have redundant and multiple routing schemes, and there is rarely a single route between two cities. Since the cost of this alternative routing is comparable to the cost of direct routing, id. at n.49, city-pair markets are technically indefensible.[17]

Moreover, a city-pair market would ignore consumer demand patterns. Consumers primarily buy their long distance service as a single bundled product. And interexchange carriers sell it as such; unlike airlines, they usually do not sell point-to-point service between Washington and Chicago. Cf. NPRM ¶ 123 & n.228. There is no reason to think that BOC affiliates or independent LECs would sell anything but service that terminates anywhere in the Nation.

Finally, in addition to being analytically flawed, a city-pair market would be unadministrable. The Commission itself concedes this point, recognizing that "it would be impracticable to conduct a market power analysis in each geographic market implied by this point-to-point market definition." NPRM ¶ 124. USTA thus urges the Commission to follow its traditional precepts and, for purposes of analyzing the dominance issue in this proceeding, treat the relevant geographic market as national.[18] That said, however, even

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[17]If city-pairs were appropriate, AT&T could not be classified as a non-dominant interexchange carrier. AT&T is the sole interexchange carrier that serves a number of cities, such as Beggs, Oklahoma, Alamo, Tennessee, and Troy, Idaho. As the sole interexchange provider, AT&T must be the dominant provider in those markets.

[18]For the same reasons, USTA supports the Commission's tentative conclusion that market power in the international telecommunications market should be measured on a world-wide,

with the Commission's proposed market definition, it is clear that the BOCs are non-dominant.

B. BOC Affiliates Should Be Classified As Non-Dominant

As the Commission itself recognizes -- and USTA agrees -- BOC interLATA affiliates will have zero market share and no cost, size or resource advantage. NPRM ¶ 133. Moreover, since the interexchange market is characterized by significant supply substitutability and by customers who are highly price sensitive and willing to shift their traffic to other carriers based on price concerns, it would be suicidal for the BOC affiliates to raise their interLATA prices above competitive levels. Id. Consequently, there is simply no way the BOCs could exercise market power by virtue of their position in the interexchange market itself.

The only other possible source of market power is the BOCs' control over exchange facilities used in the provision of interexchange service. But the Commission's regulations -- buttressed by the new regulatory safeguards mandated by the Act -- are more than sufficient to ensure that this does not occur. Indeed, in decision after decision before the passage of the Telecommunications Act, the Commission repeatedly has held that its safeguards are more than adequate to preclude the BOC affiliates from exercising power in the interexchange market.

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rather than a route-by-route, basis.

1. Cost Misallocation. As the Commission correctly notes in the NPRM, cost misallocation is only relevant to market dominance insofar as it would allow the BOC affiliate to undercut and drive its competitors out of the interexchange market. NPRM ¶ 135. See also United States v. Western Elec. Co., 900 F.2d 283, 297 (D.C. Cir. 1990) (cross-subsidization is relevant only "insofar as it may be used to price below cost in the competitive market, and thereby unfairly to acquire power and impede competition in that market"), cert. denied, 498 U.S. 911 (1990). This type of concern is far-fetched -- for three reasons.

First, existing price cap regulation eliminates a BOC's incentive to misallocate costs. See NPRM ¶ 136. Under price caps, the FCC simply sets a maximum price for a service or combination ("basket") of services, allowing the carrier to select a rate at or below that maximum price. Because cost increases do not trigger automatic increases in the cap, there is no "reward for shifting costs from unregulated activities into regulated ones, for the higher costs will not produce higher legal ceiling prices." National Rural Telecom Ass'n v. FCC, 988 F.2d 174, 178 (D.C. Cir. 1993). Consequently, BOCs under price caps have no more incentive to engage in cross-subsidization than do unregulated firms.

Second, while price caps eliminate the incentive to engage in cross-subsidization, the Act's structural separation requirements and the Commission's accounting rules further deter such misconduct -- and ensure detection of any misconduct that is not deterred. As the Commission itself points out, structural separation "make[s]

such competitive abuses easier to detect and more difficult to accomplish." Computer III, 104 F.C.C.2d at 969 (1986). This is achieved by reducing the extent of joint and common costs between the regulated carrier and its affiliate; requiring that transactions move from one set of corporate books to another; and mandating the publication of rates, terms and conditions on which services will be made available to all comers. Final Decision, Amendment of Section 64.702 of the Commission's Rules and Regulations, 77 F.C.C.2d at 462. The Act also requires the BOC to fund a biennial audit by an independent auditor verifying that Section 272's requirements have been met. 47 U.S.C. § 272(d).

Third, and finally, the structure of the interexchange market makes it virtually impervious to effects of cross-subsidization. As the Commission notes, cross-subsidization will impede competition only to the extent the BOC affiliates are able to price below cost so as to drive their competitors out of business. In general, such predation is exceedingly unlikely to succeed. Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986) (predation is "rarely tried, and even more rarely successful"). In the interexchange market, predation by BOC affiliates is not merely improbable; it is impossible. To acquire power in the interexchange telecommunications services market, the BOC affiliate would have to drive AT&T and MCI -- multibillion dollar companies many times its size -- from the market. The magnitude of cross subsidy that would be necessary to drive these

leviathans from the market simply could not be shielded from detection.

Moreover, the BOC affiliate would have to outlast the intended victim of its predation. Given the differentials in resources between the BOC affiliate and industry giants like AT&T and MCI, the BOC affiliate is far more likely to be the victim of predation than a predator itself. Finally, even if one could imagine a predatory strategy that succeeded in driving a competitor from the market -- and none can be imagined -- such a strategy would still be irrational, as the BOC still could not recoup the losses from below-cost pricing. Any attempt to raise prices would simply cause another firm to buy and revitalize the abandoned fiber transmission capacity of the victimized carrier, introducing new competition and foiling the attempt to raise prices.

2. Raising Rivals Costs. The Commission also postulates that a BOC might be able to discriminate against unaffiliated interLATA carriers in the provision of exchange and exchange access service. But to the extent such practices might emerge -- a concern we dispel below -- classifying BOC affiliates as dominant carriers in no way constitutes a solution. Indeed, as the Commission itself concedes, its "regulations associated with the classification of a carrier as dominant generally are designed to prevent a BOC affiliate from raising price by restricting its output rather than to prevent a BOC from raising price by raising its rivals' costs." NPRM ¶ 132. Raising rivals' costs is thus no justification for classifying BOC affiliates as dominant. See

Schurz Communications, Inc. v. FCC, 982 F.2d 1043, 1052 (7th Cir. 1992) (vacating restrictions predicated on market power because, "if the [appellants] do have market power, the new rules . . . do not seem rationally designed to prevent its exercise").

Moreover, experience indicates that the Commission's regulations are fully capable of preventing discrimination. For instance, comparable incentives to discriminate exist in wireless markets whenever BOC-affiliated wireless carriers compete head-to-head with unaffiliated wireless carriers. To ensure a level playing-field, the FCC required all LECs to provide non-LEC wireless carriers with interconnection equal in type, quality, and price to that provided to wireless carriers owned by the LEC. Specifically, LECs were required to offer wireless carriers the same type of interconnection, from the same tariffs, and with access to the same discounts, as they offered to their own mobile service affiliates.[19] The Commission also announced other detailed requirements designed to ensure that LEC-owned wireless carriers do not, by virtue of the LEC's control of the wireline network, enjoy any advantages over their competitors.[20] And as Professor Hausman explains, these regulations have proven effective; in fact,

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[19]Report and Order, Amendment of Part 21 of the Commission's Rules with Respect to the 150.8-162 Mc/s Band, 12 F.C.C.2d 841, 849-850 (1968).

[20]Id. at 850. The Second Circuit relied on these requirements in upholding the FCC's decision to permit wireline carriers to provide mobile services. Radio Relay Corp. v. FCC, 409 F.2d 322, 327 (2d. Cir. 1966). The court noted that the FCC's conditions on the wireline affiliates were "designed to obviate any advantages that may accrue and equalize the competitive situation." Ibid.

wireless prices are actually lower when an in-region BOC provides the wireless service, indicating that BOCs have not engaged in any form of anticompetitive conduct. Hausman Aff. ¶ 29. Similarly, the Commission's safeguards have proven effective in the burgeoning enhanced services market, and should prove more than adequate to prevent discrimination in the less vulnerable interexchange market.[21]

Comparable safeguards for competing interLATA carriers are incorporated in Section 272 of the Act. USTA suggests that the Commission's regulations will prove equally effective in this arena, and that unaffiliated interLATA carriers will receive exchange and exchange access comparable to that afforded to the BOC affiliate. Moreover, the increasing automation of telecommunications networks would make it difficult for a BOC to insidiously discriminate against interLATA carriers. Network systems assign central office equipment, trunks, loops and nearly all other facilities automatically, based on the technical requirements of the service being provided and equipment availability. There is little, if indeed any, opportunity for discriminatory intervention

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[21]"There is evidence to suggest that these [nonstructural] safeguards have been effective. For example, the Commission determined in the BOC Safeguards Order that BOC nondiscrimination reports over a three-year period showed that discrimination against competing ESPs had not taken place. Nondiscrimination reports in the three years since that order have similarly not shown any access discrimination by BOCs. . . . Moreover, no formal complaints have been filed at the FCC by ESPs alleging BOC access discrimination since the Computer III Phase I Order." Notice of Proposed Rulemaking, Computer III Further Remand Proceedings, 10 FCC Rcd at 8379.

in the mechanized assignment and provisioning process. Most other BOC technical and operational activities are also now mechanized, and similarly present very little potential for discrimination.[22]

Finally, no BOC could successfully raise its rivals' costs by simply raising the price it charges for exchange access services. NPRM ¶ 141. These same increased access charges would have to be imputed to the BOC affiliate, which, in order to gain an advantage in the interLATA market, would have to sell its long distance service below cost. But as Professor Hausman explains, below cost sales are "economically irrational unless the BOC believes it can drive its competition from the market and charge supra-competitive prices." Hausman Aff. ¶ 31. As the above discussion of predatory pricing demonstrates, regulatory safeguards and technological reality render such fears groundless.

Moreover, BOCs currently provide exchange access under price caps. This makes a predatory strategy wholly implausible, since the BOCs would find it impossible to increase their access charges

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[22]Nor are the interexchange carriers passive "takers" of access. With respect to the portion of the transport system that is dedicated to a single provider, i.e., the link from the BOC switch to interexchange carrier POP, systems (collectively referred to as electronic bonding) are now being deployed which permit interexchange carriers and other access customers to use the same surveillance systems for their access services that the serving exchange carriers use for those same services. These arrangements eliminate the possibility of any differences in the abilities of exchange carriers and access customers to observe, measure and evaluate the performance of the dedicated portion of the customer's exchange access services. In fact, as a practical matter the IXCs, and particularly the large facilities-based carriers such as AT&T, could monitor interconnected BOC facilities to virtually any extent they choose.

sufficiently so as to offset their losses incurred by their affiliate. It is simply not realistic to believe that a BOC could manipulate prices within the narrow bands established by the Commission (and without exceeding the overall price cap established for the basket) so greatly as to drive competitors of the BOC's affiliate out of business; it is even more unlikely that the unregulated affiliate could raise prices sufficiently to recover the profits lost by the BOC.

C. Dominant Carrier Status Would Make It Difficult For The BOC Affiliates To Compete

Classifying an interexchange carrier as dominant triggers a slew of regulatory restrictions: The Commission may impose price caps on dominant interexchange carriers, in addition to tariff notification periods of up to 120 days, 47 C.F.R. §§ 61.41, 61.58(c) (1995); dominant carriers subject to price caps also must file cost data to support new services and above-cap and out-of-band tariffs, id. § 61.38, 61.49; and all dominant carriers must obtain Commission permission to construct, acquire, lease, extend, or operate a line, id. § 63.01, as well as to discontinue, reduce or impair service, id. § 63.62.

As the Commission itself has consistently recognized, these regulatory protections carry with them serious costs. "Such barriers and burdens impair competition by delaying or deterring carriers in their service and rate offerings and causing them to bear additional costs." Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations

Therefor, 95 F.C.C.2d 554, 580 (1983). Longer tariff requirements prevent a dominant carrier "from quickly introducing new services and from quickly responding to new offerings by its rivals"; longer notice requirements "reduce the incentive . . . to initiate price reductions"; other competitors can "use the regulatory process to delay, and consequently, ultimately thwart [the dominant carrier's] strategies." AT&T Non-Dominance Order, 11 FCC Rcd at 3288. And all of this red tape "imposes compliance costs on [the dominant carrier] and administrative costs on the Commission." Id.

The Commission cited all of these concerns in approving AT&T's petition to be reclassified as a non-dominant interexchange carrier. See id. at 3288. The Commission concluded that the economic costs of dominance regulation outweighed the benefits, even though AT&T controls over fifty percent of the interstate interexchange market, whether measured by toll minutes or revenue.[23] If the costs of regulating AT&T were unwarranted, there is certainly no logic that would warrant dominance classification for new entrants with zero market share. BOC affiliate would be unable to respond quickly and efficiently to their competitors, and consumers would be deprived of procompetitive benefits as a result.

Moreover, as the Commission has repeatedly recognized, "classifying these carriers as non-dominant" would not remove "regulatory checks on their prices." Fourth Competitive Common

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[23]See Industry Analysis Division, FCC, Trends in Telephone Service (May, 1996) (AT&T's controls 50 percent of the toll minutes and 55.2 percent of revenues).

Carrier Report and Order, 95 F.C.C.2d at 576. Non-dominant carriers -- other than those treated by forbearance -- must still file tariffs, and the Commission retains "the right to suspend and investigate tariff filings either on our own initiative or in response to petitions from customers or others." Id. Non-dominant carriers are still subject to Title II regulation: They must offer interstate service under rates terms and conditions that are just, reasonable and not unduly discriminatory (Sections 201-202); remain subject to the Commission's complaint process (Sections 206-09); and are required to file tariffs pursuant to streamlined procedures (Sections 203, 205) and to give notice prior to discontinuance, reduction or impairment of service (Section 214). For these reasons, USTA urges the Commission to classify BOC affiliates providing in-region, interLATA domestic and in-region international services as non-dominant.

Respectfully submitted,

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August 15, 1996

Statement of Professor Jerry A. Hausman

1. My name is Jerry A. Hausman. I am MacDonald Professor of Economics at the Massachusetts Institute of Technology in Cambridge, Massachusetts, 02139.

2. I received an A.B. degree from Brown University and a B.Phil. and D. Phil. (Ph.D.) in Economics from Oxford University where I was a Marshall Scholar. My academic and research specialties are econometrics, the use of statistical models and techniques on economic data, and microeconomics, the study of consumer behavior and the behavior of firms. I teach a course in "Competition in Telecommunications" to graduate students in economics and business at MIT each year. I was a member of the editorial board of the Rand (formerly the Bell) Journal of Economics for the past 13 years. The Rand Journal is the leading economics journal of applied microeconomics and regulation. In December 1985, I received the John Bates Clark Award of the American Economic Association for the most "significant contributions to economics" by an economist under forty years of age. I have received numerous other academic and economic society awards. My curriculum vitae is included as Exhibit 1.

3. I have done significant amounts of research in the telecommunications industry. My first experience in this area was in 1969 when I studied the Alaskan telephone system for the Army Corps of Engineers. Since that time, I have studied the demand for local measured service, the demand for intrastate toll service, consumer demands for new types of telecommunications technologies, marginal costs of local service, costs and benefits of different types of local services, including the effect of higher access fees on consumer welfare, demand and prices in the cellular telephone industry, and consumer demands for new types of pricing options for long distance service. I have also studied the effect of new entry on competition in paging markets, telecommunications equipment markets, and interexchange

markets and have published a number of papers in academic journals and books about telecommunications. I have also edited two recent books on telecommunications, Future Competition in Telecommunications (Harvard Business School Press, 1989) and Globalization, Technology and Competition in Telecommunications (Harvard Business School Press, 1993).

4. I have previously provided affidavits before the FCC on the proper regulatory framework for Local Exchange Companies (LECs). I recently submitted an affidavit in CC Docket No. 96-61 on question of detariffing, bundling, and other issues which arise in competition in long distance services. I have also testified before state regulatory commissions on similar topics. I have recently published two papers on the proper regulatory treatment of "monopoly building blocks" controlled by LECs: J. Hausman and T. Tardiff, "Efficient Local Exchange Competition", Antitrust Bulletin, 1995, and J. Hausman, "Proliferation of Networks in Telecommunications", ed. D. Alexander and W. Sichel, Networks, Infrastructure, and the New Task for Regulation (Univ. of Michigan Press, 1995).

5. I have significant experience in antitrust matters. I have testified in approximately six antitrust trials and been involved in numerous merger proceedings before the DOJ and FTC. I also submitted numerous affidavits to the U.S. District Court in charge of the MFJ with respect to RBOC waiver proceedings. I have given invited seminars to the American Bar Association, the U.S. Department of Justice, and the U.S. Federal Trade Commission on topics in antitrust economics. I have also published numerous academic papers in antitrust economics. My most recent paper is "Market Definition Under Price Discrimination", Antitrust Law Journal, 1996.

I. Summary and Conclusions

6. Dominant regulation is designed to ameliorate market power that

results from the ability of a firm to increase prices above the competitive level by restricting output. BOCs will not have this ability to raise prices in the long distance market.

7. Potential problems of cross subsidy and cost shifting as well as discrimination are already treated by other regulations. Dominant firm regulation will not significantly affect these potential problems. However, dominant firm regulation is very likely to decrease competition and harm consumers. Dominant regulation will lead to less price competition and less provision of new services to consumers.

8. All interstate domestic interexchange telecommunications services provide the appropriate market definition for competitive analysis. The competitive effects of any anti-competitive actions can be analyzed within the overall market definition proposed in the NPRM. Because of the importance of potential supply responses in interstate interexchange telecommunications services, the proposed market is especially well suited to current and possible future inquiries into the existence and exercise of market power.

9. I disagree with the NPRM that it would be useful to define separate "point-to-point" geographic markets. Customers primarily purchase their domestic interexchange telecommunications services from a single carrier. Since customers buy their long distance service in a bundle (or cluster), "point-to-point" markets do not provide the best basis to analyze competition in long distance.

10. BOCs would be extremely unlikely to be able to restrict long distance output to raise prices. The BOCs' affiliates will begin with zero market share, and the presence of AT&T, along with the other IXCs, makes it unlikely that the BOCs could gain market share quickly enough to allow them to exercise market power by restriction of output.

11. The BOCs will have an economic incentive to lower long distance prices from their current levels. Lower prices of long distance through an expansion of output, not a restriction of output, will be in the BOCs' best interests. This outcome of lower prices helps consumers and is pro-competitive, as economic theory demonstrates.

II. Market Definition

12. The NPRM correctly puts forward the concept of dominance in the economic context of maintaining prices above the competitive level. (¶ 114) The Commission then considers whether it should narrow its previous market definition of the Competitive Carrier proceeding to provide a "more refined analytical tool" to attempt to evaluate market power. (¶ 116) The primary goal of market definition is to set the boundaries of an investigation into market power. Thus, it should consider both the effects of demand and supply. Secondarily, market definition also allows calculation of market shares which provide at best, a rough guide to the possible presence of market power.

A. Product Market Definition

13. As the NPRM notes, the 1992 Merger Guidelines (MG) focuses on demand substitution factors, and brings in supply response through the "uncommitted entrant" section of ¶ 1.32ff. While I have significant doubts about the MG approach to market definition, even the MG recognizes that market share data provides "only the starting point for analyzing the competitive impact of a merger".[1] (¶ 2.0) The MG instead focus on the potential

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[1] See J. Hausman et. al. "Market Definition Under Price Discrimination", Antitrust Law Journal, 1996 and "Competitive Analysis with Differentiated Products," Annales, D'Economies et de Statistique, 1994. Note that if only demand factors were considered, a separate market for left handed golf clubs might exist, because right handed clubs do not provide an adequate substitute for left handed golfers. Also, separate markets might exist for different types of beer (e.g. premium, imported, light, ice, etc.) which is counter to established judicial opinions. Similar results might be found in automobiles and many other products which again is counter to judicial opinions. Thus, supply response must be taken into account. The MG accounts for the supply response through the participation of firms who can respond quickly so that

competitive effects of a merger, which should also be the focus of the Commission's decisions in terms of dominance.

14. Competitive effects analysis takes account of both demand factors and supply factors in determining the potential ability of a firm to exercise significant market power. The finding of a presence or absence of significant market power should be based on demand conditions, supply (cost) conditions, and competitive conditions. Market definition based on only demand conditions followed by market share calculation would omit supply factors and competitive conditions and could well come to an incorrect conclusion about the presence of significant market power.

15. Thus, I agree with the NPRM's tentative conclusion (¶ 119) that all interstate domestic interexchange telecommunications services provide the appropriate product market definition. Particular situations can arise where anti-competitive actions may arise (e.g. anti-competitive price discrimination in cellular long distance by IXCs), but the competitive effects of these situations can be analyzed within the overall market definition proposed in the NPRM. Because of the importance of potential supply responses in interstate interexchange telecommunications services which arises from the use of common facilities such as transmission and switches by IXCs for numerous different services, the proposed market is especially well suited to current and possible future inquires into the existence and exercise of market power.

16. I also agree with the tentative conclusion that international services should be treated as a separate market. International agreements and regulation create different conditions than exist for domestic interexchange services. Both demand and supply factors can be affected significantly by these agreements and regulations. Thus, separate treatment of international

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the final outcome of the analysis still focuses on the potential to exercise market power.

services is appropriate.

B. Geographic Market Definition

17. However, I disagree with the NPRM that it would be useful to define separate point-to-point geographic markets. (¶ 123) Customers primarily purchase their domestic interexchange telecommunications services from a single carrier. Thus, I choose AT&T for all my long distance calls; my employer MIT chooses MCI. Note that the situation differs markedly from the airline choice (fn. 228) referred to by the NPRM, where each choice is done separately. For instance, I choose US Air for Boston to Washington, but US Air does not even provide service from Boston to Chicago. Since customers buy their long distance service in a bundle (or cluster), a point-to-point market definition would not provide the best basis to analyze competition in long distance.

18. Furthermore, current competition in the long distance market demonstrates the absence of point-to-point markets. InterLATA pricing is done on a nationwide basis where prices do not differ with access charges or other cost factors which might cause prices to differ. Even the distance component of interLATA prices is becoming less important with offerings such as Sprint Sense and MCI Minutes. This change has arisen, in part, because of the use of fiber optic transmission networks which are much less cost sensitive to distance. Indeed, I expect the distance component over time to become redundant in pricing of interLATA calls.

19. The NPRM's proposed approach of separate evaluation of separate point-to-point markets for in-region originating calls would not serve any analytical purpose, but it would complicate matters significantly. The determination of market shares for, say, Boston to St. Louis, Boston to San Francisco, Boston to Washington, and Boston to San Antonio would be complicated and it would be difficult to gather the required information. Nor

would it aid an inquiry into the possible exercise of market power. Since the BOCs are extremely likely to sell their services to customers, not on a point-to-point basis, but on a nationwide terminating basis just as their IXC competitors do, any market definition that attempts to limit the terminating end to a single city or region is not consistent with the Commission's definition of the interexchange product market.

20. The point to point framework also makes the implicit assumption, which seems extremely unlikely to occur, that a BOC could obtain and exercise market power on calls from say Boston to St. Louis only. Given modern telecommunications networks, all locations can be served by all competitors either through their own networks or through resale of other firms' capacity. I would not find it remotely possible that capacity would become sufficiently limited among city pairs that separate competitive conditions could become important in terms of overall competition. Other factors also make this outcome extremely likely: (1) BOCs will begin with zero market share and will compete with entrenched firms such as AT&T, which has well over 50% of the market, (2) the 1996 Telecommunications Act requires structural separation and other regulatory safeguards, and (3) the possibly "bottleneck" facilities are comprehensively regulated. All of these factors tend to create a relatively uniform competitive framework without differentiating economic factors important in separate point to point markets.

III. Dominance Determination

21. Determination of dominance has two aspects: (1) does a BOC have significant market power given the regulation already in place on its bottleneck facilities and (2) will a finding of dominance increase or decrease competition? The NPRM takes the correct approach (¶ 132) by taking into account current regulation of access and asking whether a BOC could raise interstate service prices by restricting output of those services. Both price

cap regulation and regulation against discrimination are designed to stop other anti-competitive actions that a BOC might theoretically attempt. Dominance would provide another redundant layer of regulation beyond these well-established current regulations.

22. For instance, all the BOCs (except US West) have chosen price caps without sharing for FCC price cap regulation. Thus, price caps as well as the Commission's well-established cost accounting rules minimize the possibility of cross subsidy. Furthermore, the 1996 Telecommunications Act establishes structural safeguards and nondiscrimination provisions. The most important consideration is to remember why regulation is used--the purpose of regulation is to stop the exercise of market power by a dominant carrier. A determination of dominance would add little or nothing to current regulation in terms of the exercise of market power, and it could likely hinder competition as I discuss subsequently.

A. Demand Conditions, Supply Conditions, and Competitive Conditions

23. BOCs would be extremely unlikely to be able to restrict long distance to raise prices. As the NPRM notes (¶ 133) the BOCs' affiliates will begin with zero market share, and the presence of AT&T, along with the other IXCs, makes it unlikely that the BOCs could gain market share quickly enough to allow them to exercise market power by restriction of output. Furthermore, the existence of competitors' networks provides a significant amount of supply capability to stop price increases.

24. Moreover, the BOCs will have an economic incentive to lower long distance prices from their current levels.[2] Since prices for both access and long distance are well above incremental (marginal) cost (including access), a BOC has an incentive to lower prices both to gain share from rival IXCs and

[2] This basic point calls into question the discussion in fn. 241, p. 63 of the NPRM. Lowering prices is the opposite of the use of monopoly power in one market to leverage it into another market.

also to expand the use of long distance so that access minutes increase. IXCs do not have this same incentive because they do not provide access. Thus, lower prices of long distance through an expansion of output, not a restriction of output, will be in the BOCs' best interests. This outcome of lower prices helps consumers and is pro-competitive, as common sense and economic theory demonstrate.

25. An empirical example can be useful here. Assume that the interstate long distance price elasticity is about -0.7 which is near both the Gatto (AT&T) study from 1988 and the more recent Taylor and Taylor study from 1993.[3] This approximate price elasticity has been found in numerous studies over the past 20 years. Next take the average price of interstate access at $.057 per minute and, to be conservative, I will assume that the incremental cost of this access is $0.02 per minute. Again to be conservative, I will assume that average price minus incremental cost of loss distance (net of access) is about $0.04 per minute.[4] Solving for the best price for the BOC leads to an estimated decrease in long distance prices of about 23.3% (compared to AT&T prices). Note that this estimate is not much different from the discounts that I estimated for Southern New England Telephone Company (SNET) which I presented at the FCC Forum on July 23. I estimated that SNET's discount relative to AT&T is about 22.1% over all residential customers. Thus, both a calculation based on elasticities and prices and costs, as well as actual experience from SNET, indicate that residential long distance prices could decrease in the range of 20-25%.

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[3] See J.P. Gatto, J. Langin-Hooper, P. Robinson, and H. Tyan, "Interstate Switched Access Demand Analysis," Information Economics and Policy, 1988, 3, 283-309 and W. Taylor and L. Taylor, "Postdivestiture Long-Distance Competition in the United States," American Economic Review, 1993, 185-190.

[4] Lower cost of access increases the incentive of the BOC to raise prices as does a larger price cost margin for long distance service.

B. FCC Regulation and Basic Economics Demonstrate that BOC Market Power Will Not Arise in Long Distance Markets

26. As the NPRM notes correctly, cross subsidy or improper cost allocation creates a problem in the current context only if the BOC affiliate sets retail interLATA prices at predatory levels, drives out its rivals, and sets prices at above competitive levels. (¶ 135) These events could not occur. First, for BOC cross subsidy to have an adverse competitive effect, the BOCs would need to succeed in forcing AT&T and other IXCs to exit interLATA markets. The BOCs could not hope to succeed because the marginal cost of interLATA traffic is around 1-2 cents per minute (excluding access). Given the very low marginal costs compared to fixed costs, the BOCs would have to keep the price extremely low and suffer huge financial losses while engaged in a predatory strategy. Alternatively, the BOCs would need to misallocate huge amounts of costs which also could not escape detection by regulators.

27. Furthermore, such a predatory strategy could not succeed. The fiber optic networks would remain in place since they are the essence of sunk costs.[5] Thus, if the BOCs attempted to raise their interLATA prices to supra-competitive levels, there would be no barrier to re-entry. In these economic circumstances, predation cannot hope to succeed. Predation is an extremely unlikely strategy which has little prospect of success given the substantial sunk costs in telecommunications.[6]

28. Next, most regulation of interLATA traffic will be done by the FCC, which regulates interstate traffic. The FCC has adopted price cap regulation

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[5] Sunk costs are costs which are not recovered if a firm subsequently decides to exit the industry. For their potential importance in entry and exit decisions see, e.g., the 1992 Merger Guidelines, para. 3.0.

[6] In a recent case in which I was involved, the District Court found that "the Government could not cite one modern example of successful predatory pricing...". U.S. v. Eastman Kodak: 853 F. Supp. 1454, 1478 (W.D.N.Y 1994), aff'd ___, F.3d (2d Cir. Aug. 4, 1995). Also, in spite of numerous private lawsuits, pre-divestiture AT&T was never found to have engaged in predatory pricing.

for the BOCs so that cross subsidy can no longer occur since price (cap) regulation, rather than cost of service regulation, is being used. In the absence of cost-of-service regulation, no misallocation of costs can occur because there is no cost basis to misallocate. Thus, cross subsidy largely disappears as a problem under the correct form of FCC regulation. Given the absence of sharing in price caps, the cross subsidy problem is even less than previous under price caps. At the state level, about 36 states use or have initiated proceedings to establish price caps. These regulators would not permit cost misallocation and could change to price caps regulation modeled after the FCC, if they believe that cross subsidy posed a serious problem. Thus, cross subsidy leading to predation is not a realistic possibility since it would be an economically irrational strategy by a BOC.

29. Discrimination remains a theoretical possibility, but the Commission has long and successful experience in implementing rules to stop discrimination. Furthermore, the Telecommunications Act of 1996 has specific nondiscrimination safeguards. Most importantly, the experience in cellular telephone has demonstrated conclusively that the BOCs do not have the ability to distort competition through discrimination.[7] The B block (wireline) cellular carrier in most MSAs is a BOC, and the A block (non wireline) carrier depends on the BOC for local exchange access and often for long distance access. However, A block carriers have not been disadvantaged by their dependence on the local BOC as the success of McCaw/AT&T cellular has demonstrated. My research has demonstrated that cellular prices are <u>lower</u> where an in-region BOC provides the B block cellular service, holding other economic factors equal, than when a non-BOC (e.g. GTE) is the B block carrier. Thus, prices are not higher, as the anti-competitive exercise of market power would cause. If anything, prices are lower. Thus, the Commission should rely on its successful experience in cellular and CPE to conclude that anti-competitive effects which lead to the exercise of market power are extremely

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[7] Experience in CPE and Centrex also demonstrate the same point.

unlikely to occur.

C. Imputation Rules Provide Proper Safeguards Against Price Squeezes

30. The NPRM raises the possibility of an increase in access rates which could lead to an increase in long distance prices. (¶ 141) This possibility of a price squeeze has long been recognized by regulators and appropriate regulation has been designed to stop it from occurring. Of course, even without providing long distance service BOCs have an incentive to increase their access rates but Commission regulation stops them from doing so. Furthermore, Section 272 (e)(3) of the 1996 Act has an imputation requirement that a BOC must charge its affiliate an amount no lower than what it charges competitors. In this situation a price squeeze cannot occur.

31. A price squeeze occurs when the BOCs' price is below its marginal cost of access plus long distance service plus the contribution from the bottleneck service, here long distance access.[8] It is somewhat analogous to predation, and it will not occur for similar reasons. The BOC would have to lose money on its provision of long distance service since it receives the access amount whether it or its competitor provides retail long distance service. If it engages in a price squeeze, the BOC will be selling the long distance component below cost and thus losing money on the provision of this service. This strategy is economically irrational unless the BOC believes it can drives its competition from the long distance market and charge supra-competitive prices. However, for the same reasons that I discussed above, this outcome could not occur given the continued existence of the IXC networks, and the inability of the BOC to charge above competitive prices.

32. Furthermore, imputation has worked well in intraLATA market

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[8] See J. Hausman and T. Tardiff, "Efficient Local Exchange Competition", Antitrust Bulletin, 1995 for a further discussion of regulation designed to prevent price squeezes and proper imputation regulation.

situations. For instance, California adopted an imputation standard in CPUC decision 94-09-065. IntraLATA long distance competition has been especially fierce in California with PacBell now holding only about 50-60% of all business customers' intraLATA long distance traffic. Thus, no price squeeze problems have occurred at the state level, and the BOCs begin in a much weaker position in interLATA long distance traffic because they begin with a zero percent share.

33. Requiring access to be priced at incremental cost would be an incorrect action to take because of possible price squeeze problems. The shared and common costs of the network must be recovered by contribution of prices above incremental cost or the BOCs will go out of business. Similarly, long distance service price is expected to be priced in excess of marginal cost because IXCs must cover their shared and common costs.[9] As I have pointed out in previous affidavits, price above marginal cost is the expected outcome in situation of imperfect competition where fixed costs are high relative to total costs, e.g. DRAMs or microprocessors. Imperfect competition is the usual situation in modern U.S. industries.

IV. Dominant Regulation Would Decrease InterLATA Competition

34. The use of dominant firm regulation by the Commission would not add significant safeguards to the regulation against cross subsidy and discrimination already in place. However, dominant firm regulation would likely decrease interLATA competition in two respects: (1) price competition and (2) new service competition. Price competition would be reduced because

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[9] Recent BOC purchases of bulk long distance service are at prices in the range of about 1.5 cents per minute. MCI in a recent submission to the Commission acknowledged that the average retail price of long distance (excluding access) exceeds ten cents per minute. (MCI, "Survey of Wholesale-Retail Differentials for Services Provided by Incumbent Local Exchange Carriers", p. 8) However, I expect long distance prices to decrease to residential consumers with BOC entry because of the increased facilities based competition that BOCs would create in the long distance market.

the BOCs would have to give advance notice to their competitors of their future price strategies. Since the competitors could react to the advance notice with similar plans of their own, the economic incentive to decrease prices or offer innovative rate plans will decrease. Indeed, the Commission has repeatedly recognized that tariff requirements may lead to decreased competition among both cellular providers and long distance providers. Economists have analyzed the effects on competition of price announcements in concentrated industries, and often found them to facilitate oligopolistic price setting. I believe it would be extremely bad economic policy to impose advance notice and tariff requirements on the BOCs since lower prices help consumers and the BOCs will not be able to charge higher prices than their well known competitors such as AT&T.

35. New service competition is an important form of competition which is likely to be extremely important in a technologically dynamic industry such as telecommunications. I would not be surprised to see innovative service packages which remove distance sensitive long distance pricing and perhaps offer extended calling scope for flat rate calls. Some cellular carriers have adopted these strategies successfully. I would also expect to see combinations of service offerings of, for instance, voice, cellular, and Internet long distance. If BOCs must provide cost support data to offer new services and if the BOCs' competitors can delay the introduction of these new services by regulatory protest, competition will decrease. Consumers will be injured and only competitors will benefit.

36. Thus, I strongly recommend to the Commission that it consider the effect on price competition and new service innovation when considering whether to apply dominant regulation to BOC long distance. The additional benefits from such regulation seem very small or zero, while the potential costs in lower long distance competition or delayed new services will cost