The evidence presented in this proceeding proves that the safeguards and ONA regime established by the Commission are working and should be continued without further required unbundling. A study by Hausman and Tardiff shows that the benefits of integration far outweigh any benefits to competition that may arise from structural separation, and that BOC participation in the enhanced services market has been good for consumers. For example, in the voice messaging services segment, prices have decreased by about 50% since BOC entry and output has expanded rapidly. The Commission should not stifle this participation by reimposing structural separation.

Further, the current level of unbundling is sufficient for competition to flourish in the enhanced services market. Requests for further unbundling are self-serving and generally made in an effort to achieve other goals not related to the provisioning of enhanced services or to foster enhanced services competition. Further unbundling of the network into smaller units comes at increasing costs to the LECs and to society, but brings fewer benefits.

Finally, the cost of returning to structural separation would be enormous and potentially prohibitive. Having to return to structural separation would require additional sales force and the

*All abbreviations are referenced in the text of this filing.

necessary space and equipment to house them, resulting in additional costs. The result would be increased costs to customers and reduced availability of services.

Based on the evidence provided in this proceeding the Commission should allow the BOCs to continue to provide enhanced services on a structurally integrated basis under the existing non-structural safeguards and ONA plans.

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TO: The Commission

REPLY COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), by its attorneys, respectfully files these Reply Comments in response to the Commission's February 21, 1995 Notice of Proposed Rulemaking, FCC 95-48 (NPRM).

The Commission has now reviewed yet another round of comments on the issue of Bell Operating Company (BOC) structural integration for the provision of enhanced services. The evidence from these comments proves that the safeguards and Open Network Architecture (ONA) regime established by the Commission are working and should be continued without further required unbundling at this time.

I. THERE IS SUBSTANTIAL EVIDENCE THAT NON-STRUCTURAL SAFEGUARDS ARE EFFECTIVE AND PROVIDE NUMEROUS BENEFITS TO THE INDUSTRY.

A number of the BOCs' competitors continue their hollow claims that "the costs of eliminating structural separation would likely far exceed the benefits."¹ In addition, several parties

¹ Hatfield, p. 51. Also see, Ad Hoc, p. 18; CompuServe, p. 23; IIA, p. 2; ITAA, p. 59. MCI would have the Commission establish an extremely narrow cost showing standard that no company could ever hope to meet. MCI would require the BOCs to show, through economic (continued...)

claim that BOCs cannot demonstrate any significant benefits to structural integration.² These claims are nothing but well worn rhetoric and are not supported by any evidence. In fact, MCI contradicts its own claim in its comments, when MCI states that the obstacle to "mass market" enhanced services is the lack of fundamental unbundling and that with "reasonably priced, nondiscriminatory network access" the public "would have enjoyed the same benefits from ESPs."³ MCI thus admits that the public has realized benefits under the current environment. MCI and others are simply using this proceeding as yet another way to achieve economically unjustified unbundling of the BOCs' network, although the evidence before the Commission clearly shows that the current level of BOC unbundling has in no way harmed the enhanced services market.

A study by Hausman and Tardiff filed on behalf of several BOCs (including SWBT) analyzes the benefits and costs of vertical integration of basic and enhanced services. This study finds that the benefits of integration far outweigh any benefits to

¹(...continued)
data, "that they could not, under structural separation, have profitably offered on a competitive basis, the enhanced services they are offering now on an integrated basis" (p. 15). Clearly, the "economic data" needed for such a regulatory test would be nearly impossible to produce. The BOCs have, however, presented the results of their analyses of the general costs, to them and to consumers, of returning to a separate subsidiary environment.

² MCI, p. 13; CompuServe, p. 23 (the benefits are largely illusionary); ITAA, pp. 59-60 (referring to "alleged benefits"); Hatfield, p. 51 (referring to "theoretical benefits").

³ MCI, p. 20 (emphasis added).

competition that may arise from structural separation. Specifically, the study concludes that (a) joint production facilitates the offering of new products and services, which provide large benefits to consumers; (b) the delay in making voice messaging service available (due to the initial structural separation requirement) has cost consumers well over \$1 billion annually and has exceeded well over \$10 billion since 1981; (c) extra production costs that would be incurred by foregoing the economies of scope from joint production would amount to over \$100 million annually; (d) the enhanced service markets in which BOCs operate are robustly competitive; (e) the existing ONA rules followed by the BOCs are designed to offer nondiscriminatory access at prices that avoid cross-subsidies; and (f) all available evidence shows that these rules are working as intended and that the enhanced services market is thriving.⁴

As part of this study, Hausman and Tardiff evaluated BOC participation in the enhanced services market and found no evidence of any anticompetitive effects. To the contrary, they found that BOC participation has been good for consumers. In the voice messaging services segment, which is the primary segment of current BOC participation, prices have decreased by about 50% since BOC entry and output has expanded rapidly, with strong growth expected through the remainder of this decade.⁵

⁴ Hausman/Tardiff, p. 3.

⁵ Id., p. 9.

In addition, the voice messaging market is very unconcentrated, with BOC market shares for voice messaging services ranging from around 6% for Bell Atlantic, BellSouth and Pacific Telesis to only about 1% for NYNEX.⁶ Significantly, although the BOCs have signed up large numbers of subscribers in the residential and small business voice mail segments, the independent service bureaus have generally maintained their subscriber base and many companies have thrived, particularly through targeting the business market with a larger range of products and functions.⁷ Sales of voice messaging equipment, which compete directly with voice messaging services, have continued to expand as well.⁸ As Hausman and Tardiff state, for BOC entry to have an anticompetitive effect, output would need to be lower than it would have been if the BOCs had been prohibited from participation, and no party can seriously claim that output would have been higher without BOC participation.⁹ The experience with nonstructural safeguards clearly shows no BOC anticompetitive abuses.

Yet, comments filed by the BOCs' competitors continue their unsupported accusations and assertions of BOC anticompetitive

⁶ Id., p. 10. A study by Booz·Allen & Hamilton Inc. filed on behalf of U S West reaches similar conclusions, estimating that the BOCs in total have less than 10% of the market, despite participation in every segment, with no individual Regional Bell Operating Company (RBOC) controlling more than 2% of the market. Booz·Allen & Hamilton Inc., p. V-1.

⁷ Booz·Allen & Hamilton Inc., p. III-7.

⁸ Id., p. III-1.

⁹ Hausman/Tardiff, n. 6.

abuse. They claim that existing safeguards have not been effective in preventing BOC abuse,¹⁰ and that technological changes have increased the opportunities for BOC abuse and make it more difficult for regulators to detect and remedy such abuse.¹¹ CompuServe points to nineteen informal complaints regarding Computer III or ONA since 1991 (although the Commission located only six such informal complaints).¹² MCI cites various "anticompetitive abuses" including one against SWBT by the Missouri Teleessaging Association regarding unhooking and "soliciting new customers before the competition ever has a chance to earn their business."¹³ SWBT acknowledges that some minor operational errors may have previously been made with regard to enhanced services, as

¹⁰ For example, MCI, pp. 27-45.

¹¹ For example, Hatfield, not surprisingly, offers extensive conjecture regarding a host of technological complexities, resulting ability and opportunity for BOCs to discriminate, and alleged anticompetitive strategies and tactics the BOCs would employ. Hatfield, pp. 17-36. However, these claims should be dismissed because as SWBT elaborates in Section II, no further unbundling is necessary for the provision of integrated enhanced services.

¹² CompuServe Comments at p. 38. CompuServe notes that only "some of the complaints may involve allegations that the BOCs have discriminated against their enhanced service competitors." Obviously, CompuServe relies on an assumption about the nature of the informal complaints rather than clear and convincing evidence of BOC anticompetitive conduct.

¹³ MCI Comments at p. 33 and Exhibit C. In this section, MCI also points to a lawsuit involving SWBT regarding publishing of directories and an investigation into alleged bribery by SWBT of an Oklahoma Corporation Commissioner as further evidence of SWBT's anticompetitive conduct. MCI has once again twisted the facts to suit its own purposes. Furthermore, neither of these matters is at issue in this proceeding to decide enhanced service structural integration.

with all (new and old) services. However, such innocent human errors cannot be eliminated by structural separation.

These possible errors are similar in nature to those database entry or telemarketing errors made by numerous interexchange carriers (IXCs), including several commenters in this proceeding, in the Primary Interexchange Carrier (PIC) field. Thousands of informal complaints are filed each year by consumers regarding unauthorized changes of their PIC. Many times the answer from the IXC is as simple as "database entry error." The IXCs have not characterized these errors as anticompetitive abuses, but rather as simple mistakes made and corrected. Given the small number of informal complaints (and complete lack of formal complaints) against the BOCs in the enhanced services arena, the Commission should recognize these incidents as minor mistakes which have been promptly corrected with the appropriate adjustments given. Structural separation will not remove the slight possibility of such errors from the enhanced services market.

Several parties consider the current cost allocation system inadequate to prevent BOC cross-subsidization.¹⁴ The

¹⁴ ITAA at pp. 39-47, CompuServe at pp. 27-36, and MCI at pp. 42-46. These parties also refer to SWBT's affiliate transaction joint audit, which is still under examination and for which a final order has not been issued. SWBT's position on this issue continues to be that the preliminary audit report tried to establish very specific interpretations of the affiliate rules that are not specified in the existing rules. The proper forum for the resolution of these issues is underway now. The joint audit covered the substantial majority of SWBT affiliate transactions whereas the issues still under discussion for the four-year audit period represent only five percent of those transactions. And, the issues are ones of interpretation, not violation of the rules. The
(continued...)

"Hatfield Report" was commissioned by MCI, CompuServe, and ITAA and its characterization of the "rules" that make up the current cost allocation system is not only totally self-serving, it takes previous Commission orders and uses the information in those orders out of context to support the inappropriate conclusions reached in the report.

A good example is the contention that rapid technological changes and local telephone company control over those changes make revisions to the Commission's cost allocation rules obsolete. As support the report quotes from the Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking in CC Docket No. 87-266:

...such accounting rules can be rapidly overtaken by technological or marketplace changes. Joint petitioners, for example, supported in their pleadings the establishment of accounts to identify loop investment as either copper or fiber. Such accounts, had we adopted them in 1992, would no longer serve the purpose envisioned by their proponents because carriers have since that time

¹⁴(...continued)

scope of the SWBT audit clearly indicates that the Commission has adequate oversight capabilities. SWBT also submits that pure price cap regulation eliminates the cross subsidy incentive. SWBT agrees with those commenters (MCI, p. 45; Hatfield, pp. 38-41; LDDS, pp. 11-14; ITAA, pp. 10-11) who claim that the sharing mechanism incorporated into the Commission's price cap plan and into many state incentive plans retains the core of rate-of-return regulation and a reliance on cost allocation. The remedy, however, is elimination of the sharing mechanism, not structural separation. Price cap regulation, without sharing, and the existing non-structural safeguards effectively insulate the regulated consumer from any potential for cross-subsidization. In any event, reimposition of structural separation would not eliminate the potential for affiliate transaction problems.

developed proposals to incorporate a third transmission medium, coaxial cable, into the loop.¹⁵

This quote is used to portray the cost accounting system as somehow inadequate as an effective tool for the identification and allocation of costs. In fact, if the whole quote is taken in context, the Commission's conclusions are just the opposite:

We decline, however, to adopt technology-specific cost accounting rules. The record in this proceeding demonstrates that such cost accounting rules can be rapidly overtaken by technological or marketplace changes.¹⁶

The Commission correctly designed these accounting rules without dependence on technology-specific requirements, because that technology would be subject to rapid change.¹⁷ That does not mean the systems are inadequate; rather, it means that there is flexibility to meet the Commission's regulatory program without extensive rule changes. The Hatfield Report recommendations were denied in CC Docket No. 87-266, Telephone Company-Cable Television Cross Ownership Rules, and should not be resurrected now out of context.

¹⁵ In the Matter of Telephone Company-Cable Television Cross-Ownership Rules, 10 FCC Rcd 244 (1994) at paras. 164-165.

¹⁶ Id.

¹⁷ "The revised USOA should not be tied to any particular cost of service methodology, as such methodologies may well change with time, with changing technology, or with relevant economic or legal considerations. A stable base from which to build is necessary to provide the ability to produce consistent and reliable output without the necessity of changing the accounting system each time a costing methodology is revised." In the Matter of Revision of the Uniform System of Accounts and Financial Reporting Requirements for Class A and Class B Telephone Companies, FCC 86-221, CC Docket No. 78-196, released May 15 1986. 1986 FCC Lexis 3427 at para. 7.

Clearly, the comments of the parties urging structural separation are the same worn arguments made in this proceeding previously. However, based on several years of actual experience with nonstructural safeguards, the enhanced services market is vigorously competitive and there is no evidence of the BOCs stifling growth in any of the submarkets. To the contrary, BOC participation has been good for consumers, and the Commission should not crush this participation by reimposing structural separation.

II. RECORD EVIDENCE SHOWS NO FURTHER UNBUNDLING OF BOC NETWORKS IS NECESSARY FOR THE PROVISION OF INTEGRATED ENHANCED SERVICES.

The evidence filed in this proceeding shows that the current level of unbundling is sufficient for competition to flourish in the enhanced services market. The BOCs are currently offering the unbundled network services (e.g., unbundled local transport, virtual collocation, and Integrated Services Digital Network) that the IXCs and ESPs have requested for use in enhanced services applications.¹⁸ Moreover, alternative sources of local access to switched services exist and will be increasingly available to enhanced service providers in the near term.¹⁹

Requests for further unbundling are self-serving and generally made in an effort to achieve other goals not related to the provisioning of enhanced services or to foster enhanced services competition. For example, Hatfield and others use this

¹⁸ For example, see Bell Atlantic, p. 23; BellSouth, p. 29; NYNEX, pp. 15-18; Pacific, p. 57.

¹⁹ For example, see Pacific, pp. 27-48, 58-61.

proceeding to address issues of local exchange competition, maintaining that local exchange competition "requires" unbundling and that "CAPs would benefit greatly from the ability to utilize unbundled local loops to extend their reach."²⁰ Clearly, the BOCs' competitors would benefit from such unbundling. However, Hatfield and others neglect the fact that it is not impossible to build the needed facilities, it simply is expensive. Competitors are looking for the cheapest way to increase their scope by using the regulatory process to avoid costly construction. But a high cost of construction is no justification to mandate that Local Exchange Carriers (LECs) unbundle their facilities into potentially dozens of components available at marginal or nearly marginal rates. The fact remains that the enhanced services market is vigorously competitive and that the Commission's ONA and interconnection policies have been effective and adequate in achieving this competition. Further unbundling is simply not necessary.

This conclusion, derived from the state of competition in the enhanced services marketplace, is also supported by sound economic principles. Any unbundling policy will lead to a change in economic efficiency. Aggregate economic welfare will be affected through four components: (1) the net change in the incumbent LEC's profits (from sales in both the upstream (wholesale) and downstream (retail or end user) markets); (2) competitive providers' profits in the downstream market; (3) the change in the consumer surplus in the end user market from the

²⁰ Hatfield, p. 2.

competitive rivalry that results from the unbundling; and (4) the cost of regulation in obtaining compliance with mandatory unbundling. Depending on the respective amounts of these changes, an unbundling policy may yield a significant positive change in economic efficiency, or it may result in a decline in economic efficiency. Thus, it is not a foregone conclusion that unbundling will automatically lead to increases in economic welfare. In economic terms, unbundling should be pursued only up to that point at which the marginal increase in economic efficiency from unbundling an upstream bundle equals the marginal cost of additional regulation. Clearly unbundling should take place only when it makes sense economically, and not simply for the sake of unbundling itself.

Given this economic framework, one can analyze the impact on the public interest of further unnecessary unbundling in situations where the downstream end-user market is already vigorously competitive, as is the case for enhanced services today. When downstream markets are competitive, they operate efficiently and consumer surplus is maximized. In this case, aggregate economic welfare is necessarily reduced by adopting unbundling requirements: (1) the incumbent BOC's profits will be reduced as a result of both decreased sales and increased operational costs of complying with unbundling mandates; (2) the downstream or retail competitors' profits will increase by roughly the amount of the incumbent's reduced profits from decreased sales (assuming both firms operate efficiently) (3) unbundling of an upstream or

wholesale product or service cannot lead to an increase in consumer surplus since this is already maximized; and (4) society will incur substantial costs in effecting regulatory compliance. Since consumer surplus remains unchanged at best, the BOCs' profits are reduced by more than the competitors' profits are increased, and society incurs additional costs of regulation, aggregate welfare would be lower if further unbundling were mandated under the current market conditions. When downstream retail markets are effectively competitive, mandated unbundling does nothing to improve the downstream market and such policies should not be pursued.

Fundamental unbundling of all basic network capabilities and service components as discussed by the Commission in Computer III is needlessly broad and costly, and would result in reduced aggregate welfare. While complete unbundling may well allow additional entry, such entry would impose substantial costs on the BOCs and on the public. Not all entry into telecommunications markets constitutes efficient, welfare-enhancing competition that the antitrust laws or sound regulatory policies were designed to protect or promote. The Commission should be concerned only with fostering efficient competition, not merely entry or redistribution of revenues. What many of the BOCs' competitors would like to achieve with their cries for fundamental unbundling is the fostering of entry, which they portray as efficient competition. However, there is a very big difference between these two concepts, and mere entry of firms into the enhanced services market via

fundamental unbundling may not constitute the type of competition that can make consumers better off. This is especially true if the unbundled components and functionalities must be made available at less than market-based prices. A "competitive environment" does not involve selective access to an incumbent firm's facilities when entrants are not efficient in all areas of producing a service.

Neither the courts nor regulatory agencies such as the Commission are expected to "cherry pick" all the most efficient assets of firms, and then use regulation or antitrust law to somehow combine them to minimize industry costs in the markets in which they intervene. If this were so, the courts would be intervening in practically every American industry. Instead, the courts and regulatory agencies are charged with ensuring that the efficiency-enhancing competitive process takes place where (absent government intervention) it otherwise could not. There is a very big difference between these latter two concepts. The BOCs' competitors have adopted the position that regulators must mandate access to the assets of integrated LECs so that they can be mixed with the assets of other, smaller or less integrated firms to provide telecommunications services at the least cost. Clearly, competitive markets do not work this way, and the Commission need not support or mandate complete unbundling to foster true competition.²¹ In competitive markets, the most efficient

²¹ Furthermore, the Ninth Circuit Court is not requiring that the Commission mandate complete unbundling. As recognized by the Commission, the issue on remand is whether the Commission should totally lift structural separation requirements for the provision
(continued...)

combination of the assets of several firms results voluntarily through mergers, voluntary contracts, or other means, not by selective intervention by the courts or regulatory agencies.

To see this important distinction, consider the following illustrative example. Although there are a number of small micro breweries in the St. Louis area, Anheuser-Busch is by far the largest and most dominant brewery in the area. There are probably many small breweries that could be in business and earn profits if Anheuser-Busch would simply share its facilities, distribution channels, or innovations with them. This does not make such assets or innovations "essential facilities" required to make the brewing industry more competitive; and no economic model would support mandated access to such assets or innovations. Such a policy would stifle the very innovations other firms would wish were shared with them.

Mandated fundamental unbundling could lead to other negative consequences as well. First, any prospective entrant knows that if there are network or service components it needs, it could gain access to them via unbundling (in the name of enhanced "competition") in lieu of engaging in its own investment or in other normal activities required for entry. Second, BOC competitors in general may seek to gain access to valuable network components at prices that do not reflect the true social costs of access. Such entrants may be able to enter the market only if they

²¹(...continued)
of BOC enhanced services given the current state of network unbundling under ONA (see NPRM, paras. 1&2).

are allowed access to these network components at advantageous rates and terms (in lieu of engaging in their own investment), which they hope to achieve through fundamental unbundling. Third, the Commission should consider the effect a fundamental unbundling policy would have on BOC investment incentives. The BOCs invested in the network, in part due to their obligation to serve, even when it wasn't certain that the services enabled by these investments would be profitable. Now, after the BOCs took this risk, other firms wish to come along and help themselves selectively to just those pieces of the network they need. Forcing complete unbundling of the existing network could seriously undermine the BOCs' ability to recover this past investment. This, coupled with prospects of having to fundamentally unbundle future technologies and efficiency enhancements as they become available at prices less than market levels, would seriously reduce incentives for BOCs and other firms to engage in cost-reducing innovation or network modernization in the future. BOCs would likely limit investment in the infrastructure since they must expect that they may be required to make components of their innovations available to competitors on terms that may not allow recovery of their investment and other associated risks. Other firms likewise would have little incentive to invest since they could rely on the BOCs to undertake the costly investment, while they could simply purchase selected components at a much lower price via regulatory intervention. This would result in very real costs to telecommunications users and other sectors of

the economy since reduced investment and innovation could seriously dampen the development of the information superhighway.

The substantial costs that would arise as a result of fundamental unbundling stand in contrast to the very limited, if any, benefits that may be possible in specific circumstances. Today's level of unbundling -- which includes the ONA requirements and the unbundling subsequently required with the switched and special access expanded interconnection and local transport orders -- provides effective safeguards that preclude BOC access discrimination. These orders have resolved claims made by competitors during the Computer III proceeding that they will never achieve comparable access because they cannot collocate their equipment at BOC central offices or purchase transport separately from switching. Thus, the additional unbundling ordered by the Commission since Computer III, in effect, achieves some of the fundamental unbundling requested by competitors and considered by the Commission as a safeguard against access discrimination.

The Commission has a responsibility to potential entrants to ensure conditions that allow effective competition to develop and flourish. The Commission has created these conditions through a series of orders that have required progressively greater levels of network unbundling, and that contain provisions for monitoring and ensuring compliance with reasonable access to different or new basic services desired by ESPs, whether or not the BOC uses these basic services in its provision of enhanced services. It makes no economic sense to unbundle just for the sake of unbundling.

Further unbundling of the network into increasingly smaller "building block" units, while possible in concept, comes at increasing costs to the LECs and to society, but brings fewer and fewer benefits. Unbundling should be pursued only up to that point where economic welfare is maximized, but should not be pursued beyond that point if the costs to society outweigh the benefits that can be realized. Methods already exist to ensure that competitive providers can obtain reasonable access to the components they need. There is no need to require fundamental unbundling.

III. RECORD EVIDENCE SHOWS THAT THE COSTS OF RETURNING TO STRUCTURAL SEPARATION FAR OUTWEIGH THE BENEFITS.

The BOCs have shown conclusively in their comments that the costs of returning to structural separation would be enormous and potentially prohibitive. These costs include: one-time start-up costs of establishing the separate subsidiary; significant cost increases to separate BOC subsidiaries providing enhanced services; higher ongoing costs as a result of reduced efficiencies in operations; higher BOC prices as a result of the higher costs, with some BOC enhanced services potentially discontinued; customer inconvenience and service disruption; and fewer new services. For example, Bell Atlantic estimates that the one-time cost of relocating Bell Atlantic's entire voice messaging network would be at least \$15 million; increased operating costs would raise prices about 25%; without an integrated sales force, new sales would decline by at least 80% in each future year; by the end of the decade, Bell Atlantic's voice messaging service would have more

than one million fewer customers than under the existing rules, and the public would be deprived of new enhanced mass market services from the BOCs since they could not market them through existing telephone company sales channels.²²

Likewise, BellSouth estimates that the unit cost of providing a voice mailbox would increase by 176% over six years, unit sales costs would increase 209%, advertising costs would increase 300% and be less effective, and unit customer service costs would increase 40%.²³ US West estimates that one-time start-up costs alone would be between \$59 and \$90 million,²⁴ with increased ongoing operating costs not included in this estimate. SWBT also estimates that voice messaging service costs would increase by at least 78%.

These costs directly reflect the efficiencies and economies of scope the BOCs realize from integrating basic and enhanced service operations. The direct results of these efficiencies are lower prices and greater service options for consumers than if the BOCs were not allowed to realize these cost savings. In addition, these efficiencies represent better use of resources, freeing up resources for other productive uses.

While some commenters dismiss the benefits from integration as theoretical or illusory, Ad Hoc would dismiss the efficiencies from joint marketing as "simply a cost sharing

²² Bell Atlantic Comments, pp. 17-20.

²³ BellSouth Comments, pp. 60-63.

²⁴ U S WEST Comments, p. 9.

mechanism," because "joint marketing does not improve output of BOCs' personnel and, thus, creates no 'true' efficiencies."²⁵ This argument defies basic economic principles. Having to return to structural separation would, among the many other additional costs, require additional sales force and the necessary space and equipment to house them, resulting in additional costs. Conversely, the nonstructural safeguard environment imposes less costs, not merely a sharing of a fixed amount of costs. This creates "true" and substantial efficiencies.

As David J. Teece (industrial organization economist and full professor at the University of California at Berkeley) explains, the BOCs have, under structural integration, a wide range of financial, technological, and marketing capabilities relevant to the provision of enhanced services; imposing structural separation would undermine the very sources of organizational scope economies that engender innovation, depriving consumers and the American economy of the performance of an important class of qualified competitors.²⁶ Permitting the BOCs to utilize their particular competitive strengths enhances competition. Foreclosing one group of competitors--the BOCs--from integrated solutions but allowing other competitors to offer integrated solutions (e.g., AT&T long distance and voice mail) would erode social welfare and create significant competitive distortions. As professor Teece shows, the

²⁵ Ad Hoc, p. 9.

²⁶ Affidavit of David J. Teece, filed on behalf of Ameritech, p. 7.

BOCs are particularly well situated to serve the majority of less profitable customer markets through mass marketing. If the BOCs are prevented from joint marketing, many less profitable consumers will not be served at all. The main beneficiaries of the economies of scope derived from integrated basic and enhanced services are those customers whose profit contribution would be marginal if enhanced services had to be provided on a stand-alone basis.²⁷

MCI and others dismiss the significant one-time start-up costs associated with converting from the current integrated environment to structural separation as "irrelevant" because, in their view, the public policy status quo is structural separation and these costs would have already been incurred.²⁸ Clearly, this makes no sense. First, the BOCs today are lawfully operating under nonstructural safeguards, which were adopted by the Commission in part to avoid the significant costs to the BOCs and the public of establishing and operating under structural separation. The costs which the BOCs would have to incur to transition to structural separation would be the direct result of that decision and as such, are quite relevant to an evaluation of the costs and benefits of that decision. Second, regardless whether the BOCs would have had to establish separate subsidiaries in the past (if the current

²⁷ Id., pp. 13-14.

²⁸ MCI, pp. 10-11; CompuServe, p. 25. Hatfield likewise argues that these costs should not be considered legitimate since this would reward the BOCs for "the bait and switch tactics that were used to gain structural relief in the first place." Hatfield, p. 52. This inflammatory allegation does nothing to change the fact that these costs would be tangible and substantial, and would in large part have to be passed on to customers.

waiver had not been granted), or would have to in the future due to a misguided order to return to structural separation, this would not change the fact that these costs would be incurred by the BOCs at some time as a result of the decision to require structural separation. MCI's claim that these start-up costs are "irrelevant" is wholly unfounded.

Finally, ITAA and LDDS both argue that "the cost of separation is substantially less than originally anticipated because RBOCs will be establishing new subsidiaries for other competitive purposes anyway."²⁹ These parties argue that the incremental cost of requiring BOCs to provide enhanced services through these future subsidiaries would be lower than requiring the establishment of a new subsidiary for enhanced services only. These arguments have no merit and should be summarily dismissed. First, resolution of this case should not hinge on speculation about future requirements that may or may not be adopted regarding entirely separate issues. Second, this argument addresses only some of the costs of establishing a separate subsidiary. It fails to consider the substantial costs to society that would arise as a result of the elimination of many of the efficiencies now possible from integration, particularly from joint marketing and mass targeting of customers, since these activities could no longer take place regardless of which separate subsidiary enhanced services fell under. The result would still be increased costs to customers and reduced availability of services.

²⁹ LDDS, pp. i-ii; ITAA, p. 58.