BOCs must disclose individual response times for each service request, categorized by "type of service requested, including separate categories for new service upgrades, maintenance, and so on." AT&T at 37. But AT&T provides no reasoning to support its demand, and *nowhere* explains how the detailed but less burdensome Computer III disclosures have proven inadequate. See MCI at 50 (urging use of Computer III type reporting requirements). Thus, to the extent the Commission does require disclosures not contemplated by Section 272 expressly, it should model them closely on Computer III, which the Commission itself has determined to be effective in precluding discrimination.[2] No one has offered any reason to believe otherwise.[3]

B. The Section 271(d)(6) Complaint Process [¶¶ 97-107]

Various commenters also seek to turn 271(d)(6) complaint procedures from their legitimate function -- determining whether a BOC has ceased to meet the conditions for entry into in-region, interLATA service -- into a field for regulatory guerilla warfare. First, some commenters try to expand Section 271(d)(6)'s scope to encompass any violation, no matter how isolated, of any

[2]Notice of Proposed Rulemaking, Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services, 10 FCC Rcd 8360, 8379 (1995) ("The nondiscrimination safeguards described in the BOC Safeguards Order provide the Commission and competing ESPs with data to monitor whether BOCs have engaged in access discrimination."); Report and Order, Computer III Remand Proceedings, 6 FCC Rcd 7571, 7602 (1991) ("We conclude that our nondiscrimination reporting requirements adequately protect ESP competitors from discrimination in the installation, maintenance, and quality of basic services."); Id. ("Based on our experience, we find that, within the ONA framework that the Commission has developed, [reporting requirements] adequately protect against discrimination in the installation, maintenance, repair, and quality of basic services.").

[3]AT&T's suggestion that BOCs must meet every demand of unaffiliated carriers in the same or less time than its shortest response time for an affiliated enterprise is absurd. AT&T at 37. Under such a rule, BOCs would have to discriminate against their affiliates -- undermining their competitiveness by offering them the worst service possible. Nothing in the statute or common sense counsels such a result. BOCs should be required to meet the demands of unaffiliated carriers in the same amount of time, on average, that they meet the demands of affiliated enterprises. After all, the statute prohibits discrimination against unaffiliated carriers. It does not mandate discrimination against affiliated ones.

Commission rule. But the plain language of the statute refutes those arguments. Section 271(d)(6) can only be invoked if the allegations and supporting evidence indicate conduct of such a nature as suggests that the BOC no longer meets the conditions for entry -- not that the BOC inadvertently violated an unrelated Commission rule. Even MCI agrees with this. See MCI at 53 (complainant must identify specific condition for approval that is no longer met).[4]

Second, other commenters try to exacerbate the procedural disadvantage suffered by BOCs because of the 90-day deadline on adjudications. (It is no secret that abbreviated schedules favor plaintiffs, who can delay filing a complaint until they are ready, over defendants, who are often caught by surprise). AT&T, for example, proposes the BOC be allowed only two weeks to offer a defense and produce the documents the complainant demands. AT&T at 52. This is not only grossly unfair -- the complainant gets as long as it wishes to prepare its case, while the defendant gets two weeks to put up a defense and produce documents -- but irrational. There is no reason to engage in costly and time-consuming discovery before issues are joined, as the BOC's answer may eliminate the need for discovery entirely.

Moreover, allowing for automatic, unsupervised, expedited discovery virtually invites competitors to use the complaint process as a vehicle for fishing expeditions -- or for discovering their competitors' confidential data. Consequently, the BOC should be allowed at least 21 days to respond. If the response and the initial submissions by the complainant indicate that discovery

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[4]MCI mistakenly asserts that a prima facie case is made out by alleging that service quality has declined, see MCI at 54, or that there is favoritism among unaffiliated entities, ibid. Although service declines are regrettable and discrimination between two unaffiliated carriers is inconsistent with common carrier principles, Section 271(d)(6) only precludes discrimination in favor of BOC affiliates. Presumably, Congress believed that the Commission's rules, which long have barred unreasonable discrimination among unaffiliated entities, and state rules concerning service quality, adequately address those issues and therefore need not be considered under Section 271.

is appropriate, the Commission should order simultaneous discovery to proceed over the following 21 days.

The various proposals for shifting the burden of proof to the BOC likewise are unnecessary, unwise, illogical, and unlawful. They are not necessary to get the BOC to come forward with information because no sensible BOC would, when confronted with a prima facie case, refuse to offer a thorough defense. They are unwise because they invite abusive litigation. Even the most half-hearted complaint would force the BOC to bear the burden of mounting a full-scale defense -- and it would have to do so on an expedited basis (in a matter of days under AT&T's proposal). See Bell Atlantic at 10; Pacific Telesis at 42.[5] They are illogical because, once a BOC has shown that it meets the conditions for entry and the Commission so determines, the most rational presumption is that the BOC continues to meet those conditions, unless the contrary is shown. Ameritech at 76-77.[6] Finally, such burden shifting is inconsistent with the APA. BellSouth at 37 & n.88.[7]

[5]Those that rely on the short time frame as grounds for shifting the burden of proof to the BOCs, see MCI at 56, have it precisely backwards. The burden should lie with the party that has more time to prepare -- the complainant. See Ameritech at 76.

[6]Proposals that BOCs be held strictly liable, see Time Warner at 37, are similarly inappropriate. As an economic matter, strict liability does not increase deterrence beyond a negligence standard. Moreover, strict liability for isolated instances of differential service is inconsistent with the statutory language. The violation must be very serious -- intentional or willful -- before Section 271(d)(6) can even be invoked. Only if the Commission would not have approved entry in light of the misconduct can it be said that the BOC has "ceased to meet . . . the conditions required for . . . approval."

[7]AT&T's further suggestion (at 52) that the Commission itself -- and not the staff acting under delegated authority -- must act on the complaint within 90 days is simply wrong. While the statute states that "the Commission shall act on such complaint," it is settled law that the actions of Commission staff, Bureaus and panels under delegated authority constitute "action" by the Commission. See 47 C.F.R. § 0.203(b) ("any action taken pursuant to delegated authority shall have the same force and effect . . . as actions of the Commission"). Tellingly, AT&T cites no authority for the proposition that a statutory reference to the Commission precludes the Commission from delegating the obligation and authority to its staff.

VIII. BOC In-Region InterLATA Offerings Should be Classified as Non-Dominant [¶¶ 108-162].

Some commenters (mainly interexchange carriers) urge the Commission to impose dominant classification until "robust competition" develops in local exchange service. But they have failed to articulate how consumers or competition would be helped by such an approach. There is a reason for this -- the only beneficiaries would be incumbent interexchange carriers themselves. Dominant treatment would do nothing more than preserve the existing interexchange oligopoly by saddling the fledgling BOC interLATA affiliates -- who enter this market with no market share at all -- with competitively crippling red tape.

While the commenters concede that BOCs have no market share in the interLATA market and thus no direct market power, they argue that the BOCs would leverage their alleged "bottleneck control" over access facilities by misallocating costs, raising access charges or selectively degrading access. But the Commission has developed a wealth of safeguards to prevent such conduct, and price caps -- in place at the federal level as well as in many states -- also eliminate any BOC incentive to misallocate costs or engage in "price squeezes." No commenter seriously disputes this fact: None has proffered a convincing explanation of why or how a BOC could misallocate costs or engage in a price squeeze. Nor has any commenter explained how access could be selectively degraded in a modern network.

Moreover, imposing dominant classification upon the BOCs would serve no purpose. Even proponents of BOC dominant classification recognize as much. AT&T, for instance, concedes that most aspects of dominant carrier regulation "are not designed to address the leveraging problems" allegedly "presented by BOC entry into competitive markets," and further concedes that "the different risks" dominant regulation was "meant to address appear to have little application here." AT&T at 65-66. Given that dominant classification would not address the problems the commenters purport to identify -- and the severe anticompetitive consequences it would have -- non-dominant classification for BOC interLATA affiliates is not only appropriate but mandatory.

A. Market Definition

1. Product Market. Almost every competitor agrees that the proper market, for present purposes, is the national market for interexchange services. AT&T, for instance, explains that "the Commission's existing 'single national market' definition is the only approach that is consistent with settled legal and economic principles, including the Justice Department's Merger Guidelines." AT&T at 62 n.54. MCI and Sprint agree. MCI at 59; Sprint at 60. CompTel -- the lone proponent of a different market (at 33) -- defines the product market as solely "those services relying on or utilizing the BOCs' local network." But this makes no sense: Product markets in this context are defined by substitutability of supply and demand, not by the ingredients used to make them. The Commission's tentative conclusion that the relevant market for present purposes is "all interstate, domestic, interLATA telecommunications services," NPRM ¶ 119, thus is not open to serious challenge.

2. Geographic Market. While no commenter suggests that the Commission analyze interexchange markets on a city-pair basis -- an approach the Commission itself suggested was impracticable, NPRM ¶ 124 -- several commenters argue for a region-wide analysis. CompTel at 34; Sprint at 62. But as USTA explained in its opening comments (at 39-44), for purposes of dominant/non-dominant classification, the Commission has consistently treated the relevant market as national. As the Common Carrier Bureau has explained, "it would be inaccurate to segment the market into distinct city pairs or even domestic regions" for purposes of dominant/non-dominant determinations "because many networks have alternative routing capabilities with nationwide or near nationwide service areas." Memorandum Opinion and Order, Application of MCI Communications Corp., 10 FCC Rcd 1072, 1075 (1994) (emphasis added).

Telecommunications networks have redundant and multiple routing schemes, and there is rarely a single route between two cities.[8] For that reason, for purposes of determining dominance and non-dominance, the Commission should follow the approach it adopted in the Competitive Carrier proceeding and "treat interstate, interexchange services as a single national market when examining whether [a BOC] has market power." NPRM ¶ 124.

B. Pseudo-Economic Arguments About Leveraging Are Unpersuasive and Irrelevant.

Although some commenters propose that the BOCs be regulated as dominant carriers, they do not so much as pause to address the extreme costs -- not just to the BOCs but to consumers and society -- that this would impose. The Commission itself, by contrast, has consistently recognized that these regulatory protections do 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). And all of this red tape "imposes compliance costs on [the dominant carrier] and administrative costs on the Commission." Order, Motion of AT&T to be Reclassified as a Non-Dominance Carrier, 11 FCC Rcd 3271, 3288 (1995).

Moreover, the rationales in favor of dominant regulation are utterly unconvincing. AT&T and other proponents of dominant classification argue that the BOCs can leverage their alleged control over the local exchange "through acts of discrimination, cost misallocation, the charging

[8] NYDPS suggests (at 7) that "in the case of merger, the relevant 'in-region' market area of a BOC that is being evaluated would have to be expanded to incorporate all states of the merged entity." Sprint argues (at 63) that mergers and other combinations "may require consideration of geographic markets more extensive than a particular BOC's region." But these suggestions are misguided, for the Bureau's conclusion that the relevant market should be treated as national for dominant/non-dominant classification is not affected by the geographic scope of the exchange carrier.

of excessive prices for access, and similar abuses." AT&T at 63; see Time Warner at 39; Excel at 9.[9] But none of these arguments have merit, whether judged by legal or economic standards.

1. Raising Rivals' Costs. Proponents of dominant classification argue that an across the board hike in access charges would allow the RBOC affiliate to undercut other interexchange carriers. LDDS at 23; Excel at 10. But Professor Hausman already has explained that BOCs have precisely the same theoretical incentive to raise access charges even if they do not enter the interexchange market -- and that any such incentive has been kept in check by effective regulatory oversight and an increasingly competitive market. Hausman Aff. ¶¶ 26-28. Nowhere do the proponents of dominant classification explain how BOC entry into interLATA market would cause them to have a greater incentive to raise access prices or a greater ability to evade the regulations that have thus far prevented them from doing so. MCI for instance, blithely suggests that by "raising their own interLATA and rivals' access costs equally," the increased access charges would make up for the BOC's interLATA losses. MCI at 60-61. But MCI's argument assumes economic irrationality. If MCI is right that BOCs could raise prices across the board, they would be better off raising prices and not taking any interLATA losses. Moreover, MCI utterly fails to explain how these across the board price hikes would escape regulatory notice.

Similarly meritless are the various arguments about price squeezes. When costs are imputed to the BOC IX affiliate at the same rate they are charged to competing interexchange carrier, the BOC interexchange affiliate has no advantage vis-a-vis the competing carriers. MFS attempts

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[9]Frontier argues that "[t]he scope and size of the Bell companies' exchange operations provide them with the necessary leverage to disadvantage their rivals substantially throughout large swaths of the country." Frontier at 8. Yet if control over the in-region bottleneck is the source of power, then the argument should apply to each and every LEC, not just those with "geographically concentrated networks." Frontier is being disingenuous.

to prove to the contrary by demonstrating that the BOC affiliate has a price advantage even when competing IXCs have lower cost structures. MFS at 4 & Appendix A. But MFS has failed to impute access at tariffed rates in its cost model.[10] When the MFS model is modified to include such an imputation requirement, it indicates that the IXC with the lowest cost structure will have the lowest price structure, regardless of any affiliation with the BOC.

Moreover, to the extent opposing commenters purport to fear predation, they never have explained how a BOC affiliate could run at a loss indefinitely. Again, MCI states that the BOC "can absorb the paper losses on their own interLATA services." MCI at 63. Yet this would be economic suicide. As the Commission has recognized, such a "loss-taking" strategy would be rational only to the extent that the BOC interexchange affiliate sought to drive out its competitors and raise its prices to supracompetitive levels. But, as USTA explained in its opening comments, a predatory policy is outright impossible in the interexchange marketplace. Accounting safeguards, price caps, regulatory and competitive oversight, and the technical characteristics of the industry -- already existing network and plant -- all augur against predatory strategies.[11]

LDDS also suggests that a BOC might seek to raise its rivals' costs by selectively degrading the quality of access it provides to unaffiliated IXCs. LDDS at 23. But LDDS never explains how this discrimination is technically possible, let alone how it would go undetected by regulators or the IXCs themselves. In fact, the increasing automation of local exchange networks

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[10]The MFS model presumes that the BOC affiliate will pay 3 cents per minute for access, while competing IXCs will pay 7 cents per minute. But a proper imputation requirement would place a cost of 7 cents per minute on both the BOC and the IXC.

[11]MCI suggests that dominant classification will allow the Commission and other parties to verify that the BOC interexchange affiliates are complying with the imputation requirement. MCI at 65. See also Time Warner at 39. But this same function is performed by the Commission's existing accounting regulations, affiliate disclosure requirements, and biennial audits -- which do not have the same anticompetitive consequences as dominant classification.

and the increasingly sophisticated monitoring capabilities of the IXCs make undetected selective degradation a virtual impossibility. TRA concedes that the large interexchange carriers would be able to detect any BOC attempts at selectively degrading access, but "submits that . . . the hundreds of smaller carriers which currently populate the interexchange industry are far more vulnerable." TRA at 26. But TRA never offers any explanation of how its members' ability to detect degraded access differs from that of the IXCs. More fundamentally, TRA never explains "what advantage a BOC could draw from beating down small rivals whose customers could readily shift to the BOC's larger competitors." United States v. Western Elec. Co., 993 F.2d 1572, 1579 (D.C. Cir. 1993).

Indeed, if such "selective degradation" were possible, one would expect to see it in the cellular market, where the BOCs have precisely the same incentives they have in the interexchange market. But as Professor Hausman explained, no such "degradation" exists in the cellular market. Hausman Aff. ¶ 29.[12] No commenter has disputed this empirical evidence; none has provided examples or even anecdotal evidence that selective degradation is possible.[13]

Finally, even if the BOCs were able to discriminate in the provision of access services, dominant classification would not address such problems. Even AT&T concedes this, acknowledging that dominant regulation was "meant to address" risks that "have little application here." AT&T at 65-66. Thus, imposing dominant classification would do no more than impose anticompetitive red tape without any countervailing benefits.

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[12]The same holds true in the enhanced services context, where the Commission recently noted that "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.

[13]Some commenters suggest that the BOCs would price access services so as to favor those offerings purchased by the BOC IX affiliate. LDDS at 23; Frontier at 9. But regulators and competitors are well-equipped to determine whether cost differentials are justified.

2. Cost Misallocation. For the most part, opposing commenters do not argue that the BOCs would be able to engage in wholesale cost misallocation. But see AT&T at 64 (stating that "misallocations that shift competitive costs to BOC monopoly services mean that the BOC affiliate's interLATA competitors will necessarily be paying excessive rates for access".) This makes good sense, as USTA explained in their opening comments, since price caps remove any incentive to misallocate costs, while the Commission's accounting regulations make detection virtually inevitable. By contrast, attacking cost misallocations by classifying dominant carriers is like attacking flies with an elephant gun -- unlikely to be productive for anyone but certain to be costly for society as a whole. The Commission's existing rules, by contrast, attack the issue directly, without any detrimental consequences for society.

Respectfully submitted,

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August 30, 1996

CERTIFICATE OF SERVICE

I, DonnaMarie Young, do certify that on August 30, 1996, comments of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.

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Reply Statement of Professor Jerry A. Hausman

1. My qualifications have been given in my previous submission. In this reply statement I first respond to claims of AT&T and LDDS who want to impose dominant carrier regulation on BOC provision of interexchange long distance services. I also explain the fundamental economic error in the submission by MFS, who claims that a BOC could gain an "unfair advantage" in long distance markets through the provision of long distance access.

2. I also respond to arguments of AT&T and MCI who recommend excessively stringent structural separation and nondiscrimination safeguards. These proposed restrictions are in no way "costless" since they reduce or eliminate economies of scope leading to higher BOC costs and higher consumer service prices. I consider the tradeoff between economies of scope and the efficient provision of long distance and other services by the BOCs versus possible competitive distortions which could arise because of regulation. The Commission, if it adopts excessively stringent regulatory restrictions on the BOCs, is likely to (1) decrease innovation in long distance service, (2) create economic inefficiency, and (3) create higher prices for consumers. The Commission recognized these problems many years ago in the Computer II and Computer III proceedings, and nothing has changed in economics or telecommunications technology which makes the potential problems any less important today.

I. Potential Competitors of the BOCs Long Distance Services Do Not Raise Realistic Problems which Would Allow the BOCs to Exercise Market Power in the Market for Long Distance Telecommunication Services

A. AT&T

3. AT&T confuses market definition and makes a claim of market power because of BOC control of the local network. (p. 61) But, AT&T's statement that, "The proper markets to analyze here, therefore, are the markets for local and access services--the market where those bottlenecks exist--rather than the interexchange market." (pp. 61-62) is incorrect as a matter of economics and is also incorrect as a matter of law. The correct market to consider is the market for long distance services, and whether the BOCs will have market power there. Opponents to BOC provision of information services made similar claims to AT&T's claim here during the MFJ proceedings, but the DC Circuit correctly posed the question as whether the BOCs could exercise

market power in the market provision of information services if they entered. (U.S. v. Western Electric, 900 F.2d 283, DC Dir. 1990). Similarly, claims about potential leverage of the local network are treated in the same manner.[1] Thus, as I explained in my first Statement in this proceeding, the correct question for the Commission to consider here is whether the BOCs could raise the price of long distance service by restricting output. The BOCs cannot exercise market power in this market because of their competitors' existing long distance networks. AT&T's focus on the local exchange market is incorrect.

4. AT&T's claims that the BOCs could exercise market power in the interexchange market (pp. 62-63) do not consider the effect of Commission regulation of the BOCs. For instance, AT&T claims that the BOCs could exercise market power by "the charging of excessive prices for access". Of course, BOCs are not unconstrained in their access prices (as the Commission recognized in the NPRM). Nowhere does AT&T recognize the effects of FCC price cap regulation on BOCs' access prices. The correct question to answer is whether given current regulation the BOCs could use their control of the local network to exercise market power in the market for long distance services. AT&T does not attempt to answer this straightforward question.

5. AT&T takes issue with the NPRM's analysis of the effect of possible cost misallocation on long distance competition (pp. 63-64).[2] First, AT&T misunderstands how competition works. AT&T states, "An affiliate that receives favored treatment should be paying the BOC more than it is in fact paying for the services it receives..." (p. 63) AT&T never explains where the word "should" comes from. So long as the price of long distance service offered by a BOC exceeds its incremental cost, no damage to competition will occur. AT&T seems to be assuming implicitly that Rate of Return regulation still is used by the Commission. However, under price caps the price that an

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[1] AT&T, in an earlier submission, has attempted to use the outdated definition of leveraging and claimed that "any advantage in the local market can be leveraged into the interexchange market." (AT&T Comments on Market Definition Separations, Rate Averaging and Rate Integration, CC Docket No. 96-61, April 19, 1996, p. 11-12). Note that leveraging is not gaining an advantage in a separate market as AT&T claims, leveraging is exercising market power in the related market. Indeed, competitive advantages in other markets typically lead to consumer benefits as firms can offer lower prices (from economies of scope) or more innovative services in the associated markets.

[2] LDDS advances the same arguments (p. 23).

affiliate "should pay" for the services it receives from a BOC is a figment of a regulatory accountant's imagination since it has no effect on the regulatory outcomes. AT&T again attempts to return to the world of Rate of Return regulation by claiming that sharing is in force (p. 64, fn. 56), but the Commission well knows that no BOC, except US West, any longer has a sharing provision in its price cap formula. Especially with no sharing present, claims of cost misallocation have no economic effect since a regulated cost basis does not affect competitors prices charged by the BOCs.

6. AT&T's claims here have once again been recognized as incorrect by economists. First, AT&T never explains why the BOCs would be able to misallocate costs or raise access prices any more if they provide long distance service than they could now. Nor does AT&T explain why the BOCs would want to waste these misallocations in a doomed effort to attempt predation. As I explained in my original statement, since barriers to exit are high and the IXCs' networks would remain to eliminate the possibility of BOC recoupment, a predation attempt would be economically irrational.

7. AT&T calls for dominant carrier regulation of the BOCs long distance services (p. 65). However, AT&T gives no explanation of how dominant carrier regulation would affect the BOCs control over the local network. BOC control over the local network is currently addressed by Commission price cap and other regulations. Dominant carrier regulation for long distance services addresses a different economic market and a different locus of competition. The Commission correctly did not declare the BOCs dominant in the provision of information services, CPE, or cellular, although AT&T's argument would have led to such an illogical regulatory outcome. Nor have the BOCs gained monopoly power in the provision of information services, CPE, or cellular, despite similar claims by BOC opponents over the past 15 years. If the Commission adopts AT&T's proposal for dominant carrier regulation for BOC provision of long distance, the Commission will create an outcome of <u>decreased</u> competition in long distance markets and less innovation in long distance services. While such an outcome would favor AT&T, consumers would be injured by this regulatory outcome.[3]

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[3] LDDS states, (p.24) that the BOCs might have an advantage in the "provision of packages of local exchange and interLATA services." So might AT&T given its name recognition among consumers. So might LDDS with its purchase of MFS. But LDDS never even attempts to answer the question of

8. Lastly, AT&T's continued claims of possible predation (p. 66) cannot be taken seriously by the Commission as a matter of economics. The BOCs begin with a 0% long distance share and face the largest telecommunications company in the world, AT&T. No rational individual would believe that the BOCs could successfully predate against AT&T and the other facilities-based IXCs. AT&T remains the largest telecommunications company with unconstrained access to capital markets. Thus, even the "deep pockets" approach to predation doesn't work here. AT&T has put forward no credible economic support for how predation would be possible.

B. MFS

9. MFS in its Attachment 1 attempts to give a numerical illustration of how a "BOC can leverage its control over essential facilities to obtain a competitive advantage in vertical markets." The Attachment commits a fundamental economic mistake. LDDS makes a similar mistake (pp. 22-23).

The claim, to begin with is not credible. MFS claims that "so long as essential services contain any economic margin, a BOC can leverage that margin to gain an unfair competitive advantage over rivals..." (p. 1) Note that if this claim were true then antitrust law would allow no vertical integration where a firm provides an (essential) input to a competitor. Thus, Intel would not be allowed to manufacture computers since it provides microprocessors to Compaq. Microsoft would not be allowed to produce word processing programs or spreadsheet programs. Indeed, no vertical integration would be allowed by any company which earned a margin on their upstream product. Thus, no company that manufactured a product which had intellectual property or significant amounts of R&D involved would be permitted to integrate vertically.[4] A

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whether these "advantages" could allow a BOC to exercise market power in long distance services. It will only be successful in offering a packaged local and long distance service if it can offer consumers a better deal than purchase of the services separately. If consumers are made better off, the outcome is pro-competitive, even if LDDS does not have the "advantages" to compete.

[4] Indeed, an upstream margin of the type that MFS examines exists upstream in all markets which are imperfectly competitive. Since almost all markets in the U.S. economy are imperfectly competitive, MFS' example would demonstrate that vertical integration would reduce competition downstream. Actually, the reverse outcome of increased competition typically occurs as economists and the Courts have recognized for decades.

strange outcome indeed.

10. MFS' example assumes that the competitor is more efficient than the BOC at provision of long distance service. However, MFS' economic example posits non-profit maximizing behavior on the part of the BOC. If the competitor is actually more efficient than the BOC in terms of incremental costs, the BOC should buy the long distance component from its competitor and its profits will be higher. Indeed, the BOC can have higher profits of $100 million in the MFS example if it buys its long distance service from the competitor. The BOCS could still stimulate demand as in the MFS example (p. 4), but the BOC would still earn an extra $100 million.[5]

11. However, what MFS has discovered is the well known result in economics that a BOC would have an economic incentive to lower long distance prices if allowed to provide them. While MFS claims a price decrease of this type would be an "anticompetitive result" (p. 6), economists consider lower prices to be a pro-competitive result. Thus, MFS misuses the term "leverage", which leads to a higher price, not a lower prices as MFS' example creates. An anti-competitive result only occurs if prices in long distance market would increase, but MFS' own example causes them to decrease. Furthermore, if the example were done correctly, more efficient long distance competitors would continue to thrive because a BOC wants to maximize its value to shareholders which it does by only producing services where it is economically efficient to do so.

II. Economies of Scope and Structural Separation

12. Economists have long recognized that economies of scope are important in telecommunications. BOCs provide numerous services to consumers, and they can do so at lower cost and lower prices because of economies of scope. However, a small probability will always remain that some type of anti-competitive outcome can occur because regulation is never perfect. The Telecommunications Act of 1996 includes modified structural separation and nondiscrimination requirement to be in place for a transition period for

[5] MFS seems to have made another mistake because it defines "common fixed costs" in Tables 1 and 2 to be a proportion of total costs, which includes the incremental cost of services. Costs cannot be common or fixed if they depend on total costs wince as incremental costs increase, common or fixed costs would increase which means they are not common or fixed.

specified BOC activities to minimize the chance of an anti-competitive outcome. The purpose of the statutory requirements is to prevent cross-subsidy and misuse of BOC control of the local network. However, as I discussed in my original statement, an analysis of proposals must take into account current regulation. For instance, price caps used by the FCC greatly attenuate or even eliminate the problem of cross subsidy, especially since none of the BOCs (except US West) are subject to sharing. (¶ 7 of NPRM) Other safeguards such as imputation also exist to prevent price squeezes as I discussed in my original statement. Lastly, market experience has demonstrated that the BOCs have not used either cross subsidy or discrimination to distort competition in markets they have been allow to enter such as CPE, cellular, and information services. Indeed, the BOCs' market shares in all of these businesses have remained quite modest, despite opponents previous claims that BOCs would come to dominate these markets.[6]

13. Thus, a benefit-cost tradeoff will exist. Too strict regulation will lead to fewer innovative services, decreased economic efficiency, decreased competition, and decreased consumer welfare. However, too loose regulation could lead to regulatory distortions. A balance between the costs of structural separation and the benefits of regulation exists. The Commission recognized the costs of structural separation moving from Computer II to Computer III. The benefit-cost tradeoff continues to exist, just as it did 10 years ago.

14. The Commission in the NPRM considers returning to the "maximum separation" requirement of Computer II for the provision of information services, long distance and manufacturing. But economic evidence has already demonstrated that Computer II requirements led to consumer welfare losses in the billion of dollars. For example, consider the particular example of voice messaging services offered by the BOCs. AT&T first proposed to offer these services in the late 1970's. However, the FCC delayed its decision and then refused to allow the BOCs to offer these voice messaging services on an integrated basis with the rest of their telecommunications services under Computer II. In 1986 the FCC reversed its decision with Computer III.

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[6] In cellular with only two market participants in each MSA, BOCs market shares have been in the range of 45-60%. However, the Block A (non-wireline) competitors have done very well in cellular as McCaw's experience demonstrates.

However, by 1986 the AT&T divestiture decree, the Modification of Final Judgment (MFJ), forbade the BOCs from offering voice messaging services. In 1988 the MFJ Court vacated the restriction on information services, and the next year the BOCs began to offer the services, over ten years after they were first proposed to be offered. The services have been available for the past 6 years, and about 9 million consumers currently buy the service. For 1994 I estimate the consumer value from these services to be about $1.27 billion.[7] Thus, the "maximum separation" of Computer II cost consumers lost welfare of over $1 billion per year from this one service alone.

15. By proposing structural separation requirements well beyond what Congress proposed in the 1996 Act, the NPRM's proposals will likely lead to <u>decreased innovation and fewer new services</u>. The NPRM's total neglect of the importance of dynamic economic efficiency of new services which economies of scope and integration of services allows, is directly contradictory to the 1996 Telecommunications Act's purpose "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans..." Less advanced telecommunications and information technologies and services will be the result of overly restrictive regulation as the experience with Computer II demonstrates. Economic efficiency will also decrease.

16. The proposed restrictions will also lead to higher costs for the provision of services by the BOCs. In a previous submission to the Commission last year, I estimated that costs would be approximately 30% higher in the provision of voice messaging services using data from Bell Atlantic and US West, if Computer II-like restrictions were reimposed.[8] For voice messaging services alone these additional costs would exceed $100 million year. For other enhanced services and long distance, the total costs of the restrictions would be in the hundreds of millions or billions of dollars per year. This extra cost reduces economic efficiency and creates waste in the US economy as I explain below. The restrictions also decrease competition, and the

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[7] This calculation is explained in J. Hausman and T. Tardiff, "Valuation and Regulation of New Services in Telecommunications."

[8] J. Hausman and T. Tardiff, "Benefits and Costs of Vertical Integration of basic and Enhanced Telecommunications Services", report to the FCC, April 7, 1995, pp. 19-25.

resulting higher prices decrease consumer welfare.

A. Ownership of Facilities

17. MCI (p. 23) and AT&T (pp. 20-23) recommend that the BOC interLATA affiliate not use any transmission or switching facilities used by the BOC. (p. 23) This requirement would eliminate economies of scope, raise the BOCs' costs, and decrease competition. Currently, the BOCs use their transmission facilities and switching facilities to provide intraLATA long distance. Thus, market experience demonstrates that economies of scope lead to lower costs, or the BOCs would not use these facilities jointly.[9] If MCI's and AT&T's recommendation were adopted, the Commission would force the BOCs to operate in an economically inefficient manner.

18. Productive inefficiency of this type is well known to create the largest type of (first order) economic inefficiency in the economy. As the Nobel laureate Paul Samuelson explains in his introductory textbook:

> "Efficiency is a central (perhaps the central) concern in economics. Efficiency means there is no waste." (P.A. Samuelson and W.D. Nordhaus, Economics, (McGraw Hill, 12th ed., 1985, p. 28, emphasis in the original)

MCI and AT&T ask the Commission to impose a penalty on the BOCs which will lead to higher costs. This penalty leads to waste in the economy as Prof. Samuelson explains. Higher costs also leads to higher prices for consumers. Thus, MCI's and AT&T's recommendation is anti-competitive, leads to inefficient production, and harms consumers. The recommendation has little to recommend itself for adoption from an economic standpoint.

B. Cost Misallocation

19. Sprint discusses the problem of "misallocation of costs' between the BOC interLATA affiliate and the BOC.(pp. 22 ff.) However, Sprint never explains how a problem can arise here in the absence of Rate of Return regulation. When Computer II was adopted, Rate of Return regulation was

[9] Not only the BOCs, but every telecommunications company in the world that I am familiar with jointly uses facilities to provide both local and long distance service. Thus, market evidence demonstrates that important economies of scope are present in the provision of local and long distance services.

universally used.[10] Now the Commission regulates the BOCs with price caps, and no BOC has sharing except for US West. Thus, the effect of "cost misallocation" either does not exist or would have at most, a minor effect. Sprint's recommendation uses the chimera of cost misallocation, where costs do not affect price cap regulation of the BOCs, to attempt to eliminate economies of scope. Thus, Sprint's recommendation of no common use of switches and other facilities again would raise the BOCs cost, create economic inefficiency, and decrease competition.

C. Sharing of Administrative Services

20. MCI (pp. 27-28) and AT&T (pp. 24-26) propose that the BOC and its affiliate not be allowed to share administrative services. Administrative services are a classic example of a situation where common costs are an important component of overall costs. Thus, economies of scope are likely to be important. Indeed, almost every major US corporation that I have observed provides many administrative services in a centralized manner and purchases outside services as a company to achieve lower overall prices. A prohibition on these normal business activities would increase the BOC affiliate costs leading to less competition and higher prices to consumers.

21. The prohibition on sharing of administrative services seems especially puzzling since at most a problem of cross subsidy could arise (since no potential discrimination problem exists here). The use of price caps by the Commission, with no sharing by the BOCs (except US West) greatly attenuates, or even eliminates, potential problems raised by cross subsidy or cost misallocation, as I have explained in my original statement and again in the preceding paragraphs. Again, neither MCI nor AT&T do any economic analysis which considers the tradeoffs of the economies of scope versus possible regulatory distortions. The Commission should consider these tradeoffs because the future of innovative services, competition, and consumer welfare will be affected by the outcome.

D. Limitations on Joint Marketing

22. MCI (pp. 44-49) and AT&T (pp. 54-58) also propose strict

[10] The GTE Consent Decree, to which Sprint's comments quote extensively, also took place during a period of Rate of Return Regulation. Thus, the regulation conditions have changed markedly since the entry of the decree.

limitations on joint marketing between the BOC and its affiliate. Joint marketing will be an important feature of competition between the BOCs and IXCs. MCI's proposed restrictions do not accord with the use of price caps since the BOCs prices for its regulated services will not be affected by how joint marketing is done. MCI also attempts to limit the size of discounts offered by BOCs (p. 49), but the economic test is well known here that the price of the bundled package must exceed the BOC's incremental costs of the package. This rule is used by antitrust authorities, and no reason for a different rule exists here. Also, MCI states that the BOC cannot make both type of service available from a single source (p. 49), but this restriction undermines the notion of joint marketing. So long as prices are set according to regulation, a single point of contact for "one stop" shopping will increase competition. Thus, MCI's proposals are anti-competitive.

23. AT&T also makes anti-competitive recommendations. It recommends (p. 55) that a BOC be forced to give 3 months notice of any joint marketing package. As the Commission has recognized numerous times and in the current NPRM, such advance notice requirement decreases competition, because it gives competitors time to respond. It would be equivalent to the Commission allowing AT&T to have a "company spy" at each BOC which would provide 3 months notice of future competitive activity. "First mover" advantages are the essence of competition; so not surprisingly, AT&T attempts to make the BOCs less competitive by having the Commission impose this requirement which would eliminate a potential first mover strategy of competition.

E. Conclusion

24. Economists stress the importance of economic efficiency. Production of goods and services in the economy in the lowest cost manner is the single most important aspect of a well-functioning economy. Sprint recognizes, as do most economists, that economies of scope are very important in modern telecommunications networks. Thus, if the Commission accedes to the IXCs' recommendation to ban joint use of switches, transmission facilities, and other joint facilities of BOC networks, the Commission rules will cost the US economy billions of dollars per year in economic waste. Other proposed restriction which I discussed above will have a similar effect. Reduced innovation will additionally cost further billion of dollars as the voice mail example demonstrates. Yet the Commission would levy this cost on the economy

because of remote possibilities, which have not occurred in information services and other services where the BOCs provide used shared facilities, that some regulatory distortions may occur. However, no one has demonstrated that the cost of these distortions, if they did occur, would be anywhere near the known additional cost due to the economic inefficiencies created by the elimination of economies of scope. Thus, the Commission's decision appears relatively straightforward. Should it increase regulation, increase BOC costs, reduce innovative services, and increase regulation, or should it attempt to meet the goals of the 1996 Telecommunications Act? The NPRM is silent on the costs to the U.S. economy of increased regulation and elimination of economies of scope. The Commission should be more attentive to these important economic matters.

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